STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

A PERFORMANCE AUDIT
OF THE

STATE BANKING DEPARTMENT

OCTOBER 1983

A REPORT TO THE
ARIZONA STATE LEGISLATURE

REPORT 83-21

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OFFICE OF THE
AUDITOR GENERAL

October 26, 1983

Members of the Arizona Legislature
The Honorable Bruce Babbitt, Governor
Mr. Walter C. Madsen, Superintendent
State Banking Department

Transmitted herewith is a report of the Auditor General, A Performance Audit of the State Banking Department. This report is in response to a January 18, 1982, resolution of the Joint Legislative Oversight Committee. The performance audit was conducted as a part of the Sunset Review set forth in A.R.S. §§41-2351 through 41-2379.

The blue pages present a summary of the report; a response from the State Banking Department is found on the yellow pages preceding the appendices.

My staff and I will be pleased to discuss or clarify items in the report.

Respectfully submitted,

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SUMMARY

The Office of the Auditor General has conducted a performance audit of the State Banking Department in response to a January 18, 1982, resolution of the Joint Legislative Oversight Committee. This performance audit was conducted as a part of the Sunset Review set forth in Arizona Revised Statutes (A.R.S.) §§41-2351 through 41-2379.

The State Banking Department, created by the Legislature in 1922, supervises State-licensed financial institutions and enterprises. The Governor appoints the Superintendent of Banks, who oversees all operations. The Department charters and examines banks, savings and loan associations, credit unions, trust companies and small loan companies. The Department also licenses financial enterprises and investigates potential mismanagement of the enterprises. The Department does not have jurisdiction over federally chartered banks, savings and loans and credit unions. A variety of Federal agencies have responsibility for federally chartered institutions.

Licensing Small Loan Companies Is Not Necessary to Protect Consumers (see pages 15-25)

Protecting consumers does not require licensing small loan companies. Arizona statutes authorize the Banking Department to license consumer finance companies but do not require any small loan companies to obtain a license from the Department. Loan companies may determine the extent to which they will be subject to departmental regulation by deciding whether or not to seek a license. Because companies choosing to be licensed are subject to more regulatory requirements than unlicensed companies, the law provides an economic incentive for companies to not be licensed. As a result, many small loan companies in Arizona have discontinued their licenses in recent years.

Although borrowing money poses some risk, consumers can assume the responsibility for protecting themselves if they have sufficient information to evaluate terms offered by lenders. However, existing

disclosure requirements do not provide the borrower with sufficient information to permit comparisons among lenders. Although State law and Federal truth-in-lending regulations establish requirements governing loans, neither require lenders to inform borrowers about these legal requirements. As a result, consumers may be unable to compare charges against requirements to determine if they are being treated fairly.

The Legislature should consider amending A.R.S. §44-1201 et seq to 1) incorporate provisions of Federal truth-in-lending regulations into State law, 2) require all lenders to fully inform each borrower about State and Federal requirements concerning allowable charges and methods of computing interest rates, and 3) specifically authorize the Attorney General to enforce all State laws governing loans. The Legislature should also consider amending A.R.S. §6-601 et seq to remove all licensing requirements for small loan companies including interest rate limitations placed on these companies. The Banking Department should prepare an information brochure which informs consumers about legal requirements governing loans.

Changes Needed in Regulation of Financial Enterprises (see pages 27-37)

Two of the six enterprises under the supervision of the Banking Department, motor vehicle dealers and sales finance companies, pose limited harm to consumers. Continued licensing is not required for these enterprises because consumers can adequately protect themselves if the Legislature strengthens truth-in-lending statutes as recommended in Finding I. The Legislature should consider amending A.R.S. §44-281 et seq to delete all licensing requirements for motor vehicle dealers and sales finance companies and to empower the Attorney General to investigate violations of the Motor Vehicle Time Sales Disclosure Act.

In contrast, the remaining four enterprises can create serious financial harm to individuals and businesses who use their services. Banking Department regulation is necessary to protect consumers who have little recourse for protecting thenselves against financial losses from mortgage

brokers, escrow agents, collection agents and debt management companies. However, the Department does not routinely examine these enterprises and thus lacks an effective means for deterring potential fraud and abuse. The Department should develop procedures to implement routine examinations of a sample of financial enterprises each year. Audit work at each enterprise should focus on a valid sample of priority transactions and documents.

The Department Can Improve Utilization of Its Examiners (see pages 39-44)

Although the Banking Department adequately supervises financial institutions, it can improve the utilization of its professional staff. The Department should review examination procedures used by other states and Federal agencies to determine the feasibility of increasing the efficiency of examination procedures. The Department should develop a personnel management system which provides accurate estimates of staff resources needed for examinations.

The Conflict of Interest Statute for Banking Department Employees Is Unnecessarily Restrictive (see pages 45-47)

The law prohibiting Banking Department employees from holding loans at institutions regulated by the Department is more stringent than necessary to prevent conflicts of interest. The prohibition may limit the Department's ability to attract qualified staff or cause hardship to new employees. Less restrictive requirements will reduce the potential hardship without increasing the risk of conflicts of interest. The Legislature should consider amending A.R.S. §6-113 to 1) allow professional staff to retain loans with entities regulated by the Department if the loan existed prior to employment with the Department and the employee continues to amortize the loan under its original terms and 2) require that each employee fully disclose all loans with entities regulated by the Department and the terms of such loans at the time of initial employment. The Department should establish a policy of not assigning personnel to examine institutions from which they hold a preexisting loan.

INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a performance audit of the State Banking Department in response to a January 18, 1982, resolution of the Joint Legislative Oversight Committee. This performance audit was conducted as a part of the Sunset Review set forth in Arizona Revised Statutes (A.R.S.) §§41-2351 through 41-2379.

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Development of Banking Department Responsibilities

The role of the Banking Department has changed significantly since 1922. The assets of State-chartered financial institutions have grown substantially although the number of banks has decreased. Through its insurance of deposits at State-chartered institutions, the Federal government now shares oversight responsibility with the Department. In addition, the Arizona Legislature has made the Department responsible for supervising a number of financial enterprises.

Financial Institutions - Financial institutions have changed significantly since the Department's beginning. Banks have shown the greatest transformation in numbers and assets. In 1922, Arizona had 58 State-chartered banks with assets of $54.9 million and 4 State-chartered savings and loan associations with assets of $1.4 million. There were also 22 national banks chartered by the Federal government. At that time, banks were small community units. Branch banking and growth of statewide banks did not begin until the late 1930s.

The 1920s and 1930s were a difficult time for Arizona banks. Numerous State-chartered banks failed. By the early 1930s bank failures became so numerous that the Superintendent of Banks opened special liquidating offices throughout the State. This greatly reduced the number of banks. Arizona now has fewer banks. In recent years the number of State-chartered savings and loan associations and credit unions has decreased. However, the assets of Arizona's State-chartered financial institutions have grown substantially since the 1920s. Assets now total in billions of dollars rather than millions (Table 1).

TABLE 1

STATE CHARTERED FINANCIAL INSTITUTIONS

Type of Institution	Date of Report	Number of Home Offices	Number of Branches	Assets (In Millions)
Banks	6/30/83	30	225	$5,382
Savings and Loan Associations	6/30/83	6	165	5,601
Credit Unions	12/31/82	63	-0-	455
Trust Companies	8/30/83	15	10	2,572
Consumer Finance Companies	6/30/82	150	-0-	709*

Source: State Banking Department

* Consumer loans accounted for $106 million of total assets.

In addition to these State-chartered institutions, a number of federally chartered financial institutions also operate and represent some of the State's largest banks and savings and loan associations in Arizona (Table 2). However, the State Banking Department does not have jurisdiction over federally chartered institutions.

TABLE 2

FEDERALLY CHARTERED INSTITUTIONS IN ARIZONA

Type of Institution	Date of Report	Number of Home Offices	Number of Branches	Assets (In Millions)
Banks	6/30/83	3	392	$11,932
Savings and Loan Associations	6/30/83	3	99	3,653
Credit Unions	12/31/82	67	N/A	716

Source: State Banking Department and National Credit Union Administration

The Federal Role - The financial crisis created by the Great Depression brought Federal agencies into the supervision of State-chartered institutions. In 1933, the Legislature required State-chartered banks to insure their accounts with the Federal Deposit Insurance Corporation (FDIC) which was established in 1933 to protect depositors against bank failure. In 1960 the Legislature required State-chartered savings and loan associations to obtain similar Federal insurance and in 1977 State-chartered credit unions were required to carry insurance on accounts with the National Credit Union Administration (NCUA).

As a result of these changes, both the State Banking Department and Federal agencies are involved in oversight of State-chartered banks, savings and loan associations and credit unions. To protect their interest (insurance) in State-chartered institutions, Federal agencies now also oversee the functional operations of these financial institutions. Federal agencies and the Department conduct joint examinations, and A.R.S. §6-128 allows the Department to accept Federal examination reports in lieu of State examinations.

During the past 5 years, the Banking Department conducted 28 audits of State-chartered institutions using its own examiners and 24 joint audits with Federal agencies. Federal agencies made 15 examinations on their own. The Department devoted over 4,400 staff days to examinations during the period, while the Federal agencies spent almost 4,800 staff days.

Financial Enterprises - Legislation enacted since the 1950s has added financial enterprises to the Banking Department's responsibilities. Enterprises are activities under the jurisdiction of the Department which involve financial transactions but are not institutions under Arizona law. These activities include collection agencies, escrow agents, debt management companies, mortgage brokers, motor vehicle dealers and sales finance companies. The Department is responsible for licensing, investigating complaints and examining 1,427 financial enterprises (Table 3). Unlike requirements for examining financial institutions, State law does not require a specific frequency of examination for enterprises.

TABLE 3

LICENSED FINANCIAL ENTERPRISES, MAY 31, 1983

Enterprise	Number of Home Offices	Number of Branches
Collection Agencies	140	7
Debt Management Companies	6	-0-
Escrow Agents	60	234
Mortgage Brokers	611	108
Motor Vehicle Dealers	530	-0-
Sales Finance Companies	80	164
Total	1,427	513

Source: State Banking Department

Budget and Personnel

Although the Department operating budget is appropriated from the General Fund, it collects fees from the industry for examinations, licenses, applications and investigations. The receipts go into the General Fund. Revenues from fees and expenditures are shown in Table 4.

TABLE 4

BANKING DEPARTMENT EXPENDITURES AND REVENUES, FISCAL YEARS 1981-82 THROUGH 1983-84

Expenditures	Actual 1981-82	Estimated 1982-83	Approved Budget 1983-84
General Fund:			
FTE positions	36	32	41
Personal services	$ 740,100	$ 692,900	
Employee-related expenses	144,700	139,700	
Professional and outside services	4,500	2,500	
Travel	51,100	53,500	
Other operating expenses	42,500	35,000	
Equipment	700	500	Lump sum
Total	$ 983,600	$ 924,100	$1,181,400
Revenues	$1,087,100	$1,159,500	$1,600,000

Source: Compiled by Auditor General staff from Joint Legislative Budget Committee Appropriations Report and Banking Department budget requests.

In addition, the Department has a $50,000 revolving fund derived from civil penalties assessed against institutions and enterprises. The purpose of the fund is to meet investigation and prosecution expenses. During 1983 the Department purchased data processing equipment for use in conducting investigations.

The Department had 32 positions during 1982-83. The 1983-84 budget authorizes an additional nine examiners, three of which will concentrate their efforts on investigations. The Department is organized into five divisions. Four divisions are in Phoenix: Banking, Savings and Loans, Licensing and Financial Enterprises and Consumer Affairs and Administrative Services. Two examiners work out of a fifth division located in Tucson.

Audit Scope and Purpose

Our audit focuses on the ability of the State Banking Department to perform duties as outlined by statute. The audit report presents findings and recommendations in four major areas:

- The need for Banking Department regulation of small loan companies,
- The effectiveness of financial enterprise regulation,
- The adequacy of Departmental oversight of financial institutions and the efficiency of its personnel utilization, and
- Conflict of interest statutes.

In addition, we developed information on interstate banking, Banking Department work-space needs and implementation of recommendations made in the 1979 Auditor General performance audit on regulation of collection agencies. The section "Other Pertinent Information" presents this information.

Due to time constraints, we were unable to address all potential issues identified during our preliminary audit work. The section "Areas for Further Audit Work" describes these potential issues.

The Auditor General and staff express appreciation to the Superintendent of Banking and Department employees for their cooperation and assistance during the audit.

SUNSET FACTORS

In accordance with A.R.S. §41-2354, the Legislature should consider the following 11 factors in determining whether the Banking Department should be continued or terminated.

1. Objective and purpose in establishing the Agency

Although Banking Department statutes contain no explicit statements of legislative intent, A.R.S. §6-110 states the Department will ". . . have charge of the execution of the laws of the state relating to financial institutions and enterprises." The Superintendent describes the Department's purpose as one of protecting the public welfare by "protecting the financial assets of the citizens of Arizona." This is accomplished by 1) license requirements, 2) examinations, and 3) resolution of consumer complaints.

The Department has responsibility for two areas of financial activity, institutions and enterprises. A.R.S. §6-181 states that regulation of banks provides for the safe and sound conduct of banks and the protection of interests of depositors, fiduciary beneficiaries and the public. A.R.S. §6-181 may apply to other institutions such as credit unions and savings and loan associations. In recent years these institutions have become more like banks, offering similar services and performing like functions. Consumer protection is the primary factor for regulating financial enterprises. Although statutes do not declare a specific purpose for regulating enterprises, Department officials contend that laws regarding enterprises protect the public from abusive practices such as fraud, misrepresentation and embezzlement.

2. The effectiveness with which the Agency has met its objective and purpose and the efficiency with which it has operated

Banking statutes mandate periodic examinations of financial institutions but not enterprises. The Department appears to be effectively meeting the statutory requirements for examining institutions with the exception of trust companies. In the case of trusts, the Department recognizes the problem and is taking action to improve future compliance (see pages 39-41).

The Superintendent has authority to perform examinations of licensed enterprises but is not mandated to do so. Presently the Department examines enterprises when there are indications of problems or illegal activities. Although this approach meets the statutory requirements, it provides limited oversight of enterprise operations. The Department needs to improve supervision of enterprises by examining a sample of enterprises each year (see pages 33-36).

The Department can also improve its efficiency in the use of personnel. The Department should: 1) investigate the potential for a revised audit scope to reduce personnel requirements and 2) develop a personnel management system to more accurately estimate work load and staff needs (see pages 41-44).

3. The extent to which the Agency has operated in the public interest

The Banking Department operates in the public interest by protecting the financial assets of the citizens through the following activities:

- Investigating new applicants. The Department performs a background check on each applicant for institution charters and most enterprise licenses. Based on the outcome of the investigation, the department issues or denies the application.

- Examining institutions and enterprises. The Department performs regular examinations of financial institutions to determine the soundness of operations and to prevent abusive practices. The Department currently examines enterprises only when problems occur. Routinely examining enterprises would more adequately serve the public interest (see pages 33-37).

- Investigating unlicensed activities. When unlicensed activities are suspected, the Department will investigate. If the investigation confirms the suspicions, the Department requires the operator to obtain a license or cease operation and may take appropriate legal action.

- Resolving consumer complaints. The Division of Consumer Affairs and Administrative Services investigates and resolves consumer complaints. A consumer complaint may lead to a full-scale investigation or examination, if warranted.

4. The extent to which rules and regulations promulgated by the Agency are consistent with the legislative mandate

The Department has broad rule-making authority as stated in A.R.S. §6-123. The Attorney General has approved the Department's current rules and regulations and certified that they are consistent with the statutes. A review of the rules and regulations showed that they focus on licensing/renewal requirements and operating procedures. The Department's regulations are consistent with the mandate to promote sound operations and to protect the consumer.

The Department is currently promulgating rules and regulations for two types of financial enterprises, escrow agents and mortgage brokers. Because of statutory changes made during the 1983 Legislative session, the Department is also repealing some savings and loan association regulations to maintain consistency with the new law.

5. The extent to which the Agency has encouraged input from the public before promulgating its rules and regulations and the extent to which it has informed the public as to its actions and their expected impact on the public

The Banking Department has encouraged public input for proposed revisions in its rules and regulations but provides little information to the public about its actions. The Department appears to be complying with the Administrative Procedures Act. The Department is currently in the process of repealing four rules and regulations. As required by law, the Department has sent the proposal to interested parties for comment. However, public information is limited. The Department seldom issues newsletters or press releases to inform the public of Department activities. The Superintendent cites statutory requirements (A.R.S. §6-129) to preserve confidentiality of information as reason for not actively providing information to the public.

The Department's reluctance to inform the public of its activities and areas of responsibility may diminish its effectiveness. The Department's Assistant Attorney General told us that the public does not always realize that the Banking Department regulates operations other than banks. For example, a representative of the Better Business Bureau said she thought the Department regulated only banks and collection agencies. Consequently, complaints may not reach the Department.

6. The extent to which the Agency has been able to investigate and resolve complaints within its jurisdiction

The Department appears to have responded adequately to complaints. During fiscal year 1982-83, 799 complaints were filed. We sampled 100 of these complaints and found that the Department handled them in a timely manner, with initial action generally taken within two days. Complaints were resolved within 18 days on the average. Twenty-nine complaints were resolved in the consumer's favor and fifty-one were resolved in the institution/enterprise's favor. Only five of the sampled complaints investigated violated Arizona Revised Statutes. The remaining cases are in litigation or have not been resolved in either party's favor.

7. The extent to which the Attorney General or any other applicable agency of State government has the authority to prosecute actions under enabling legislation

The Attorney General has the authority to prosecute actions concerning all Department statutes. The Superintendent indicates that the Department has a complete range of disciplinary options including the ability to 1) remove officers and directors of any licensee, 2) issue memoranda of understanding, 3) issue cease and desist orders, and 4) seek civil penalties through court action.

The Attorney General's office reported that as of April 30, 1983, six cases were in litigation and two cases were at the administrative hearing level. The office also reported that from July 1, 1982, to April 30, 1983, three judgments and eight cease and desist orders were issued in cases involving unlicensed or illegal activities. Civil penalities totaled $232,000 in these cases.

8. The extent to which the Agency has addressed deficiencies in the enabling statutes which prevent it from fulfilling its statutory mandate

The Department frequently attempts to clarify or strengthen statutes through minor amendments. The Department has proposed several changes in recent Legislative sessions such as revising credit union laws and regulating individual retirement accounts. The Department has also proposed new legislation in anticipation of future needs or in reaction to current problems. For example, during the 1983 session the Department sought and obtained jurisidiction over financial holding companies with the passage of Senate Bill 1320.

9. The extent to which changes are necessary in the laws of the Agency to adequately comply with the factors listed in the Sunset laws

Based on our audit work, we recommend the Legislature consider making the following changes in the Banking Department statutes:

- Amend A.R.S. §6-601 et seq to remove all licensing requirements for small loan companies and all interest rate limitations placed on these companies (see page 24).

- Amend A.R.S. §44-1201 et seq to require all lenders to fully inform each borrower about all State and Federal requirements concerning allowable charges and methods of computing interest rates (see page 25).

- Amend A.R.S. §44-1201 et seq to explicitly empower the Attorney General to enforce all State laws regulating lending activities (see page 25).

- Amend A.R.S. §44-281 et seq to delete all licensing requirements for motor vehicle dealers and sales finance companies and to empower the Attorney General to investigate violations of the Motor Vehicle Time Sales Disclosure Act (see page 37).

- Amend A.R.S. §6-101 to delete reference to §44-281 et seq from the definition of "Title." This change would make Banking Department statutes no longer applicable to motor vehicle dealers and sales finance companies (see page 37).

- Amend A.R.S. §6-113 to
  a. Allow professional staff to retain loans with entities regulated by the Department if 1) the loan existed prior to employment with the Department and 2) the employee continues to amortize the loan under its original terms and

  b. Require that each employee fully disclose all loans with entities regulated by the Department and the terms of such loans at the time of initial employment (see page 47).

10. The extent to which the termination of the Agency would significantly harm the public health, safety or welfare

Termination of the Banking Department would harm the public by increasing its exposure to deceptive practices of financial enterprises and reducing Arizona's control over financial institutions. The Banking Department is the only State regulatory

authority responsible for enterprises which pose economic risks to consumers. The Department shares oversight of financial institutions with a variety of Federal agencies and some overlap exists. However, the Department's chartering and examination of financial institutions allow State authorities to control the development and operation of these very important economic activities.

11. The extent to which the level of regulation exercised by the Agency is appropriate and whether less or more stringent levels would be appropriate

Banking Department regulation of financial institutions is appropriate. The Department meets statutory requirements for examinations. However, some regulation is not needed. The Legislature should consider eliminating State licensing of consumer finance companies, motor vehicle dealers and sales finance companies. None of these activities pose extensive harm to individual consumers which cannot be addressed through other less restrictive methods. Strengthening laws which require lenders to inform borrowers about charges, interest and loan requirements would adequately protect consumers (see pages 24-26 and 37).

Regulation of four types of enterprises is not adequate. Mortgage brokers, escrow agents, collection agents and debt management companies can pose significant financial harm to consumers. However, the Banking Department does not routinely examine these enterprises. To deter potential fraud and abuse, the Department needs to establish procedures to examine a random sample of financial enterprises each year (see page 37).

FINDING I

LICENSING SMALL LOAN COMPANIES IS NOT NECESSARY TO PROTECT CONSUMERS.

Protecting consumers does not require licensing small loan companies. Licensing is voluntary and the regulated portion of the loan industry is steadily shrinking. Further, consumer harm has been minimal. With sufficient information, consumers can adequately protect themselves when borrowing money from all lenders.

Recent changes in the statutes governing money lenders in Arizona have created a confusing, inconsistent regulatory environment. Prior to 1980, usury statutes limited interest rates to 12 percent. Companies wishing to exceed this limit could make loans with interest up to 36 percent if the company obtained a license from the Banking Department and complied with statutes and regulations governing such loans. The 1980 Legislature removed interest rates from all loans except those made by licensed companies. As a result, the loan industry is divided into licensed and unlicensed segments, each of which is subject to a variety of regulations often at a company's own discretion.*

Small Loan Companies Are Not Required to Be Licensed

Arizona statutes authorize the Banking Department to license consumer finance companies but do not require any small loan company to obtain a license from the Department. The Banking Department interprets the statutes as requiring only those companies which advertise "consumer loan" services to be licensed. Therefore, loan companies may determine the extent to which they will be subject to Departmental regulation by deciding whether or not to seek a license. Because companies choosing to be licensed are subject to more regulatory requirements than unlicensed

* Appendix I describes the regulatory requirements for both licensed and unlicensed loan companies.

companies, the law provides an economic incentive for companies not to be licensed. As a result, the number of licensed small loan companies in Arizona has declined in recent years.

Licensing Requirements Are Not Mandatory - Arizona law does not require small loan companies to obtain a license. An Arizona Legislative Council Opinion, issued August 23, 1983, states that A.R.S. title 6, chapter 5, article 1 does not require anyone making a consumer loan to be licensed by the State. More specifically, the Legislative Council Opinion noted:

> "Under the Arizona consumer loan act, A.R.S. section 6-602, subsection A states that it is unlawful for a person to make a consumer loan and charge and collect interest at a rate higher than the general usury rate unless the person first obtains a license. Since in Arizona the general usury rate is the rate set by the marketplace, i.e., there is no longer a prescribed limit, A.R.S. section 6-602 has no effect in requiring a consumer lender to become licensed." *

Banking Department Requires Some Licenses - Although the statutes do not require licensing for small loan companies, the Banking Department requires some loan companies to be licensed. The Department interprets A.R.S. §§6-601 and 6-602 to require companies which advertise or represent their services as "consumer loans" to obtain a license. A.R.S. §6-601 defines consumer loans as those in amounts of $10,000 or less and A.R.S. §6-602.A. states, "Any person . . . who advertises for, solicits or holds himself out as willing to make or procure a consumer loan is presumed to be in the business prescribed in this subsection." Based on the Department's interpretation, only those companies which choose to represent their services as "consumer loans" are required to be licensed. Companies representing their services under other terms such as "personal loans" are not required to be licensed. However, based on the Legislative Council Opinion, the Department's authority to require any loan company to be licensed may be questionable.

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* See Appendix II for the full text of the Legislative Council Opinion.

Licensed and Unlicensed Companies Subject to Different Regulatory Requirements - Licensed and unlicensed small lenders are subject to different regulatory requirements. All loan companies must adhere to the Federal truth-in-lending requirements of Regulation Z. However, those companies which elect to be licensed are also subject to additional requirements of Arizona law.

Federal Regulation Z--truth in lending--establishes disclosure requirements for both licensed and unlicensed small loan companies. Truth-in-lending regulations require the creditor to provide the borrower with specific information about the loan in an initial disclosure statement (see Figure 1). Truth in lending seeks to inform the borrower of interest charge calculations and rates to allow consumers to make comparisons among different sources.

In addition to the Federal regulations, Arizona law places certain restrictions on loans made by licensed companies. These provisions include:

- interest rate limitations (A.R.S. §6-622),
- allowable charges (A.R.S. §6-628),
- annual examinations (A.R.S. §6-122), and
- disclosure requirements (A.R.S. §6-621).

These statutes delineate maximum interest charges and specify other charges that companies may assess against borrowers. They also mandate that consumers receive a copy of the statutes which specify the interest rate limitations.* The statutes also require the Banking Department to examine each licensed company annually. However, only the consumer loan portion of a licensee's business is bound by these requirements. Licensees may also offer loans in greater amounts under the authority of A.R S. §44-1201 et seq.

* Licensees are not required to disclose which financing charges or types of insurance are permitted for consumer loans.

As illustrated in Figure 1, unlicensed companies conduct their lending activities entirely under the authority of the usury statutes A.R.S. §44-1201 et seq. These companies may charge whatever interest rates the marketplace will bear.* Other charges which may be assessed the consumer are specified in A.R.S. §§44-1205.A.3 and 44-1205.B. These loans are bound only by the Federal truth-in-lending disclosure requirements. Unlicensed companies are not explicitly required to reveal what financing charges or credit-related insurance policies are permitted in the usury statutes.

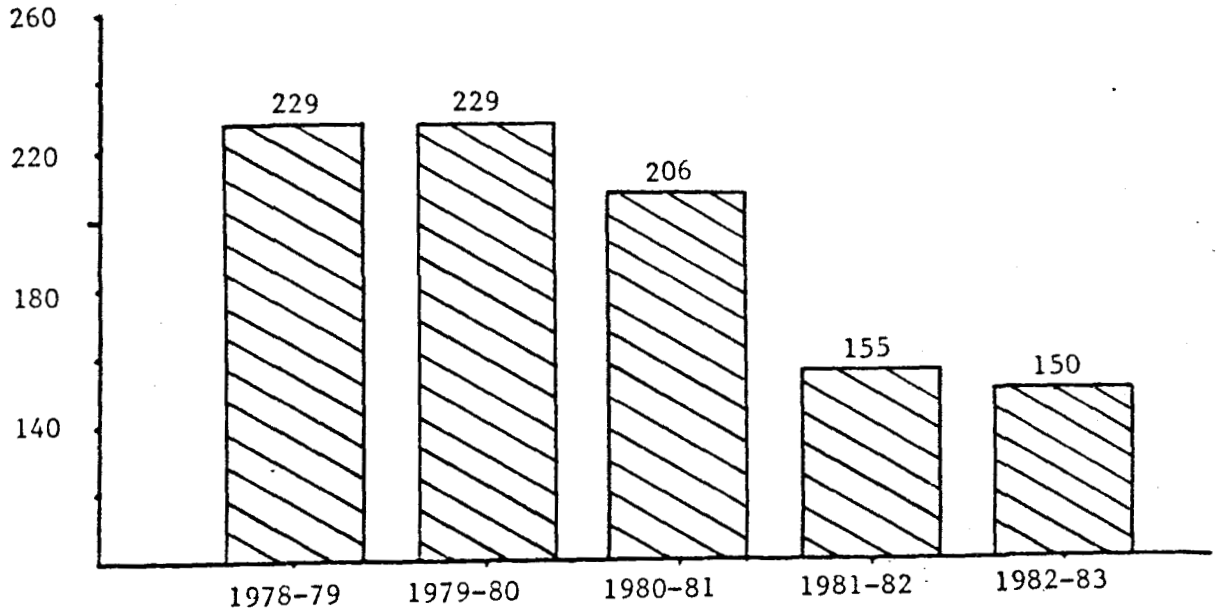
Reduction of Licensed Companies and Consumer Loans - The number of licensed small loan companies and amount of consumer loans has decreased. Since 1980 Arizona's usury statutes have provided an economic incentive for companies to choose not to be licensed. Prior to that year licensed companies could charge higher interest on their loans than unlicensed companies. The law now provides the opposite incentive: companies which are not licensed face no limits on their interest charges while licensed companies may charge only the interest allowed by law.

The number of licenses decreased by approximately 34 percent between fiscal years 1978-79 and 1982-83 (Figure 1). However, many of these companies remain in business making loans. For example, 6 of the 18 companies in Phoenix which surrendered licenses during 1981-82 were listed in the February 1983 Yellow Pages and still make small loans. In addition, the majority of the small loan companies listed in those same Yellow Pages were unlicensed as of June 30, 1983. This reduction of licensees has occurred statewide.

* A.R.S. §§13-2301 and 13-2302 indicate an annual percentage rate which exceeds 45 percent could be considered an extortionate extension of credit.

FIGURE 1

NUMBER OF LICENSED SMALL LOAN COMPANIES,
FISCAL YEARS 1978-79 THROUGH 1982-83

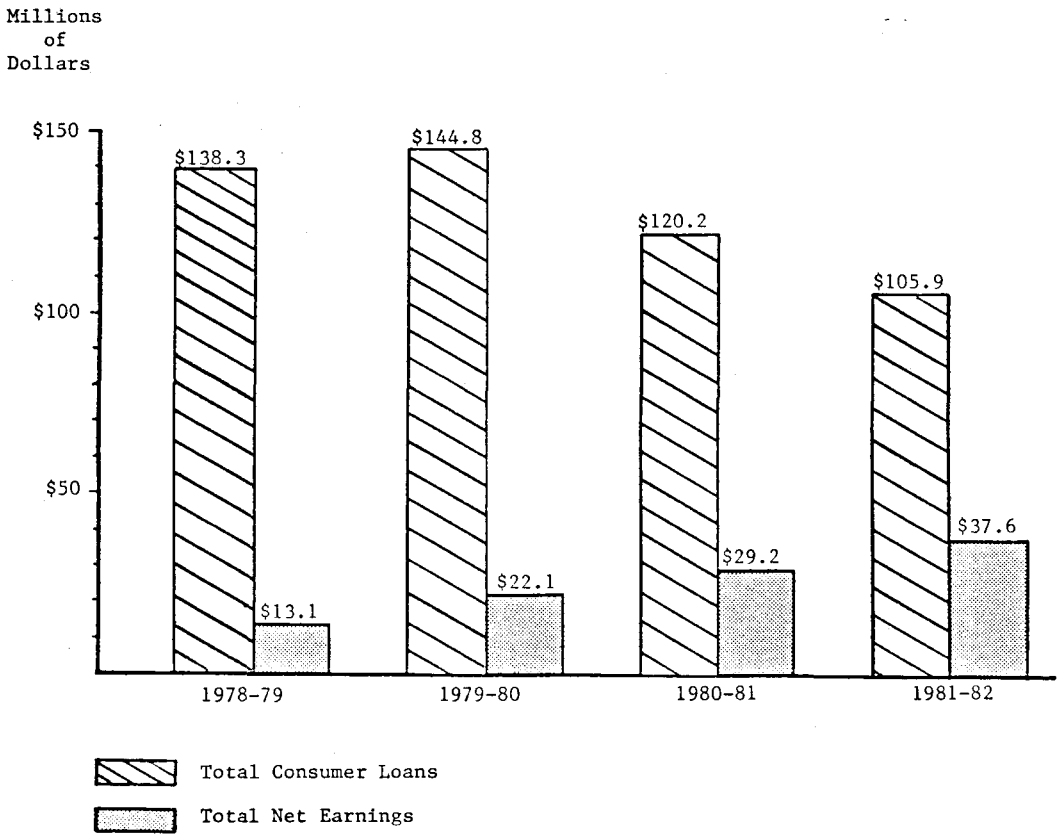


Source: Banking Department records

Moreover, "consumer loans" appear to comprise an increasingly smaller portion of the licensed companies' total lending activities. As illustrated in Figure 2, the licensed small loan companies have remained profitable, despite a reduction in the amount of money loaned as "consumer loans." Total consumer loans decreased by 23 percent between 1978 and 1982, but total profits on all loans almost tripled. Thus, licensees appear to be deemphasizing consumer loans in their asset bases and concentrating on other types of loans.

FIGURE 2

TREND IN SMALL LOAN INDUSTRY PROFITS VS THE AMOUNT OF CONSUMER LOANS, FISCAL YEARS 1978-79 THROUGH 1981-82



Source: Banking Department records

Arizona regulates loans in two very different ways. The Legislature has prescribed interest rate limitations for consumer loans and directed the Banking Department to supervise the activities of companies making these loans. At the same time, however, no company is required to submit to Departmental regulation and the law does not limit interest rates on other loans which constitute the majority of loan activity. As a result, regulation is inconsistent.

With Sufficient Information, Consumers Can Protect Themselves

Although borrowing money poses some risk, consumers can assume the responsibility for protecting themselves if they have sufficient information. However, existing disclosure requirements do not provide the borrower with sufficient information to permit comparisons among lenders. Strengthening existing disclosure requirements, supported by a consumer brochure, could provide the consumer with information necessary to make knowledgeable credit decisions.

Rationale for Licensing - Occupational and professional licensing and regulation seek to prevent significant harm to the public which may result from the unrestricted practice of particular occupation. The Council of State Governments has published criteria for assessing the potential for harm in a given occupation. Based on these criteria, the State should regulate a particular occupation if

- the unlicensed practice of an occupation poses a serious risk to the consumer's life, health or or economic well-being;
- the potential users of the occupational service cannot be expected to possess the knowledge needed to properly evaluate the qualifications of those offering services; and
- the benefits to the public clearly outweigh any potentially harmful effects such as a decrease in the availability of services, higher costs of goods and services and restrictions on optimum utilization of personnel.

In the case of small loan companies the amount and likelihood of harm coupled with consumers' potentials to evaluate the services indicate licensing is not necessary.

Harm to Consumers - Although borrowing money may entail some risk for the consumer, the risk is minimal. The Banking Department examines each small loan company annually, but these examinations have identified few problems. In addition, the Department receives relatively few complaints about small loan companies, and there has been no indication of widespread harm caused by the unlicensed companies.

Department examinations of licensed companies reveal few violations of statutes. During examinations, Department staff identify areas of noncompliance (recorded as errors) with A.R.S. §6-601 *et seq*. In fiscal year 1982-83, the Banking Department found no errors in approximately 57 percent of the companies examined. Furthermore, the majority of companies where errors were identified had three or fewer errors.

The Department receives relatively few complaints about small loan companies. Only 3 percent of a sample of approximately 100 complaints for 1982-83 were made against small loan companies.* Other regulated entities attracted a much higher level of complaints (collection agencies, 29 percent; mortgage companies, 25 percent). Complaints against the small loan companies involved questions about the appropriateness of a company's actions and disagreements over final disposition of the loan. The Department found no violation and took no action on any of the three complaints.

Finally, the fact cannot be ignored that a substantial proportion of the loan industry is not licensed--including many companies which were formerly licensed under the small loan company statutes. Since the 1980 changes in the usury statutes, consumers have been obtaining loans from a largely unregulated industry with little evidence of harm. Thus, there is no evidence to suggest that consumers would be at greater risk by removing what are currently voluntary licensing provisions.

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* During 1981-82, the Department received 44 complaints against small loan companies, 8 percent of the year's total complaints.

Consumer Information Not Adequate - Although risks are minimal, requirements do not ensure that consumers will have sufficient information to evaluate terms offered by lenders and make knowledgeable decisions. Both State and Federal regulations seek to inform consumers about loan requirements. But neither requires lenders to inform borrowers about many of these requirements. For example, A.R.S. §6-628 prohibits licensed loan companies from passing all but certain charges to consumers. However, the law does not require lenders to inform borrowers of the prohibition. The Federal truth-in-lending regulation is deficient in the same manner. Lacking information about legal requirements, consumers may be unable to compare charges against requirements and may be unaware that they are being overcharged.

Strengthened loan disclosure requirements coupled with a consumer brochure can enable the consumer to assume the responsibility of self-protection. The Legislature should strengthen State disclosure requirements and make them applicable for all lenders. Lenders should be required to disclose all Federal and State requirements for loan transactions. In this way, consumers would be aware of the pertinent information about interest charges and calculations, which financing charges are permitted by the State and those insurance policies which may be sold as a condition of the loan. A consumer brochure detailing 1) the specific limitations placed on small lenders and 2) consumer rights and means of recourse from unfair practitioners would further assist the consumer in making decisions.

Equipped with sufficient information, the consumer can compare terms among lenders. Providing consumers with information detailing which interest and financing charges are permitted by law would allow the public to compare actual charges against what is authorized by law and the prices of various financing charges among different small loan companies.

Providing consumers with sufficient information to compare loan terms and interest rates would also eliminate the need for the interest rate limitations in A.R.S. §6-622. With adequate information, consumers could judge interest charges for themselves along with other charges levied by lenders.

Also, with adequate disclosure requirements, consumers would continue to have recourse even if small loan companies are no longer licensed. If problems occur, complaints against small loan companies could still be brought to the attention of the Attorney General's Office or the Federal Trade Commission. However, Arizona law must contain comprehensive disclosure requirements which apply to all lenders to ensure that State control is maintained, and the Attorney General's Office will have full jurisdication over the loan industry.

Freeing Department Resources - Eliminating licensure would also free Department staff for other duties. The Banking Department's oversight of licensed small loan companies requires processing license documents, conducting examinations, compiling the Consumer Finance Companies' Annual Report and resolving complaints. Relieving the Department of this regulatory function would free up approximately 1.3 professional staff positions. In addition, the industry would save approximately $46,500 in annual examination fees.

CONCLUSION

Licensing small loan companies is not necessary to protect consumers. Because Arizona's statutes on licensing small loan companies are not mandatory, the majority of the small loan industry is unregulated. Lending activities can pose some risk to the consumer but strengthening existing truth-in-lending requirements can allow the consumers to protect themselves.

RECOMMENDATIONS

1. The Legislature should consider amending:

    a. A.R.S. §6-601 *et seq* to remove all licensing requirements for small loan companies and all interest rate limitations placed on these companies,

b. A.R.S. §44-1201 et seq to require all lenders to fully inform each borrower about State and Federal requirements concerning allowable charges and methods of computing interest rates, and

c. A.R.S. §44-1201 et seq to explicitly empower the Attorney General to enforce all State laws regulating lending activities.

2. The Banking Department should prepare a brochure to inform consumers about legal requirements governing disclosure of information about loan charges and interest.

FINDING II

ALTHOUGH THE STATE BANKING DEPARTMENT NEEDS TO STRENGTHEN SUPERVISION OF FOUR TYPES OF ENTERPRISES, TWO OTHERS DO NOT REQUIRE DEPARTMENTAL REGULATION.

Changes are needed in the regulation of Arizona's financial enterprises. Two types of enterprises, motor vehicle dealers and sales finance companies, pose limited harm to consumers and do not need to be regulated by the Banking Department. Four other enterprises now under the Department's jurisdiction do create financial risks and require regulation. However, the Department does not adequately supervise these enterprises and needs to examine them on a regular basis.

Financial enterprises are businesses under the jurisdiction of the Banking Department which involve financial transactions but are not institutions under the law. Arizona law defines six types of financial enterprises: mortgage brokers, escrow agents, collection agencies, debt management companies, motor vehicle dealers and sales finance companies. Over 1,400 enterprises conduct business in Arizona and their operations encompass a wide range of financial activities (Table 5). Although these activities are under the supervision of the Banking Department, Arizona law does not mandate a specific examination schedule as is the case for financial institutions.

Need for Regulation

Two of the six enterprises under the supervision of the Banking Department, motor vehicle dealers and sales finance companies, pose limited harm to consumers. Continued regulation is not required for these enterprises because consumers can adequately protect themselves if the Legislature strengthens existing truth-in-lending statutes. In contrast, the remaining four enterprises can create serious financial harm to individuals and businesses who use their services. Banking Department regulation is necessary to protect consumers who have little recourse for protecting themselves against financial losses from mortgage brokers, escrow agents, collection agents and debt management companies.

TABLE 5

TYPES AND NUMBER OF LICENSED FINANCIAL ENTERPRISES
MAY 31, 1983

	Home Offices	Branches
Motor Vehicle Dealers Sell on a noncash basis three or more motor vehicles at retail in any year	530	0
Sales Finance Companies Purchase retail installment contracts for motor vehicles from one or more retail sellers; also a retail seller who creates and holds motor vehicle installment contracts which exceed a total aggregate of outstanding indebtedness of $25,000	80	164
Mortgage Brokers Receive compensation for negotiating a mortgage loan; a mortgage loan is any loan secured by a mortgage or deed of trust on real estate	611	108
Escrow Agents Hold items of value (property, money, or evidence of title or possession) for another until fulfillment of a condition at which time items are delivered to a third party	60	234
Collection Agencies Collect claims owed to another party; also any person who in the process of collecting debts occurring in the operation of his own business, uses any name other than his own which would indicate that a third person is collecting such debts	140	7
Debt Management Companies As agent of a debtor, distribute payment of obligations to debtor's creditors	6	0
Total	1,427	513

Source: Compiled by Auditor General staff from Arizona Revised Statutes and State Banking Department records.

Licensing Not Needed for Two Enterprise Categories - Continued licensing of motor vehicle dealers and sales finance companies is unnecessary. These businesses pose limited harm to consumers. Arizona law provides adequate information to allow consumers to protect themselves in dealing with these businesses.

Although motor vehicle dealers who sell on contract are one of the largest enterprise categories, the Department receives few complaints. Only 1 of the 100 1982-83 complaints we reviewed involved this activity; only 7 of the 573 complaints during the previous fiscal year were about motor vehicle dealers. The individual harm is usually small and results from dealers failing to accurately inform consumers about interest charges.

Sales finance companies purchase installment contracts from motor vehicle dealers and in some cases actually write contracts. The potential harm is similar to that of motor vehicle dealers if the finance company writes the contract. If the company purchases the contract, the dealer who originally wrote the contract creates the potential harm. Only 1 of the 100 complaints we reviewed for 1982-83 was made against a sales finance company. The complainant alleged that the company fraudulently attempted to collect debts and repossess automobiles. The Banking Department found no violation of law and took no action against the company.

Licensing motor vehicle dealers and sales finance companies does not appear to be an effective means of protecting consumers. Because statutes do not authorize investigation fees for these enterprises, the Banking Department makes only minimal investigations of applicants for licenses. All applicants during the first seven months of 1983 were approved. Thus, licensing does not appear to pose a meaningful barrier to unscrupulous persons. Equally important, consumers may borrow funds from other sources, such as unlicensed small loan companies (see pages 15-26) which make loans for similar purposes. As a result, licensing does not appear necessary to protect consumers.

Arizona law and Federal regulations provide an effective alernative to licensing and regulation by the Banking Department. The Motor Vehicle Time Sales Disclosure Act (A.R.S. §44-281 et seq) establishes requirements and prohibitions for motor vehicle contracts. For example, the law requires that contracts be in writing and warn consumers not to sign if any provisions are left blank. In addition, Federal truth-in-lending regulations, enforced by the Federal Trade Commission, require lenders to disclose contract terms and charges to all borrowers. Thus, the law offers consumers some means to protect themselves against all businesses which make vehicle loans.

Strengthening Arizona law as recommended in Finding I (see pages 24-26) will enable consumers to decide for themselves about motor vehicle contracts. Authorizing the Attorney General to investigate violations of the Motor Vehicle Time Sales Disclosure Act will provide consumers with adequate recourse if problems occur.* By taking these actions, the Legislature will eliminate the need to regulate motor vehicle dealers and sales finance companies beyond the requirements applicable to all lenders.

Continued Regulation Needed for Four Enterprise Categories - In contrast to the two enterprises discussed above, continued regulation is needed for the remaining four enterprise categories. The primary need for regulating mortgage brokers, escrow agents, collection agencies and debt management companies arises from the large sums of money these enterprises hold in trust. Combined with complex operating procedures at the various enterprises, these trust funds provide opportunities for fraud and abuse.

MORTGAGE BROKERS AND ESCROW AGENTS offer the most dramatic examples of need for regulation. Although the Department lacks specific information on the sizes of these companies, one official estimated that a large brokerage company can exceed $100 million in loans per year. Recent Departmental investigations have revealed cases involving major fraud.

* According to the Banking Department's Assistant Attorney General, the Attorney General can now investigate such violations only at the Superintendent's request.

Example 1

A mortgage broker concealed adverse information about property for which clients were lending money. The company also concealed reports of unsatisfactory credit ratings on potential borrowers, misrepresented its services in advertisements, misrepresented charges, made unauthorized charges to customers and concealed charges. A two-year investigation resulted in more than $825,000 restitution to borrowers and lenders and payment to the State of over $200,000 in civil penalties and attorney fees.

Other investigations of mortgage brokers have resulted in restitutions of $5,400 and $7,600 for similar violations. Department officials anticipate that a current investigation will identify over $1 million in losses. In a similar manner, escrow agents can also harm consumers.

Example 2

An escrow agency handled an account involving several illegitimate land sales and transfers. Although the agency knew or should have known of the fraudulent practices, it did not disclose the information to the lenders. The Banking Department obtained a consent judgment against the company and its president which resulted in $25,000 in restitution for seven victims and $20,000 in civil penalties and attorney fees. Legal actions against three other individuals for consumer fraud, Banking Act violations and racketeering are pending.

Example 3

An escrow agent embezzled funds and failed to provide promised services. The Department expects its investigation of this case to result in restitution of $60,000 to $70,000.

Two current investigations of escrow agencies involve larger examples of fraud. In one case the Banking Department has identified an estimated $700,000 in potential claims. A second investigation involves losses which a Department official estimates to be in the "low to mid six figure range."

Mortgage brokers and escrow agents harm consumers by failing to properly discharge their trust responsibilities and misleading persons who seek their services. Almost half (47 percent) of the 100 complaints we reviewed were made against these two enterprise categories. Because the fraudulent activities are often internal and highly complex, potential victims are not in a position to adequately protect themselves.

COLLECTION AGENCIES also pose a threat to consumers, both creditors and debtors. The Department is currently investigating a case where a collection agency commingled funds paid by debtors and fraudulently misappropriated some $40,000.

In addition to financial fraud, collection agency practices may threaten debtors. For example, the Department found one agent who solicited sexual favors in return for more liberal payment terms. Collection agencies may also harass debtors by repeatedly calling them, threatening legal action when no grounds exist and using rude and abusive language. As a result, collection agencies were the single largest target of complaints we reviewed (29 percent).

DEBT MANAGEMENT COMPANIES can harm consumers by misappropriating funds in their trust. Debt management companies assist individuals in managing their finances. The individuals will usually turn over a portion of their income to the company which in turn pays the individuals' creditors. Two of the six debt management companies are nonprofit. The remaining four companies are profit oriented and usually charge an initial fee and a percentage of the funds they handle on behalf of the individual client.

Debt management companies manage accounts through trust funds into which they deposit client funds. The companies then pay clients' creditors from the trust funds. As with the other enterprises, trust funds held by debt management companies offer the potential for fraud. The Banking Department investigated one case involving embezzlement at a debt management company during 1982-83. The Department's investigation resulted in $6,200 restitution and a $10,000 civil penalty.

Department Does Not Routinely Examine Enterprises

Although four of six enterprises pose financial risk to consumers, the Banking Department does not routinely examine enterprises. Because other regulatory activities, such as licensing, do not necessarily screen out unscrupulous persons, the Department's failure to routinely examine enterprises means that it lacks an effective means for deterring illegal and unethical practices of mortgage brokers, escrow agents, debt management companies and collection agencies.

Regulatory Activities - The Department regulates enterprises in several ways. Each enterprise must obtain a license. Principal owners of mortgage brokerages, escrow agencies, collection agencies and debt management companies must submit personal histories and fingerprints. Persons applying for motor vehicle dealer and sales finance company licenses must also submit personal histories, but the Department only fingerprints applicants who indicate criminal records. Although the licensing investigation may screen out persons with known criminal records, the Department denies few applications. Between January and July of 1983 only 14 applicants out of 247 (6 percent) failed to qualify for a license. The Department also investigates complaints, but in most instances Department action consists of sending a form letter to the enterprise. Although recurring complaints against a particular enterprise may result in a special investigation, the extent of Banking Department control of enterprises through licensing and complaint investigation is relatively limited.

The final method of regulation is examination. State law does not mandate a specific examination schedule for enterprises. Rather, the Superintendent may examine these entities at his discretion. Despite their potential for deterring fraud and abuse, enterprise examinations are very infrequent.

Infrequent Examinations - The Banking Department has examined very few enterprises in recent years. During fiscal years 1980-81 through 1982-83 the Department conducted 29 examinations or investigations, less than 2 percent of the licensed enterprises (Table 6). Thus, the odds of being examined are only slightly more than 1 in 100 over a 3-year period.

TABLE 6

ENTERPRISE EXAMINATIONS, FISCAL YEARS
1980-81 THROUGH 1982-83

Enterprise	Number of Examinations	Average Number of Enterprises	Percent Examined
Mortgage Brokers	12	663	1.8%
Escrow Agents	2	316	0.6
Collection Agencies	7	143	4.9
Debt Management Companies	1	6	16.7
Motor Vehicle Dealers/ Sales Finance Companies	7	787	0.9
Total	29	1,913	1.5%

The limited number of examinations reduces the effectiveness of the Department's oversight. Departmental officials maintain that the Department lacks adequate staff to routinely examine enterprises. Currently, an investigation occurs only when the Department has reason to suspect problems. As a result, investigators may examine all records for a multiyear period. In two cases, investigations took two years to complete. While the Department's approach appears adequate for investigating suspected problems, the relative infrequency of examinations offers little deterrent against fraud and abuse.

Routine Examinations Would Improve Protection

The Banking Department can increase consumer protection against fraud in financial enterprises by developing procedures to conduct systematic, effective examinations of these entities on a routine basis. Such routine examinations would be a "spot check" of enterprises selected randomly and in sufficient numbers to deter potential wrongdoing. These examinations would focus on key documents and procedures most likely to identify problems. Routine examinations would not replace in-depth investigations but, rather, would identify enterprises failing to comply with legal requirements.

The Banking Department can develop effective procedures to ensure systematic examination of mortgage brokers, escrow agents, collection agents and debt management companies based on three principles:

- Identifying a random sample of enterprises in each category for examination. The Department would commit resources to examine all enterprises selected for each year's sample. Problems identified would be further investigated by the Department's existing special investigations team.

- Establishing priority areas for audit work. The Department should focus on transactions and documents which provide the clearest indications of compliance with the law (trust accounts and unified financial statements, for example).

- Sampling key documents. To promote efficiency the Department should review a sample of key documents at each enterprise under examination. Relatively simple statistical methods are available to ensure that sample documents are representative of all such records at an enterprise.

The cost of implementing routine enterprise examinations will depend on the size of the sample chosen. A 10 percent sample of enterprises (excluding motor vehicle dealers and sales finance companies) would require approximately 3.6 FTE positions; an 8 percent sample would require 2.9 FTEs (Table 7). If a routine examination disclosed serious problems, the Department could then conduct a detailed investigation similar to those it now conducts. Although additional staff would be required to conduct routine examinations, our audit work in Finding I indicates that the Department can provide 1.3 professional FTE positions by reassigning existing personnel (see page 24).

TABLE 7

ESTIMATED COSTS FOR ROUTINE EXAMINATIONS OF FINANCIAL ENTERPRISES(1)

	Sample Size	
	8 Percent	10 Percent
Number of Examinations	65	82
Hours Required	5,200	6,560
FTEs Required	2.9	3.6

(1) Assumptions: a) motor vehicle dealers and sales finance companies excluded, b) 80 staff hours per enterprise, and c) FTEs based on 1,800 direct hours per year.

CONCLUSION

The potential for fraud and abuse in many financial enterprises creates a clear need for regulation. However, because financial harm is limited, strengthened truth-in-lending requirements would provide adequate protection for persons dealing with motor vehicle dealers and sales finance companies. On the other hand mortgage brokers, escrow agents, collection agents and debt management companies require more extensive surveillance than the Banking Department currently provides. The Department can provide effective oversight of these financial enterprises by conducting routine examinations.

RECOMMENDATIONS

1. The Legislature should consider amending:
   a. A.R.S. §44-281 *et seq* to delete all licensing requirements for motor vehicle dealers and sales finance companies and to empower the Attorney General to investigate violations of the Motor Vehicle Time Sales Disclosure Act and

   b. A.R.S. §6-101 to delete reference to §44-281 *et seq* from the definition of "Title." This change would make Banking Department statutes no longer applicable to motor vehicle dealers and sales finance companies.

2. The Department should develop procedures to implement routine examinations for a sample of financial enterprises each year. Audit work at each enterprise should focus on a valid sample of priority transactions and documents.

FINDING III

OVERSIGHT OF FINANCIAL INSTITUTIONS IS ADEQUATE BUT THE DEPARTMENT CAN IMPROVE UTILIZATION OF ITS EXAMINERS.

The Banking Department adequately supervises State-chartered financial institutions but can improve the use of its examiners. The Department has met or exceeded statutory requirements for examining institutions in recent years. However, revising examination procedures and improving personnel management could increase departmental efficiency.

Examination and Follow-up Activities Are Adequate

The Banking Department adequately supervises State-chartered financial institutions. Our review of Department records for a five-year period shows that the Department has largely complied with statutory requirements for examining institutions and in most cases effectively followed up on problems identified during examinations. Although we found some shortcomings, they were not major and are being corrected.

Institutions and Supervisory Responsibility - Arizona law defines five types of State-chartered financial institutions: banks, savings and loan associations, trust companies, credit unions and small loan companies. The Department monitors the performance and conditions of these institutions through periodic examinations. Arizona statutes require the Department to examine these institutions on a regular basis. The required schedule is: 24 months for banks and savings and loan associations, every 12 months for trust companies and credit unions and each fiscal year for small loan companies.

Federal agencies such as the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation examine State-chartered institutions. Arizona law requires State-chartered banks, savings and loan associations and credit unions to carry Federal deposit insurance.

This protects depositor funds up to a specified dollar amount if an institution fails. As a result, all State-chartered institutions are subject to Federal regulation and examination. A.R.S. §6-128 allows the Banking Department to participate jointly with Federal agencies when conducting examinations. This section also permits the Superintendent to accept Federal examination reports in lieu of a State examination.

Examinations - Our review of examination records shows that the Department met statutory examination requirements for banks, savings and loan associations, credit unions and small loan companies. Table 8 shows that for banks and savings and loan associations, the average examination frequency was twice as often as required by law during fiscal years 1978-79 through 1982-83. The Department met requirements for examinations of credit unions each calendar year during this same period. Every small loan company was examined during fiscal year 1982-83 as required by statute. Federal agencies which share oversight responsibility with the Banking Department often examine the institutions jointly with the Department and consider Arizona's examinations to be comparable to their own.

TABLE 8

COMPLIANCE WITH EXAMINATION REQUIREMENTS,
FISCAL YEARS 1978-79 THROUGH 1982-83

Institution	Statutory Requirement	Average Time Between Examinations (1)
Banks	24 months	11.6 months
Savings and Loans	24 months	10.7 months
Credit Unions	each calendar year	12.5 months
Trust	12 months	13.6 months
Small Loan Companies	each fiscal year	(2)

(1) Includes Federal agency and joint Federal/State examinations. A.R.S. §6-128 allows the Superintendent to accept Federal examinations in lieu of State examinations.
(2) Due to the large number of small loan companies, we reviewed only one year of examination data. We found that the Department examined each small loan company during fiscal year 1982-83.

In contrast, the Department has not examined any trust companies since May 1982 when its trust examiner died. However, Federal agencies conducted six examinations and one jointly with the State. As a result the Department was able to meet examination requirements for all but two trust companies. The Department has hired an individual to begin training as a trust examiner who will begin work in October 1983.

Follow-up - The Department's follow-up of problems identified during examinations appears adequate. The Department acts to resolve problems using letters, telephone calls and unscheduled examinations to ensure that institutions correct problems. The only noticeable lack of consistent follow-up occurred in one credit union. The credit union operated for four years under an order to stop declaring dividends in excess of earnings. Although examiners noted the same problem during three of the last four examinations, the Department was reluctant to close the credit union as long as its capital remained sufficient and its Federal insurance was not in jeopardy. Until recently closure was the Department's only option in such matters. The 1983 Legislature authorized the Department to remove personnel responsible for such violations. The Superintendent believes that this authority will provide a credible means of ensuring compliance.

The Department Can Improve the Use of Professional Staff

Although supervision of financial institutions is adequate, the Department can more efficiently utilize its professional personnel. The Department may be able to improve staff utilization by investigating procedures developed by other agencies for increasing audit efficiency. Developing an accurate personnel management system would also contribute to more efficient use of personnel.

Efficiency of Institutional Examinations - The Department may be able to increase the efficiency of institutional examinations. Although most financial regulatory agencies follow procedures very similar to Arizona's,

approaches used by two organizations suggest that the Department may be able to reduce examination time without sacrificing effective oversight. The Department examines financial institutions to determine if they are financially sound. The standard examination is basically the same for all institutions and is very detailed. For example, examiners typically review 80 percent of each institution's loans.

The Department's detailed examination appears unnecessary compared to the process used by other agencies. The United States Comptroller of the Currency and the Virginia Bureau of Financial Institutions have developed procedures that suggest the Banking Department can ensure financial soundness with a less detailed examination of some institutional assets. Both agencies have changed from procedures similar to Arizona's to methods that they believe provide adequate oversight in a more efficient manner.

The Comptroller of the Currency bases the scope of its examination on a bank's financial condition as indicated by the previous examination. For banks with higher ratings Comptroller staff will review information supplied by the institutions. Unless this review identifies problems, the Comptroller will allow the maximum time allowed by policy (18 months) to elapse before examining an institution. When the examination takes place, it is limited to a review of the bank's financial report and a small number of loans. Banks with lower ratings, on the other hand, are examined more frequently and to a greater extent than higher rated banks.

The Virginia Bureau of Financial Institutions is changing its supervisory procedures in a similar manner. The Bureau collects information from institutions and from other sources and reviews it to identify potential problems. The review focuses on internal controls, assets which are subject to influences beyond the institution's control, previous examinations and institutional financial statements to identify problems. The extent to which this review identifies any problems determines the scope of the Bureau's subsequent examination.

Because these examination procedures are relatively new, experience with them is limited. However, the procedures may offer opportunities for staff savings that could be used to meet the growing responsibilities of the Banking Department. (For example, the number of banks has grown from 13 in 1978 to 30 in 1983, and beginning in 1983 the Department is responsible for supervising bank holding companies and international banks.) Much of the information used by the Comptroller and Virginia is now available to the Department or can be readily obtained from the institutions or outside sources. The Department should review the experiences of other states' and Federal agencies to determine if such procedures are applicable to Departmental activities.

Manpower Planning - The Banking Department lacks accurate information for estimating personnel requirements. Activity reports submitted by examiners do not provide sufficient information to departmental managers to allow them to estimate resources necessary to examine institutions. Without accurate activity reporting the Department will be unable to efficiently implement changes in examination procedures.

The Department does not systematically plan for institutional examinations. Departmental managers informally project manpower requirements based on previous years' experiences. However, the data base for these projections is limited. Department examiners do not report their time by activity. Rather, examiners report time only in terms of individual institutions (i.e., banks, savings and loan associations). Thus, the Banking Department can only project time required for existing examination procedures as a whole; the Department cannot estimate the impact of any procedural changes on personnel requirements for examinations.

The Department needs to develop a personnel management system which provides accurate estimates of personnel needed to conduct examinations. Improved reporting of examiners' activities and time would provide a more accurate basis for estimating staff requirements and developing agency

budgets. Review and analysis of time reports would generate the information a manager needs to estimate the time required for specific activities at each institution. In addition, time reports would identify problems such as high use of professional staff for clerical duties.

CONCLUSION

Although the Banking Department adequately supervises financial institutions, it can improve the utilization of its professional staff. The Department may be able to improve efficiency of institutional examinations by revising examination procedures. In addition, a personnel management system will improve Departmental budget estimates.

RECOMMENDATIONS

1. The Department should review examination procedures used by other states and Federal agencies to determine the feasibility of increasing the efficiency of examination procedures.

2. The Department should develop a personnel management system which provides accurate estimates of staff resources needed for examinations. The system should report time spent by individual examiners on major activities at each institution.

FINDING IV

THE CONFLICT OF INTEREST STATUTE FOR BANKING DEPARTMENT EMPLOYEES IS UNNECESSARILY RESTRICTIVE.

The statutory prohibition on certain loans to Banking Department employees is more stringent than necessary to prevent conflicts of interest. The prohibition may limit the Department's ability to attract qualified staff or cause hardship to new employees. Less restrictive requirements will reduce the potential hardship without increasing the risk of conflicts of interest.

Department Employees May Not Have Loans from Regulated Institutions

Arizona law prohibits all Banking Department employees from holding loans at institutions regulated by the Department. A.R.S. §6-113 provides that no Banking Department employee shall

> ". . . Be indebted, directly or indirectly, as borrower, accommodation endorser, surety or guarantor to any . . . financial institution or enterprise . . . [under the jurisdiction of the Department]."

The provision is intended to eliminate potential conflicts of interest by reducing incentives for collusion between Banking Department staff and regulated financial institutions or enterprises.

To comply with this requirement new employees holding loans with regulated entities must divest themselves of the loans. The employees must either refinance the loans with an institution not regulated by the Department (a national bank or federally chartered savings and loan association, for example) or pay it off. All Department staff, including clerical personnel, must comply with this statute.

A Less Restrictive Statute Will Effectively Prevent Conflicts of Interest

The prohibition against holding any loans with regulated entities may prevent prospective employees from accepting positions with the Department. However, the Legislature can prevent potential conflicts of interest among Banking Department personnel without prohibiting all loans from State-regulated entities.

Persons accepting employment with the Department may encounter financial hardships in complying with the law. Refinancing may result in penalty charges, procurement fees and higher interest rates. The cost of refinancing, especially of older housing loans with low interest rates, may prevent qualified candidates from accepting a position with the Department. Six of twenty-one employees had to refinance loans when they began working for the Department. Two employees paid prepayment penalties. Interest rates on a bank card and auto loans increased by as much as 10 percent for a third employee, and the interest rate for one employee's home mortgage went up by approximately 1 percent.

The 1983-84 appropriations act allows the Department to hire nine new examiners. Candidates with industry experience are preferred. However, the Department may encounter difficulty filling the positions. According to a Department official, one prospective candidate decided to not continue interviewing rather than refinance an existing loan.

Less restrictive controls used by other states' and Federal agencies effectively address potential conflict of interest situations without requiring employees to divest existing loans. These controls would allow Department employees to retain loans from regulated entities under certain conditions without creating a conflict of interest. If a loan existed prior to employment with the Department and the employee continued to pay it under the original terms, a loan from a regulated entity would offer no incentive for an examiner to compromise his or her objectivity.

The Federal Deposit Insurance Corporation (FDIC) and Federal Home Loan Bank Board (FHLBB) have functions similar to the Banking Department but allow their employees to have loans from regulated institutions. The FDIC permits its employees to retain loans existing prior to employment provided that they fully disclose the loans when they begin work. The employees may not change the terms of the existing loans, nor may they obtain new loans from regulated agencies. The FHLBB allows employees to obtain residential loans from regulated institutions. Employees must disclose the loan, provide a statement from the lender that the employee received no preferential treatment and make payments so as to avoid any penalties or late charges.

CONCLUSION

The statute prohibiting certain loans to Banking Department employees is unnecessarily restrictive. It may limit the Department's ability to attract qualified staff and create hardship to new employees. The Legislature can lessen existing restrictions without risk to the Department's impartiality.

RECOMMENDATIONS

1. The Legislature should consider amending A.R.S. §6-113 to
   a. Allow professional staff to retain loans with entities regulated by the Department if the loan existed prior to employment with the Department and the employee continues to amortize the loan under its original terms and
   b. Require that each employee fully disclose all loans with entities regulated by the Department and the terms of such loans at the time of initial employment.

2. The Banking Department should establish a policy of not assigning personnel to examine institutions from which they hold a preexisting loan.

OTHER PERTINENT INFORMATION

During the audit we developed pertinent information in the following three areas: 1) interstate banking, 2) Banking Department office space needs, and 3) the status of previous performance audit findings on the regulation of the collection industry.

INTERSTATE BANKING

Although a number of states have enacted or considered legislation to allow out-of-state bankholding companies to operate within their boundaries, "interstate banking" involves much uncertainty and speculation. Nine states allow some form of interstate banking. Statutes in some of these states permit only limited operations while other states allow a full range of services. The different provisions in these state laws reflect the varying purposes each state seeks in permitting out-of-state banks to operate.

Federal Law Allows States to Restrict Interstate Banking

Under existing Federal law each state may prohibit interstate banking. Title 12, §1842(d) of the United States Code prohibits a bank holding company from acquiring "all or substantially all" assets of a bank outside of the state where it principally operated on July 1, 1966, unless specifically authorized by a state. Arizona law defines banking as taking deposits subject to payment on request (A.R.S §6-201.B.) and prohibits any one "except a national banking association with its principal place of business in this state. . ." from engaging in banking business without a permit from the Arizona Banking Department (A.R.S. §6-201.A.). State law (A.R.S. §6-204.A.1) further requires that applicants for State bank charters be Arizona corporations. Department policy limits out-of-state ownership of Arizona banks to 20 percent. Thus, all banks operating in Arizona must be domiciled within the State if they wish to take deposits.

Arizona law affects national banks as well as State-chartered banks because Federal law recognizes State primacy in this area. As a result, interstate banking is not permitted in Arizona. The prohibition does not mean that out-of-state banks are not active in the State. Several large banks, such as Citibank and Chase Manhattan operate loan companies in Arizona. Arizona businesses and individuals may also seek loans from out-of-state banks if they wish. However, A.R.S. §6-201.A. prohibits such banks from accumulating capital by taking deposits in Arizona. Thus, out-of-state banks must finance loans with their own capital brought into the State.

The statute barring interstate banking in Arizona has been in effect since at least 1922. Although no specific documentation of intent is available, the purpose of this law appears to be to ensure that Arizona's capital remains within the State to promote its economy and growth. Without such a statute, an out-of-state bank could accumulate capital by taking deposits from Arizonans and then using the capital in another state or foreign country. According to the State Banking Superintendent, the prohibition also allows the Department to exercise greater control over banks because they will be owned by Arizona corporations.

Some States Allow Interstate Banking

In recent years, several states have enacted legislation to permit some form of interstate banking. As of May 1983, nine states permitted out-of-state bank holding companies to acquire or establish banks within their borders. Another 10 states were considering similar legislation. Two states, Delaware and South Dakota, claim that interstate banking has created new employment opportunities and increased tax revenues. Interstate banking has increased capital availability in Maine, according to that state's superintendent of banking.

An analysis of interstate banking in the nine states reveals that there are three types of interstate banking laws: 1) full-service banking, 2) limited operations, and 3) aquisition of troubled banks. Of the three types only the first allows a full range of services across state lines. The remaining approaches limit bank activities within the host state.

Full Service Interstate Banking - Full-service banking allows banks to offer a complete range of services across state lines. States use two approaches to full-service banking: regional and national banking. Regional banking permits interstate banking among states in a given area of the country. The six New England states are developing legislation to allow banks within the region to conduct interstate business. One of these states, Maine, also extends the invitation nationally. Besides Maine only two other states, Alaska and New York, allow national full-service banking. Even where states invite out-of-state banks to acquire institutions, there are some restrictions. For example, Maine requires that the entry of an out-of-state bank results in a net capital increase to the state. In addition, most states allowing national or regional full-service operations require that the out-of-state bank's home state extend similar privileges to banks in the state where it seeks to operate.

Interviews with banking officials in New York and Maine show that the two states seek different goals from full-service interstate banking on a national basis. New York's law allows its banks to take advantage of similar legislation in other states. As the nation's major banking center, interstate banking benefits the many large banks headquartered in New York by allowing them to expand into new markets. Maine, on the other hand, seeks to import capital and banking services not available to the state. Interstate banking offers out-of-state banks a market in which to expand their operations while making additional capital available to

Maine's businesses. Although Maine was among the first states to permit interstate banking, the first acquisition of a Maine bank by an out-of-state bank took place in May 1983. The acquisition resulted in an infusion of new capital by the acquiring bank according to Maine's banking superintendent.

Limited Operations - Several states specifically limit the activities of interstate banks operating within their borders. The most common restriction is to limit the out-of-state bank to one office for the purpose of establishing a national credit card operation. South Dakota and Delaware pioneered this concept in 1981. Virginia and Nebraska enacted similar legislation in 1983. In most cases, these states enhance their attractiveness as a location for such operations by emphasizing economic incentives (no limit on interest rates or low taxes) and geographic and logistic advantages.

The potential for attracting economic development is largely responsible for much of the interest in interstate banking. Delaware, according to its banking superintendent, has attracted 11 bank credit or wholesale operations which have produced 1,500 direct jobs and increased state tax receipts from banking from $2.2 million in 1981-82 to an estimated $7.5 million in 1983-84. South Dakota has attracted one out-of-state bank and 900 new jobs according to officials in that state.

States seeking bank operations impose a variety of restrictions on the out-of-state banks to protect their own banks from competition from the larger out-of-state banks. Delaware and Virginia impose specific restrictions on the out-of-state banks: number of offices, minimum capital and employment requirements and a prohibition against soliciting local business. Banks deciding to operate in these states must agree to these terms in order to gain the state's approval of its entry into the state. South Dakota relies on the limited attraction of its financial markets to restrict operations of outside banks. Regardless of the method, officials in these states clearly indicate that they want to attract the jobs created by bank operations without increasing competition with in-state banks.

Troubled Banks - One state, Washington, allows out-of-state banks to acquire banks which are experiencing financial difficulties. This legislation allowed the Bank of America to acquire the SeaFirst Bank which was close to bankruptcy in 1983. One other state, Oregon, is considering similar legislation. This type of interstate banking provides a means for rescuing troubled banks when no in-state institution is willing or able to do so.

Industrial Banks Would Permit Interstate Banking in Arizona

In addition to the methods discussed above, establishing industrial banks would allow out-of-state banks to take deposits in Arizona. The Federal prohibition against interstate banking does not include industrial banks such as those authorized by A.R.S. §6-331 through 6-338. Title 12, §18-42(d) of the U.S. Code applies only to banks which accept demand deposits (checking accounts) and make commercial loans. Industrial banks in Arizona may not accept demand deposits. Thus, the Banking Department has no authority to deny an out-of-state bankholding company permission to open an industrial bank simply because the holding company is not located in Arizona. Existing State law, however, imposes restrictions on industrial banks which offer little incentive for their creations. Industrial banks may not make loans in excess of $1,000 and interest may not exceed 10 percent. As a result, Arizona has no industrial banks.

The 1983 Legislature considered changes in State law which would have increased the attractiveness of industrial banking and would have created opportunities for out-of-state banks to take deposits in Arizona. Senate Bill (SB) 1219 would have removed the limits on loan amounts and interest rates for industrial banks, thus enhancing their attractiveness. The Legislature did not pass the bill. Enactment of such legislation would permit the creation of industrial banks owned by non-Arizona banks or investors. However, SB 1219 did not restrict the movement of capital held by industrial banks. As a result, the bill offered no protection against taking deposits in Arizona for use outside the State.

Does Arizona Need Interstate Banking?

Interstate banking varies considerbly from state to state, depending on each state's goals. Deciding whether or not Arizona should permit interstate banking will depend on what goals the Legislature hopes to achieve. Banking officials and regulators do not agree on this question.

Representatives of larger Arizona banks support the idea of interstate banking in Arizona. They say that such deregulation will increase services and lower prices through competition. These bankers acknowledge that the competition may drive smaller banks out of business or force them to merge,* but maintain that this is due to the greater efficiency of larger banks.

Representatives of one New York bank which has moved into interstate operations also suggest that interstate banking would benefit Arizona by increasing competition within the State. The out-of-state banks could also provide employment opportunities by locating operations centers in Arizona. Although one representative noted that no law prohibits out-of-state banks from establishing operations centers, Arizona law limits their potential for offering other financial services.

The president of one small bank, on the other hand, claims that the disappearance of smaller, locally oriented banks will result in less service to many Arizona citizens and communities. Large banks would be more attuned to national markets and less likely to meet local needs according to the president of one small bank. This banker also disputed the benefits of competition from interstate banking by predicting that banking would become more concentrated and less competitive after the initial period of adjustment.

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* The Superintendent of Banking suggests that some smaller Arizona banks would be bought at profitable terms by larger out-of-state banks as a means of gaining entrance into the Arizona market.

The Banking Superintendent and one Arizona economist questioned the benefit of interstate banking. Both think permitting out-of-state banks to take deposits in Arizona would provide little benefit to Arizonans. Existing State and national banks provide 800 branches for business and can add more branches anywhere in the State because Arizona permits statewide branching. They also maintain that Arizona does not lack capital for economic growth. The Superintendent also noted that Arizona need not allow out-of-state banks to take deposits to attract bank operations centers and promote job growth. He added that as a practical matter, however, banks will seek deposit authority in return for the potential jobs they will bring.

A representative for the Conference of State Banking Superintendents (CSBS) also expressed reservations about the benefits of interstate banking. CSBS supports state authority to either permit or restrict interstate banking. However, the representative noted that growing states such as Arizona are attractive investments which may not need interstate banking to enhance this attractiveness. He said that any state which considers interstate banking must carefully define its intended objectives and draft legislation accordingly.

Our review of other states' experiences with interstate banking confirms the CSBS observation that interstate banking legislation needs to be precisely drafted. Of the five states we contacted, all placed some restrictions on out-of-state banks. Only New York has a relatively unrestricted law. Other states impose requirements which vary in restrictiveness to ensure that interstate banking achieves its desired purpose.

The decision to authorize interstate banking, and in what form, will rest on the Legislature's estimate of Arizona's economic climate. If Arizona needs to attract additional employment opportunities, banking services or capital or desires to increase competition in the industry, interstate banking may be a desirable option. If Arizona can benefit from the growth

generated by its large banks expanding into out-of-state markets, an interstate banking law may contribute to this expansion. Any legislation to authorize interstate banking should carefully define the desired objectives and establish provisions to ensure achievement of those objectives. If, on the other hand, Arizona's economy will not benefit from such opportunities, then interstate banking may not be advisable.

OFFICE SPACE NEEDS

Our observations during the course of the audit suggest that space is a critical problem. Although further audit work is necessary to ascertain the extent of space problems, it appears that space is not adequate for existing staff. In addition, State planning guidelines may not be appropriate for Banking Department needs.

Existing Space Is Not Adequate

Banking Department personnel do not have adequate work space. Although most examiners spend the majority of their time in the field, at least seven examiners are in the office each workday. Currently some examiners share office space with division chiefs or work in a file room. Examiners frequently share desks and small tables for workspace. In one case a division chief shares his desk with an examiner. Another examiner has a chair and a clipboard for his work area.

The Banking Department also lacks private office space. Although each division chief has a separate office, he shares it with one or two examiners. If a division chief meets with individuals to discuss confidential matters, any examiners who are present must find another area in which to work and may have limited or no access to resource material in the chief's office. One division chief shares his office with the Department's computer, various materials and records and two examiners. In the future computer training also will take place in this office.

Storage space also appears to be inadequate. The Department maintains records for each of the 2400 licensed institutions and enterprises. The most current records are located in the office. File cabinets and boxes cover almost every wall. The basement storage area is full and the Department must rent an additional 400 to 450 square feet of space to store materials.

State Space Guidelines May Not Meet Department Needs

Current guidelines for agency office space may not be appropriate for the Banking Department. The Division of Property Management within the Department of Administration estimates the basic space requirement to be 125 square feet per FTE position. This figure includes a small amount of storage and corridor space. Using this criterion, the Banking Department requires between 2,500 and 2,625 square feet of space.* The Department has 2,360 square feet plus 140 square feet for storage.

However, the property management guidelines do not take into account field personnel who are in the office infrequently or exceptional storage requirements. To account for such needs the Department assesses each agency individually. The crowding observed during our audit work strongly suggests that space is not adequate. Further research is necessary to determine whether the property management guidelines provide adequate work and storage space for an agency such as the Banking Department.

* Based on 20 and 21 FTE positions. Although the Banking Department has over 30 employees, we estimated space requirements using a lower number to account for the fact that many employees are usually working in the field.

STATUS OF 1979 AUDIT FINDINGS ON REGULATION OF THE COLLECTION INDUSTRY

The June 1979 Performance Audit Report, The Collection Agency Advisory Committee and the Regulation of the Collection Industry in Arizona, presented four findings regarding regulation of collection agencies. Of the four findings, the Legislature and the Department fully implemented two, took no action on one and made changes other than those recommended in one.

Finding: The Superintendent of Banks Needs Additional Regulatory Authority to Adequately Police the Collection Industry.

The Legislature implemented all recommendations made in this finding. The Superintendent received additional powers to regulate the collection industry. Table 9 compares the Superintendent's powers in 1979 to his current authority. The Superintendent's authority over collection agencies is now comparable to his authority over the other industries under his jurisdication.

TABLE 9

REGULATORY POWERS OF SUPERINTENDENT OF BANKS, 1979 and 1983

Regulatory Powers of Superintendent	1979	1983
May initiate investigation into financial records of licensee	No(1)	Yes
May issue cease and desist orders	No	Yes
May order removal of corporate officer	No	Yes
May issue temporary restraining order	No	Yes(2)
May apply to superior court for enforcement of his actions	No	Yes
May revoke or suspend licenses	Yes	Yes
May issue written warnings	Yes	Yes
Attorney General may bring legal action at request of Superintendent	No	Yes
May assume active control of business	No	Yes

(1) The Superintendent had the responsibility to appoint a CPA for investigation. However, the 1979 audit did not consider this as "regulatory authority."

(2) The Superintendent has the right to go to court to seek a temporary restraining order but the issuance of the order is at the discretion of the court. Temporary restraining orders are court orders.

Finding: The State Banking Department Needs to Expand Its Regulatory Authority over Collection Activity.

The Department has taken no action on this finding. This finding recommended amending the statutes to permit the Banking Department to license individual collectors. Although the Department supports the recommendation and has considered such action, no legislation has been introduced to effect the recommendation. The Department continues to license only the responsible party of a collection agency, not individual collectors.

Finding: Financial Information Submitted by Collection Agencies Is Not a Valid Indication of Financial Responsibility.

The Department has implemented this finding. The audit recommended use of a financial form which provided information similar to one used by Nebraska. The Department adopted a new financial statement form in December 1979. This form is similar to the one recommended but requires more information.

Finding: Changes Needed to Enhance the Superintendent of Banks' Ability to Regulate the Collection Industry.

This finding cited four areas for improvement (Table 10). The only change in these areas concerned the examination of collection agencies. The Auditor General recommended that the Legislature amend A.R.S. §32-1052 to authorize the use of Banking Department examiners for routine examinations and to require licensees to pay examination fees. Although the specific recommendation was not followed, the same results were achieved. The Legislature repealed A.R.S. §32-1052 and amended Title 6 to include §32-1001 *et seq* thereby giving the Banking Department full authority to license and examine collection agencies.

TABLE 10

STATUS OF RECOMMENDATIONS ON ABILITY TO REGULATE COLLECTION AGENCIES

Recommendations	Status	Comments
Amend statutes to incorporate provisions of Federal Consumer Credit Protection Act	No Change	Statutes were not amended; the provisions are in the Department rules and regulations as they were at time of audit
Amend A.R.S. §32-1025 to include a $5 per day penalty fee	No Change	Statutes were not amended
Amend A.R.S. §32-1052 to authorize use of bank examiners to routinely examine collection agencies and to require licensees to pay examination fees	Change	A.R.S. §32-1052 was repealed and Title 6 was amended to include A.R.S. §32-1001 *et seq* thereby giving the Banking Department full authority to license and examine collection agencies
Inform public of Banking Department's role in regulating collection agencies through public service announcements	No Change	The specific methods recommended were not implemented

AREAS FOR FURTHER AUDIT WORK

During the course of the audit, we identified several potential issues which we were unable to complete due to time constraints. We have listed these issues as areas for further audit work. These include as follows:

- Would the adoption of a uniform licensing procedure for all enterprises be more efficient and equitable than individual requirements?

- Does the present fee structure for licensing and examining institutional enterprises cover all costs of regulation?

- To what extent will changes in Federal laws governing the provision of financial services affect the Banking Department's ability to effectively regulate institutions and enterprises?

- Should all Department activities be funded through a revolving fund supported by fees collected from regulated entities?

- Should persons who purchase receivables from the original creditors and collect these accounts as their own be required to comply with regulations similar to those governing collection agencies?

STATE BANKING DEPARTMENT

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PHOENIX, ARIZONA 85007

WALTER C. MADSEN
SUPERINTENDENT OF BANKS

TELEPHONE
(602) 255-4421

October 25, 1983

OCT 1983
AUDITOR GENERAL

Douglas A. Norton, Auditor General
Auditor General's Office
111 West Monroe, Suite 600
Phoenix, Arizona 85003

Dear Mr. Norton:

I have received a copy of the revised preliminary draft of the performance audit of the State Banking Department. This response is directed towards the summary of Sunset Factors, Findings I through IV, and comments concerning the other areas discussed in the report.

SUMMARY

Licensing Small Loan Companies Not Necessary to Protect Consumers

While Arizona has no usury laws which makes regulation of small loan companies somewhat superfluous, complete deregulation does contain some hazards. While looking at implementing various consumer protection laws and disclosure requirements, we should also consider the in present laws that allow industry choice of licensing. We should require licensing for all or none.

The recommended regulatory authority for the Attorney General can best be dealt with by that office, however, if this responsibility is assumed, some exemption for financial institutions should be considered.

Changes Needed in Regulation of Financial Enterprises

The recommendation to no longer license motor vehicle dealers, and sales finance companies is workable, however, the lack of consumer complaints and problems may be the result of few examinations and little consumer awareness as much as any perceived limited harm to consumers. As noted, the department does not routinely examine financial enterprises, and such a program is definitely needed. Before the statistical examination program can be implemented, additional staffing and office space will be required.

The Department Can Improve Utilization of Its Examiners

The department can and will review examination procedures used by other states and Federal agencies which might increase our efficiency. Top-down examination techniques used by the Comptroller of the Currency are now used by the department in larger institutions, however, the large number of new companies now operating in Arizona dictate a closer review program - at least until such time as a proven successful track record is in place. The department will work at developing a program for accurately forecasting staffing needs for examinations.

The Conflict of Interest Statute for Banking Department Employees Is Unnecessarily Restrictive

The recommendation for amending A.R.S. Section 6-133 is appropriate with the two provisions discussed in the report included. Consideration should be given to exempting all clerical employees from A.R.S. Section 6-113, because they have no direct contact with any licensees.

SUNSET FACTORS

1. Objective and purpose in establishing the Agency

   No comment.

2. The effectiveness with which the Agency has met its objective and purpose and the efficiency with which it has operated

   More effective regulation and oversight of financial enterprises can be accomplished only through increased staffing, and consideration should be given to making examinations mandatory. There is no question that more supervision of enterprises is needed, and a "Sample" examination program can be implemented with adequate staffing.

   The department will review the examination scope to find efficiencies, and hopefully reduce staffing requirements. Further, consideration will be given to developing a different personnel management system.

3. The extent to which the Agency has operated in the public interest

   No comment.

4. The extent to which rules and regulations promulgated by the Agency are consistent with the legislative mandate

No comment.

5. The extent to which the Agency has encouraged input from the public before promulgating its rules and regulations and the extent to which it has informed the public as to its actions and their expected impact on the public

The department has not been reluctant to inform the public of its activities, but rather has relied on the advise of counsel that the language of A.R.S. Section 6-129 prevented disclosure of most all department activities. Changes made during the 1983 session of the Legislature now allows disclosure concerning financial enterprises, and a press release program has been implemented.

6. The extent to which the Agency has been able to investigate and resolve complaints within its jurisdiction

No comment.

7. The extent to which the Attorney General or any other applicable agency of State government has the authority to prosecute actions under enabling legislation

No comment.

8. The extent to which the Agency has addressed deficiencies in the enabling statutes which prevent it from fulfilling its statutory mandate

No comment.

9. The extent to which changes are necessary in the laws of the Agency to adequately comply with the factors listed in the Sunset laws

The changes recommended are discussed elsewhere in this response.

10. The extent to which the termination of the Agency would significantly harm the public health, safety or welfare

No comment.

11. The extent to which the level or regulation exercised by the Agency is appropriate and whether less or more stringent levels would be appropriate

The enterprise problems discussed are not a matter of adequate regulation, rather they are a matter of inadequate statutes. Examination of enterprises should be mandatory, not optional as is now the case, and with such an examination program, adequate staffing must be provided.

FINDING I

Finding I addresses the question of totally eliminating the licensing and regulation of small loan companies by the Banking Department.

The licensing problem is the result of the apparent conflict between A.R.S. Section 44-1201 and 6-601 et. seq., and a part of the review function should include consideration of licensure for all lenders of $10,000 or less.

A further consideration is that deregulation would most likely result in the elimination of any source for the public to borrow very small amounts. Very small loans are viewed as unprofitable to lenders, even if interest rates are high on the loans, and most lenders if unregulated would probably cease making small loans.

A brochure to inform consumers about laws is a workable recommendation, however, brochures and disclosures do not necessarily create an informed borrower in that few are equipped for instance, to determine the authenticity of a disclosed "A.P.R." (annual percentage rate).

FINDING II

Oversight and regulation of Financial Enterprises could clearly be improved. In addition to the deregulation of motor vehicle dealers and sales finance companies, consideration should be given to making the examination of enterprises mandatory rather than permissive as is presently the case. Mandatory examinations and even the statistical examination proposal discussed in the audit report will require adequate staffing for implementation.

FINDING III

In discussing the department's follow-up techniques, the report discussed the situation with one credit union where follow-up was regarded as not consistent. It should be noted that the credit union involved paid a monetary fine and was ultimately merged into an existing stronger credit union with no loss to the members of the credit union.

Examination Efficiency

The department will certainly look at the methods used by the Comptroller of the Currency and other agencies as a means of increasing efficiency. The comptroller and the other agencies using the methods detailed in the audit rely extensively on computerized monitoring programs, and even though the department has funds to purchase such equipment we have been unable to do so.

While some efficiencies may be found, care must be taken to avoid excessive risks and unfamiliarity with what is going on in each institution. Historically, National Banks have failed with a much greater impact on the public - PennSquare National Bank being a case in point. This could well result, at least in part, from inadequate examination. Moreover, monitoring examinations as discussed in the audit can only be used where a history of operation is available. Sixteen of thirty-two, or fifty percent, of the state chartered banks have opened in the last two years, and have no history available for monitoring purposes. On-site extensive examinations are required in new institutions if potential problems are to be dealt with in a prompt meaningful manner.

The department will develop a personnel management system to more accurately measure professional staffing needs.

In conclusion, I would like to thank Bill Thompson and the remainder of your staff for the professional and competent manner in which the performance audit was conducted. We all learn from audits, and this one has not been an exception.

Very truly yours,

Walter C. Madsen

APPENDIX I

STATE AND FEDERAL REGULATORY REQUIREMENTS FOR LOAN COMPANIES IN ARIZONA

REQUIREMENTS FOR LICENSED SMALL LOAN COMPANIES
(Consumer Finance Companies)

Loan Services	Statutory Requirements
All loans	Federal Truth-in-Lending Requirements - Regulation Z (see discussion under unlicensed companies, p. I-3)
Loans under $10,000 which are adverstised as consumer loans	Title 6, Chapter 1 A.R.S. §6-122 - Annual examinations Title 6, Chapter 5 A.R.S. §6-621 - Disclosure requirements - a printed copy of A.R.S. §6-622 (interest rate limitations) - the amount and date of the loan - a schedule or description of the payments - the type of security - the name and address of the licensed office - each person primarily obligated and the agreed rates of charge or and exact copy of the loan agreement - loans subject to precomputed charges should include a statement as such and disclosure that charges are subject to refund or recomputation as provided in the article A.R.S. §6-622 - Interest rate limitations A. For loans not exceeding $1,000, charges are not to exceed: - 3% per month on outstanding principal $\leq$ $300 - 2% per month on outstanding principal $>$ $300 $\leq$ $600 - 1.5 per month on outstanding principal $>$ $600 $\leq$ $1,000

REQUIREMENTS FOR LICENSED SMALL LOAN COMPANIES
(Consumer Finance Companies) (Concl'd)

	B. For loans not exceeding $10,000, charges are not to exceed: - 2.5% per month on outstanding principal $\leq$ $300 - 2% per month on outstanding principal $>$ $300 $\leq$ $1,000 - 1.5% per month on outstanding principal $>$ $1,000 $\leq$ $1,500
Loans under $10,000 which are adverstised as consumer loans (Concl'd)	A.R.S. §6-122 - Interest rate limitations (Concl'd) - 1% per month on outstanding principal $>$ $1,500 $\leq$ $10,000 OR - 1.625% per month on the entire outstanding balance
	C. A one-time charge of 1% on any loan amount not exceeding $1,500 to defray operating costs
	A.R.S. §6-628 - Allowable charges - court costs - reasonable attorney fees assessed and fixed by the courts - actual fees for filing, recording and releasing an instrument securing a loan at any public office - certain credit-related premiums
	A.R.S. §6-632 - Any insurance sold as a condition of receiving a loan must bear a reasonable and bona fide relation to the existing hazard or risk of loss
All other loans	Title 44, Chapter 9 A.R.S. §44-1201 - No interest limitations
	A.R.S. §§44-1205.A.3 and 44-1205.B. - Allowable charges (see discussion under unlicensed companies, p. I-3)

REQUIREMENTS FOR UNLICENSED SMALL LOAN COMPANIES

Loan Services	Statutory Requirements
All loans	Federal Truth-in-Lending Requirements - Regulation Z - consumers should receive a statement indicating when interest charges begin to accrue, including an explanation of any time periods which may exist when the loan may be repaid without incurring a finance charge - the periodic interest rate as well as the annual interest rate - an explanation of the method used to determine the balance on which the interest charge will be computed - an explanation of how the amount of any interest charge will be determined - the amount of any other finance charge other than the interest charge or an explanation of how that charge will be determined - the fact the loan company has or will acquire a security interest in the property purchased under the plan or in other property identified by item or type - a statement of the consumer's billing rights Title 44, Chapter 9 A.R.S. §44-1201 - No specific limitations for interest charges A.R.S. §§44-1205.A.3. and 44-1205.B. - Charges (other than interest) permitted by law - late payment fees - actual fees for filing or recording in a public office - actual fees for motor vehicle, title, registration, assessor's fees and lien filings - actual fees for acknowledging the instrument securing the loan, costs of obtaining a preliminary title report and title research policies - lender may not charge for any other service or expense except for casualty or other insurance covering the security for the loan and credit life and disability insurance

APPENDIX II

LEGISLATIVE COUNCIL OPINION ON REGULATION OF SMALL LOAN COMPANIES

ARIZONA LEGISLATIVE COUNCIL

MEMO

August 23, 1983

AUDITOR GENERAL

TO: Douglas R. Norton
Auditor General

FROM: Arizona Legislative Council

RE: Request for Research and Statutory Interpretation (O-83-15)

This is in response to a formal request submitted on your behalf by William Thomson in a memo dated August 15, 1983.

FACT SITUATION:

Arizona Revised Statutes (A.R.S.) section 6-601 provides the following definition of a consumer loan:

> 3. "Consumer loan" means the loan of money, credit or other things of value in an amount of ten thousand dollars or less.

A.R.S. section 6-602 describes the scope of the article:

> A. It is unlawful for a person to engage in the business of lending in amounts of ten thousand dollars or less and contract for, exact or receive, directly or indirectly, or in connection with any such loan, any charges, whether for interest, compensation, consideration or expenses, which in the aggregate are greater than the interest that the lender would be permitted by law to charge for a loan of money if he were not a licensee under this article, except as provided by this article, and without first having obtained a license from the superintendent. Any person not exempt under subsection B who advertises for, solicits or holds himself out as willing to make or procure a consumer loan is presumed to be engaged in the business described in this subsection. (Emphasis added.)

Currently, the banking department licenses only certain persons or companies making loans in amounts less than $10,000. If a person or company specifically represents its services as "consumer loans", that person or company must obtain a license from the department and comply with all provisions of A.R.S. title 6, chapter 5. If persons or companies make loans in amounts less than $10,000 but do not represent these as consumer loans, no license is required. The department interprets these loans to be usury loans made under the authority of A.R.S. section 44-1201 et seq., and not within the purview of A.R.S. section 6-601 et seq.

QUESTIONS PRESENTED:

1. Do the statutes require licensing of all persons or businesses making loans in amounts of $10,000 or less?

2. What is the banking department's authority to distinguish among persons making loans in amounts less than $10,000?

3. Do Arizona statutes limit interest rates charged by persons or companies that obtain a license from the department pursuant to A.R.S. section 6-602, subsection A and represent their services as "consumer loans"? Specifically, does A.R.S. section 6-622 conflict with A.R.S. section 44-1201?

DISCUSSION:

State usury laws, laws which limit the rate of interest on a loan, date back to the beginning of this country. Prior to 1980, the general usury law in Arizona set the maximum rate of interest on a loan at 12%. Laws 1978, chapter 186, section 4.

State usury laws generally set a maximum rate of interest on loans between 6% and 12%. Due to increased demand for money from individuals, the high risks associated with personal loans and the high administrative costs involving such loans, the limitation on interest rates imposed by state usury laws made it unprofitable for traditional lenders to make loans to individuals.

Therefore, many states, including Arizona,* made an exception to the general usury law by enacting "small loan acts". Generally, under these laws, a lender would be able to make loans up to an amount set by statute and charge a rate of interest on the loan at a rate sufficient to yield a profit. Typically a lender making a loan under such an act could lend at a rate of interest up to 3% per month. However, in order to take advantage of this higher rate, a lender would have to be licensed by the state and submit to a certain amount of state regulation. Thus, when the general usury law set the legal rate of interest below that permitted by the small loan act a lender had an economic incentive to become licensed.

In 1980, reacting to changing economic conditions, Arizona removed the maximum interest rate limitation for all types of loans except consumer and pawnbroker loans. Presently, A.R.S. section 44-1201 provides that the maximum rate of interest on a loan could be set at any rate of interest agreed upon by the parties. The intent of this section was to let the marketplace set the interest rate on loans.

During the same session, the Arizona legislature, in a separate bill, renamed the Arizona small loan act from "small loans" to "consumer loans" and defined a consumer loan as the loan of money, credit or other things of value in an amount of ten thousand dollars or less.** In addition, the legislature attempted to retain an interest rate lid on consumer loans. A.R.S. section 6-622.

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*A.R.S. title 6, chapter 5, article 1.

**Laws 1980, chapter 252.

Under the Arizona consumer loan act, A.R.S. section 6-602, subsection A states that it is unlawful for a person to make a consumer loan and charge and collect interest at a rate higher than the general usury rate unless the person first obtains a license. Since in Arizona the general usury rate is the rate set by the marketplace, i.e., there is no longer a prescribed limit, A.R.S. section 6-602 has no effect in requiring a consumer lender to become licensed. In fact, there is an economic incentive for a lender not to operate under A.R.S. title 6, chapter 5 since theoretically the lender could charge a rate of interest higher than the limit set by A.R.S. section 6-622.*

The legislature recognized but did not resolve this "loophole" by introducing H.B. 2248 during the 1981 legislative session. H.B. 2248 would have required any person who made a consumer loan to obtain a license from the state banking department, unless specifically exempted, and subject such person to the provisions of law limiting the amount of interest the person could charge on the loan. However, after receiving final passage in the house of representatives, the bill failed to pass the senate.

CONCLUSION:

1. A.R.S. title 6, chapter 5, article 1 does not contain any requirement that a person making a consumer loan must be licensed by the state.

2. A.R.S. title 6, chapter 5, article 1 does not contain any authority which allows the banking department to distinguish among persons making loans in amounts less than $10,000.

3. A.R.S. title 6, chapter 5, article 1 provides that unless licensed it is unlawful for a person making a consumer loan to contract for a rate of interest higher than a rate of interest charged if the person were not licensed. Since an unlicensed lender could charge whatever interest rate he wishes under A.R.S. section 44-1201, there is no economic reason why a lender would become licensed under A.R.S. title 6, chapter 5, article 1. If a lender chooses to become licensed and make loans under that chapter, the lender would be subject to all the provisions in title 6, chapter 5, article 1, including the interest rate limitation under A.R.S. section 6-622.

RECOMMENDATION:

You may wish to recommend that A.R.S. title 6, chapter 5, article 1 be amended in a manner similar to H.B. 2248, 35th Legislature, First Regular Session, in order to clarify the role of the state banking department in regulating persons engaged in the business of lending monies in amounts of $10,000 or less.

cc: William Thomson, Manager
Performance Audit Division

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*A lender would presumably still be restricted by the criminal definition of extortionate extension of credit. See A.R.S. sections 13-2301 and 13-2302.