STATE OF ARIZONA
OFFICE OF THE
AUDITOR
GENERAL

Arizona Department of Financial Institutions

REPORT HIGHLIGHTS
PERFORMANCE AUDIT

Our Conclusion

The Arizona Department of Financial Institutions (Department) partners with federal examiners to examine financial institutions, such as banks and credit unions, and has primary responsibility for examining financial enterprises, such as collection agencies and mortgage brokers. These examinations are designed to protect consumers and ensure sound business operations. Although the Department has established policies and procedures for effectively examining financial institutions, as of April 2013, the Department had a backlog of 197 statutorily required financial enterprise examinations. In order to address the backlog, the Department should spend less time examining enterprises that comply with the law and spend more time examining noncompliant or high-risk enterprises. The Department should also improve its complaint handling by enhancing its policies and procedures and establishing complaint-processing time frames. In addition, the Department should ensure that the fees it charges match its costs.

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Department should enhance its examination strategy

Department has a backlog of enterprise examinations—The Department's financial enterprise examination program aligns with national best practices, which includes using established examination procedures and standard checklists, and identifying licensee risk. After an examination, the Department assigns a number to the licensee's risk of complying with the law—a 1 representing the lowest risk, i.e., no major areas of concern, and a 5 representing the highest, i.e., critical problems threaten the existence of the business. Although it uses these best practices, the Department was behind on 197 required examinations as of April 2013.

Department should revise its examination approach—Although statute requires financial enterprise examinations at scheduled intervals, the Department can determine the scope of the examinations. However, the Department rarely varies from a full-scope examination when conducting on-site reviews, even when the Department knows the licensee has a low-risk rating.

According to best practices, agencies should avoid burdening businesses with unnecessary compliance costs, such as those incurred by examinations. The Department could lighten the burden by reducing the scope of on-site examinations for its low-risk licensees. To help reduce the number of on-site exams, the Department has implemented an "e-exam," which is a self-assessment of compliance with state laws and rules for enterprises rated as a 1 or 2 risk. In practice, the Department intended to make the e-exam available only to low-risk enterprises that had a previous examination, and an enterprise cannot have two e-exams in a row. However, we found that the Department authorized the e-exam for other than low-risk enterprises and for enterprises the Department had not yet examined.

Department should update its risk assessment process—The Department has used its post-examination risk assessment tool for about 20 years, and it needs updating. The Department does not use a uniform set of criteria for assessing risk, but assigns risk factors to particular license types based on different criteria. The difference in criteria means that the Department cannot compare the risk across all license types, thereby limiting the Department's ability to prioritize examinations across all license types. In addition, most of the risk categories carry the same weight. For example, a licensee's level of preparation for the examination is weighted the same as the number of violations found regardless of the seriousness of the violations. The Department should also enhance the process it uses to identify risks early. For example, the Department should consider comparing licensees' financial performance to peers', or the potential harm that some licensees' products may have on financially vulnerable consumers.

Department should improve its follow-up process—The Department follows up with some licensees to ensure violations found during an examination have been addressed, but its process for doing so does not always ensure that serious problems are addressed. Although conducting extensive followup on all violations would not be a good use of the Department's time, it should enhance its follow-up practices to better ensure serious violations do not persist between examinations, which can be several years apart.

Recommendations

The Department should enhance its existing processes for assessing licensees' risks, both before and after an examination. In addition, the Department should develop and implement policies and procedures for:

- Varying the scope of examinations;
- Determining when to administer an e-exam; and
- Determining when to conduct followup and what level of followup is appropriate.

Department should enhance its complaint-handling process

Complaint-handling process has several weaknesses—The Department receives about 860 complaints a year, and most complaints involve financial enterprises. Although the Department quickly resolved most of the complaints it received between January 1, 2010 and October 10, 2012, we found that some complaints took more than a year to resolve or had been open and unresolved for more than a year. Additionally, either the Department had not investigated or had not sufficiently investigated some complaints. Similarly, unlicensed financial enterprises are supposed to be tracked by the Department by putting the entities on a "watch list." However, the Department does not consistently place unlicensed entities on this list. These complaint-handling weaknesses could impact consumer protection. For example, a complaint about unlicensed financing at a car dealership was not investigated until a second complaint was received 6 months later. The Department closed the complaint a month after the second complaint was received when it found the car dealer had vacated the location.

Recommendations

The Department should:

- Enhance its complaint-handling policies and procedures to address weaknesses and to ensure complaints are investigated in a timely manner.
- Enhance its supervisory review process to include a review of the status of ongoing investigations and investigation sufficiency.

Department should establish a structured approach to set fees

The Department collects fees that pay for its programs. However, most fees have not been reviewed or changed since 1994 or earlier and likely do not match up with the Department's current costs. For example, in fiscal year 2013, assessment fees on industry assets of approximately $970,000 covered the estimated $946,000 in costs to regulate banks and credit unions, but did not cover any of the Department's administration and information technology costs, which totaled approximately $716,000. The Legislature established the Arizona State Agency Fee Commission (Commission) to review agencies' fees and their impact on regulated industries and consumers, and agency budgets, and the Commission recommended that the State General Fund should not benefit from fees. However, the Department's fee structure benefited the State General Fund by $29.5 million between fiscal years 2003 and 2013.

Recommendations

The Department should:

- Assess the efficiency of its operations to ensure costs are as low as possible, while considering service quality.
- Develop a method to determine its costs, including direct and indirect costs.
- Use these costs to analyze its fees and determine appropriate fees to charge.