REPORT OF

THE

STATE AUDITOR

Divisions of Banking and Financial Services
Department of Regulatory Agencies

Performance Audit
October 2003

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October 9, 2003

Members of the Legislative Audit Committee:

This report contains the results of a performance audit of the Divisions of Banking and Financial Services within the Department of Regulatory Agencies. The audit was conducted pursuant to Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct audits of all departments, institutions, and agencies of state government. The report presents our findings, conclusions, and recommendations, and responses from the Divisions of Banking and Financial Services, the Department of Regulatory Agencies, and the Department of Revenue.

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STATE OF COLORADO
OFFICE OF THE STATE AUDITOR

REPORT SUMMARY

JOANNE HILL, CPA
State Auditor

Divisions of Banking and Financial Services
Performance Audit, October 2003

Authority, Purpose, and Scope

This performance audit was conducted pursuant to Section 2-3-103, C.R.S., which authorizes the Office of the State Auditor to conduct performance audits of all departments, institutions, and agencies of the state government. The audit work, performed from April through September 2003, was conducted in accordance with generally accepted governmental auditing standards.

Our audit focused on the regulatory activities of the Divisions of Banking and Financial Services, primarily related to commercial banks, credit unions, money order/transmitter companies, and foreign capital depositories. During the audit, we reviewed the quality of examinations performed on commercial banks, credit unions, and money order/transmitter companies, assessed the Divisions' monitoring efforts, evaluated their chartering and licensing processes, analyzed both Divisions' workloads and use of resources, and reviewed their methods for setting fees. In addition, the audit evaluated the implementation status of recommendations made in the March 2000 performance audit of the Public Deposit Protection Act.

We gratefully acknowledge the assistance and cooperation extended by management and staff at the Divisions of Banking and Financial Services.

Overview

Both the Divisions of Banking and Financial Services within the Department of Regulatory Agencies are responsible for ensuring that financial institutions serving Colorado citizens operate in a safe and sound manner. The Division of Banking regulates commercial banks, industrial banks, trust companies, electronic data servicers, money order and transmitter companies, and foreign capital depositories, and enforces the Public Deposit Protection Act for funds deposited by state and local governments in state and national banks. The Division of Financial Services regulates credit unions, savings and loan associations, and life care institutions (facilities that provide care for the duration of an elderly person's life conditioned upon fees paid to the providers for the care and services involved) and administers the Savings and Loan Association Public Deposit Protection Act.

For more information on this report, contact the Office of the State Auditor at 303.869.2800.

Key Findings

Money Order/Transmitter Companies

Under the authority of the Money Order Act (Section 12-52-101, C.R.S., et seq.), the Division of Banking regulates the activities of money order/transmitter companies in Colorado. Money order/transmitter companies sell or issue exchange (e.g., check, draft, money order) and transmit money through means such as wire, facsimile, or electronic transfer. We identified the following concerns related to the licensing and examination of money order/transmitter companies:

- **A significant proportion of the money order/transmitter companies that have operated in Colorado since 2000 have been unlicensed.** The Money Order Act requires all money order/transmitter companies, with the exception of governmental organizations and insured financial institutions, to be licensed by the Banking Board. We estimate that anywhere from 31 to 50 percent of the companies in operation in the State between 2000 and 2003 were not licensed by the Banking Board, as required by statute. Banking has made efforts to identify unlicensed money order/transmitter companies in recent years but has not established a process to follow up on all companies that do not readily comply with licensing requirements. Additionally, Banking currently does not seek assistance from other agencies in the State, such as the Attorney General's Office, district attorneys' offices, and the Office of Preparedness and Security within the Department of Public Safety, in investigating companies that may be operating without licenses. Further, although federal law makes it a crime for a money order/transmitter company to operate without a license, Banking has not established a process to refer cases of unlicensed companies to the federal government.

- **Banking has not imposed any penalties or enforcement actions against unlicensed money order/transmitter companies.** Two enforcement tools are available to Banking to use in dealing with unlicensed companies. First, under Section 12-52-115, C.R.S., a money order/transmitter company that operates in Colorado without a license may be guilty of a misdemeanor and subject to a fine up to $10,000 upon conviction. Second, penalty provisions under the Colorado Consumer Protection Act may be available to Banking in cases where companies are operating in the State without a required license. In such cases, the Attorney General or a district attorney may apply for a temporary restraining order and/or an injunction prohibiting the person from continuing such practices. Banking has not referred any cases of unlicensed companies to the Attorney General's Office or district attorneys for legal action under this Act. We also found that the penalty provisions in the Money Order Act related to unlicensed companies are not as strong as provisions in other state and federal laws.

- **Criminal history checks for money order/transmitter applicants do not include fingerprint-based checks through the Federal Bureau of Investigation (FBI).** Currently criminal history checks of money order/transmitter applicants are conducted through the

Colorado Bureau of Investigation (CBI) using the applicant's name and birth date. We noted two concerns with this process. First, CBI only has information on arrests in Colorado, so the results of the check do not reflect criminal activities in other states. Second, checks based primarily on name are less reliable than those based on fingerprints, in part because they can provide results on multiple individuals with the same name as the applicant and may not fully identify criminal histories of individuals using aliases. Conducting fingerprint-based criminal history checks through the FBI would address both of these issues, but would require specific authority in state statutes. Colorado statutes currently do not include any provisions related to criminal history checks for money order/transmitter companies.

- **Minimal criteria exist in state statutes and regulations to guide money order/transmitter examinations.** In recent years Banking's money order/transmitter examinations have increasingly concentrated on companies' compliance with anti-money laundering provisions in federal laws, such as the Bank Secrecy Act and the USA PATRIOT Act. However, Colorado's Money Order Act focuses on protecting consumer funds and is silent on compliance with federal law. We believe changes to the Money Order Act would provide a stronger mechanism for Banking to enforce compliance with federal laws. Another concern with Banking's money order/transmitter examination process is that it is unclear how the Division makes determinations about the financial health of licensed companies. No written criteria exist for assessing the financial well-being of a money order/transmitter licensee, either in state statutes or rules, federal guidelines, or Division policy.

Foreign Capital Depositories

Under the authority of the Colorado Foreign Capital Depository Act (Section 11-37.5-101, C.R.S, et seq.), Banking is responsible for regulating foreign capital depositories. Created by the Colorado Legislature in 1999, foreign capital depositories resemble other "offshore" financial institutions (e.g., Swiss banks) by giving nonresident aliens of the United States a secure, private place to hold their money. In September 2003, the Banking Board approved an application for a foreign capital depository and the Division expects to issue a charter to the institution by the end of October 2003, making it the first to be issued in Colorado. We identified a number of concerns and risks related to foreign capital depositories, as follows:

- **Concerns related to the creation of foreign capital depositories need to be addressed.** The U.S. Department of Treasury's Financial Enforcement Crimes Network (FinCEN) submitted written comments that were presented during legislative deliberations for Senate Bill 99-083 (the bill that created the Colorado Foreign Capital Depository Act). FinCEN made four overall recommendations with respect to authorizing the establishment of foreign capital depositories: 1) foreign capital depositories should be required to implement anti-money laundering programs and undergo testing by independent parties other than banking regulators for compliance with federal anti-money laundering laws; 2) applicants for foreign capital depository charters should undergo federal background checks; 3) banking regulators should ensure they have sufficient resources and training on anti-money laundering safeguards and the symptoms of money laundering; and 4) legislation authorizing depositories should provide for coordination among banking regulators, law enforcement, and prosecutors, and the state's existing money-laundering statutes should be examined. The first of these issues was addressed in the Senate Bill 99-083, but the other issues have not been fully resolved. In addition, current statutes may not provide adequate authority to effectively regulate the depositories in two areas. First, the privacy provisions with the Act may inhibit the Division's ability to access records necessary for regulating depositories. Second, state statutes provide limited guidance on the valuation of tangible assets and ensuring that depositories maintain adequate control over them.

- **As with money order/transmitter license applicants, criminal history checks for foreign capital depository applicants do not include fingerprint-based checks through the Federal Bureau of Investigation (FBI).** For the foreign capital depository application approved by the Banking Board in September 2003, no FBI fingerprint criminal history checks were performed on the organizers or directors.

- **Fees that foreign capital depositories are required to pay to the Department of Revenue could be manipulated, significantly reducing the amount collected.** The Colorado Foreign Capital Depository Act requires depositories to pay a fee each June 15th and December 15th to the Department of Revenue equal to one-quarter of one-percent of all assets on deposit or in a safe deposit box. The fee assessments are based on account balances as they exist on a particular day, which could allow manipulation of account balances to avoid or reduce the fees. One solution to this problem is to modify the statutes so that fee assessments are based on the average balance over the six-month period prior to the assessment rather than the balance at a specific point-in-time.

Traditional Financial Institutions

Traditional financial institutions regulated by the Divisions include commercial banks, industrial banks, trust companies, credit unions, and savings and loan associations. We evaluated the processes used by each Division to conduct safety and soundness examinations and periodic monitoring of commercial banks and credit unions, and we identified several issues, as follows:

- **The processes used by the Divisions to ensure the quality of examinations of commercial banks and credit unions could be improved.** First, we found that both Divisions could strengthen their processes for identifying and addressing the fraud risks facing commercial banks and credit unions. In particular, we found that Financial Services has not developed systematic methods to document its fraud detection efforts. For Banking, examiners are, in most cases, not providing overall conclusions on a bank's fraud risk on the standardized fraud evaluation form. Second, we identified a number of unresolved issues and inconsistencies in work papers prepared by Banking staff for commercial bank examinations. Banking could improve its examination process by better ensuring that all potential concerns found during an examination are properly researched, reported, and corrected. Finally, we found managers at Financial Services do not regularly review examination work papers to ensure their completeness and accuracy.

- **Financial Services' examiners do not always analyze and conclude on data received as part of the Division's monitoring efforts.** Financial Services receives quarterly reports from the National Credit Union Administration (NCUA) that indicate potential operating concerns related to credit unions regulated by the Division. We found that 36 percent of the concerns identified in the December 2002 report were not adequately concluded on by examiners. We also reviewed Financial Services examination-based monitoring efforts. As part of this process, examiners may require a credit union to provide information, such as financial statements, policies, or status reports on corrective actions, on a quarterly or monthly basis. The examiner reviews the data to assess the institution's progress in correcting deficiencies noted in previous examinations. We found that for five of the seven credit union monitoring files we reviewed the examiners did not appear to be analyzing the data reported by the credit unions to assess progress in correcting deficiencies identified in the prior examination. We believe the monitoring process could be more clearly defined and streamlined.

Administration of the Divisions

Both Banking and Financial Services employ examiner and other regulatory staff that have expertise related to the institutions they oversee. In total, the FTE appropriations for Banking and Financial Services in Fiscal Year 2003 were 38.5 and 11, respectively. Both Divisions are exclusively cash funded, primarily from various fees charged to regulated institutions. As part of the audit, we evaluated both Divisions' use of resources and fee-setting practices, and we identified the following issues:

- **The Division of Banking could improve the use of its resources in several areas.** For instance, regulated institutions, in general, have an examination interval of 12 to 18 months, depending on their condition and size. This has resulted in a heavier workload for Banking in some years, and a lighter load in others. Currently, Banking hires and trains most of its examiners to conduct specific types of examinations. By expanding its efforts to cross-train examiners so they can conduct multiple types of examinations, Banking may be able to better handle workload fluctuations. Another area in which Banking can improve its workload is to ensure that no examinations are conducted on money order/transmitter companies that are not operating in the State. We identified one instance where Banking performed an examination on a company that received a license from the Banking Board, but did not begin operating in the State until nine months after the examination.

- **The similarities in regulatory activities between Banking and Financial Services could provide an opportunity for a certain level of consolidation and coordination.** Combining the resources of the two Divisions could provide a broader range of expertise that could enhance regulation of Colorado's financial institutions. In addition, a consolidation of some of Banking and Financial Services' staff resources would result in some personal services cost savings by potentially eliminating the need for two full-time commissioner positions and reducing the total number of administrative staff positions. The primary drawback of combining the resources of the Divisions is opposition from the bank and credit union industries. Banks and credit unions are competitors and each strongly opposes being regulated by the same division and board. In particular, each does not want to be under the regulatory authority of a board composed of members who represent their competitors.

- **The fee structures used by Banking and Financial Services are cumbersome and complex.** Both Divisions charge institutions numerous fees and assessments at various times, depending on the regulatory activity involved. Since the Divisions are cash-funded, they must establish fees to generate sufficient revenue to fund operations. However, the need for layers of fees for virtually every institution type is unclear. The Divisions could reduce their own efforts and those of the institutions by establishing two types of fees covering all appropriate costs - a license or charter application fee and a routine (annual or semi-annual) fee.

Our recommendations and the Divisions' responses can be found in the Recommendation Locator on pages 7 through 9 of this report.

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
1	26	Improve the processes for investigating suspected cases of unlicensed money order/transmitter companies.	Division of Banking	Agree	December 2003
2	29	Improve the effectiveness of penalty provisions against unlicensed money order/transmitter companies operating in Colorado.	Division of Banking	Agree	June 2004
3	31	Work with the Legislature to propose statutory changes to require money order/transmitter license applicants to undergo CBI and FBI fingerprint-based criminal history checks and to define criminal histories that would lead to denial of an application.	Division of Banking	Agree	June 2004
4	35	Strengthen examinations of money order/transmitter companies.	Division of Banking	Agree	June 2004
5	37	Strengthen enforcement of the deadline for submission of annual audited financial statements from money order/transmitter companies.	Division of Banking	Agree	June 2004
6	44	Work with the Legislature to consider changes to the Colorado Foreign Capital Depository Act.	Division of Banking	Agree	November 2004
7	47	Work with the Legislature to propose changes to state statutes to require foreign capital depository charter applicants to undergo CBI and FBI fingerprint-based criminal history checks.	Division of Banking	Agree	June 2004

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
8	48	Work together to propose changes to state statutes to require that the semiannual fee assessed on foreign capital depository deposits be calculated based on average asset balances over the six-month period of the assessment.	Division of Banking Department of Revenue	Agree Agree	June 2004 June 2004
9	55	Improve the processes for evaluating fraud risks at regulated institutions by ensuring that fraud risks are identified, evaluated, and addressed throughout the examination process, and are properly documented.	Division of Banking Division of Financial Services	Agree Agree	August 2003 December 2003
10	59	Ensure that all material issues identified during commercial bank examinations are fully documented and resolved and that inconsistencies in examination data are minimized.	Division of Banking	Agree	February 2004
11	62	Enhance the quality assurance processes for credit union examinations.	Division of Financial Services	Agree	February 2004
12	65	Improve the monitoring program for credit unions.	Division of Financial Services	Agree	January 2004
13	68	Improve oversight of the Public Deposit Protection Act for banks.	Division of Banking	Agree	November 2004
14	77	Improve use of resources by expediting the training of new examiners, expanding efforts to cross-train examiners, and conducting a comprehensive evaluation of the use of administrative staff resources on an annual basis.	Division of Banking	Agree	April 2004

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
15	79	Improve the use of resources related to regulatory oversight of money order/transmitter companies.	Division of Banking	Agree	November 2003
16	82	Continue to evaluate methods to cross-utilize resources between the Divisions of Banking and Financial Services, and recommend statutory changes as necessary.	Department of Regulatory Agencies	Agree	April 2004
17	85	Modify fee structures by reducing the number and types of fees assessed and work with the Legislature to make statutory changes as necessary.	Division of Banking Division of Financial Services	Partially Agree Agree	July 2004 July 2004

Overview of the Divisions of Banking and Financial Services

Both the Division of Banking and the Division of Financial Services within the Department of Regulatory Agencies are responsible for regulating financial institutions. In particular, the Divisions are charged with ensuring that financial institutions serving Colorado citizens operate in a safe and sound manner. The regulation of financial institutions is important for several reasons, including:

- **Consumer protection.** The most basic reason for the regulation of financial institutions is depositor protection. Such regulation has become increasingly important as businesses and individuals have begun holding a significant portion of their funds in banks. In addition to protection of depositors' funds, regulation protects consumers by requiring financial institutions to provide their customers with a meaningful disclosure of deposit and credit terms, which gives them a basis for comparing and making informed choices among different institutions and financial instruments. The growing complexity of financial instruments and the uniqueness of individual customers have made consumer protection a very complicated and detailed regulatory process.

- **Monetary and financial stability.** Regulation is essential in providing a stable framework for making payments. With the vast volume of transactions conducted each day by individuals and businesses, a safe and acceptable means of payment is critical to the health of the U.S. economy. Regulation of financial institutions fosters the development of strong institutions with adequate liquidity and discourages practices that might harm depositors and disrupt the payment system. The objective of monetary stability has been closely linked with the goal of depositor protection.

- **Efficient and competitive financial system.** The regulatory framework encourages efficiency and competition within the financial system, and ensures an adequate level of services throughout the economy.

- **Prevention of money laundering and other financial crimes.** Regulation provides a means for determining whether institutions are complying with laws designed to deter and detect individuals or groups from using financial institutions as a mechanism for money laundering or other financial crimes.

The following table shows the types of institutions regulated by each of the Divisions. Their regulatory functions are described in more detail later in the Overview.

Financial Institutions Regulated by the Divisions of Banking and Financial Services

Type of Institution	Regulated By: Banking	Regulated By: Financial Services
Commercial Banks, which are owned by stockholders and accept demand deposits, make commercial and industrial loans, and perform other banking services for the public. [1]	T	
Industrial Banks, which are finance companies that are differentiated from commercial banks by the types of checking products offered and exemption from certain ownership restrictions applicable to commercial banks.[1]	T	
Trust companies, which are corporations that provide a variety of fiduciary services, including traditional managed trust business, self-directed IRA or pension funds, and administration of collective investment funds.	T	
Money Order and Transmitter Companies, which sell or issue exchange (e.g., money orders) and/or transmit money.	T	
Electronic Data Processing Servicers, which provide data processing services to regulated entities.	T	
Foreign Capital Depositories, which are a new class of financial institution that provides asset preservation and management services exclusively to nonresident aliens.	T	
Credit Unions, which are not-for-profit financial cooperatives that make personal loans and offer other consumer banking services to persons sharing a common bond, typically employment at the same firm.		T
Savings and Loan Associations, which are depository financial institutions that hold their assets mostly in residential mortgages and collect their deposits from consumers.[2]		T
Life Care Institutions, which are facilities that provide care for the duration of an elderly person's life conditioned upon fees paid to the providers for the care and services involved.[3]		T

Source: Colorado Revised Statutes, Division of Banking and Financial Services budget documents, and *Barron's Dictionary of Banking Terms*.

[1] Banking is responsible for regulating all state-chartered banks as well as all public funds held in nationally chartered banks (i.e., funds deposited by a state or local government entity).

[2] Financial Services is responsible for regulating all state-chartered savings and loan associations as well as all public funds held in nationally chartered associations.

[3] Life care institutions are not required to be licensed by the state or federal government.

Division of Banking

According to Section 11-101-102, C.R.S., the primary purposes of the Division of Banking (Banking) are to preserve and promote:

- Sound and constructive competition among financial services institutions;
- A dual federal and state banking system;
- The security of deposits;
- The safe and sound conduct of the business of state banks; and
- A statewide safe and sound banking system.

Statutes also state that the purpose of the Division is to: (1) seek regulatory coordination and cooperation, (2) seek regulatory parity among financial institutions, and (3) encourage diversity in financial products and services.

Banking's primary regulatory activities include performing periodic monitoring reviews and examinations of state-chartered institutions and licensees to ensure the safety and soundness of the entities and the business they conduct. Additionally, Banking is responsible for processing, reviewing, and approving/denying charter applications, collecting fees from the regulated institutions, and initiating enforcement actions against institutions not complying with requirements. Banking also enforces the Public Deposit Protection Act (Section 11-10.5-101, C.R.S, et seq.), which is intended to protect public entity deposits (i.e., funds deposited by state and local governments) held by state and national banks. The Division has been accredited by the Conference of State Bank Supervisors (CSBS), a national organization for state banking regulators, since 1991.

In Fiscal Year 2003, Banking regulated 179 institutions and licensees in the State. As the table below shows, more than 60 percent of the institutions regulated by Banking are commercial banks. In addition, during this year the Banking Board approved five de novo (new) charters for banks and trust companies, five new licenses for money order/transmitter companies, five bank and trust company mergers, and one conversion (a national bank charter converted to a state bank charter).

Institutions Regulated by the Division of Banking in Fiscal Year 2003		
Type of Institution	**Number of Regulated Institutions**	**Percent of Total Regulated Institutions**
Commercial Banks[1]	113	63.1%
Industrial Banks	4	2.2%
Trust Companies	10	5.6%
Money Order/Transmitter Companies	29	16.2%
Electronic Data Processing Servicers	23	12.9%
Foreign Capital Depositories [2]	0	0.0%
TOTALS	**179**	**100.0%**

Source: Office of the State Auditor's analysis of data provided by the Division of Banking.
[1] Some commercial and industrial banks have internal trust departments. Banking was responsible for regulating 14 trust departments exercising trust powers located within state-chartered commercial and industrial banks in Fiscal Year 2003.
[2] In September 2003 the Banking Board approved its first charter application for a foreign capital depository.

Assets held by state-chartered commercial and industrial banks and trust companies totaled more than $22.5 billion as of June 30, 2003. The total amount of money transmitted and exchange (e.g., money orders, traveler's checks) sold by licensed money order/transmitter companies in Calendar Year 2002 (most recent data available) was more than $22.6 billion. Under the Public Deposit Protection Act (PDPA), Banking also regulated over $1 billion in public deposits maintained in 120 national- and state-chartered banks in Fiscal Year 2003.

As shown in the table below, the Division performs various types of examinations, with the most common being safety and soundness examinations. These examinations are typically conducted in 12- to 18-month intervals on commercial and industrial banks, trust companies, and money order and transmitter companies. In Fiscal Year 2003, Banking conducted more than 190 examinations of regulated institutions.

Examinations Conducted by Banking in Fiscal Year 2003		
Type of Examination	**Number of Examinations**	**Percent of Total**
Safety and Soundness *(for banks, trust companies, and money order/transmitter companies)*	89	46.3%
Trust Department *(for trust departments within banks and depository trust companies)*	4	2.1%
Information Technology *(for electronic data processing servicers)*	15	7.8%
Public Deposit Protection Act *(compliance reviews)*	84	43.8%
TOTALS	**192**	**100.0%**
Source: Office of the State Auditor's analysis of data provided by the Division of Banking.		

According to Section 11-102-104(1), C.R.S., the Banking Board of Colorado is the policy- and rule-making authority for the Division of Banking. The Banking Board is composed of eight members: four executive officers of state banks, one executive officer of an industrial bank, one executive officer of a trust company, and two members of the general public. Among its duties, the Board is responsible for:

- Promulgating, amending, and repealing rules for the proper enforcement and administration of the Banking Code, the Public Deposit Protection Act, the Money Order Act, and provisions of the Colorado Foreign Capital Depository Act related to the chartering of foreign capital depositories.

- Making all final decisions with respect to chartering and conversions, mergers and acquisitions, and change of control in institutions regulated by the Division of Banking.

- Annually establishing such fees and assessments as are necessary to generate the moneys appropriated by the Legislature.

- Initiating enforcement actions against institutions when examinations reveal violations or other problems at the institutions.

The Banking Board may delegate certain powers and duties to the State Bank Commissioner, who is the administrative head of the Division of Banking and is responsible for the Division's day-to-day operations.

Division of Financial Services

As part of its regulatory duties, the Division of Financial Services (Financial Services) conducts periodic monitoring reviews and examinations of credit unions, savings and loan associations, and life care institutions (i.e., facilities that provide care for the duration of an elderly person's life conditioned upon the prepayment of some fees for services provided). Additionally, Financial Services is responsible for processing, reviewing and approving/denying state charter applications, collecting various fees from regulated institutions, and initiating enforcement actions against institutions not complying with requirements. Financial Services also administers the Savings and Loan Association Public Deposit Protection Act (Section 11-47-101, C.R.S., et seq.) to safeguard uninsured deposits of public funds in state and federal savings and loan associations. Since 1996, Financial Services has been accredited by the National Association of State Credit Union Supervisors (NASCUS), which is a national organization for state credit union regulators.

In Fiscal Year 2003, Financial Services regulated 87 institutions in the State, as shown in the table below. In addition, Financial Services approved three credit union mergers and one conversion (a federal credit union charter converted to a state credit union charter) during this year. No applications for new credit unions or savings and loan associations were submitted during the year.

Institutions Regulated by the Division of Financial Services in Fiscal Year 2003

Type of Institution	Number of Regulated Institutions	Percent of Total Regulated Institutions
Credit Unions*	77	88.5%
Savings and Loan Associations	4	4.6%
Life Care Institutions	6	6.9%
TOTALS	**87**	**100.0%**

Source: Office of the State Auditor's analysis of data provided by the Division of Financial Services.

* The total number of credit unions includes 76 natural person credit unions and one corporate credit union. Natural person credit unions serve individuals, while corporate credit unions serve other credit unions.

Assets held by state-chartered credit unions and savings and loan associations totaled nearly $10 billion as of June 30, 2003. Life care institutions held more than $10 million in escrows and reserves as of this date. Section 12-13-104, C.R.S., requires life care providers to establish escrow accounts to hold entrance fees paid by individuals prior to their occupancy of a living unit in the facility. Additionally, Section 12-13-107, C.R.S., requires life care providers to maintain reserves covering the obligations under all life care agreements. Under the Savings and Loan Association Public Deposit Protection Act, Financial Services regulated nearly $70 million in public deposits maintained in 12 national- and state-chartered savings and loan associations in Fiscal Year 2003.

Financial Services performed 60 safety and soundness examinations, 36 supervisory contacts (i.e., limited scope reviews) of credit unions and savings and loan associations, 5 compliance examinations of life care institutions, and 10 public deposit protection examinations on savings and loan associations in Fiscal Year 2003.

According to Section 11-44-101.7(1), C.R.S., the Financial Services Board is the policy- and rule-making authority for the Division of Financial Services. The Financial Services Board is composed of five members: three executive officers of state credit unions; one executive officer of a state savings and loan association; and one member of the general public. Among its duties, the Board is responsible for:

- Promulgating rules for the proper enforcement and administration of state statutes related to credit unions, savings and loan associations, and life care institutions.

- Making all final decisions related to the organization, conversion, or merger of credit unions and savings and loan associations, and administration of life care institutions or providers.

- Making all final decisions on the suspension or liquidation of credit unions and savings and loan associations.

- Issuing cease and desist orders; suspending a director, officer, or employee of a credit union or savings and loan association; or assessing civil money penalties when examinations reveal violations or other problems at the institutions.

The Financial Services Board may delegate its powers and duties to the Financial Services Commissioner, with the exception of actions taken related to the organization of community charter credit unions. The Financial Services Commissioner is the administrative head of the Division of Financial Services and is responsible for the Division's day-to-day operations.

Federal Regulation of Financial Services Institutions

The supervision and regulation of Colorado state-chartered commercial and industrial banks, certain trust companies, credit unions, and savings and loan associations are conducted within the framework of a dual chartering system. The distinguishing feature of the system in the United States is the ability of these institutions to make a free choice between state and federal chartering and regulation. Under such a system, both Banking and Financial Services coordinate their regulation of institutions with other federal regulatory agencies. The primary federal agencies involved with the oversight of these institutions are described below.

The Federal Reserve System controls the flow of money in and out of banks, and lends money to banks to help them meet their short-term liquidity needs. Membership in the Federal Reserve System is required for national banks, but optional for state banks. While many large state banks are Federal Reserve members, most smaller state banks are not. Currently 29 of the 120 state-chartered commercial banks, industrial banks, and depository trust companies in Colorado belong to the Federal Reserve System. The Federal Reserve regulates state-chartered member banks, and cooperates with state bank regulators to supervise these institutions. The Federal Reserve is also responsible for federal oversight of state-chartered and -licensed offices of foreign banks in the United States. The Federal Reserve Bank (FRB) works with the Division of Banking to supervise and examine state-chartered banks and electronic data processors.

The Federal Deposit Insurance Corporation (FDIC) administers the Bank Insurance Fund, which insures the deposits of member banks up to $100,000 per account. The FDIC is the federal regulator of state-chartered banks that do not belong to the Federal Reserve System. The FDIC works with the Division of Banking to supervise and examine state-chartered banks, depository trust companies, and electronic data processors. The Banking Board requires that deposits in state-chartered commercial banks be insured by the FDIC.

Banking performs joint and alternating examinations with both the FRB and FDIC of state-chartered banks, depository trust companies, and electronic data processors.

The National Credit Union Administration (NCUA) is the independent federal agency that charters and supervises federal credit unions. The NCUA operates the National Credit Union Share Insurance Fund (NCUSIF), insuring up to $100,000 per depositor (as defined by federal law) in all federal credit unions and many state-chartered credit unions. The Division of Financial Services independently conducts examinations of most natural person credit unions every 12 to 18 months, and it performs a limited number of examinations jointly with the NCUA on the same interval. For the state-chartered corporate credit union, Financial Services always conducts joint examinations with NCUA.

The Office of Thrift Supervision (OTS) is the primary regulator of all national-chartered and many state-chartered thrift institutions, which include savings and loan associations. The Division of Financial Services conducts joint examinations with OTS on all state-chartered savings and loan associations.

Currently there is no overarching federal regulatory agency that oversees the operations of money order/transmitter companies. Some federal agencies, such as the FBI's Joint Terrorism Task Force, the Internal Revenue Service, and the Financial Crimes Enforcement Network (FinCEN), are interested in these companies' operations, particularly as they relate to potential money laundering activities. However, none of these entities, separately or in combination, regulate money order/transmitter companies, and no federal agencies regulate foreign capital depositories.

Funding and FTE

Funding for both the Division of Banking and the Division of Financial Services is provided entirely through cash funds from fees paid by regulated entities. The table below shows the Fiscal Year 2003 appropriations for both Divisions.

Fiscal Year 2003 Long Bill Appropriations
Divisions of Banking and Financial Services

Division	Dollars Appropriated	FTE Appropriated
Banking	$3,164,361	38.5
Financial Services	$964,927	11.0

Source: Long Bill Appropriation for Fiscal Year 2003.

Audit Scope

Our audit focused on the regulatory activities of the Divisions of Banking and Financial Services, primarily related to commercial banks, credit unions, money order/transmitter companies, and foreign capital depositories. During the audit we reviewed files related to examinations performed on commercial banks, credit unions, and money order/transmitter companies to evaluate the quality of examinations and monitoring efforts as well as the chartering and licensing of institutions. We also analyzed both Divisions' workloads and use of resources and reviewed their methods for setting fees. In addition, the audit evaluated the implementation status of audit recommendations made in the March 2000 performance audit of the Public Deposit Protection Act administered by the Division of Banking.

Money Order/Transmitter Companies

Chapter 1

Background

The majority of the Division of Banking's regulatory activities relate to commercial banks, industrial banks, and trust companies. However, in addition to regulating these traditional financial institutions, under the authority of the Money Order Act (Section 12-52-101, C.R.S., et seq.), Banking regulates the activities of money order/transmitter companies in Colorado. Money order/transmitter companies sell or issue exchange (e.g., checks, drafts, money orders) and transmit money through means such as wire, facsimile, or electronic transfer. Internet payment providers are also regulated under the Money Order Act. All money order/transmitter companies, with the exception of governmental organizations and insured financial institutions, are required to be licensed by the Banking Board. Banking staff perform periodic examinations of licensed money order/transmitter companies and require companies to report their financial activities on a regular basis.

Money order and transmission services are commonly used by individuals who do not maintain accounts with traditional banks and are widely used to transfer funds to other countries. In international transactions involving the exchange of one currency for another, it is common for money order/transmitter companies to provide currency exchange services. Historically, money order and transmission services were provided by a small number of large organizations with global networks. However, in recent years the use of money order and transmission services has dramatically increased as a result of demographic changes, increased immigration, and a higher percentage of lower-income wage earners. Growth in this market has resulted in a proliferation of smaller money order/transmitter companies that serve specific groups and regions. Between December 1998 and June 2003, the number of Colorado-licensed money order/transmitter companies increased from 23 to 29 (26 percent). Over approximately the same time period (Calendar Years 1998 to 2002), the amount of exchange (e.g., checks, drafts, money orders) sold by licensed companies grew from about $8.3 billion to more than $22.6 billion (172 percent).

The regulation of money order/transmitter companies has become a greater focus of the Division of Banking in recent years, primarily due to changes in federal laws. Following the September 11, 2001, terrorist attacks, money transmitters came into the spotlight due to implications that they could be used in money laundering, illegal transfers, and other financial crimes. In particular, evidence was found by federal agencies, such as the Department of Justice and the FBI, that informal money transmitters were used to finance the September 11 terrorist attacks. In October 2001, Congress passed the USA PATRIOT Act, which included several provisions affecting money order/transmitter companies. Among the provisions, the USA PATRIOT Act requires companies to maintain anti-money laundering programs that must include at least a compliance officer; an employee training program; the development of internal policies, procedures and controls; and an independent audit feature. Additionally, the Act makes it a federal crime to operate a money services business (e.g., money order/transmitter company) without a license and imposes penalties that can include imprisonment and fines on individuals who fail to comply with this law. Within the last year, Banking has modified its examination tools to include reviews of money order/transmitter companies' anti-money laundering programs and compliance with other requirements under the USA PATRIOT Act.

As part of the audit, we evaluated Banking's regulation of money order/transmitter companies. We identified problems related to the licensing and examinations of these companies that are, at least in part, a result of outdated state statutes. Colorado's Money Order Act has not undergone significant changes in recent years, despite changes in the money order/transmitter industry and the passage of new federal laws. We describe these issues in greater detail in this chapter.

Investigations of Unlicensed Money Order/Transmitter Companies

As discussed earlier, all money order/transmitter companies, with the exception of governmental organizations and insured financial institutions, are required to be licensed by the Banking Board. We found that a significant proportion of the money order/transmitter companies that have been operating in Colorado since 2000 have been unlicensed. The number of licensed companies operating between 2000 and 2003 ranged from a low of 25 to a high of 34 (with an average of 28). Over this period, Banking identified 11 companies that have operated illegally during at least a part of this time (5 subsequently obtained licenses from the Banking Board and 6 informed Banking that they would cease operations) and an additional 13 companies that may have operated without a license. For 9 of these 13 companies, Banking has been unable to verify that money order/transmitter services were being provided because the companies did not respond to Banking's inquiries. For four companies, Banking is still investigating whether the companies provided such services without a license. We estimate that anywhere from 31 to 50 percent of the companies in operation in the State since 2000 were not licensed by the Banking Board, as required by statutes. Many of these entities are small family businesses that have operated beneath the regulatory "radar screen", while others are larger companies providing Internet services to Colorado citizens. Although it is difficult to determine how long some unlicensed companies have been in operation, it is possible that some have been operating for years. One company, in particular, operated from 1995 to 2002 without a license.

The licensing of money order/transmitter companies is important for a number of reasons, including:

- **Protection of consumers' funds.** As part of the licensing requirements, companies must secure a surety bond to cover all outstanding money orders and transmissions (i.e., monies that, at the end of any given time, have not been paid by the company to beneficiaries). Bonds provide protection to consumers by paying any outstanding money orders and transmissions in the event a company terminates its business.

- **Systems for identifying and reporting money laundering and other financial crimes.** Licensed companies undergo examinations by state agencies, which help ensure that systems are in place to prevent money laundering and other financial crimes. Following the passage of the USA PATRIOT Act, Banking has placed a greater emphasis in its examination process on ensuring that companies are complying with the provisions of this federal legislation.

In addition, a company that is operating in the State without a license has an unfair advantage over its licensed competitors. For example, an unlicensed company avoids costs such as licensing and examination fees that its licensed competitors must pay. We estimate that the 11 companies that were operating without a license between 2000 and 2003 avoided about $78,000 in license and renewal fees. Additionally, unlicensed companies may not be incurring costs to obtain required surety bonds or to implement various compliance systems required by the USA PATRIOT Act.

Banking staff indicated that it is often difficult to identify unlicensed companies. For example, it is not always readily apparent that a particular business is offering money order or transmission services. Some companies do not advertise their businesses in phone books or publications but rather rely on word-of-mouth referrals to solicit business. Others operate as a part of another business (e.g., salon, grocery store, restaurant) and do not have a storefront that would indicate a money order/transmitter business is operating at the location. Additionally, some companies operate via the

Internet, making it difficult to determine whether they are providing services to Colorado citizens. Finally, language barriers can impede the Division's ability to determine whether a company in question is providing services that require it to be licensed. Currently Banking has one Spanish-speaking examiner but does not employ any other bilingual staff. As a result, Banking staff have difficulty communicating with the increasing number of business owners/operators who speak languages other than English and Spanish. Also, the language barrier prevents Division staff from easily identifying advertisements for possibly unlicensed money order/transmitter companies in foreign-language publications.

Despite these challenges, in recent years Banking has made efforts to identify unlicensed money order/transmitter companies, as follows:

- **Complaints from licensed companies.** According to Banking staff, one source of information is complaints from licensed money order/transmitter companies. Competitive advantages enjoyed by unlicensed companies are strong incentives for licensed companies to report them to Banking.

- **Suspicious activity reports from banks.** Banking sometimes receives suspicious activity reports from banks that have identified an unlicensed money order or transmitter company in the normal course of business.

- **Registrations with the Financial Crimes Enforcement Network (FinCEN).** FinCEN is a network of databases and financial records maintained by the U.S. Department of Treasury that includes thousands of reports on suspicious financial activities. All money order/transmitter companies are required by federal law to register their businesses with FinCEN. In 2002, Banking staff requested from FinCEN a listing of all money order/transmitter companies operating in Colorado that had registered with FinCEN and compared the listing against those companies licensed in the State.

- **Direct contacts.** Banking staff identify unlicensed companies by randomly visiting businesses advertising money order and/or transmission services and by searching the Internet.

Since 2000, Banking staff have identified 55 companies that were potentially operating in the State without a license. Of these 55 companies, 31 were not required to be licensed because they were agents of a licensed company or the services they provided did not meet the Money Order Act's definitions of money order or transmission services. For the remaining 24 cases, the results of Banking's investigations were as follows:

- Five companies applied for and were granted applications after being contacted by the Division.

- Nine companies did not respond to letters sent by Banking. In three of these cases, the letters were returned because the recipient's address was invalid. Banking staff visited one location and confirmed that the business was no longer operating. For the remaining six companies, the letters were not returned and staff did not conduct any follow-up.

- Six companies reported to Banking that they had ceased operations in Colorado. In most of these cases, Banking did not follow up to verify the reports, and Banking staff discovered a year later that one company was still providing services to Colorado citizens.

- Four companies are under investigation, three of which provide services over the Internet. One of the Internet companies informed Banking that it had blocked its Web site in Colorado, but follow-up efforts by the Division of Banking found that the Web site was still accessible to Colorado citizens.

Banking has implemented a variety of methods to detect unlicensed money order/transmitter companies in Colorado. However, as noted above, the Division's efforts rarely include any significant follow-up on companies that do not readily comply with licensing requirements. In fact, Banking does not have any formal policies or procedures in place for conducting complete investigations into unlicensed businesses. We believe the Division should expand its efforts by establishing formal procedures that would include a system for following up with unresponsive companies. These procedures should establish mechanisms for continuing contact efforts and verification that companies have ceased operations if they do not pursue licensing.

In addition, Banking should establish a process to seek investigative assistance from other agencies in the State, particularly the Attorney General's Office, district attorneys' offices, and the Office of Preparedness and Security within the Department of Public Safety. Such agencies could assist Banking in making the determination of whether a company is operating in the State without a license and provide guidance on what information would be needed if legal actions were to be taken against such companies. Further, because operating without a required license is a federal crime, Banking should develop a system for referring all cases of unlicensed companies to the U.S. Department of Treasury's FinCEN section and any other appropriate federal agencies. FinCEN has a process in place for states to refer such cases, but Banking currently does not participate in the process.

Recommendation No. 1:

The Division of Banking should improve its processes for investigating suspected cases of unlicensed money order/transmitter companies by:

a. Developing and implementing procedures for investigating suspected unlicensed companies, which should include a system for following up on cases where companies are unresponsive or when a company reports that it has ceased operations.

b. Seeking investigative assistance from agencies in the State (e.g., the Attorney General's Office, district attorneys' offices, and the Office of Preparedness and Security) in determining whether companies are operating without a license in the State and identifying the types of evidence needed if legal action is to be taken.

c. Establishing a process for referring all cases of unlicensed companies to the U.S. Department of Treasury's Financial Crime Enforcement Network (FinCEN) and any other appropriate federal agencies.

Division of Banking Response:

Agree. Implementation date: December 2003. The Division of Banking will:

a. Develop a policy to formalize the Division's investigative practices, and upon Banking Board approval, implement procedures to provide staff with clear guidance and expectations. Such policy and procedures will include the Division's existing practices of soliciting referrals from licensed entities, following up on suspicious activity reports, conducting reviews of media advertising, periodically reviewing and reconciling FinCEN listings, performing Internet searches, and conducting random visitations. Specific time frames for the various activities will be developed, as well as follow-up, referral, and close out procedures.

b. Initiate meetings with representatives of other Colorado state agencies to discuss referral procedures, evidentiary requirements and information sharing agreements. Relevant information, forms, and contact lists will be incorporated into the above-described policy.

c. Develop federal agency referral guidelines.

Penalties for Operating Without a License

As of our audit, Banking had not imposed any penalties or enforcement actions against unlicensed money order/transmitter companies operating in the State. However, two enforcement tools are available to Banking to use in dealing with unlicensed companies. First, Section 12-52-115, C.R.S., states that any person who violates any provision of the Money Order Act is guilty of a misdemeanor and subject to a fine of up to $10,000 upon conviction. Money order/transmitter companies operating in Colorado without a license, as required by the Money Order Act, would be subject to this criminal penalty. However, we found that Banking has not referred any unlicensed money order/transmitter companies to district attorneys for prosecution. Banking staff stated that these cases were not referred, because they believe there is a low probability that the cases would be pursued by district attorneys.

Second, penalty provisions under the Colorado Consumer Protection Act may be available to Banking in cases where money order/transmitter companies are operating without a required license. Legal advice provided by the Attorney General's Office in 1997 stated that Banking may want to "ask the Consumer Protection Section of the Colorado Attorney General's office to seek an injunction" against unlicensed companies as being in violation of the Colorado Consumer Protection Act. According to Section 6-1-105(1)(z), C.R.S., it is a deceptive trade practice if someone "refuses or fails to obtain all governmental licenses or permits required to perform the services or to sell the goods, food, services, or property as agreed to or contracted for with a consumer." By statute, if the Attorney General or a district attorney has cause to believe that a person has engaged in or is engaging in any deceptive trade practice, they may apply for a temporary restraining order and/or an injunction prohibiting the person from continuing such practices. As of our audit, Banking had not referred any money order/transmitter companies that were operating in the State without a required license to the Consumer Protection Section of the Colorado Attorney General's Office.

Banking has expressed concerns that district attorneys and the Attorney General's Office may not pursue legal actions against unlicensed money order/transmitter companies. We recognize that resource constraints can affect district attorneys' and the Attorney General's Office's ability to pursue such cases. However, we believe that Banking should develop a policy for referring all cases of unlicensed money order/transmitter companies to district attorneys and the Consumer Protection Section. Referral of these cases gives district attorneys and the Consumer Protection

Section, rather than Banking, the opportunity to determine if legal actions should be pursued.

Strengthening Penalty Provisions

We found that the penalty provisions in the Money Order Act related to unlicensed money order/transmitter companies are not as strong as provisions in other states' statutes, federal law, and other Colorado laws. For instance, Oregon, Wyoming, and Idaho laws make it a felony for any person to operate a money transmission business without a license. Under Wyoming's law, a felony conviction for operating a money transmission business without a license is punishable by imprisonment of up to three years and/or a fine of up to $10,000. Additionally, federal laws provide for stricter penalty provisions than Colorado's statutes. As discussed earlier, the USA PATRIOT Act makes it a federal crime for any person to operate a money transmission business without a license in a state that requires a license. Conviction of the felony is punishable with not more than five years imprisonment and/or a fine.

We also found that other statutory provisions provide the Division of Banking with stronger enforcement tools related to its regulation of commercial banks, industrial banks, trust companies, and foreign capital depositories. For instance, the Colorado Foreign Capital Depository Act states that individuals must possess a valid and current charter from the Banking Board before they can operate or conduct business as a foreign capital depository in the State. Section 11-37.5-105, C.R.S., states that "a person who is found by the Commissioner to have falsely represented to a customer that a charter had been obtained is permanently disqualified from obtaining a charter." In addition, the Banking Code describes the circumstances in which cease and desist orders can be issued and civil money penalties assessed by the Banking Board, which are as follows:

- Section 11-102-104(7), C.R.S., states that the Banking Board "has the power to order any person to cease violating a provision of this code [i.e., the Banking Code] or a rule or regulation issued pursuant to this code."

- Section 11-102-503(1)(a)(I), C.R.S., states that the Banking Board may assess against and collect a civil penalty from a person who has violated any final cease and desist order issued by the Banking Board pursuant to Section 11-102-104(7), and "any state bank . . . or . . . person participating in the conduct of the affairs of such bank who violates or knowingly permits any person to violate any of the provisions of this code or any rule promulgated pursuant to this code, or engages or participates in any unsafe or unsound practice in connection with a bank." Statutes state that the penalty must not exceed $1,000 per day for each day the violation continues.

We found similar statutory provisions related to other divisions within the Department of Regulatory Agencies. For example, Section 10-15-115, C.R.S., authorizes the Commissioner of the Division of Insurance to "issue an order to cease and desist the act or acts violating any provision of this article." Section 10-3-1109, C.R.S., states that any person who violates a cease and desist order of the Commissioner may be subject to a monetary penalty of up to $10,000 per violation.

Currently the Money Order Act does not include provisions related to the use of cease and desist orders and the assessment of civil money penalties against unlicensed money order/transmitter companies. In 1997, Banking requested guidance from the Attorney General's Office to determine if the Board had the authority to issue a cease and desist order to an unlicensed money order/transmitter business. The Attorney General's Office responded:

> The short answer to your question is no because the authority of the State Banking Board to issue a cease and desist order extends only to violations of the State Banking Code. The Colorado Money Order Act is not part of the Banking Code but is a separate statutory scheme.

Therefore, Banking should work with the Legislature to strengthen the laws related to penalties against money order/transmitter companies that operate without required licenses.

Recommendation No. 2:

The Division of Banking should improve the effectiveness of penalty provisions against money order/transmitter companies operating in Colorado without a license by:

a. Referring all cases of unlicensed companies to the appropriate district attorneys for prosecution and to the Consumer Protection Section within the Attorney General's Office for injunctions under the Consumer Protection Act.

b. Evaluating how other agencies and states enforce licensing requirements, including ways to strengthen penalties or other enforcement tools. Upon completion of this evaluation, the Division should propose statutory changes to enhance enforcement provisions in the Money Order Act, as necessary.

Division of Banking Response:

Agree.

a. Implementation date: December 2003. The Division of Banking will develop a contact list and refer all cases of unlicensed money transmitter activity to the respective district attorneys, Attorneys General, and U.S. Attorneys, subject to coordination with federal law enforcement authorities. Division staff met with representatives of the federal Joint Terrorism Task Force (JTTF) in May 2003, and it was requested that JTTF members be contacted prior to initiating any action against an individual or entity suspected of operating a money transmission business without a license in order to confirm that the company is not the target of a JTTF investigation.

b. Implementation date: June 2004. The Division is currently conducting a survey of other states' investigative practices, penalties, and enforcement tools. Upon completion of the survey, best practices will be identified and cost benefit factors considered. Enhanced statutory enforcement authority, as appropriate and as approved by the Executive Director of the Department of Regulatory Agencies, will be pursued during the 2004 legislative session.

Criminal History Checks

One statutory requirement for an individual to be approved for a money order/transmitter license in Colorado is that he or she be of “good moral character.” The Division of Banking conducts criminal history checks through the Colorado Bureau of Investigation (CBI) for all money order/transmitter applicants. The Division submits the name and birth date of each individual applicant to CBI, where the information is checked against Colorado’s criminal history database. This CBI check provides information on whether an individual has been arrested in Colorado. If the results of this criminal history check indicate that the applicant has an arrest record, the Division will access the Judicial Department’s database to determine the disposition of the case. If the check does not reveal any arrests in Colorado for such crimes, the Division will approve the applicant for a license.

We noted two concerns with the Division’s current criminal history check process. First, the CBI check conducted for money order/transmitter license applicants provides information only on arrests in Colorado. Therefore, if an applicant committed a financial-related crime in another state, the CBI check would not detect that crime. Second, criminal history checks based primarily on name are less reliable than those based on fingerprints. One reason for this is that a name check can report inaccurate results, providing information on multiple individuals with the same name as the applicant. In addition, if an applicant has used an alias on the license application, or has been charged with or convicted of crimes under other names, a name check will not be entirely accurate. Fingerprint-based checks are much more likely to provide accurate information on the individual being checked.

One way to address both the issues above would be to conduct fingerprint-based checks through the CBI and the Federal Bureau of Investigation (FBI) on all license applicants. These checks are more comprehensive than CBI name checks because they include criminal records from throughout the country and because fingerprints, unlike names, cannot easily be changed. Using FBI fingerprint checks would bring oversight of money order/transmitter companies in line with other institutions regulated by Banking and with other regulated entities in Colorado. For example, the Federal Deposit Insurance Corporation (FDIC) often requires FBI fingerprint-based checks of applicants for state-chartered commercial banks. Likewise, state gaming laws require lottery sales agents to submit FBI fingerprint checks. We believe license applicants for money order/transmitter companies should be held to this rigorous standard. Currently the combined cost of a fingerprint-based check by the CBI and FBI is about $40. The costs of criminal history checks for money order/transmitter license applicants are covered by license fees paid to the Division.

Under current law, the FBI will not perform fingerprint checks for state agencies unless that state has enacted laws specifically requiring the checks for a defined population. As a result, Banking will need to pursue statutory changes to access FBI information. In addition, although Banking staff perform criminal history checks on prospective licensees, statutes and regulations do not require these checks. Further, statutes and regulations do not include any provisions related to the types of crimes that would disqualify applicants from being approved for a license. We believe the Division should work with the Legislature and the Banking Board to recommend changes to the statutes and regulations that would specify the types of criminal histories that would result in denial of an application.

Recommendation No. 3:

The Division of Banking should improve the regulation of money order/transmitter companies by:

a. Working with the Legislature to propose changes to state statutes to require license applicants for money order/transmitter companies to undergo both CBI and FBI fingerprint-based criminal history checks.

b. Working with the Legislature and the Banking Board to define criminal histories that would result in denial of an application.

Division of Banking Response:

Agree.

a. Implementation date: June 2004. Proposed statutory language will be drafted to allow the Division to require applicants for a money transmitter license to provide fingerprints, and provide the Division with the authority to request both CBI and FBI fingerprint-based criminal history checks.

b. Implementation date: December 2003. Banking staff will define a list of criminal convictions that would preclude approval of a money order/transmitter license. In addition, the Division will specify the types of violations, both criminal and civil, that may cause the Banking Board to deny a license application. Application instructions and guidelines will be amended to reflect these changes.

Strengthening Money Order/Transmitter Examinations

During the audit we reviewed three examinations conducted by Banking on money order/transmitter companies. The main purpose of our review was to determine how the Division assessed the safety and soundness of these companies because, unlike the other institutions regulated by Banking, minimal criteria exist in either statutes or in Banking's policies and rules to guide these examinations, as discussed in this section.

Assessing Compliance With Laws and Regulations

Our review found that Banking's money order examinations primarily focus on ensuring compliance with state and federal statutes and regulations. In particular, the examinations have increasingly concentrated on companies' compliance with anti-money laundering provisions in federal laws, such as the Bank Secrecy Act and the USA PATRIOT Act. Banking staff modified the money order examination process about one year ago to place more emphasis on compliance with federal requirements. Changes involved increasing, from 1 to 51, the number of steps for ensuring compliance with federal laws. As a result, federal compliance issues now comprise the bulk of the money order/transmitter examinations, and many of the violations cited during examinations relate to noncompliance with federal requirements. Banking management believe it is important for its examiners to monitor money order/transmitter companies' compliance with federal laws because noncompliance could affect the financial stability of the companies. For example, according to the Division, if a licensed company engages in money laundering, federal authorities could shut down the company and freeze its assets, preventing the completion of any outstanding transactions and leading to default.

As discussed earlier, changes in federal laws following the September 11, 2001, terrorist attacks have increased the government's interest in the operations of money order/transmitter companies, particularly due to the concerns that these companies could be used by individuals or organizations for money laundering or other financial crimes. As a result, it makes sense for Banking to focus a portion of its examinations on ensuring compliance with federal laws. However, Colorado's Money Order Act focuses on protecting consumer funds and is silent on compliance with federal laws. One concern with the absence of any reference to federal laws in the Money Order Act is that the Division may have difficulty taking enforcement actions based on violations of such laws. A March 2002 opinion from the Attorney General's Office raised this issue, stating:

> If state examiners discover a violation of federal law, the additional question arises as to what remedies are permitted under the law for the Banking Division to address that violation. The Money Order Act contains no provisions I have found that would permit the revocation of a money transmitter's license for a violation of federal law. The law does permit disciplinary action if a licensee has "failed to comply with any order, decision, or finding of the banking board or the commissioner made pursuant to this article . . ." The State Banking Board may wish to consider promulgating a regulation that directs money transmitters to comply with federal anti-money laundering provisions. If such a rule existed, a money transmitter could be subject to disciplinary action for a violation.

As a result of this opinion, the Banking Board modified its rules in July 2002 to include a provision requiring companies to "develop a compliance plan outlining policies, procedures, and practices implemented to ensure compliance with federal laws and regulations applicable to money services businesses." Within the last year, Banking staff have recommended revocation of two companies' licenses primarily due to violations of this rule. In both cases, the Banking Board has chosen to not pursue revocation because both companies have made good faith efforts to improve their compliance.

The Banking Board's rule may be sufficient to allow the Division to revoke the license of a company that fails to comply with federal requirements, but since the Banking Board has not revoked any money order/transmitter licenses, it does not know whether such a revocation, if challenged, will be upheld. We believe changes to the Money Order Act would provide a stronger mechanism for Banking to enforce compliance with federal laws. We identified three states that have included provisions in their statutes to address compliance with federal requirements. Specifically, Wyoming statutes require companies to comply with the Bank Secrecy Act, which contains most of the federal requirements that apply to money order/transmitter companies. Indiana and Maryland statutes require companies to comply with all state and federal money laundering laws.

Colorado statutes currently require compliance with federal laws with respect to other financial institutions. In particular, the Colorado Foreign Capital Depository Act states that a foreign capital depository must "comply with federal reporting and record-keeping requirements as provided in the 'Bank Secrecy Act,' the 'Money Laundering Control Act of 1986,' the 'Annunzio-Wylie Anti-Money Laundering Act,' and the implementing regulations of each of those acts concerning money laundering and other financial crimes." The Colorado Foreign Capital Depository Act declares that "it is the intent of the General Assembly to protect both state and national interests by promoting legal and technical standards and procedures to deter, prevent, and detect money laundering and other types of financial crime."

Assessing Financial Condition

Another concern with Banking's money order/transmitter examination process is that it is unclear how the Division consistently makes determinations about the financial health of licensed money order/transmitter companies. This is important because Section 12-52-102, C.R.S., states that it is imperative that the financial responsibility and reliability of those engaged in money order/transmitter businesses be "above reproach." Currently Banking's money order/transmitter examination reports include a section on capital adequacy and earnings. In the three exams we reviewed, the examiners provided many financial statistics, such as the company's net worth, retained earnings, and net income, that could be used to analyze and conclude on the company's financial position. However, for two of the three examinations, neither the reports nor the supporting work papers offered a conclusion about whether the company's capital and earnings were adequate. On the third examination, the examiner concluded that capital was adequate but it was unclear what criteria were used to reach this conclusion. In fact, there are no written criteria for assessing the financial well-being of money order/transmitter licensees in state statutes or rules, federal guidelines, or Division policy.

We believe Banking should develop written criteria for evaluating the financial health of money order/transmitter companies. Examples of such criteria include minimum levels of capital, retained earnings, and net income. The criteria should be communicated to current and potential licensees and incorporated into the financial review and examination process. Banking should be able to implement financial requirements on money order/transmitter licensees through its rule-making authority. However, if the Division believes that modifying the Money Order Act to include these financial provisions would strengthen its power to enforce them and make regulatory efforts more effective, the Division should pursue such changes.

Recommendation No. 4:

The Division of Banking should strengthen its examinations of money order/transmitter companies by:

a. Working with the Legislature to propose legislation requiring money order/transmitter companies to comply with federal requirements.

b. Developing rules containing criteria for evaluating the financial health of money order/transmitter companies and communicating the rules to current and prospective licensees.

Division of Banking Response:

Agree.

a. Implementation date: June 2004. The Division will work with the Legislature to include language in the Money Order Act that specifically requires licensees to comply with state and federal anti-money laundering requirements, including the Bank Secrecy Act, USA PATRIOT Act, and the Office of Foreign Assets Control Act.

b. Implementation date: March 2004. Division staff will draft proposed rules to define minimum net worth requirements for licensees. Such rules will allow a phase-in period for existing licensees, and prescribe penalties, including license revocation, for failure to maintain the minimum capital levels. Application forms and instructions will be amended to include the new requirements. In addition, the Division's capital adequacy review procedures will be expanded to include compliance with minimum net worth requirements.

Annual Financial Statements

Section 12-52-110(2), C.R.S., requires every money order/transmitter licensee to file annual financial statements with the Banking Commissioner within 120 days of the close of the licensee's fiscal year, typically December 31. Financial statements must have been audited by an independent certified public accountant or registered accountant. Licensees failing to submit statements on time are subject to a penalty of up to $25 for each delinquent day. If the Banking Board determines that the licensee's delay in submitting its audit is excusable for "good cause shown", then the assessment can be waived. The timely submission of financial statements is important because such statements are used by Banking staff to evaluate the financial condition of the company. If a company's condition has deteriorated since the last reporting period, timely receipt of statements allows staff to address financial problems sooner and possibly prevent a company from failing.

We found that Banking is not enforcing the 120-day requirement for submission of external audits. Our review revealed that 25 of the 72 financial statements due (35 percent) were submitted late in the past three years. Delays ranged from 1 to 109 days beyond the 120-day deadline, with statements being submitted an average of 41 days late. Even so, the Division did not impose fines for any of the 17 late statements submitted in Calendar Years 2000 and 2001.

For 2002, compliance with the 120-day requirement improved, with only eight companies (28 percent) submitting their statements after the deadline. The Division granted a 30-day extension to all eight companies and waived all penalties during the extension period. Two of the companies submitted their financial statements within the extended deadline, five were fined for submitting their statements past the 150-day deadline, and one surrendered its license to the Division and was not assessed a fine. Division staff indicated that the extensions were granted to align the reporting deadlines for money order/transmitter companies with those of other regulated institutions, such as banks and trust companies, which have 150 days to submit their annual statements. Banking state also indicated that they have not involved the Banking Board, as statute requires, in the decision to extend the deadline and waive penalties.

If Banking believes that a 150-day requirement is more appropriate than the current 120-day limit for submission of annual audited financial statements, the Division should propose statutory changes to reflect the later deadline. Until such changes are made, Banking should assess penalties on any company that does not adhere to the 120-day deadline unless the Banking Board formally decides that there is "good cause shown" for extending the deadline.

Recommendation No. 5:

The Division of Banking should strengthen enforcement of the deadline for submission of annual audited financial statements from money order/transmitter companies by:

a. Determining whether the current 120-day deadline is appropriate and recommending statutory changes to extend the deadline, as necessary.

b. Applying the current 120-day deadline until the statutes are changed. The Division of Banking should only extend the deadline beyond the statutory requirement and waive penalty fees when a formal decision for the extension and waiver has been made by the Board.

Division of Banking Response:

Agree.

a. Implementation date: June 2004. The 2003 Sunset Review of the Money Order Act includes the recommendation that Section 12-52-110(2)(a), C.R.S., be amended to extend the time frame for annual financial statement submission from 120 days to 150 days. This change will align the submission requirements of money transmitters with that of commercial banks, industrial banks, and trust companies.

b. Implementation date: October 2003. Internal policies and practices have been reviewed to ensure that the 120-day filing requirement is enforced. Late filing penalties will be assessed if the 120-day time frame is exceeded, unless the licensee can provide a valid reason for the late filing, in which case the matter will be presented to the Banking Board for approval prior to waiving the penalty. Additionally, Division *Policy No. 50-7 Institution Reporting Requirements*, will be amended to specifically address penalty provisions for money order/transmitter licensees and presented to the Banking Board for review/comment, and approval.

Foreign Capital Depositories

Chapter 2

Background

Under the authority of the Colorado Foreign Capital Depository Act (Section 11-37.5-101, C.R.S., et seq.), Banking is responsible for regulating foreign capital depositories. Created by the Colorado Legislature in 1999, foreign capital depositories resemble other "offshore" financial institutions (e.g., Swiss banks) by giving nonresident aliens (i.e., individuals who are not citizens or residents of the United States) a secure, private place to hold their money. Section 11-37.5-102, C.R.S., states that the reason foreign capital depositories were created was to provide a safe haven for foreign capital derived from legitimate business activities that, in turn, will serve the State's public interest by enhancing its revenue through fees assessed on the accounts in the depositories. State statutes only allow nonresident aliens to deposit funds and/or tangible assets (e.g., gold, diamonds) into foreign capital depositories, and deposits must be worth a minimum of $200,000. To attract foreign capital to these institutions, Colorado's law includes privacy and asset protection provisions not typically available to other types of financial institutions and their customers. The privacy sections of the law forbid disclosure of financial records and customer identities, except in certain cases, and the asset protection provisions guard depositors against foreign judgments.

Colorado and Montana are currently the only states that allow for the operation of foreign capital depositories. According to representatives from Montana, no foreign capital depositories have been chartered in the state. Colorado has received two applications for foreign capital depository charters since 1999, and in September 2003 the Banking Board approved an application for a charter. Banking management informed us that they expect a charter to be issued to the depository by the end of October 2003.

We evaluated the impact that foreign capital depositories may have on Colorado as well as the statutory authority granted to the Division of Banking and other interested agencies to regulate such institutions. Overall, we identified a number of concerns and risks related to foreign capital depositories that we believe need to be addressed by the Division of Banking.

Establishing and Regulating Foreign Capital Depositories

One of the primary benefits of creating foreign capital depositories in Colorado is the revenue generated from fees assessed on the depositories' account balances. The Colorado Foreign Capital Depository Act requires depositories to pay a semiannual fee to the Department of Revenue equal to one-quarter of one percent of all assets on deposit or in a safe deposit box. Section 11-37.5-401, C.R.S., states that the fee assessments are one of the main reasons for creating foreign capital depositories, as follows:

> The general assembly recognizes that revenue gains to the state and the possibility of subsequent tax reduction for Colorado taxpayers are among the most significant reasons for establishing a statutory framework for the foreign capital depository and that a relatively steady, predictable flow of revenue is preferred to a volatile one.

Based on projections provided by the foreign capital depository approved for a charter in September 2003, we estimate the State could collect an average of about $5 million annually in the first three years of the depository's operations. Although the State will benefit from the revenue generated from foreign capital depositories, a number of concerns have been identified with the creation of these institutions, as described in greater detail below.

Concerns Identified by the U.S. Department of Treasury

Following the introduction of Senate Bill 99-083 (the bill that created the Colorado Foreign Capital Depository Act) during the 1999 Legislative Session, the U.S. Department of Treasury's Financial Enforcement Crimes Network (FinCEN) submitted written comments related to the bill that were presented during one of the committee hearings. FinCEN is a federal agency charged with spearheading the development of regulation intended to prevent and detect money laundering within a broad range of financial institutions, which would include foreign capital depositories. In its written comments, FinCEN stated:

> The adoption of a new statute is but the first step in a series of steps that must be performed, many of them by the Colorado Executive Branch, in order to ensure the integrity of any future foreign capital depositories. A lack of resources and resolve in confronting these issues have the potential to render the intent of any statute as nugatory.

FinCEN stated that four main issues must be discussed and resolved prior to the creation of foreign capital depositories in Colorado, as follows:

- **Framework for anti-money laundering measures.** FinCEN recommended that the legislation require foreign capital depositories to implement anti-money laundering programs and provide for independent testing by outside parties (hired by the foreign capital depository) for compliance with federal anti-money laundering laws. Requiring foreign capital depositories to hire outside entities to conduct ongoing reviews of their compliance systems was intended to reduce the regulatory burden placed on the Division of Banking.

- **Resources to adequately scrutinize the background of applicants for a foreign capital depository charter.** FinCEN noted that applicants for foreign bank charters are required to undergo federal background checks, and suggested that a similar check for foreign capital depository charter applicants may require additional resources and training. FinCEN stated that "inasmuch as this is a critical area in order to prevent money laundering, neglect of this will create potentially more expensive repercussions later on."

- **Resources to train Banking staff on preventing and detecting money laundering.** FinCEN stated that the Division of Banking must determine whether it has adequate resources to train its own examination staff on appropriate anti-money laundering safeguards and symptoms of money laundering. FinCEN noted that Banking "would be required to perform a very important role in assuring the ongoing integrity of the foreign capital depositories domiciled in the State. Appropriate levels of resources would be needed to ensure that this important task is performed properly."

- **Appropriate channels of interaction between Banking, law enforcement, and prosecutors.** FinCEN questioned whether adequate coordination was addressed in the legislation and whether Colorado's existing money laundering law (Section 18-18-408, C.R.S.) had been examined by the State Attorney General's Office to determine whether any modifications should be made.

Amendments were made to the original version of Senate Bill 99-083 to address the first issue raised by FinCEN. The statutes do include requirements for anti-money laundering measures and for each foreign capital depository to appoint an independent auditor to perform at least four compliance audits of the depository each year. However, we found that the remaining concerns noted by FinCEN have not been fully addressed.

First, we found that criminal history checks of charter applicants do not include a federal fingerprint-based check. We have included a more extensive discussion of this issue later in this chapter.

Second, minimal resources have been allotted for training Banking staff on methods for detecting and preventing money laundering activities in foreign capital depositories. Banking management expressed some doubts about the Division's ability to identify money laundering and other criminal acts through its regulation of foreign capital depositories because examiners are not, in general, trained to detect such crimes. Banking believes that to regulate these activities would require more training of its examiners, and possibly more resources. This is an important consideration because unlike banks, there is no federal regulator for foreign capital depositories that Banking can rely on for guidance in overseeing these institutions. Banking should develop mechanisms to train its staff to detect money laundering activities during examinations of foreign capital depositories.

Finally, Banking has not developed partnerships with law enforcement agencies and prosecutors related to oversight and regulation of foreign capital depositories. We believe that Banking should establish such partnerships, particularly with the Attorney General's Office, district attorneys' offices, local law enforcement agencies, and the Office of Preparedness and Security within the Department of Public Safety. These agencies could assist Banking in detecting money laundering and other financial crimes and take the lead in prosecuting individuals involved in these crimes. Further, Banking should develop similar relationships with appropriate federal law enforcement agencies, including FinCEN. We also found that Colorado's money laundering laws have not been modified since the passage of SB 99-083. Section 18-18-408, C.R.S., establishes penalties against individuals involved in money laundering as it relates to proceeds received from the sale of controlled substances. The statutes do not address other types of illegal proceeds (e.g., from fraud or terrorist activities). We believe Banking should work with the Attorney General's Office to determine whether state statutes should be modified to address FinCEN's concerns related to foreign capital depositories and the State's money laundering laws.

Concerns Related to Banking's Regulatory Authority

Consistent with the issues raised by FinCEN when the Colorado Foreign Capital Depository Act was being considered, Banking management expressed concerns that the statutes do not provide adequate authority to effectively regulate the depositories in two areas. First, the privacy provisions within the Act may inhibit the Division's ability to access records necessary for regulating depositories. Section 11-37.5-201(a), C.R.S., states:

> The viability of one or more foreign capital depositories in Colorado depends to a large extent upon both the secure nature of the depository and the confidential nature of transactions between a customer and a depository....The confidential relationship between a foreign capital depository and its customers is to be protected by restrictions on the disclosure of financial records to supervisory agencies and a prohibition against disclosure of financial records to other state and local agencies and to private individuals except under specified conditions.

These requirements give foreign capital depositors greater privacy protection than is currently available to customers of other financial institutions (e.g., commercial banks). Banking management is concerned that this lack of access will impair its efforts to detect and combat money laundering schemes.

The Colorado Foreign Capital Depository Act does provide exceptions to the privacy provisions that allow some access to depository records for fulfilling regulatory purposes. For instance, Section 11-37.5-116 (2), C.R.S., states that a foreign capital depository must provide books, records, and accounts of the depository to the Department of Regulatory Agencies or an examiner from the Federal Reserve System or the U.S. Department of Treasury upon request, "except that the identity of the customer shall not be disclosed to the Department or any examiner unless the disclosure is necessitated by the Department's procedure for verifying that the depository's procedures to prevent and combat money laundering have been implemented." However, to clarify its regulatory authority, the Division should seek an official opinion from the Attorney General's office regarding its access to records necessary to adequately regulate foreign capital depositories.

Second, the statutes provide limited guidance on the valuation of tangible assets and ensuring that depositories maintain adequate controls over them. The Colorado Foreign Capital Depository Act allows depositories to accept deposits of tangible assets, which are non-cash goods such as precious metals, diamonds, or works of art. Section 11-37.5-403(2), C.R.S., requires foreign capital depositories to develop valuation systems for most tangible assets and states that precious metals are to be valued using market quotations from *The Wall Street Journal*. The statute also requires Banking to review and approve depositories' valuation systems. However, the statutes and regulations do not specifically address how depositories are to maintain adequate controls over tangible assets. We believe that Banking should work with the Legislature to modify the statutes to include such provisions.

Adequate regulation by Banking may be particularly important for foreign capital depositories because statutes currently do not require these institutions to obtain federal insurance (e.g., FDIC) or surety bonds for assets deposited. This means that if a foreign capital depository fails, the depositors may have no recourse for recouping their losses. As the regulatory body responsible for ensuring the safety and soundness of financial institutions, the Division of Banking may be vulnerable to legal actions brought by depositors if a foreign capital depository fails, particularly if it is determined that Banking did not effectively regulate these institutions. Due to this risk, we believe that Banking should work with the Legislature to ensure that it has adequate regulatory authority and determine whether insurance requirements should be included in the Colorado Foreign Capital Depository Act to ensure that deposits are protected.

Other States

We found that the experiences of other states that have implemented laws creating foreign capital depositories (i.e., Montana) or have considered such laws (i.e., Hawaii) reinforce the concerns noted above. Specifically, Montana enacted its law in 1997 but has not yet chartered a depository. The state has received only one charter application, which was put on hold in 2000 because, according to representatives from Montana's Banking and Financial Institutions Division, the applicants could not satisfactorily answer questions about issues including capitalization, qualifications, and banking industry knowledge. To date, the application has not been finalized and one of the principal organizers behind the charter application has been imprisoned for theft. Hawaii considered creating laws that would allow foreign capital depositories, but concluded that it would be difficult for these institutions to prosper. A task force created in Hawaii in 1998 found that these institutions would likely have little success because of high marketing costs and hard-to-define regulatory and enforcement expenses. Hawaii does not currently authorize the establishment of foreign capital depositories in the state.

Due to the potential risks associated with foreign capital depositories, as discussed throughout this chapter, we believe it would be prudent for Banking to work with the Legislature on reevaluating the law and its provisions. Specifically, it would be beneficial for Banking to conduct an evaluation of its ability to effectively regulate foreign capital depositories under the existing statutes about one year after it has approved its first charter. Such an evaluation would help management in making more meaningful recommendations on needed changes in the statutes.

Recommendation No. 6:

The Division of Banking should work with the Legislature to consider changes to the Colorado Foreign Capital Depository Act. This should include:

a. Developing mechanisms to train staff to detect money laundering activities during examinations of foreign capital depositories.

b. Establishing partnerships with the Attorney General's Office, district attorneys' offices, local law enforcement agencies, and the Office of Preparedness and Security within the Department of Public Safety related to oversight and regulation of foreign capital depositories. The Division should work with the Attorney General's Office to determine whether state money laundering laws should be modified to address concerns related to foreign capital depositories, and recommend changes to the Legislature if appropriate.

c. Seeking an official opinion from the Attorney General's office to clarify the Division's access to customer records.

d. Evaluating the effectiveness of its current regulatory powers during the first year a chartered depository is in operation. This effort should include an overall assessment of Banking's ability to regulate these institutions and whether foreign capital depositories should be required to obtain insurance to cover deposits. The results of this evaluation should be reported to the Legislature to assist in developing necessary statutory changes.

Division of Banking Response:

Agree.

a. Implementation date: Ongoing. It is anticipated that the Division's two money transmitter examiners will lead and/or assist on the compliance examinations of foreign capital depositories (FCD). These individuals are the most knowledgeable of federal and state anti-money laundering requirements. Individual training profiles for selected examiners will include periodic training on Bank Secrecy Act, Office of Foreign Asset Control Act, and USA PATRIOT Act requirements, subject to course availability and budgetary constraints.

b. Implementation date: June 2004. Division managers will meet with the representative(s) of the Attorney General's Office and the Office of Preparedness and Security to discuss FCD regulation, potential risks, scope of enforcement authority, legislative safeguards, and state money laundering regulations. The outcome of these meetings will be memorialized and included in the Division's FCD enforcement/referral policies and procedures.

c. Implementation date: November 2003. An opinion will be requested from the Office of Attorney General as to the Division's ability to access confidential customer records as needed to confirm compliance with state and federal anti-money laundering regulations, verify that the funds on deposits were derived from legal sources, and fulfill its regulatory responsibilities.

d. Implementation date: November 2004. The Division will closely track its FCD regulatory efforts over the next 12 months and endeavor to identify potential weaknesses in the regulatory program, operating risks, working agreements with federal regulators and law enforcement agencies. The Commissioner will prepare a report for the Executive Director of the Department of Regulatory Agencies detailing the findings of the study, and suggestions for improvement. Such study and report to be completed on or before November 30, 2004.

Criminal History Checks

As noted above, current law does not provide for a federal criminal history check on foreign capital depository organizers. Statutes do require the Banking Board to determine whether the organizers, directors, executive officers, and any persons with a controlling interest in the proposed depository are of "good character" in order for a charter application to be approved. Under the authority of Section 11-37.5-110, C.R.S., the Division of Banking conducts name-based criminal history checks through the Colorado Bureau of Investigation (CBI) for all foreign capital depository charter applicants to ensure they are of "good character." Section 11-37.5-110(2), C.R.S., gives examples of behavior that would show that the applicant does not have good character, including being convicted of money laundering, fraud, or theft, and willfully making false statements to regulatory agencies.

We noted the same two concerns with the Division's criminal history checks on foreign capital depository applicants as with money order and transmitter company applicants, as discussed in Chapter 1. First, the CBI check conducted for foreign capital depository charter applicants provides information only on arrests in Colorado. Second, criminal history checks based primarily on name are less reliable than those based on fingerprints. As with money order/transmitter company criminal history checks, one way to address these two issues would be to conduct fingerprint-based checks through both the CBI and the Federal Bureau of Investigation (FBI) on all charter applicants.

As noted in Chapter 1, the FBI will not perform fingerprint checks for state agencies unless that state has enacted laws specifically requiring the checks for a defined population. As a result, Banking will need to pursue statutory changes to access FBI information. For the current foreign capital depository application the Banking Board approved in September 2003, no FBI fingerprint criminal background checks have been performed on the organizers and directors.

Recommendation No. 7:

The Division of Banking should improve the regulation of foreign capital depositories by proposing changes to state statutes to require charter applicants for foreign capital depositories to undergo both CBI and FBI fingerprint-based criminal history checks.

Division of Banking Response:

Agree. Implementation date: June 2004. Proposed language has been drafted that would amend Section 11-37.5-110(4), C.R.S., to require applicants for a foreign capital depository charter to provide fingerprints, and provide the Division with the authority to request both CBI and FBI fingerprint-based criminal history checks. The Division will work with the General Assembly to adopt this amendment in 2004.

Fee Assessments

As discussed earlier, the Colorado Foreign Capital Depository Act requires depositories to pay a semiannual fee to the Department of Revenue equal to one-quarter of one percent of all assets on deposit or in a safe deposit box. However, we found that the statutorily set fee could be manipulated, significantly reducing the amount collected by the Department of Revenue. Specifically, statutes require payment of the fee on June 15 and December 15 of each year. Section 11-37.5-403, C.R.S., states that the basis of the value for each asset is as follows:

- For currency, the United States dollar exchange value of the currency on deposit **on the date of the assessment** (emphasis added).

- For gold, silver, platinum, and other precious metals held in precious metals accounts, the spot market price as published in *The Wall Street Journal* **on the date of the assessment** (emphasis added).

- The market value of other tangible property held in safe deposit boxes or other accounts **at the time of the assessment**, as determined by the depository using a method approved by the Commissioner (emphasis added).

As indicated above, the fee assessments are based on account balances as they exist on a particular day. The potential problem is that this allows manipulation of account balances to avoid or reduce the fees. For example, under the current law, an account holder who normally maintains a $1 million balance could withdraw $800,000 from that account on June 14 and then redeposit it on June 16, maintaining the minimum $200,000 required by statute, but significantly reducing the amount on which fees would be assessed. Under this scenario, the depositor would only pay fees on the $200,000 in the account on that day, resulting in individual savings of $2,000 ($800,000 x 0.25%) and depriving the State of this same amount of revenue.

One solution to this problem is to modify the statutes so that fee assessments are based on the average asset balance over the six-month period prior to the assessment date rather than the balance at a specific point-in-time. Using an average asset balance makes sense because it more accurately reflects the amount of money held by the depository throughout the assessment period. Since no foreign capital depositories have begun operations in Colorado so far, the State has not yet lost any revenue under the current law.

Recommendation No. 8:

The Division of Banking and the Department of Revenue should work together to propose changes to state statutes to require that the semiannual fee be calculated based on average asset balances over the six-month period of the assessment.

Division of Banking Response:

Agree. Implementation date: June 2004. Representatives with the Department of Revenue have been contacted to discuss the concerns regarding the assessment date and calculation method. It was agreed that an average daily balance calculation would be more equitable and less subject to manipulation. The Division of Banking and Department of Revenue will work with the 2004 General Assembly to amend Section 11-37.5-403, C.R.S., in 2004. In addition, both agencies will research the possibility of rule promulgation as an interim means to establish a calculation method until such time that legislative changes can be enacted.

Department of Revenue Response:

Agree. Implementation date: June 2004. The Department of Revenue supports a statutory change to the above referenced Act to require that the associated fee be based on average asset balance. In addition, we propose the addition of an explicit definition of the term "assessment period." For example, the definition of assessment period could be the six-month period from December 1 of a calendar year to May 31 of the subsequent year and the six-month period from June 1 of a calendar year to November 30 of a calendar year. Sections 11-37.5-403(1), C.R.S., and all parts of (2) could be amended to require that the depository shall pay a fee equal to one-quarter of one percent of the average asset balance during the assessment period preceding the payment due date.

These changes will prevent temporary fluctuations of balances from influencing the fee to any great degree. In addition, these changes will enable the depository to open for business in the middle of an assessment period and only bear the percentage of the fee related to the percent of the six month period they are open and accepting deposits.

The Department of Revenue is ready to work with the Division of Banking to obtain theses statutory changes.

Traditional Financial Institutions

Chapter 3

Background

The core mission of both the Division of Banking and the Division of Financial Services is to ensure the safety and soundness of the financial institutions they regulate. The Division of Banking is responsible for regulating state-chartered commercial and industrial banks, trust companies, electronic data processors, money order/transmitter companies, and foreign capital depositories. The Division of Financial Services regulates credit unions, savings and loan associations, and life care institutions (i.e., facilities that provide care for the duration of an elderly person's life conditioned upon fees paid to the providers for the care and services involved). The primary tools used by the Divisions to achieve this mission are regular examinations and routine monitoring.

Regulatory examinations involve a comprehensive review of each institution's operations and are used to evaluate the overall financial health of the institutions, to detect any violations of federal or state laws and regulations, and to determine which institutions need extra supervisory attention. In general, the Divisions are required by state statutes and/or internal policies to conduct safety and soundness examinations of commercial banks and credit unions at least once every 18 months. Both Divisions have implemented a risk-based system for determining the frequency of examinations. For banks and credit unions, the Divisions determine risk using ratings devised in the Uniform Financial Institutions Rating System (UFIRS). The UFIRS is an internal rating system used by federal supervisory agencies, like the Federal Deposit Insurance Corporation (FDIC) and National Credit Union Association (NCUA), represented on the Federal Financial Institutions Examination Council (FFIEC) for assessing the soundness of financial institutions on a uniform basis. The FFIEC is a formal interagency body empowered by, among others, the FDIC and NCUA to prescribe uniform principle standards for the examination of financial institutions. Under this system, the Divisions assign a composite "CAMELS" rating to each institution that ranges from 1 (strongest performance) to 5 (weakest performance). The composite rating is based upon assessments made during examinations for the following six key components:

- **Capital adequacy**, which measures whether the institutions are maintaining capital commensurate with their risks.

- **Asset quality management**, which assesses existing and potential risks associated with the institutions' loan and investment portfolios as well as with other assets.

- **Management and internal controls**, which determines the capability of the board of directors and management to ensure safe and sound operations.

- **Earnings**, which identifies whether the institutions are operating profitably and their earnings are sustainable.

- **Liquidity**, which determines whether the institutions' funds management policies ensure that they have enough liquidity to meet their financial obligations.

- **Sensitivity to market risk**, which reflects the degree to which changes in interest rates and other prices can affect the institutions' capital and earnings.

It should be noted that Financial Services does not use the sensitivity to market risk component in its credit union exams because the NCUA, its federal counterpart, did not adopt this component when FFIEC developed it in 1997. The information covered in the sensitivity to market risk component is included under the liquidity portion of credit union exams.

As the table below shows, nearly 95 percent of state-chartered commercial banks received a composite CAMEL(S) score of 1 or 2 on their most recent examination, and these banks held almost 99 percent of the total commercial bank assets regulated by the Division of Banking. Both of these ratings indicate that the institutions' operations consistently provide for safe and sound operations, although 1-rated institutions are considered to be stronger performers. The majority of credit unions (72 percent) are also rated at 1 or 2, and just over one-quarter (mostly small institutions) are rated at 3, indicating that their performance and risk management practices need improvement and are of supervisory concern. As the table below shows, more than 95 percent of the credit union assets regulated by the Division of Financial Services are held by credit unions rated 1 or 2, which compares favorably to banks. Financial Services indicated that the weakened economy has had a greater impact on smaller credit unions, which have more limited resources than large ones and often serve low-income memberships. There are currently no banks or credit unions assigned a rating of 5.

CAMEL(S) Composite Ratings Assigned to State-Chartered Financial Institutions As of June 30, 2003

Type of Institution	Measure	CAMEL(S) Ratings 1	2	3	4	5	TOTALS
Commercial Banks	Institutions	66 (58.9%)	39 (34.8%)	7 (6.3%)	0 (0.0%)	0 (0.0%)	112 [1]
	Total Assets ($000)	$13,823,683 (70.0%)	$5,695,175 (28.8%)	$245,062 (1.2%)	$0 (0.0%)	$0 (0.0%)	$19,763,920
Credit Unions	Institutions	15 (20.0%)	39 (52.0%)	20 (26.7%)	1 (1.3%)	0 (0.0%)	75 [2]
	Total Assets ($000)	$2,734,474 (43.3%)	$3,273,033 (51.9%)	297,641 (4.7%)	$3,187 (0.1%)	0 (0.0%)	$6,308,335

Source: Office of the State Auditor's analysis of data provided by the Divisions of Banking and Financial Services.

[1] A total of 113 commercial banks were state-chartered as of June 30, 2003. One bank is not represented in the table because it was not assigned a CAMELS rating as of this date.

[2] A total of 77 credit unions were state-chartered as of June 30, 2003. Two credit unions (includes the corporate credit union) are not represented in this table because they were not assigned CAMEL ratings as of this date.

Between examinations, the Divisions monitor the activities of financial institutions to follow up on problems identified during past examinations, to measure compliance with any enforcement actions imposed by the Divisions, and to detect problems that could threaten the institutions' financial health. Monitoring activities primarily consist of reviewing financial and other relevant data reported by the institutions and, in some cases, conducting on-site visits.

Quality of Examinations

During the audit, we evaluated the processes used by each Division to conduct safety and soundness examinations of commercial banks and credit unions. We reviewed work papers and reports for the most recent examinations performed on six commercial banks and five credit unions to measure the quality of the examination process. Our sample consisted of healthy institutions (composite ratings of 1 or 2) as well as those needing improvement (composite ratings of 3 or 4.) Overall, we found that both Divisions can improve on how they ensure the quality of their examinations, as we discuss in greater detail in the following three sections.

Evaluation of Fraud Risks

We reviewed both Divisions' processes for evaluating fraud risks at the institutions they regulate. In general, we found that both Divisions could strengthen their processes for identifying and addressing the fraud risks facing commercial banks and credit unions.

Currently the two Divisions use different processes for evaluating fraud risks. For Financial Services, examiners use a guide developed by the NCUA called "Operation Red Flag." This guide discusses common signs of fraud and outlines examination procedures that should be used to detect fraud. Although staff indicated that the Division's examiners do complete most, if not all, of the NCUA's suggested procedures during their examinations, Financial Services has not developed a systematic method to document its fraud detection efforts. We believe that it would be beneficial for Financial Services to adopt procedures for documenting how fraud risks were considered during an examination and what the results were. This approach is required for auditors conducting independent audits of financial statements under the Statement of Auditing Standards No. 99 (SAS 99), which is issued by the American Institute of Certified Public Accountants (AICPA). Although Financial Services' examiners are not required to follow SAS 99, AICPA standards offer an example that Financial Services could use to document its fraud evaluation efforts. By adopting these techniques, management would be able to better ensure that its examiners are consistently evaluating and concluding upon fraud risks at credit unions.

For Banking, examiners complete a standardized form at the end of the examination that is intended to evaluate the bank's vulnerability to fraud in 50 different categories, such as management's operating style (e.g., responsive or nonresponsive to regulators), the adequacy of internal control systems, and the effectiveness of the bank's loan review program. Ratings for each category range from 1 (low risk) to 5 (high risk). Examiners use the individual ratings to formulate an overall conclusion of the bank's susceptibility to fraud. The conclusion may, if it indicates a significant risk of fraud, lead to an enforcement action against the bank. Otherwise, this analysis is generally used as a tool for identifying scope issues for the bank's next examination.

We found that in five of the six examinations we reviewed, examiners did not provide an overall conclusion on the bank's risk of fraud. This is a concern because examiners rated three of the five banks as being vulnerable to fraud on at least 8 of the 50 individual categories, with one bank receiving that designation for 23 of the items (46 percent). Without an overall conclusion on the bank's fraud susceptibility, Banking may not be adequately addressing the bank's fraud exposure and its impact on the safety and soundness of the bank's operations. Further, without this conclusion, critical information may not be assessed for use in the bank's subsequent examination.

Recommendation No. 9:

The Divisions of Banking and Financial Services should strengthen their processes for evaluating fraud risks at the institutions they regulate by ensuring that fraud risks are identified, evaluated, and addressed throughout the examination process, and are properly documented.

Division of Banking Response:

Agree. Implementation date: Implemented August 2003. To evaluate fraud and insider abuse at Division of Banking regulated banks various, evaluation procedures are performed. During the scoping/preanalysis examination phase, an examination scope matrix is completed to assist examiners in determining the high-risk areas of the bank's operation that have the potential for fraud and insider abuse. The examiner-in-charge must determine the level of risk (high, moderate, and low) for three risk measurements materiality, financial risk, operational risk (addresses potential for fraud) for all of the Examination Documentation (ED) workpaper modules. Based on the assessment, the examiner will determine the level of work to be performed for each ED module. Two questionnaires have been developed (internal control questionnaire and internal auditor questionnaire) that institutions are required to complete prior to the commencement of an examination. Examiners review the answers during the exam and determine if any control issues are evident that could lead to fraud or insider abuse. In addition, the examination workpapers (ED) require the examination staff to evaluate and report on the institution's control environment in all areas of the bank's operation (accounting, lending, securities, etc.) to determine if potential or actual fraud/insider abuse is present. Examiners must consider internal control weaknesses, poor loan documentation, improper internal audit reporting relationships, to name a few areas, as potential opportunities for large frauds when conducting an examination. If concerns are noted then additional exam procedures are performed.

As the auditors indicated, examiners were rating the 50 factors on the "Fraud Risk Evaluation Form." Items rated 4 or 5 contained brief comments from the staff but they were not consistently providing a written summary of the institution's risk of fraud on the form. The form summarizes the exam staff's evaluation of fraud risk based on the work paper procedures performed and discussions that were held with management during the examination. While the form instructed the preparer to provide an overall conclusion, space was not provided on the form. To address this issue, Division management and staff were informed of the deficiency at the July 22, 2003 group leaders meeting, and the form was modified in August 2003 to include a heading "overall assessment of fraud risk." The examiners are currently using the revised form.

Division of Financial Services Response:

Agree. Implementation date: December 2003. The Division will adopt a policy to require that examiners complete "Operation Red Flag" examination procedures at each regular credit union examination and document their reviews. The "Operation Red Flag" process is comprehensive and includes two questionnaires to be completed by examiners as a part of the automated examination system for credit unions. One questionnaire covers 35 potential "red flag" circumstances that may indicate weaknesses in internal controls that could expose a credit union to fraud risk. The other questionnaire is a checklist of 34 specific examination procedures that examiners may use to evaluate fraud risk. In addition, the automated examination system contains an additional 26 internal control questionnaires covering all types of loans, deposits, management, cash, wire transfers, money orders, traveler's checks, ATM, ACH, and lines of credit.

The Division believes that this issue is one of a need for established guidelines and appropriate documentation, and not a situation in which the examiners have failed to properly review and evaluate fraud risks. The Division believes that requiring the completion of the "Operation Red Flag" questionnaires and the applicable internal control questionnaires at each regular examination will provide much improved documentation of the examiners' efforts in this important area.

Unresolved Issues and Inconsistencies

As part of our review of examinations, we evaluated whether all issues identified during commercial bank and credit union examinations were fully resolved and whether examination reports were fully supported by underlying work papers. We considered an issue unresolved if the examiner noted what appeared to be a potential concern in the work papers without documenting whether it was an actual problem that the institution needed to address. We questioned whether reports were fully supported by work papers when documentation in one part of the work papers contradicted information contained in another part or in the final examination report. The focus of this evaluation was to determine whether the conclusions presented in examination reports accurately reflected the institution's financial health. Further, an underlying principle of audits and examinations is that work papers should "stand on their own." This principle supports the standard of sufficient information to enable a reviewer having no previous connection with the examination to ascertain from the work papers the evidence that supports significant conclusions and judgments.

For each commercial bank examination we reviewed, we noted at least two instances where there were unresolved issues and inconsistencies in the examination work papers and/or the reports, which suggests a systemic problem. Examples of these issues and inconsistencies include:

- **The presence of managers who appear to dominate operations** was noted in the examination work papers for two banks. Banking indicated to us that this situation is not unusual for the smaller banks it regulates. However, we would have expected the Division to evaluate the effect this situation has on the bank's operations because, according to the Division, dominant managers may tend to override internal controls, making banks more susceptible to fraud. We found that the work papers and the reports for these two examinations did not conclude on whether dominant management represented a significant risk for the banks.

- **The possibility of collusion** between a bank and an outside lending company was noted in the work papers for one bank. Although the Division subsequently reported to us that an investigation had occurred and collusion was not found, neither the work papers nor the examination report concluded on whether collusion existed or indicated that an investigation would take place.

- **Speculation that loans may have been extended or renewed to hide loan delinquencies and improve the balance sheet** was noted in the work papers for one bank. Examiners should have documented the basis for the concerns, what steps were taken to verify them, and any actions taken to address the situation.

- **Conflicting statements within the work papers** regarding a bank's capability to monitor economic trends affecting its loan portfolio. In this case, one section of the work papers indicated the bank was not capable of monitoring trends that could impact its loans while another section stated that the bank was generally familiar with these trends. Monitoring such statistical data is important in helping bank management adequately manage the risks of the bank's portfolio. We found no evidence in the work papers or in the examination report that these two inconsistent positions were resolved.

- **Conflicts between an exit conference agenda and the final examination report** for one bank. The agenda for the exit conference (where the examiners would have discussed the results of the exam with the bank's management) listed a violation of state law that was not included in the final report. We did not find any information in the work papers to explain why this violation, which involved incomplete attendance records for the board of directors, was not included in the report.

As these examples suggest, Banking could improve its examination process by better ensuring that all potential concerns found during an examination are properly researched, reported, and corrected. Doing so would increase the effectiveness of its examinations by foreseeing and addressing all issues that could impair a bank's viability. In addition, reconciling all inconsistencies in the work papers would increase the likelihood that they support the conclusions presented in Banking's examination reports.

To minimize unresolved issues and inconsistencies in examinations, we believe Banking must improve its policies and procedures. For example, Banking's policies require that any material questions raised during the examination process be satisfactorily answered. Banking management indicated to us that the need to resolve issues is based upon whether they are considered material. However, Banking's policies do not define what a "material question" is. Materiality is a difficult concept to define because, as noted in the United States General Accounting Office's *Government Auditing Standards*, it "is a matter of professional judgment". In fact, we had to use our judgment to make determinations, which the Division did not always agree with, on what would reasonably be considered "material" as we reviewed the files. Because "materiality" is open to interpretation, we believe it is important for Banking management to develop standards on what it considers to be material concerns or, at a minimum, to provide examples of material concerns to guide examiners.

We found that the basis for a materiality standard may already exist in Banking's examination process. Specifically, examiners use their testwork to prepare a document called the "Core Analysis Decision Factors" for each of the CAMELS components as well as other areas of bank operations being tested. This document consists of questions and answers on issues affecting performance in each area and is the basis for any conclusions stated in the examination report. We found that many of the unresolved issues and inconsistencies in our file review were answers to questions in the Core Analysis Decision Factors that raised concerns that were not followed up on. We believe that the Division could establish a reasonable standard for materiality if it changed its work paper documentation policy to state that all issues raised in the Core Analysis Decision Factors will be considered material questions that must be addressed by the examination. Such a standard would better ensure that the determination of “materiality” will be consistently applied by examiners and that all material issues are sufficiently addressed during examinations.

In addition, Banking should modify its policies to provide a systematic mechanism for documenting in the work papers how all material issues raised during examinations are resolved. One option would be for managers to include a listing of all issues identified during the examination and the disposition of each issue. Currently Banking does include an “Exception Worksheet” in its examination work papers. However, examiners typically use this form to document violations of law and regulations, rather than as a more general listing of concerns. We also found that some of Banking’s examiners-in-charge as well as a Financial Services examiner maintain informal records of the issues identified during the examinations and how they were resolved. However, in Banking’s case, these lists are typically not included in the examination work papers. Expanding the use of the “Exception Worksheet” or making the examiners’ lists of identified issues a more formal process are two options that Banking could choose to help minimize the number of unresolved issues and inconsistencies in its examinations.

Finally, Banking should improve its review process because the unresolved issues and inconsistencies we noted were not addressed through the Division’s current review process. To ensure accuracy and completeness, managers and examiners-in-charge review work papers and draft copies of the examination report. Improvements to this system should include emphasizing to managers and examiners-in-charge the importance of identifying unresolved issues and inconsistencies in the work papers and providing training on ways to identify such problems. Further, upper management should periodically review a sample of examination work papers to measure the quality of the work. Currently Banking has a policy that requires upper management to review each quarter the work papers associated with two examination reports that have been released. However, upper management has not performed these reviews in the three years since the policy was adopted. We believe that such reviews would be helpful to the Division in determining ways to improve the quality of its examinations.

Recommendation No. 10:

The Division of Banking should ensure that all material issues are fully documented and resolved during examinations and that inconsistencies in examination data are minimized. To accomplish this, Banking should:

a. Modify its work paper documentation policies to better define what constitutes a “material question” and to develop mechanisms that can be used by examiners to document the identification and resolution of material issues for each examination.

b. Establish examination review procedures that ensure that managers and examiners-in-charge verify that all material questions have been addressed and that inconsistencies in the examination work papers have been resolved. These procedures should include establishing the use of quarterly reviews by upper management on a sample of examinations.

c. Provide training to staff on changes in policies.

Division of Banking Response:

Agree.

a. Implementation date: November 2003. The Division’s *Policy 80-19 Examination Work Paper Documentation* will be revised to address what constitutes a material item or issue.

b. Implementation date: February 2004. Examination review procedures will be enhanced to ensure that Division managers and examiners-in-charge (EICs) verify that all material questions and inconsistencies have been addressed or resolved in the examination work papers. The Division concurs that the completion of Report of Examination Quality Assurance Reviews could prove beneficial in improving the quality of the examination product. Over the past three years, the staff member responsible for completing the reviews has had to focus efforts on higher risk areas, e.g., development of personnel tests to fill vacant Financial Credit Examiner (FCE) II, III, and IV positions, revising rules, revising/developing policies and examination work programs, and assisting on examinations, to name a few; and these activities were considered a higher priority by senior Division management than completion of two quarterly quality assurance reviews. Nonetheless, the Division will implement the quarterly review process in accordance with Division *Policy 80-23 Examination Quality Assurance Program*.

c. Implementation date: November 2003. Examiners and supervisors will be trained on workpaper documentation and examination process changes during the course of the November 17, 2003, staff meeting.

Review of Examination Work Papers

Another purpose of our examination review was to determine whether the Divisions' managers and supervisors review work papers. Reviewing examination work papers is an important quality assurance measure because it allows management to confirm that an examination's conclusions are supported by evidence from examiners' work. For Banking, we found indications that managers and examiners-in-charge do review the work papers prepared during commercial bank examinations, although, as we noted in the previous section, Banking should strengthen its review process.

For Financial Services, we found managers do not regularly review examination work papers to ensure their completeness and accuracy. Quality assurance efforts primarily consist of one manager's reviewing all credit union examination reports to ensure that the examiner's conclusions (e.g., assigned CAMEL ratings) are adequately supported by the data in the report. The only time the manager will review examination work papers is if information in the report raises questions or concerns. Further, such reviews are not performed on the examination work papers of other institutions regulated by Financial Services (e.g., savings & loan associations and life care institutions). According to management, time and resource constraints are the main reasons the Division does not review examination work papers. Our review of Financial Services' examination work papers found minor problems, such as a missing checklist in one file and a change in rating for another, that were not adequately documented.

Although we did not find major problems, the lack of systematic work paper review by someone other than the examiner is still a problem for two main reasons. First, by not regularly reviewing work papers, Financial Services cannot ensure that its examination conclusions are always based on a reasonable and accurate analysis of available data. Without this assurance, Financial Services increases the risk that its reports will contain errors or unsubstantiated conclusions. Ultimately, a pattern of inaccurate examination conclusions would diminish the Division's ability to regulate its institutions effectively. Second, management cannot verify that all material questions considered by the examiners were adequately researched, documented, and resolved by the examiner before the end of the examination. This verification is important so that the Division can ensure that it proactively identifies and addresses as many potential problems as possible before they threaten the safety and soundness of the institutions.

In addition, the risks associated with the lack of work paper review are heightened by the fact that many of Financial Services' examinations are conducted by solo examiners. Specifically, for the most recent examinations conducted on each credit union, more than 50 percent were performed by examiners working alone. Without a team performing the examinations, there is less opportunity for staff to provide ongoing feedback to each other to ensure the reliability and accuracy of their methods and conclusions. Not having this routine feedback increases the need for a thorough review of the work at the end of the process to ensure that important issues that could affect an institution's safety and soundness have not been overlooked.

To mitigate these risks, Financial Services should develop a structured quality assurance program for its examinations that includes reviewing at least a sample of examination work papers. Such a program would enhance the accuracy and usefulness of Financial Services' examinations by ensuring that errors in the work papers are corrected and that issues developed in the work papers are properly addressed in the report. It could also help management identify ways in which to improve the examination process. The Division already includes credit union examiners in its current examination report review process. We believe that Financial Services should expand the scope of these reviews so that examiners are reviewing not only examination reports but also work papers. In addition, Financial Services should consider establishing a process, like Banking, where it reviews a sample of examinations and work papers after the reports have been issued. These reviews, could act as a peer review on both the examiner and the reviewer for the original report and could also provide additional assurance that the Division is producing useful and accurate examinations of the institutions it regulates.

Recommendation No. 11:

The Division of Financial Services should enhance its quality assurance processes for credit union examinations by:

a. Requiring that at least a sample of examination work papers be reviewed by a manager or examiner who did not perform the examination to verify that material issues and data inconsistencies in the work papers are sufficiently addressed and resolved by the end of the examination.

b. Considering establishing a peer review process where a sample of examinations and their work papers are reviewed at least once annually by a manager or examiner who did not perform or review the original examination.

Division of Financial Services Response:

Agree. Implementation date: February 2004 and ongoing. The Division will enhance its examination quality assurance process by requiring that a manager or an examiner who did not perform the examination reviews the work papers of every tenth regular examination conducted of natural person credit unions, savings and loan eligible public depositories, and life care institutions. Further, the Division will increase the percentage sample of work papers reviewed over time as personnel resources and workloads permit.

The Division will exclude from such reviews the work papers for joint savings and loan and corporate credit union examinations, because our federal regulatory agency counterparts on those joint examinations perform complete reviews of all work papers. The Division does not believe it is feasible to establish the recommended peer review process at the present time because of a lack of sufficient personnel resources. However, the Division will consider implementing such a process in the future as resources permit.

Monitoring of Credit Unions

Financial Services conducts both off-site (i.e., desk reviews) and on-site monitoring of its credit unions between examinations. Its monitoring is designed to identify and address potential risks facing the credit unions, to assess the credit unions' overall financial health between examinations, and to determine compliance with outstanding enforcement actions. We reviewed Financial Services' monitoring processes to determine how effective they are in helping the Division meet these goals. We noted two areas where monitoring processes could be improved.

Risk Report Monitoring. Each quarter, credit unions must submit a standardized report (known as a "Call Report") that contains various financial data. Examiners use these reports to evaluate the financial health of the credit union and to determine whether there are any unusual statistics (e.g., a ratio goes up or down dramatically) that need to be researched further with the institution. The examiners must also transmit this data to the NCUA. From this information, NCUA produces risk reports, which identify statistics about particular credit unions that may indicate potential operating concerns (e.g., operating expenses are high). The examiners must address each of these potential concerns and determine if they do, in fact, represent problems that the credit unions need to correct or that should be monitored closely in the future.

We reviewed the monitoring completed by Financial Services' examiners for the NCUA risk reports produced for the quarter ending December 2002. The December 2002 report identified 148 potential concerns for 62 of Colorado's 76 (82 percent) state-chartered credit unions. We found that the examiners did not adequately conclude on the significance of these potential concerns for 53 (36 percent) of the issues identified by the NCUA. Included in this number are 38 (26 percent) issues raised by the NCUA risk reports where there was no indication that the examiners reviewed them. In addition, we found no evidence that examiners addressed any of the potential concerns identified by the NCUA for 11 of the 62 credit unions (18 percent of our sample).

The results of our analysis indicate that Financial Services' risk report monitoring may not fulfill its purpose of evaluating the significance of all potential issues that arise between credit union examinations. Determining this significance is important to enable the Division to identify problems timely and develop solutions to problems facing its credit unions. Financial Services' management indicated that many of the issues identified by NCUA are not material concerns. However, Financial Services' examiners should be required to document the analysis used in determining the materiality of the concerns.

Examination-Based Monitoring. Credit unions receiving CAMEL composite scores of 4 or 5 are subject to on-site "supervisory contacts" every three to four months while 3-rated credit unions are subject to such reviews every six to nine months. A supervisory contact is a limited version of an examination in which the Division focuses on whether the credit unions are correcting deficiencies noted in the previous examinations. These deficiencies may include violations of law or regulations, weak financial data (e.g., minimal or negative earnings), or general operational weaknesses. On the basis of this contact, the Division may calculate a new CAMEL composite rating for the credit union. In addition to the on-site supervisory contacts, an examiner may require a credit union to provide information such as financial statements, policies, or status reports on corrective actions, on a quarterly or monthly basis. The examiner reviews the data off-site to assess the institution's progress in correcting deficiencies noted in previous examinations.

We reviewed off-site monitoring files for seven credit unions and onsite supervisory contact reports for six credit unions that were subject to extra supervisory attention. In general, we found that the on-site supervisory contacts are effective in ensuring that the credit unions are complying with enforcement actions previously implemented by the Division. However, we found the quarterly or monthly off-site monitoring was not effective because it did not appear that examiners were analyzing the data reported by credit unions to assess the institutions' progress in correcting deficiencies. Specifically, five of the seven off-site monitoring files (71 percent) we reviewed contained minimal evidence that the examiner had analyzed or even reviewed the data provided by the credit unions. This problem appeared widespread with these five files distributed among three of the Division's six credit union examiners. The remaining two files we reviewed did contain notes from the examiner indicating that data about the credit unions were being routinely analyzed.

Our results suggest that Financial Services' monitoring program should be modified and procedures defined more clearly. The Division does not currently have any monitoring policies in place. The Division needs to give its examiners consistent procedures to follow for completing and documenting their monitoring. These new policies should also ensure that management reviews monitoring activities, at least periodically, to ensure policy compliance. Of the monitoring we reviewed, only the supervisory contacts have well-established procedures, which come from the Division's examination policies. In addition, we believe the Division should evaluate the effectiveness of its monitoring program to identify ways to improve it. This should include determining whether its monitoring processes could be streamlined. Based on the results of this evaluation, the Division should modify its monitoring programs, as necessary.

Recommendation No. 12:

The Division of Financial Services should improve its monitoring program for credit unions. This should include:

a. Establishing a formal policy for monitoring credit unions between examinations. This policy should define procedures to be used by examiners for completing and documenting their monitoring and should ensure that management reviews these activities to ensure policy compliance on a periodic basis.

b. Evaluating the effectiveness of its monitoring program to identify ways to improve it, including determining whether any processes can be streamlined. Based on the results of the evaluation, the Division of Financial Services should modify its monitoring program, as necessary.

Division of Financial Services Response:

Agree. Implementation date: January 2004. The Division will enhance its credit union monitoring program by developing a policy identifying what procedures should be done, how to document said monitoring, how long to retain documentation of monitoring, and management review requirements. The Division also will conduct an evaluation of the effectiveness of the monitoring program in order to identify ways to improve it.

The Division's examiners, in fact, review the monitoring data from various sources and consider it in their ongoing supervision and examination scheduling/scoping decisions. In our opinion, the issue highlighted by the auditors is one of the need for a formal policy to guide such monitoring and proper documentation of such monitoring. The Division believes that the overall financial soundness of state-chartered credit unions (including a strong industry capital ratio of over 10.5 percent) and the complete absence of failures in more than a decade support the effectiveness of our regulatory program.

Reconciliation of PDPA Account Data

The Colorado Legislature passed the Public Deposit Protection Act (PDPA) in 1975 "to serve the taxpayers and the citizens of Colorado by establishing standards and procedures to ensure the preservation and protection of all public funds held on deposit" in financial institutions. In the event eligible banks or savings and loan associations default, the statutes provide for expedited repayment of public deposits not covered by the Federal Deposit Insurance Corporation (FDIC). The PDPA-eligible financial institutions are to repay these public funds through a form of collateralization—the set-aside of marketable instruments for each public deposit held. At a minimum, banks must pledge collateral with a market value equal to 102 percent of the aggregate amount of uninsured public deposits.

In March 2000 the Office of the State Auditor (OSA) completed a performance audit of the Public Deposit Protection Act (PDPA). The audit focused primarily on the administration of PDPA as it related to state government deposits of public funds in banking institutions. As part of the current audit, we evaluated the implementation status of recommendations included in the March 2000 PDPA audit. For all but one of the five recommendations in the 2000 audit, we concluded that the Division has implemented the suggested changes. Appendix A discusses the current implementation status of each recommendation.

The one recommendation that has not been fully implemented relates to the Division's reconciliation of public deposit account data. The March 2000 audit concluded that the Division of Banking did not have fundamental systems or procedures in place to ensure that all public deposits were reported correctly. Specifically, the audit identified at least $21 million in discrepancies between bank account data maintained by the Division and information reported to the State Controller's Office. The Division of Banking receives reports from Colorado banks with PDPA accounts. In addition, the State Controller's Office maintains a list of state agency bank accounts reported by the agencies. In total, the auditors were unable to conclude on the appropriateness of PDPA coverage for almost 800 state agency accounts. The discrepancies found were significant for two reasons. First, when accounts are not properly reported to the Division of Banking, there is a risk that the accounts will not be protected by PDPA in the event of default. Second, there could be inaccuracies in the State Controller's data that could result in misreported amounts in the Statewide Financial Statements and could diminish both the State Controller's and the State Treasurer's ability to ensure that the risks associated with state funds are minimized.

The March 2000 audit recommended that the Division of Banking "strengthen its oversight of PDPA by reconciling public entity deposit reports submitted by banks to those available from public entities." Banking partially agreed with the recommendation, stating:

> Although Division management does not agree with the conclusions drawn in the Report, internal review procedures will be expanded to include a periodic reconciliation of bank PDPA reports and the State Controller reports. The Division will research the type and availability of local public entity reports. Within resource constraints and subject to a cost-effectiveness standard, the Division will conduct periodic reconciliations based on sampling. The findings will be reported to the Banking Board.

As part of our review of the implementation status of this recommendation, we found that during the last three years Banking has conducted annual reconciliations of accounts reported by banks and state agencies. Each year the State Controller's Office provides to the Division a list of all public deposit accounts reported by state agencies as of June 30. The Division of Banking compares the list provided by the State Controller's Office to its own list of public deposit accounts held as of June 30, as reported to the Division by banks. Division staff investigate all accounts on the State Controller's list that are not on Banking's list. The Division also notifies the State Controller's Office of all accounts that were reported by banks but were not on the State Controller's list of accounts reported by state agencies. The State Controller's Office investigates these accounts. The purpose of this reconciliation process is to ensure that both Banking and the State Controller's Office have complete information on bank accounts of state agencies.

One of the primary problems encountered by the State Controller's Office in its investigation of accounts not reported by state agencies is that banks sometimes do not provide detailed information about the accounts, such as the name of the state agency that holds the account and the assigned PDPA number. Without this detailed data, the State Controller's Office cannot determine which agency holds the account. For the reconciliation of accounts reported as of June 30, 2002, the State Controller's Office could not identify the state agency associated with 73 accounts reported by banks, due to the lack of detailed data.

To assist the State Controller's Office in identifying agencies holding these accounts, we believe the Division of Banking should further educate banks on the types of information, such as the name of the state agency holding the account and the assigned PDPA number, that should be reported to the Division each June 30th. In addition, as part of the reconciliation process, Banking should work with banks to obtain any account information that was not provided but is needed to identify the state agency holding the account. Such information should be provided to the State Controller's Office.

In addition to the concerns regarding reconciliation of information on state agency accounts, we found that Banking staff have not reconciled account data maintained by local agencies to information reported by banks. Currently, there are approximately 3,500 local entities (e.g., municipalities, counties, and special districts) that hold public deposit accounts in financial institutions. At a minimum, we believe Banking should perform annual reconciliations on a sample of local government agencies. Banking should use the data from these reconciliations to improve its oversight of PDPA.

Recommendation No. 13:

The Division of Banking should improve its oversight of the Public Deposit Protection Act by:

a. Educating banks on the types of account data (e.g., specific state agency name, assigned PDPA number) that should be provided in their June 30th reports submitted to the Division.

b. Assisting the State Controller's Office in obtaining account data necessary for identifying state agencies that hold accounts reported by banks.

c. Developing and implementing a method to sample and reconcile account data reported by local government agencies' with information reported by banks to the Division of Banking.

Division of Banking Response:

Agree.

a-b. Implementation date: June 2004 and ongoing. The Division of Banking continues to believe that the most effective means of identifying unreported public funds held by regulated depositories is through onsite examinations. However, in response to the auditor's recommendation, this process has been supplemented by performing annual reconciliations of bank public deposit reports with the State Controller's report of State deposit accounts. The annual reconciliations that have been conducted the last three years disclosed a relatively small number of unreported accounts on bank records; however, the reviews revealed a significantly higher number of accounts reported by the banks and adequately collateralized, but not reported by the respective state agencies to the State Controller's Office. We agree that accuracy of the State Controller's annual financial statements is extremely important and will continue to work closely with the State Controller's Office to improve reporting of public deposits by state agencies and enhance the annual reconciliation process as needed to accomplish this goal.

The Division will work with reporting banks to improve the data provided in the annual June 30 reports. In addition, the Division will follow up with banks on the exception list provided to the State Controller's Office, to obtain copies of the source documentation provided to the bank by the official custodian. As set forth in Section 11-10.5-111(2), C.R.S., ". . . It is the responsibility of the official custodian to maintain documents or other verification necessary to properly identify the public funds which are subject to the provisions of this article." Therefore, documents provided to the bank at the time the account was opened should be considered the most reliable means of identifying the respective state agency accountholder.

c. Implementation date: November 2004. The Public Deposit Protection Act explicitly requires banks to submit public deposit reports to the Division of Banking under Section 11-10.5-109. The Act does not contain a reporting requirement for State or local government agencies. Therefore, although the Division has bank reports listing public deposit accounts, it does not have corresponding reports from local government agencies to use for reconciliation purposes. The Division has been unable to locate public source documents that list the bank account information needed to conduct a reconciliation of local government deposit accounts with bank deposit reports. In the absence of statutory authority requiring local governments to provide bank names and addresses, account numbers, and account balances, the Division will work to obtain account information from a sample of local governments that agree to voluntarily provide the information. The Division will reconcile the account data with the information reported by depository banks to better verify the accuracy of the bank reports. If the process reveals material variances, i.e. local government accounts that are not reported by the banks, the sample will be expanded and legislative changes will be sought to compel local governments to provide the account data to the Division on a periodic, or as requested, basis.

Administration of the Divisions of Banking and Financial Services

Chapter 4

Background

Both the Divisions of Banking and Financial Services employ examiners and other regulatory staff who have expertise related to the institutions they oversee. In total, the FTE appropriations for the Divisions of Banking and Financial Services in Fiscal Year 2003 were 38.5 and 11, respectively.

Both Divisions are exclusively cash-funded, primarily from various fees charged to regulated institutions. State statutes require both the Banking and Financial Services Boards to "annually establish such fees and assessments and the percentages thereof as are necessary to generate the moneys appropriated by the General Assembly" for the Divisions. In Fiscal Year 2003, Banking collected more than $3.3 million in revenue, and Financial Services collected about $1 million from fees and charges paid by regulated institutions.

Examination Workload

During the audit we evaluated the workload of both Divisions to determine whether they are using their resources in the most efficient and effective ways. We believe such an analysis can provide the Divisions with data that can be used to improve their use of resources. First, we evaluated changes in some of the factors that measure workload over the last four years and the changes in FTE during this time. Second, we determined the average number of institutions and assets regulated per FTE and examiner within the Divisions and compared the ratios with similar information from other states. The results of our analysis are described below.

Changes in Workload: We reviewed data related to both Divisions' workloads for the last four years (Fiscal Years 2000 through 2003). We evaluated the data to determine whether changes in the number of institutions, condition of the institutions (i.e., CAMEL(S) ratings), the amount of assets held by institutions, and the FTE and examiners within the Division had an impact on their workload. The table below shows changes in these measures in the last four years.

Analysis of Changes in Workload Measures From Fiscal Year 2000 To Fiscal Year 2003

Workload Measure	Banking			Financial Services		
	FY00	FY03	% Chg.	FY00	FY03	% Chg.
No. of Regulated Institutions [(1)]	181	179	-1%	88	87	-1%
Regulated Assets (in billions) [(2)]	$19.5	$22.5	15%	$5.6	$9.8	75%
Institutions with CAMEL(S) Ratings of 1 or 2 [(3)]	96% (126)	94% (118)	-2%	76% (61)	73% (58)	-3%
Institutions with CAMEL(S) Ratings of 3 - 5 [(3)]	4% (5)	6% (8)	2%	24% (19)	27% (21)	3%
Number of Examiners (filled and vacant positions)	22.0	22.2	1%	5.5	6.5	18%
Total FTE	38.0	38.5	1%	10	11	10%

Source: Office of the State Auditor's analysis of data provided by the Divisions of Banking and Financial Services.
[1] These figures include all of the institutions regulated by both Divisions, except public depositories and trust departments within banks.
[2] For Banking, regulated assets include those held by commercial banks, industrial banks, and trust companies. These figures do not include assets held by trust departments within banks. Additionally, Banking does not use this workload measure for money order/transmitter companies and electronic data processors. For Financial Services, regulated assets include those held by credit unions and savings and loan associations. Financial Services does not use this measure for life care institutions.
[3] For Banking, CAMELS ratings are only assigned to commercial banks, industrial banks, and trust companies, or 131 institutions in Fiscal Year 2000 and 126 institutions in Fiscal Year 2003. For Financial Services, CAMEL ratings are only assigned to credit unions (excluding corporate credit unions) and savings and loan associations, or 80 institutions in Fiscal Year 2000 and 79 in Fiscal Year 2003.

Although the number of institutions regulated by both Divisions has remained essentially flat in recent years, assets held by regulated institutions have grown significantly during this time period, particularly for Financial Services. The total amount of assets held by an institution indicates the institution's size, which has some impact on the Divisions' workloads, with larger institutions generally requiring more time to examine than smaller ones. Another factor that can affect the Divisions' workloads is the condition of the institutions, which is reflected by composite CAMEL(S) ratings. Staff from both Divisions stated that the condition of an institution has a greater impact on the workload than its size. Specifically, examinations and monitoring efforts are more extensive and frequent with institutions rated at 3 and worse than those rated at 1 or 2. As the table above shows, the overall condition of institutions regulated by Banking and Financial Services have slightly declined since Fiscal Year 2000. Total FTE and number of examiners within both Divisions remained relatively constant during this time.

Workload Ratios: As part of the audit, we also evaluated the average number of institutions and assets regulated per FTE and examiner within the Divisions between Fiscal Years 2000 and 2003. As the table below shows, the average number of institutions per FTE and examiner dropped slightly for both Divisions during this time period, with Financial Services experiencing a larger decrease in these averages. Additionally, the average number of institutions per total FTE and examiners is higher for Financial Services than for Banking.

Ratios of Institutions per FTE and per Examiner for Banking and Financial Services Fiscal Years 2000 and 2003

Division	Average Number of Institutions per Total FTE			Average Number of Institutions per Examiner		
	FY00	FY03	% Chg.	FY00	FY03	% Chg.
Banking *	4.8	4.6	-4%	8.6	8.4	-2%
Financial Services	8.8	7.9	-10%	16.0	13.4	-16%

Source: Office of the State Auditor's analysis of workload data provided by the Divisions of Banking and Financial Services.

* The calculation for the average number of institutions per examiner for Banking includes 21 examiners in Fiscal Year 2000 and 21.2 examiners in Fiscal Year 2003. We did not include one examiner in the calculation because the examiner only regulated public depositories, which are not represented in the total number of institutions used in the calculation.

As shown in the following table, the average assets regulated per FTE and examiner within both Divisions increased from Fiscal Years 2000 to 2003. The growth in average assets per FTE and examiner was significantly larger for Financial Services than for Banking during this time period.

Ratios of Total Assets Regulated per FTE and per Examiner for Banking and Financial Services Fiscal Years 2000 and 2003						
	Average Assets Regulated per FTE (in millions)			Average Assets Regulated per Examiner (in millions)		
Division	**FY00**	**FY03**	**% Chg.**	**FY00**	**FY03**	**% Chg.**
Banking *	$513	$584	14%	$1,147	$1,308	14%
Financial Services	$560	$890	59%	$1,018	$1,508	48%

Source: Office of the State Auditor's analysis of workload data provided by the Divisions of Banking and Financial Services.
* The calculation for the average assets regulated per examiner for Banking includes 17 examiners for Fiscal Year 2000 and 17.2 examiners in Fiscal Year 2003. Total assets regulated only include commercial banks, industrial banks, and trust companies. As a result, we calculated the average assets regulated per examiner based on the number of examiners assigned to oversee these types of institutions.

We also compared Colorado with other states in terms of the Division of Banking's workload. During the audit we obtained workload data from the Conference of State Bank Supervisors (CSBS) as of 2002 for Colorado and other states, which included data on 49 states (including Colorado), the District of Columbia, and Puerto Rico. We found other states' banking regulatory agencies oversee a wide variety of institutions and financial services providers, including mortgage brokers, securities brokers, and consumer finance companies, with some agencies regulating as many as 14 different types of providers. We roughly compared Colorado to other states with respect to the total number of institutions and total assets subject to regulation and the average number of examiners used to regulate them. For all banking regulatory agencies included in the CSBS's report, we found the average number of total institutions regulated per examiner was 46, with a range of about 3 to 460 institutions per examiner. As the table on the previous page shows, the Division of Banking has an average of 8.4 institutions per examiner position. We also found the average amount of assets regulated for all states included in CSBS's report was just over $3.1 billion per examiner, with a range of about $86 million to nearly $11 billion per examiner. The table above shows that the Division of Banking regulates an average of $1.3 billion in assets per examiner.

The CSBS data do not specify how many examiners are assigned to oversee each type of regulated institution, with the exception of commercial banks, information systems, and trust companies. To provide a more focused comparison, we looked at the number of commercial banks regulated by Colorado and by several other states with a similar number of regulated institutions and assets. As the table below shows, the total assets regulated per examiner in Colorado was higher than other states included in our comparison. In addition, Colorado's average number of institutions per examiner was higher than all but one other state. This comparison may indicate that Colorado has chosen to devote a smaller proportion of its examiner resources to commercial banks than have other states. We were unable to obtain similar information on other states' workloads as they relate to Financial Services.

Comparison of the Colorado Division of Banking and Other States' Commercial Bank Workload *

State	No. of Commercial Bank Examiners	Total Assets Regulated (in billions)	Average Assets (in billions) per Examiner	No. of Regulated Commercial Banks	Average No. of Institutions per Examiner
Colorado	12	$17.4	$1.5	115	9.6
Arkansas	32	$19.9	$0.6	137	4.3
Louisiana	31	$17.2	$0.6	127	4.1
Nebraska	16	$14.3	$0.9	197	12.3
Oklahoma	27	$19.9	$0.7	185	6.9
Tennessee	33	$21.9	$0.7	162	4.9

Source: Conference of State Bank Supervisors 2002 profile of state banking departments.
* This table only includes workload data related to Colorado's and other states' regulation of commercial banks.

Use of Resources

In addition to reviewing general workload data, we also evaluated each Division's use of its resources. We identified areas in which both Divisions can improve their use of resources, as we describe in greater detail below.

General Workload Issues Within the Division of Banking

During the audit Banking management reported that the Division is inadequately staffed to conduct the examinations required and to perform them at the appropriate level of detail. We reviewed the frequency of exams conducted by the Division over the past three years and determined that most examinations do appear to be conducted on schedule. However, there were six instances (out of a total of 375 exams scheduled to be conducted by Banking) in the last two years in which federal regulators from the FDIC and the FRB agreed to conduct exams in Banking's place. Banking indicated that there are a number of issues that have negatively impacted the Division's ability to carry out all its regulatory responsibilities, as described below.

Training New Examiners: Banking has struggled to fully train its new examiners in recent years due to workload demands and budget constraints. Banking has two primary mechanisms in place to train new examiners: (1) on-the-job training, and (2) formal training provided by the Federal Reserve Bank (FRB). Ongoing budget restrictions have limited Banking's ability to send new examiners to training sessions offered by the FRB, which are located outside of Colorado. In addition, Banking has been limited in its ability to provide on-the-job training to new examiners because the examiners-in-charge assigned to perform such training are too busy trying to complete scheduled exams. Management indicated that this has impacted the Division's workload. Because new examiners have not been completely trained, managers and examiners-in-charge must provide more oversight of their work and are restricted on the components of examinations that they can assign to these examiners. As a result, examinations can take longer to complete, which in turn reduces the amount of time available for new staff training. Management informed us that six examiners (30 percent of all Division examiners) have not been fully trained to work independently on all components of an examination.

To alleviate some of the workload while new examiners are undergoing training, Banking may want to consider working with its partner federal regulatory agencies (i.e., FDIC and FRB) to request that they solely or jointly conduct some of Banking's scheduled examinations. Division staff informed us that the federal regulators are often willing and able to conduct examinations that Banking cannot complete within required time frames. Such a short-term arrangement may provide sufficient relief so that Banking can direct more of its resources toward training new examiners.

Specialization of Examiners: In general, regulated institutions have an examination interval of 12 to 18 months, depending on their condition and size. This has resulted in a heavier workload for Banking in some years and a lighter load in others. The Division currently hires and trains most of its examiners to conduct a specific type of examination; 7 of its current 20 examiners (35 percent) are trained to perform more than one type of examination. By expanding its efforts to cross-train examiners so that they can conduct multiple types of examinations, Banking may be able to better handle workload fluctuations.

Allocation of FTE Among Division Functions: We noted that 8.3 of the Division's 38.5 FTE (22 percent) are administrative and support staff. Banking does not track the time spent by its staff on Division functions, and as a result, we were unable to determine whether all of these FTE are necessary for carrying out the Division's activities. While the Division reclassified two administrative positions in 1999 and 2001, management has not conducted a comprehensive evaluation of the use of its administrative staff resources in recent years. Such an evaluation could help to determine whether shifting some of its staff resources to provide for more examiners would be a viable option in addressing some of its workload concerns.

Overall, we believe that Banking should periodically evaluate its use of resources to ensure it is using them in the most efficient and effective ways. Management should develop and implement a plan for addressing the workload and use of resource concerns addressed in the audit as well as from its own evaluation.

Recommendation No. 14:

The Division of Banking should take steps to improve its use of resources by:

a. Expediting the training of new examiners by requesting federal agencies to assist with examinations while new staff are being trained.

b. Expanding efforts to cross-train examiners in conducting various types of examinations, as resources become available for such training.

c. Conducting a comprehensive evaluation of its use of its administrative staff resources on an annual basis to determine whether any of these positions should be reclassified as examiner positions.

Division of Banking Response:

Agree.

a. Implementation date: Ongoing. The Division agrees that the most effective means of improving examiner efficiency is through expediting the training process. Division management will seek additional assistance from the federal regulatory agencies to conduct certain examinations; thereby allowing increased training time for Division examiners, subject to course availability and budgetary constraints.

b. Implementation date: Ongoing. Continued cross-training of examination staff to perform various types of examinations will improve scheduling flexibility and resource utilization, once newer examiners have completed core training courses. A majority of the Division's senior examiners have been cross-trained in more than one area. As newer hires become proficient in safety and soundness exam procedures as will be emphasized, additional cross-training opportunities will be provided.

c. Implementation date: April 2004. The Division will perform a comprehensive evaluation of all administrative functions within the Division. Such evaluation will include a review of the Division's needs, current position duties, daily workflow, available technology, duplications, opportunities for consolidation, and alternative processes. The first evaluation will be completed on or before April 30, 2004, and similar reviews will be conducted annually thereafter.

Money Order/Money Transmitter Workload Issues

Currently Banking has assigned two examiners and a manager to regulate money order/transmitter companies. During the audit we identified some ways that Banking can improve its use of resources for regulating money order/transmitter companies. One way is for Banking to establish cooperative agreements with other states related to the regulatory oversight of money order/transmitter companies. Most money order/transmitter companies licensed by Colorado are headquartered outside the State. Many other states, but not all, require money order/transmitter companies operating within their borders to be licensed and some require them to undergo state regulatory exams. The Money Transmitter Regulators Association (MTRA), a national organization for money order/transmitter regulators, has developed a cooperative agreement that establishes a framework for participating states to accept the regulatory oversight of the lead state in lieu of conducting their own oversight activities. Banking has chosen not to participate in this agreement because it believes other states' regulatory activities are not adequate to ensure Colorado's requirements are met. From July 2000 to April 2003, we estimate that Banking staff spent nearly 500 hours traveling to out-of-state sites to perform examinations of these companies. We believe Banking should work with the MTRA to determine whether the terms of cooperative agreement could be negotiated to address Banking's concerns, thereby reducing the need for Banking staff to conduct exams in other states.

Another alternative would be for Banking to develop individual, reciprocal cooperative agreements with the states where the bulk of the licensed companies are located. By participating in such agreements, Banking could reallocate some of its resources for other important Division functions. In addition, state statutes authorize such agreements. Section 12-52-110 (1), C.R.S., states that the Banking Commissioner "may designate representatives, including comparable officials of the state in which the records are located, to inspect them on behalf of the Commissioner."

Another way resource use could be improved would be to ensure that no examinations are conducted on money order/transmitter companies that are not operating the State. During the audit, we identified one example of a money order company that was examined by Banking nine months before beginning operations in Colorado. This company was licensed by Banking in May 2002, but did not begin providing services to Colorado citizens until April 2003. Banking staff performed an examination at the company's main location in Texas in July 2002. The Division spent a total of 45 hours on the examination. Banking staff stated that the examination was scheduled for July because they believed that they would not have the staff resources later in the year to conduct the examination and the company indicated to the Division that it would begin operating in the State in the near future. While we recognize the circumstances that influenced Banking's decision to conduct the examination at that time, we believe that Banking should modify its policies to only require examinations of companies after they have begun operations in the State. Additionally, we found that Banking does not have any requirements regarding the length of time a company can retain its license without operating in the State. Such requirements could better ensure that Division resources are only used on those companies that are providing services to Colorado citizens.

Recommendation No. 15:

The Division of Banking should improve its use of resources related to its regulatory oversight of money order/transmitter companies by:

a. Developing partnerships with other states to share the regulatory burden when possible and beneficial to Colorado.

b. Modifying its policies to require examinations of money order/transmitter companies only after they begin operating in the State.

c. Setting a time limit for licensed money order/transmitter companies to begin operations in the State.

Division of Banking Response:

Agree.

a. Implementation date: Ongoing. There is currently a wide range of statutory requirements among those states that regulate money order/transmitter companies. As a result, examination requirements vary dramatically from state to state and there is no uniform examination module or rating criteria. Nevertheless, the Division of Banking will work with individual states and through the Money Transmitters Regulators Association (MTRA) to develop partnerships, an information sharing protocol, and cooperative examination agreements, as practicable, to more efficiently utilize Division resources and minimize duplicative exams.

b. Implementation date: November 2003. Although the example cited was an isolated instance that resulted because of a tight examination schedule and management's representation that the company was ready to open its Colorado locations, the Division will amend its scheduling policy to specifically preclude examining a licensee prior to commencing operations in Colorado.

c. Implementation date: November 2003. The Division will modify its license application and approval procedures, and recommend to the Banking Board that the approval of any money transmitter license application include the condition that the licensee must commence operations within six months of the date of approval.

Resource Management

Within the last 15 years, the organizational structures of the Divisions of Banking and Financial Services have undergone a number of changes. One of the more significant changes occurred in 1988 when the regulation of credit unions was transferred from the Division of Banking to the Division of Financial Services (then called the Savings and Loan Division) by House Bill 88-1227. Prior to this change, credit unions had been under the direct authority of the Banking Commissioner, who was also chairman of the Banking Board. A second significant change occurred in 1993 when a separate Financial Services Board was established to set policy for all institutions regulated by the Division of Financial Services.

As part of the audit, we evaluated whether sharing staff resources between the Divisions of Banking and Financial Services would be a viable option for maximizing their use of resources. The similarities in regulatory activities between the two Divisions provide an opportunity for a certain level of consolidation and coordination. Further, the ongoing expansion of the types of services provided by financial institutions, particularly banks and credit unions, has created some overlap in the services offered and calls for a wider knowledge base than needed in the past. Combining the resources of the two agencies could provide a broader range of expertise that may enhance regulation of Colorado's financial institutions.

The two Divisions already share some staff resources for certain examinations. For example, an examiner from Financial Services participates on an examination conducted by Banking of a trust company that is owned by credit unions. In addition, the electronic data processor (EDP) auditors within the Division of Banking periodically assist on Financial Services examinations. For example, Banking's EDP auditors participated on a Financial Services exam of a large credit union service organization that provides shared services to many Colorado credit unions. This effort provides specialized EDP auditing expertise to the team of state and federal credit union examiners.

A consolidation of some Banking and Financial Services staff resources would also result in some personal services cost savings by potentially eliminating the need for two full-time commissioner positions and reducing the total number of administrative staff positions (currently 10.5 FTE between the two Divisions). Combining the resources could result in overall cost savings, which could lead to reduced fees for regulated financial institutions.

The primary drawback of combining the resources of the Divisions is opposition from the bank and credit union industries. Banks and credit unions are competitors, and each strongly opposes being regulated by the same division and board. In particular, each does not want to be under the regulatory authority of a board composed of members who represent their competition. Banking industry representatives noted that federal banks and credit unions are regulated by separate federal agencies, and these agencies will most likely not be merged because of concerns about regulatory and public policy conflicts of interest. Further, the banking industry opposes any potential commingling of industry funds that currently support the cash funding of the Divisions. Finally, the Divisions and industry representatives, have expressed doubt that combining the Divisions would result in increased efficiencies and cost savings. They believe that the institutional and regulatory differences between banks and credit unions are significant enough that cross-training of examiners for these types of examinations would not be a viable option.

According to the CSBS's *2002 Profile of State-Chartered Banking* report, a number of states' banking agencies regulate both banks and credit unions as well as a multitude of other types of institutions, but we were unable to determine if they use the same examiners to regulate both banks and credit unions. We identified one state that has organized its regulatory oversight of banks, credit unions, and savings and loan associations under one department. Specifically, Utah has created the Department of Financial Institutions to regulate these types of institutions under two separate boards, one for banks and one for credit unions. A similar organizational structure may be a viable option for Colorado.

We believe the Divisions should work together to further evaluate the advantages and disadvantages of combining resources to improve efficiencies. Combining resources could take several forms from cross-training examiners to expand their skills in conducting exams on various types of institutions, to complete consolidation of the two Divisions into one. Upon completion of the evaluation, the Divisions should pursue statutory changes as appropriate to implement any recommended changes.

Recommendation No. 16:

The Department of Regulatory Agencies should continue to evaluate methods to cross-utilize resources between the Divisions and recommend statutory changes, as necessary.

Department of Regulatory Agencies Response:

Agree. Implementation date: April 2004. As a matter of efficient management practice, the Divisions of Financial Services and Banking will continue to work on ways to cross-utilize resources between the agencies. As noted by the auditors, the agencies already cooperate and share examiner resources. This sharing of specialized expertise strengthens the examination teams of both agencies and the Department expects this type of cross-utilization to continue, as needs arise and personnel workloads permit. In addition, the Division of Financial Services manager of the savings and loan Public Deposit Protection Act (PDPA) program often consults with Division of Banking PDPA program administrator regarding best practices in protecting public monies on deposit in the State's financial institutions.

As to consolidating the agencies, the Department believes that there are potential budgetary savings to be gained by such an action, particularly in administrative personnel. Due to the strong opposition to this concept by both the banking and credit union industries, however, a consolidation could lead to conversion of state credit unions and state banks to federal charter. Hence any consolidation would need to maintain the autonomy of both regulatory bodies (separate commissioners and boards, but combined administrative functions).

Fee Assessments

As discussed earlier, both Banking and Financial Services are entirely cash-funded. In general, their funding is derived from a multitude of fees and charges paid by the regulated institutions. The table below shows the types of fees and charges assessed by Banking to its regulated institutions.

Fees and Charges Assessed by the Division of Banking by Type of Institution

Type of Institution	Fees and Charges
Commercial & Industrial Banks; Trust Companies	• A one-time new charter fee authorized by statute. The Banking Board has set the fee at $12,000. • One-time fees for any change in structure, such as branch closures. • Semiannual fees authorized by statute, which are intended to cover the cost of regulating the institutions, including routine exams. The fees are set based on total assets held by the bank. • Hourly charges set by the Banking Board for specialized exams, including IT exams ($36/hour); UCCC exams ($30/hour); and Trust Department exams ($36/hour), all with additional charges for reasonable expenses.
Public Depositories - Banks*	• A one-time application fee of $100, established by the Banking Board. • An annual assessment based on the total deposits held in the institution (authorized by statute with the rate set by the Banking Board). • A PDPA exam fee set by the Banking Board at $34/hour plus reasonable expenses.
Money Order/ Transmitter Companies	• An initial license fee authorized by statute. The Banking Board has set the fee at $7,500 if issued between 1/1 and 6/30 and $3,750 if issued between 7/1 and 12/31. • An annual license renewal fee set by the Banking Board at $3,000. • Hourly charges set by the Banking Board for exams at $34/hour plus reasonable expenses.
Foreign Capital Depositories	• An application fee of $25,000 (nonrefundable). • An initial charter fee of $71,000. • An annual charter renewal fee of $10,000. • Annual exam fees commensurate with the total projected costs of exams - set at a minimum of $500 with a $200 fee /examiner per day of exam, by Division rule. • A fee for specialty exams (in addition to the annually required exam) not to exceed $400/day per examiner plus applicable travel costs and costs of specialized personnel and services.

Source: Office of the State Auditor's analysis of Colorado Revised Statutes and fee assessment information provided by the Division of Banking.

* Both state and federal banks can also be authorized as public depositories, allowing them to accept deposits from public entities such as state and local governments.

The following table shows the types of fees and charges assessed by the Division of Financial Services.

Fees and Charges Assessed by the Division of Financial Services by Type of Institution	
Type of Institution	**Fees and Charges**
Credit Unions	• A one-time application fee authorized by statute. The Financial Services Board has set a range of fees from $100 to $1,000 depending on complexity. • One-time fees for any changes in structure. • A semiannual fee based on total assets of the credit union.
Corporate Credit Union	• A semiannual fee based on total assets.
Savings and Loan Associations	• A one-time charter fee authorized by statute. The Financial Services Board has set the fee at $2,500. • One-time fees for any changes in structure. • A semiannual fee based on total assets. • An exam fee set by the Financial Services Board at $360 for each day of the exam.
Public Depositories (S&L Associations)*	• A semiannual fee based on uninsured deposits. • An exam fee set by the Financial Services Board at $360 for each day of the exam.
Life Care Institutions	• A semiannual assessment based on escrow and reserve requirements. • An exam fee set by the Financial Services Board at $360 for each day of the exam.

Source: Office of the State Auditor's analysis of Colorado Revised Statutes and fee assessment information provided by the Division of Financial Services.
* Both state and federal savings and loan associations can also be authorized as public depositories, allowing them to accept deposits from public entities such as state and local governments.

As the two tables above show, institutions are charged numerous fees and assessments at various times, depending on the regulatory activity involved. Since the Divisions are cash-funded, it is clear that they must establish fees that generate sufficient revenue to fund operations. However, the need for layers of fees for virtually every institution type is unclear.

We believe the Divisions could simplify the fee structures to include two main fee categories: application fees and annual or semiannual regulatory charges. For example, it is reasonable to charge each new institution a nonrefundable application fee that reflects the costs of processing the application. Once an application has been approved, an annual or semiannual assessment to each institution could reflect all other regulatory functions. Currently all regulated institutions pay annual or semiannual fees, which are the primary source of revenue for both Divisions. In Fiscal Year 2003, Banking generated nearly $3 million in annual and semiannual fees, representing almost 90 percent of the Division's total revenue for the year, while Financial Services generated about $930,000 in annual and semiannual assessments, representing 97 percent of its total revenue. Therefore, under the current structures, there are more than a dozen different fees and charges paid by various institutions that generate less than 10 percent of the Divisions' revenues. Rather than setting and administering numerous additional small fees, the Divisions could reduce their own efforts and those of the institutions by incorporating all charges into the annual or semiannual fees. In simplifying their fee structures, both Divisions would need to propose statutory changes.

Recommendation No. 17:

The Divisions of Banking and Financial Services should modify their fee structures by reducing the number and types of fees assessed. The Divisions should work with the Legislature to make statutory changes to accomplish such changes.

Division of Banking Response:

Partially Agree. Implementation date: July 2004. The Division's current fee structure is intended to dampen fluctuations in assessment levels from period to period, minimize disproportionate funding among entity types, and differentiate between types of services, i.e., the fee for a branch notification should be less than a new charter application fee. The fee structure is also consistent with that utilized by the Comptroller of the Currency and most other state banking departments. Fees are reviewed and recommendations for change are presented to the Banking Board on an annual basis in accordance with Division Policy No. 30-2. The primary considerations, as approved by the Banking Board are that: (1) sufficient funds are generated to cover expenditures approved by the General Assembly; (2) charges and assessments are equitably based on activity and regulatory costs; (3) division charges and assessments are competitive with those levied by the Office of the Comptroller of the Currency; (4) fees generated represent from 10 percent to 20 percent of total revenues; and, (5) the cash fund balance does not exceed 16.5 percent of the amount appropriated by the General Assembly for the Division.

Division management acknowledges that the fee structure and cash funding process could be simplified and the number and types of fees reduced. However, the Division believes that there should be a continued correlation between use of services and individual charges. For example, it does not seem equitable to assess Division of Banking regulated institutions in order to fund the processing costs of an application for interstate certification filed by an out-state-bank. Similarly, Division management believes that regulatory costs applicable to trust examinations should be borne by those entities that operate trust departments. Nevertheless, the Division of Banking will amend Policy 30-2 with the goal of minimizing the different types of fees and more closely matching funding sources with regulatory costs by industry type. Costs will be tracked through June 30, 2004, and this data will be utilized to support recommendations to the Banking Board for revisions to the fee structure and funding process for FY 2004/2005. The Division will work with the Legislature as necessary to accomplish Banking Board approved changes to the fee structure.

Division of Financial Services Response:

Agree. Implementation date: July 2004. The Division agrees that its fee structure should be modified to reduce the number and types of fees assessed. However, virtually all changes to our fee structure will require amendments to the statutes governing our regulated institutions. Therefore, the Division will propose legislative changes in accordance with Department of Regulatory Agencies policy. It should be noted that the current fee structure is not cumbersome for the Division to administer and is supported by the regulated industries. Perhaps most importantly, the current fee assessment process reliably generates sufficient revenues to fund the Division's budget as authorized by the General Assembly without creating excessive cash fund balances.

Appendix

Appendix A
Implementation of Prior Audit Recommendations

The Colorado Legislature passed the Public Deposit Protection Act (PDPA) in 1975 "to serve the taxpayers and the citizens of Colorado by establishing standards and procedures to ensure the preservation and protection of all public funds held on deposit" in financial institutions. In the event eligible banks or savings and loan associations default, the statutes provide for expedited repayment of public deposits not covered by the Federal Deposit Insurance Corporation (FDIC). Both banks and savings and loan associations must pledge collateral to be used to repay public funds that are not insured if the institution defaulted.

In March 2000 the Office of the State Auditor (OSA) completed a performance audit of the Public Deposit Protection Act. The audit focused primarily on the administration of PDPA as it related to state government deposits of public funds in banking institutions. The audit did not review, in detail, activities as they pertain to local government deposits. Additionally, it did not evaluate the Division of Financial Services' administration of the parallel PDPA law related to savings and loan associations, because most state government entities deposit their funds in banks. The audit report contained five recommendations in two broad areas: general oversight of the PDPA and FDIC coverage. The following is a summary of the March 2000 audit findings and recommendations, along with the Division of Banking's responses, and our evaluation of the actions Banking has taken to date.

Oversight of the PDPA

As discussed in Chapter 3, the March 2000 audit concluded that the Division of Banking did not have fundamental systems or procedures in place to ensure that all public deposits were reported correctly. The audit found two primary reasons why the discrepancies had not been detected by the Division. First, Banking had not reconciled the reports it received from banks to information from other sources, such as the State Controller's Office, and did not share information about collaterization of public deposits with other public entities, such as the State Controller's and State Treasurer's Offices.

Second, Banking relied solely on its bank examinations to determine whether public funds were properly identified or properly deposited and did not target PDPA examinations in banks with high concentrations of public funds. Banking needed to enhance its reviews of the accuracy and completeness of bank reports and other PDPA-related data to help ensure public funds were protected.

Recommendation No. 1 (March 2000):

The Division of Banking should strengthen its oversight of PDPA by:

a. Reconciling public entity deposit reports submitted by banks to those available from public entities.

b. Sharing essential account information with other public entities.

c. Increasing targeted PDPA examinations in banks with high concentrations of public deposits.

Division of Banking Response (March 2000):

Partially agree.

(a) The Division disagrees with the auditors' conclusion that fundamental systems or procedures are not in place to ensure that public deposits are reported to the Division. The auditors' conclusion is based in large part on a comparison of bank public deposit reports and State Controller records. The audit report calls into question the deposit protection of almost 800 state agency bank accounts. However, the vast majority (600) of the discrepancies were public accounts that were properly reported and collateralized by the banks, but that were not listed on the State Controller's records of state bank accounts. The omission of these accounts from the State Controller's records did not jeopardize the safety of those public funds. The Division's reconciliation of the majority of the remaining exceptions did not disclose the existence of unprotected funds. The fact that the banks' reports to the Division were found to be accurate indicates that fundamental systems and procedures are in place to ensure that public deposits are reported to the Division.

The Division's PDPA efforts have historically been focused almost exclusively on the institutions under its regulatory authority. Division management believes it can most efficiently ensure accurate public deposit reporting through its on-site bank examinations for PDPA compliance and review of the annual PDPA compliance audit reports conducted by independent parties. The Division does not have the resources or, it believes, the statutory authority to police the investment practices of public entities, or to ensure the accuracy of public entity records. Nevertheless, it acknowledges the reporting discrepancies between the State Controller's records and the bank reports, and recognizes the overarching benefits to the State of accurate financial reporting by public entities.

Although Division management does not agree with the conclusions drawn in the Report, internal review procedures will be expanded to include a periodic reconciliation of bank PDPA reports and the State Controller reports. The Division will research the type and availability of local public entity reports. Within resource constraints and subject to a cost-effectiveness standard, the Division will conduct periodic reconciliations based on sampling. The findings will be reported to the Banking Board.

(b) The Division routinely shares non-confidential information with the State Treasurer's Office and many other public entities. Indeed, a senior-level management representative of the State Treasurer's Office serves on the Division's PDPA task force. The Division will increase efforts to coordinate PDPA oversight activities with the State Controller's Office and other public entities. However, it must be noted that Section 11-2-111.5, C.R.S., and federal regulatory interagency agreements preclude the Division from disclosing bank-specific CAMELS ratings and/or examination findings. Division management will seek clarification from the Office of Attorney General regarding the ability to share information contained in public deposit reports with other state agencies and local government units.

(c) The audit report recommends that the Division strengthen PDPA examinations by expanding the scope of PDPA examinations in low-risk institutions. Currently the Division conducts expanded exam reviews at high-risk banks, and reviews a sampling of deposit accounts at low-risk banks. If significant numbers of unreported public accounts are found during the sampling of deposit accounts, it is the Division's practice to schedule a second, more comprehensive examination targeting public deposit reporting. In addition to bank examinations, the Division's risk-based approach is supplemented by the annual independent PDPA compliance review required pursuant to Section 11-10.5-109, C.R.S. The Division will address the concentration of public funds in low-risk institutions by recommending to the Banking Board that the PDPA examination frequency mandate be revised to include more frequent examinations at those banks that hold a level of deposits in excess of ten percent of aggregate public deposits held by Colorado banks. The issue was discussed with the Banking Board on February 17, 2000, and the Board was receptive to the recommendation.

Auditor's Addendum (March 2000)

Prior to our audit, the Division was unaware of the discrepancies, inconsistencies, and inaccuracies related to almost 800 public agency bank accounts that we identified in our audit. The Division does not have the basic procedures in place to identify and reconcile discrepancies or to ensure the completeness of public bank account reporting. Had the Division routinely

shared information with other state agencies, for example, it could have identified reporting issues in a timely fashion. For the Division to fulfill its statutory responsibility for the PDPA, it must have accurate, complete, and current information about public agency bank accounts. Otherwise, a risk does exist that accounts will be unreported or misreported, and that public funds may not be adequately protected.

Office of the State Auditor's Evaluation of Actions Taken (September 2003):

This recommendation has been partially implemented. We found that the Division of Banking has shared account information with the State Controller's and Treasurer's Offices and increased targeted PDPA examinations in banks with high concentrations of public deposits. However, as we discussed in Chapter 3 of this report on the Divisions of Banking and Financial Services, we found that improvements can be made with the reconciliation of public account data. Specifically, as discussed in Chapter 3, we believe that Banking should educate banks on the types of information that should be reported to the Division each June 30th. Further, Banking should work with banks to obtain any account information that was not provided but is needed to identify the state agencies holding accounts, which should then be provided to the State Controller's Office. We also found that Banking staff have not reconciled account data reported by local agencies to information reported by banks. At a minimum, we believe Banking should perform annual reconciliations on a sample of local government agencies.

Recommendation No. 2 (March 2000):

The Division of Banking should improve its efforts to inform and educate public depositors and financial institutions regarding their responsibilities related to PDPA by:

a. Routinely disseminating information and updates to public entities and banks through its Web site and newsletter.

b. Providing periodic training to banks and public entities.

Division of Banking Response (March 2000):.

Agree. The Division maintains PDPA information on its Web site and will continue to enhance PDPA training of both public officials and bank staff via the Division's Web site, newsletter, informational memos, telephone training, and public speaking engagements. PDPA training goals and activities will be incorporated into the Division's budget planning and monitoring process.

Office of the State Auditor's Evaluation of Actions Taken (September 2003):

This recommendation has been implemented. The Division of Banking has developed several mechanisms for educating public officials and bank staff on PDPA requirements, including:

- A general information article on PDPA, which was included in the November 20, 2000, edition of the Division's newsletter and is periodically sent to the banking industry.

- A PDPA Fact Sheet that was added to Banking's Web site and is also mailed to banks and public entities that contact the Division seeking information on the PDPA.

- A formal PDPA bank and official custodian training plan and a related PDPA training brochure, which was mailed to all eligible public depositors in August 2001. As part of the plan, Division staff offer to provide training to bank personnel and public deposit customers during PDPA examinations. Additionally, staff provide formal PDPA training at public association meetings and other industry-related gatherings, when requested.

- A PDPA Informational Letter, which is sent to all eligible public depositories annually to update them on any new PDPA information or issues.

Synchronizing Report Dates to Enhance Oversight

The March 2000 PDPA audit found that public entities generally reported financial information as of the end of each month. The Division of Banking required banks to submit two monthly reports: the first was used to ensure proper collateralization and the second was a detailed listing of public deposits by depositor and account, which supported the first report. The audit report suggested that Banking should supplement the existing detail report requirements by annually requiring an additional detail report to be submitted as of June 30 when the State Controller's Office requires state agencies to confirm bank deposit balances. A June 30 comparison of amounts reported by banks to Banking and amounts recorded by state agencies would be valuable because agency amounts have been reviewed by the depositors for accuracy.

Recommendation No. 3 (March 2000):

The Division of Banking should enhance its monitoring activities by supplementing the existing detail report requirements by annually requiring an additional report to be submitted as of June 30.

Division of Banking Response (March 2000):

Partially agree. The Division currently requires banks to report public account information as of the one day during the previous month that the bank held its highest aggregate amount of uninsured public deposits. This is the most conservative reporting date, as it allows the Division to internally verify that the reporting bank is maintaining sufficient collateral to cover peak levels of uninsured public deposits. Implementation of the recommendation will impose an additional reporting requirement on the industry. The purported benefit of June 30th reporting is to allow easier reconciliation to external public entity reports. However, with the exception of the State Controller's list of state agency deposits, external reports from the nearly 4,000 public entities are not readily available. The proposal was presented to the Banking Board on February 17, 2000, and the Board was generally receptive. The Division will initiate formal rule-making to adjust the current reporting rules to incorporate an annual June 30 reporting requirement.

Office of the State Auditor's Evaluation of Actions Taken (September 2003):

This recommendation has been implemented. The Division of Banking has amended its rules to require all eligible public depositories to submit annual public deposit reports to the Division as of June 30 of each year.

FDIC Coverage

The March 2000 audit concluded that the Division of Banking was not ensuring that banks and public agencies were correctly applying Federal Deposit Insurance Corporation (FDIC) guidelines for the coverage of public deposits. Specifically, the audit found that the number of public depositors operating under the assumption that they were separately covered by FDIC insurance was incorrect. Consequently, there were potentially $13 million of unprotected public funds being held in Colorado banks as of June 30, 1999. The audit found that documentation, in the form of legal interpretations from the FDIC and the Colorado Attorney General's Office, existed for only 17 subdivisions of state government, although there were as many as 300 state entities assumed to be separately covered by FDIC.

Recommendation No. 4 (March 2000):

The Division of Banking should apply existing regulations and legal opinions regarding the determination and application of FDIC coverage and require PDPA-eligible banks to adjust FDIC insurance estimates and PDPA collateralization accordingly. If the Division believes that additional clarification is needed, then it should obtain the appropriate legal guidance.

Division of Banking Response (March 2000):

Partially agree. The Division is applying separate FDIC insurance coverage to the 17 State funds and political subdivisions in accordance with previous Attorney General opinions referenced above. However, it is the Division's understanding that the referenced Attorney General opinions did not state that *only* those state funds and subdivisions are separately insured. Rather, the Attorney General's opinions were responses to requests to review insurance coverage for only those specific 17 funds and subdivisions. The Division calculates FDIC insurance for public deposits based on Attorney General opinions, advice from the FDIC's Legal Department, with whom the Division is in frequent contact, and upon materials and advice from the private law firm that researched the FDIC regulations and created the official custodian numbering system. In addition, approximately 11 years ago, the Deputy State Treasurer worked with the Attorney General's office to informally determine FDIC insurance coverage for other State subdivisions, and determined that there are more State subdivisions than the 17 referenced above to which the FDIC would allocate separate insurance coverage. The Division has apportioned separate FDIC insurance to those additional subdivisions in accordance with the State Treasurer and Attorney General's informal determinations, which are supported by the FDIC's Legal Department. The FDIC will not issue its own written opinions on all of the State's funds, because they are too numerous. The Division will seek Attorney General opinions for additional support for its FDIC insurance allocation practices. The Division will adjust FDIC insurance allocation calculations, PDPA numbering system, and procedures as necessary based on these opinions.

Auditor's Addendum (March 2000):

Our conclusions regarding the eligibility of public deposits for separate FDIC coverage are based on formal, written opinions and determinations by the FDIC and the Colorado Attorney General's Office. The Division must be able

to support its position on FDIC-qualifying deposits in the event of a bank failure.

Office of the State Auditor's Evaluation of Actions Taken (September 2003):

This recommendation has been implemented. The Division of Banking sought further guidance and clarification from both the Attorney General's Office and the FDIC on this issue. The Division received three informal legal opinions from the Attorney General's Office between April and September 2001 that determined whether various government entities qualify as public units entitled to separate FDIC insurance. These opinions concluded that 8 of the 14 special authorities listed in the first request, all 14 principal departments listed in the second request, and 7 of the 9 special districts listed in the third request are entitled to separate FDIC deposit insurance. Therefore, these opinions provide the Division with a clear determination of which government entities have separate coverage under FDIC. In addition, in August 2001 the Division received an informal legal opinion from FDIC concurring with the AG's opinions regarding separate insurance coverage for the special authorities and principal departments (identified in the first two opinions mentioned above). The Division has not sought a legal opinion from the FDIC relating to the AG's guidance on special districts.

PDPA Numbering System for FDIC Coverage

The Division of Banking is statutorily charged with developing a PDPA numbering system so that "the amount of funds subject to federal deposit insurance . . . may be readily and accurately determined at all times." The March 2000 audit identified a number of problems with the design and use of the existing system as a means of control. One of the significant problems noted was that in the absence of a clear and accurate application of FDIC regulations (as noted in the previous section), the banks and state agencies had become reliant on the PDPA numbering system as a means of establishing eligibility for separate FDIC coverage. As a result, there were as many as 300 state entities assigned a PDPA number and, thereby, erroneously assumed to be separately covered by FDIC insurance. The audit also found that the numbering system had not been updated or reviewed for accuracy since it was developed, resulting in some errors in the system.

Recommendation No. 5 (March 2000):

The Division of Banking should reevaluate the existing numbering system to determine its effectiveness as a control over FDIC and PDPA coverage. This could include:

a. Making adjustments to the current numbering system or implementing a new system to support existing FDIC and State Attorney General opinions on FDIC insurance coverage.

b. Notifying depositors, banks, and oversight entities of the changes made and providing oversight entities with accurate information.

c. Recommending legislative changes, as appropriate.

Division of Banking Response (March 2000):

Agree. The Division will:

a. Automate the official custodian number data and begin providing quarterly automated reports of State assigned numbers to the State Controller and State Treasurer by December 31, 2000.

b. Notify official custodians, banks, and oversight entities of any changes made to assigned numbers as deemed necessary based on new Attorney General or FDIC opinions concerning public deposit insurance coverage.

c. If deemed appropriate, the Division will recommend legislative changes to the numbering system.

Office of the State Auditor's Evaluation of Actions Taken (September 2003):

The implementation of this recommendation is in progress. In April and May 2003, the Division notified depositors and an oversight entity of recent changes in the assigned official custodian identification (PDPA) numbers. As part of this notification, the Division requested that the oversight entities provide copies of the updated list of numbers to all banks in which they have deposited money. We believe that the Division should follow up with the oversight entity to ensure that the banks were properly notified of the changes.

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