STATE OF WISCONSIN

Letter Report

Department of Financial Institutions

April 2005

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Janice Mueller
State Auditor

April 12, 2005

Senator Carol A. Roessler and
Representative Suzanne Jeskewitz, Co-chairpersons
Joint Legislative Audit Committee
State Capitol
Madison, Wisconsin 53702

Dear Senator Roessler and Representative Jeskewitz:

We have completed audit work at the Department of Financial Institutions to meet our audit requirements under s. 13.94, Wis. Stats. The primary focus of our audit was to review the Department's fiscal operations and related activities to assess whether they are effectively managed, well-controlled, and in compliance with statutory requirements. The Department is responsible for regulating state-chartered financial institutions, the securities industry, and other financial service providers. In addition, it maintains corporate and Uniform Commercial Code filings, investigates consumer complaints related to credit transactions, and provides consumer financial education.

The Department is funded primarily through program revenue derived from fees and assessments paid by regulated entities and individuals. In recent years, it also was awarded almost $7.7 million in settlements as the result of nationwide actions against brokerage firms. In the past five fiscal years, over $128.3 million of the Department's program revenue has been transferred or lapsed to the General Fund.

Overall, we found the Department has adequate fiscal management practices in place. However, we identified several areas in which it could further improve internal controls and fiscal processes, including the efficiency and controls of its receipts processing, password security, access to the State's central payroll system, and physical inventories of capital assets. The Department agrees with the recommended improvements and has identified its plans to implement our recommendations. Its responses have been incorporated into this letter.

We appreciate the courtesy and cooperation extended to us by the Department's staff during our audit.

Sincerely,

Janice Mueller

Janice Mueller
State Auditor

JM/DA/bm

cc: Senator Robert Cowles
Senator Scott Fitzgerald
Senator Mark Miller
Senator Julie Lassa
Representative Samantha Kerkman
Representative Dean Kaufert
Representative David Travis
Representative David Cullen

DEPARTMENT OF FINANCIAL INSTITUTIONS

The Department of Financial Institutions was created by 1995 Wisconsin Act 27, which combined the offices of the Commissioner of Banking, the Commissioner of Savings and Loans, and the Commissioner of Securities into one financial regulatory agency to regulate state-chartered banks, savings and loans associations, and savings banks, as well as various operations of the securities industry. The Office of Credit Unions, which regulates state-chartered credit unions, is attached to the Department for administrative purposes. An organization chart is provided as an appendix.

Responsibilities for regulating financial institutions are divided between the State and the federal government. The Department serves as the primary regulator for approximately 89.2 percent of Wisconsin's financial institutions, which are state-chartered. At the end of 2004, it regulated 539 state-chartered financial institutions through periodic examinations and, in the interim, by monitoring reports submitted by them. Based on its assessment of a variety of factors, including capital, asset quality, management, earnings, and liquidity, the Department assigns a rating to each of these financial institutions. Based on examinations completed during 2004 or earlier, 90.7 percent of Wisconsin's state-chartered financial institutions were rated as sound, 8.6 percent were rated as fair, and no institutions were rated as unsound. No state-chartered bank has failed in at least the past 20 years. However, the federally chartered First National Bank of Blanchardville failed in 2003 and was subsequently acquired by another bank. Because it was federally chartered, the Department did not have primary regulatory responsibility for this bank.

The Department also regulates the sale of investment securities, franchise investment offerings, and corporate takeovers, and it licenses and monitors the activities of broker-dealers, securities agents, investment advisors, and investment advisor representatives. To protect the public from securities fraud, the Department has authority to conduct investigations and to issue administrative orders. A recent high-profile enforcement order was issued in May 2004, when the Department reported a settlement with Richard Strong of Strong Capital Management, based in Brookfield, following allegations that Mr. Strong had engaged in illegal market-timing practices. The enforcement action resulted in a settlement of $140 million to investors, a revocation of Mr. Strong's securities dealer and investment advisor representative licenses, and mandated corporate changes at Strong Capital Management. The settlement was coordinated with enforcement actions by the U.S. Securities and Exchange Commission and the Attorney General of New York.

As part of the 1995 consolidation of the State's financial regulatory activities, responsibility for examining and maintaining corporate and Uniform Commercial Code (UCC) filings was transferred to the Department from the Secretary of State, and responsibility for regulating the mortgage banking industry was transferred from the Department of Regulation and Licensing. The Department also administers chapters 421 through 427 of Wisconsin Statutes, commonly referred to as the Wisconsin Consumers Act, which governs consumer transactions with organizations that provide less than $25,000 in financing to individuals. To carry out these responsibilities, the Department operates a call center to collect consumer complaints and conducts investigations. It also licenses financial service providers, such as collection agencies and lending companies, and provides consumer financial education. Including its attached office, the Department has 153.0 full-time equivalent staff, most of whom are in the classified civil service system.

As part of our statutory audit responsibilities to periodically audit every state agency, we completed a review of the Department's fiscal processes, internal controls, and compliance with selected statutory provisions. Overall, we found appropriate fiscal policies and procedures in place, although we identified areas in which improvements could be made.

Financial Operations

The Department is funded primarily through program revenue derived from fees and assessments paid by regulated entities and individuals. However, it has also received settlements in recent years as the result of nationwide actions against brokerage firms. The Department's expenditures are largely associated with salary and fringe benefit costs, although information technology costs represented a significant portion of expenditures in recent years. In addition, the Department has transferred or lapsed more than $128.3 million of its funding from fees, assessments, and settlements to the General Fund over the last five fiscal years.

Revenues

The Department's revenues have increased 34.1 percent, or $12.1 million, since fiscal year (FY) 1999-00, as shown in Table 1. However, more than $6.4 million in FY 2003-04 revenues relates to proceeds from one-time settlements paid by national securities brokerage firms. Excluding the settlements received in FY 2003-04, revenues increased 16.1 percent over the past five years.

The Department receives revenue from several areas:

- corporate and UCC filing fees—most recently, 2003 Wisconsin Act 33 required that limited liability companies organized under the laws of Wisconsin, like those operating in Wisconsin but organized under the laws of other states, to file annual reports and pay fees of $25;

- securities regulation—the Department receives fees for investment specialists licenses and for securities registrations and filings, examination fees, and settlements from enforcement actions;

- banking and credit union regulation—the Department levies an annual assessment on all state-chartered institutions based on their assets and charges additional fees for examinations;

- mortgage banking and financial service provider regulation—the Department collects fees for licenses issued to mortgage bankers and brokers, collection agencies, currency exchanges, loan companies, and a variety of other financial service providers; and

- Wisconsin Consumer Act—the Department receives registration fees from businesses dealing with consumer credit transactions under the Wisconsin Consumer Act.

Table 1

Program Revenues
FY 1999-00 through FY 2003-04
(in millions)

Source of Program Revenue	FY 1999-00	FY 2000-01	FY 2001-02	FY 2002-03	FY 2003-04	Percentage Change
Corporate and UCC Filings	$13.7	$14.2	$15.6	$17.0	$16.9	23.3%
Securities Regulation[1]	12.9	13.9	12.9	13.7	19.6[1]	51.9
Banking Regulation	3.9	3.8	3.8	4.3	4.1	5.1
Mortgage Banking and Financial Service Provider Regulation	2.9	2.9	3.2	3.9	4.5	55.2
Credit Union Regulation	1.8	1.9	2.0	2.1	1.9	5.6
Wisconsin Consumer Act	0.3	0.3	0.5	0.5	0.5	66.7
Miscellaneous	0.0	0.0	0.0	0.0	0.1	n/a
Total	**$35.5**	**$37.0**	**$38.0**	**$41.5**	**$47.6**	34.1%

[1] FY 2003-04 amounts includes $6,405,000 in settlements from national securities brokerage firms.

The 55.2 percent increase in program revenue from mortgage banking and financial service provider regulation from FY 1999-00 to FY 2003-04 was largely associated with increases in mortgage banking license fees in response to a desire for increased regulatory oversight of the industry. Most recently, Wisconsin 2003 Act 260 required individuals seeking licensure as loan originators after July 2005 to pass a competency examination and established continuing education requirements for renewals beginning in July 2007. The Department will establish new examination fees to pay for these new requirements.

Expenditures

As shown in Table 2, the Department's expenditures increased only 2.2 percent over the past five years. This minimal growth is largely a result of budgetary reductions required by either the Legislature or the Department of Administration. For example, during the 2003-05 biennium, the Department reduced its staff by 14.5 positions, which included 5 examiners. Several of these positions were eliminated by consolidating the regulatory activities of banks and savings institutions. Salaries and fringe benefits represented 73.6 percent of the Department's expenditures in FY 2003-04.

Table 2

Expenditures
FY 1999-00 through FY 2003-04
(in millions)

Category	FY 1999-00	FY 2000-01	FY 2001-02	FY 2002-03	FY 2003-04	Percentage Change
Salaries and Fringe Benefits	$ 9.3	$10.5	$10.4	$10.3	$10.3	10.8%
Travel	0.5	0.7	0.6	0.5	0.5	0.0
Office Space	0.9	0.9	0.9	1.0	1.0	11.1
Computer Hardware, Software, and Consultants	1.5	1.8	2.1	1.0	1.2	(20.0)
Other[1]	1.5	1.4	1.1	2.1[1]	1.0	(33.3)
Total	**$13.7**	**$15.3**	**$15.1**	**$14.9**	**$14.0**	2.2%

[1] FY 2002-03 amounts include $1,086,800 for the payment of state deposit insurance claims by four public entities resulting from the closing of the First National Bank of Blanchardville. The State provides public entities coverage up to $400,000 each for losses incurred as the result of a failed financial institution.

The Department has undertaken significant information technology projects over the last five years, which are reflected in expenditures for computer hardware, software, and consultants. Among them are a project that allows the Department to capture and share UCC filings electronically, a project to develop a corporate registration database also capable of allowing on-line filings, and implementation of a new securities tracking and registration system.

Transfers and Lapses to the General Fund

As noted, a portion of the Department's program revenue is transferred or lapsed to the General Fund. As shown in Table 3, transfers and lapses in the past five years have occurred in four ways:

- First, as a normal course of operations, statutes require the Department to credit 12.0 percent of receipts from the Division of Banking and the Office of Credit Unions to the General Fund as General Purpose Revenue (GPR)-earned.

- Second, statutes require the Department to transfer $200,000 annually to the Secretary of State's appropriation to continue funding for that agency subsequent to the transfer of corporate and UCC operations to the Department.

- Third, statutes also require the Department to lapse any additional revenues it receives over its budget authority for general program operations, except that the Office of Credit Unions is permitted to retain a balance totaling 10.0 percent of the prior year's expenditure amounts, and the Department is permitted to retain a $100,000 balance for investor education. A large portion of the excess revenues come from fees for corporate and UCC filings, securities registrations, and investment licenses. According to a 2000 study by the federal Government Accountability Office, most state securities regulators collected significantly higher revenues than were expended by the regulators.

- Finally, as part of its efforts to address the State's budget difficulties, the Legislature required the Department to make additional lapses to the General Fund of $2.1 million in FY 2002-03 and $500,000 in FY 2003-04 through a reduction of expenditures.

Table 3

Transfers and Lapses to the General Fund
FY 1999-00 through FY 2003-04
(in millions)

	FY 1999-00	FY 2000-01	FY 2001-02	FY 2002-03	FY 2003-04
Transfers and Lapses to the General Fund:					
12% of banking and credit union receipts	$ 0.9	$ 0.9	$ 0.9	$ 0.9	$ 0.9
Secretary of State	0.2	0.2	0.2	0.2	0.2
Excess revenues over budget authority	21.6	21.0	22.1	23.2	32.3[1]
One-time lapse requirements	0.0	0.0	0.0	2.1	0.5
Total Transfers and Lapses to General Fund	**$22.7**	**$22.1**	**$23.2**	**$26.4**	**$33.9**[2]
Percentage of Program Revenue Lapsed	63.9%	59.7%	61.1%	63.6%	71.2%

[1] The increase in the excess lapse amount in FY 2003-04 was largely the result of settlements received from enforcement actions against brokerage firms.
[2] The Legislature instructed the Department to delay $20 million of the FY 2003-04 lapse into FY 2004-05.

Enforcement Action Settlements

During the course of its securities regulation activities, the Department periodically receives penalties and settlements from regulated individuals or entities for violation of securities laws. These penalties and settlements are deposited into a continuing appropriation, to be used for the purposes for which they were made or received. When funds received exceed budgeted amounts, the Department of Administration typically becomes involved in expenditure decisions. In most years, amounts received have been relatively modest. However, recent investigations of practices of the investment industry by state securities regulators, the U.S. Securities and Exchange Commission, and national self-regulatory organizations, such as the New York Stock Exchange, resulted in significantly larger amounts in FY 2002-03 and FY 2003-04.

In 2002 and 2003, enforcement actions were taken against ten national securities brokerage firms at the conclusion of investigations of allegations that the firms' research analysts recommended stocks to public investors based on improper influence from the firms' investment banking sections. Wisconsin received $893,555 in FY 2002-03 as the result of enforcement actions taken against Merrill Lynch, Pierce, Fenner & Smith, Inc. The enforcement order specified that Wisconsin's settlement be used for the enforcement of its securities laws and the promotion of investor protection. A large portion of the settlement is being used for the implementation of the new securities tracking and registration system.

The Department was also awarded civil monetary penalties totaling $6.8 million as part of settlements with nine other brokerage firms, including $6.4 million received in FY 2003-04. The enforcement order did not specify how these funds were to be used. Consequently, the Department lapsed the entire amount received in FY 2003-04 to the General Fund. It anticipates receiving the final payment of approximately $400,000 in FY 2004-05. That amount also would be expected to lapse to the General Fund because the Department has no specific requirement or authority to expend it.

Fiscal Management Practices

Overall, we found the Department has adequate fiscal management practices in place. However, we identified several areas in which it could further improve internal controls and fiscal processes, including its processing of receipts, password security, access to the State's central payroll system, and physical inventories of capital assets.

Receipts Processing

On an average day, the Department processes over $150,000 in receipts in the form of cash, checks, lockbox collections, credit cards transactions, and wire transfers. Receipts can range from $10 for a service request to a single wire transfer in excess of $3 million.

A standard control feature for receipting processes is the use of lockbox services. The Department uses lockbox services for some corporate filings, but more than 60 percent of its receipts in FY 2003-04 were checks. However, since August 2003, when the Department began offering an on-line credit card payment option for certain corporate filings, the portion of receipts received by check has declined, while credit card receipts have increased significantly. As it makes on-line processing available for more applications, the Department expects credit card transactions will continue to increase.

In light of the large volume of receipts it receives and processes directly, the Department should ensure its receipting processes are efficient and well-controlled. The merger of the different regulatory agencies in 1995 provided opportunities for improved processing through centralization and standardization, and the Department brought several receipting processes into its Division of Administrative Services and Technology. However, other processes and related systems were left unchanged. As a result, the Department retains several different receipting processes, which may not be as efficient or well-controlled as possible. The Department recognizes that inefficiencies exist and plans to develop a new billing and receipting system to further standardize procedures, although it does not have a time line for such a system.

We also believe the Department could achieve additional efficiencies and improved controls for UCC activities, corporate filings, and service requests by transferring receipting activities from the Division of Corporate and Consumer Services to the Division of Administrative Services and Technology. The Division of Corporate and Consumer Services, which received $16.9 million, or 35.5 percent, of receipts during FY 2003-04, has three staff responsible for the various receipting activities. These activities appear to have been separated largely out of a desire to not disrupt operations and staff as they had been organized under the Secretary of State before the merger, rather than as a result of any cost and benefit analysis.

☑ ***Recommendation***

We recommend the Department of Financial Institutions implement agency-wide central receipt processing. As first steps, *we recommend that three employees be transferred from the Division of Corporate and Consumer Services into the Division of Administrative Services and Technology and that a plan for implementing a new billing and receipting system be developed as funding becomes available*.

Agency Response: The Department recognizes the need for developing a comprehensive receipting system and plans to incrementally develop systems and procedures that will provide the controls and efficiencies desired. The first step, which the Department is currently developing, is to implement an on-line system that will enable customers to pay for products and services using the receipting processes developed for Internet credit card applications. The Department believes the controls associated with this system will substantially improve its overall receipting process. The Department also supports centralizing its receipting functions, including combining receipting services provided by the Division of Corporate and Consumer Services cashiers’ office with the Division of Administrative Services and Technology. The Department has not established a firm timetable but is in the process of developing plans to implement that transition.

Password Security

The Department maintains critical and sensitive information on a local area network (LAN), such as confidential information from its regulatory reviews of banks, savings institutions, and credit unions. Therefore, it is important to maintain a secure LAN environment. For instance, someone who inappropriately gained access to the Department's Accounting Information System, could gain access to confidential ratings of all financial institutions.

In reviewing selected password security parameters for the LAN, we noted that some password violation settings and the frequency of required password changes were not consistent with industry standards. We do not provide detailed discussion of our concerns in this document because of the increased risk of inappropriate access to the system and confidential data if the concerns are publicly disclosed. However, we have advised the Department on steps to take to conform to industry standards, which the Department agreed to implement.

Payroll System Access

As part of our fiscal review of the Department's operations, we reviewed access to the State's central payroll system, which maintains employee appointment information and generates paychecks. In order to protect sensitive personal information and prevent inappropriate payments, access should be limited to that necessary for individuals to complete their properly separated job duties. However, during our review, we noted that two former department staff retained access to the central payroll system after they had terminated employment. In one case, the former employee had terminated employment over one year earlier. In both instances, the Bureau of Human Resources Director was aware of the departures but had overlooked the need to remove access. Use of a checklist at the time an employee terminates employment and periodic reviews of all system access could help the Department ensure that access is properly controlled.

☑ ***Recommendation***

We recommend the Department of Financial Institutions implement procedures to ensure the access of terminated employees to systems is promptly removed and to annually review the appropriateness of employee access to different systems.

Agency Response: The Department will add the "review of all access rights" to the process it uses at the time of employee termination. In addition, at least annually, the Department will review the appropriateness of employee access to all of its systems, including payroll.

Capital Asset Inventory

Agencies need to maintain accurate and up-to-date fixed asset inventory records in order to adequately safeguard the State's assets and to accurately report fixed assets for financial reporting and risk management purposes. The State's *GAAP Conversion Manual* requires each state agency to complete a physical inventory of capital assets at least annually. The Department's fixed assets, which total approximately $3.1 million, are typical for the general operation of a state agency, such as office furniture, computer equipment, and miscellaneous office equipment.

The Department established its capital asset records based on an inventory of assets at the time of its creation. In addition, the Department performed an inventory of telecommunications equipment, representing the majority of its capital assets, approximately three years ago. However, because of staffing issues and other priorities, the Department has not completed any physical inventories since 2001. We recognize that turnover in accounting staff and an overall reduction in staff affects the Department's ability to meet the physical inventory requirement. However, we believe the Department should strive to confirm at least a portion of its fixed assets annually, with a goal of confirming all its assets over a period of time, such as three years.

☑ ***Recommendation***

We recommend the Department of Financial Institutions develop a plan and time line to complete a physical inventory of its capital assets.

Agency Response: The Department has scheduled a physical inventory of its capital assets, to be conducted by the spring of 2005.

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Appendix

Department of Financial Institutions
Organizational Chart