

Audit Report

**Department of Labor, Licensing and Regulation
Office of the Commissioner of Financial Regulation**

August 2010



OFFICE OF LEGISLATIVE AUDITS
DEPARTMENT OF LEGISLATIVE SERVICES
MARYLAND GENERAL ASSEMBLY

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Karl S. Aro
Executive Director

DEPARTMENT OF LEGISLATIVE SERVICES
OFFICE OF LEGISLATIVE AUDITS
MARYLAND GENERAL ASSEMBLY

August 17, 2010

Bruce A. Myers, CPA
Legislative Auditor

Senator Verna L. Jones, Co-Chair, Joint Audit Committee
Delegate Steven J. DeBoy, Sr., Co-Chair, Joint Audit Committee
Members of Joint Audit Committee
Annapolis, Maryland

Ladies and Gentlemen:

We have audited the Department of Labor, Licensing and Regulation – Office of the Commissioner of Financial Regulation (OCFR) for the period beginning May 7, 2007 and ending October 25, 2009. OCFR is the primary regulator for financial institutions chartered in Maryland, including banks, credit unions, and State-licensed financial entities, including mortgage lenders. OCFR is responsible for licensing and supervising these businesses to ensure compliance with the laws and regulations of Maryland.

Our audit disclosed that OCFR had not established adequate internal control over certain of its cash receipts. Additionally, OCFR's examinations of mortgage lenders were not always performed within the time frame required by State law. We also noted that OCFR did not adequately verify that eligible borrowers received certain refunds from mortgage lenders and did not always refer delinquent accounts receivable to the State's Central Collection Unit, as required.

OCFR's response to this audit is included as an appendix to this report. We wish to acknowledge the cooperation extended to us during the course of this audit by OCFR.

Respectfully submitted,

Bruce A. Myers, CPA
Legislative Auditor

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* Denotes item repeated in full or part from preceding audit report

Background Information

Agency Responsibilities

The Department of Labor, Licensing and Regulation – Office of the Commissioner of Financial Regulation (OCFR) is responsible for supervising the activities of the following entities: state-chartered banks, trust companies, savings banks, credit unions, money transmitters, safe-deposit companies, sales finance companies, installment loan lenders, credit services businesses, check-cashing outlets, debt collection agencies, debt management companies, mortgage lenders (including lenders, brokers, and servicers), and mortgage originators. OCFR also oversees retail accounts, retail installment contracts, and credit grantor contracts. Additionally, the agency issues licenses for non-depository institutions after an investigation of each applicant and approves license applications for banking institutions and credit unions to form new institutions, open branches, make stock acquisitions, form affiliates, and merge with other financial institutions.

According to the State's records, during fiscal year 2009, OCFR's operating expenditures totaled approximately \$8.5 million.

Status of Findings From Preceding Audit Report

Our audit included a review to determine the status of the five findings included in our preceding audit report dated December 17, 2007. We determined that OCFR satisfactorily addressed three of those findings. The two remaining findings are repeated in this report.

Findings and Recommendations

Cash Receipts

Finding 1

Controls over certain cash receipts were not adequate.

Analysis

Adequate internal controls were not established over cash receipts received directly by the Office of the Commissioner of Financial Regulation (OCFR). These receipts primarily consisted of bank assessment fees, licensing fees, and payments on accounts receivable for unpaid licensee examination fees. While most fees were collected through various bank lockbox accounts, certain collections were received at OCFR's office. According to its records, during fiscal year 2009, OCFR received cash receipts totaling approximately \$722,000 at its office that were subsequently forwarded to the Department's Office of the Secretary for deposit. OCFR also collected approximately \$1.1 million in licensing and exam fees that were forwarded by OCFR to its bank lockbox accounts for recordation and deposit. In this regard, although licensing and exam fees were to be mailed directly to the lockbox accounts, these fees were sometimes mailed to OCFR in error. We noted the following conditions:

- Access to an automated check log, used by OCFR to record cash receipts received at its office, was not adequately restricted. Specifically, three employees who subsequently had access to cash receipts could also access and alter the log.
- The employee who received certain of the aforementioned cash receipts, which totaled approximately \$466,000, also updated the related accounts receivable records.
- Verification was not adequately performed to ensure that licensee examination fees, which were sent to its office in error, were subsequently forwarded to the applicable bank lockbox account as required. Specifically, the employee who mailed such checks to the lockbox also verified that the checks were received by the applicable financial institution.

As a result of these conditions, cash receipts collected by OCFR could potentially be misappropriated and not timely detected. Similar conditions were commented upon in our preceding audit report.

Recommendation 1

We recommend that OCFR ensure that

- a. access to the automated check log is restricted to the employee that receives the collections (repeat),**
- b. accounts receivable records are maintained by an employee who does not have access to cash receipts (repeat), and**
- c. an employee independent of the cash receipts function verifies that all exam fee checks received by OCFR are forwarded to the lockbox for deposit (repeat).**

We advised OCFR on accomplishing the necessary separation of duties using existing personnel.

Oversight of Mortgage Lenders

Finding 2

Examinations of mortgage lenders were not performed within the time frame required by State law.

Analysis

OCFR did not always conduct examinations of mortgage lenders within the time frame required by State law. According to its records, which we tested and found to be reliable, as of November 2, 2009, OCFR had not performed examinations for 363 of 2,093 licensed mortgage lenders within the required timeframe. We noted that 107 of these 363 examinations were past due by periods ranging from at least 12 months to more than 5 years as of the aforementioned date. OCFR is required to perform periodic examinations to ensure compliance with applicable laws and regulations and to ensure proper licensure.

State law requires that each mortgage lender be examined at least once every three years and that each new mortgage lender be examined within 18 months of initial licensure. A similar condition was commented upon in our three preceding audit reports, dating back to July 2001.

Recommendation 2

We recommend that OCFR examine all mortgage lenders within the time frame required by law (repeat).

Finding 3

OCFR did not adequately verify that mortgage lenders paid refunds due to consumers.

Analysis

OCFR did not adequately verify that refunds due consumers from mortgage lenders were paid. Specifically, examinations performed by OCFR of mortgage lenders may identify lending transactions for which a lender charged a consumer (that is, the borrower) improper or excessive fees. When OCFR identifies such transactions, it notifies the lender that a refund payment is due to the consumer. However, OCFR did not adequately verify that the refunds had been paid. Specifically, although OCFR requires lenders to submit copies of the applicable refund checks that bear evidence of having been paid by the consumer's bank, OCFR did not always receive such checks or otherwise verify that consumers received the refunds, as required.

Our test of refund payments from eight different lenders, totaling approximately \$62,000, disclosed that, for refund payments from five of the lenders tested totaling \$32,144, copies of the cancelled refund checks were not submitted by the lenders, as required. Furthermore, in these five instances, there was no documentation to support that OCFR had performed any follow-up procedures to determine if the applicable consumers had received the related refund checks.

According to OCFR records, during fiscal year 2009, consumer refunds paid by mortgage lenders totaled \$1,525,613.

Recommendation 3

We recommend that OCFR

- a. take appropriate action to obtain copies of cancelled refund checks from lenders for all refunds due, or obtain written confirmation from applicable consumers that the related payments were received; and**
- b. in those instances in which a copy of a paid refund check or written confirmation is not obtained from the applicable consumer, document the follow-up efforts made and retain such documentation for audit verification.**

Finding 4

Delinquent accounts resulting from unpaid mortgage licensee exam fees were not always referred to the State's Central Collection Unit (CCU) for collection assistance as required by state regulations.

Analysis

OCFR did not always refer delinquent accounts resulting from unpaid mortgage licensee examination fees to CCU for collection assistance, as required by State regulations. In this regard, OCFR is required by State law to periodically examine the business of each mortgage licensee to ensure that licensees have complied with the State's mortgage lender laws and applicable regulations. The law also requires OCFR to assess each licensee an examination fee as determined by the Commissioner. However, according to OCFR records, which we tested and found to be reliable with respect to accounts not yet referred, as of December 31, 2009, OCFR had not referred to CCU 122 delinquent accounts totaling approximately \$66,000. We noted that 83 of these accounts totaling \$51,000 had been delinquent for at least one year as of this date.

In addition, with respect to unpaid exam fee accounts that were recorded as having been previously referred to CCU, our test of 26 accounts disclosed that 13 of these accounts had not been referred to CCU as indicated. Rather, we were advised by OCFR management that it had referred these 13 accounts (along with others) to its in-house legal counsel for review and possible collection efforts. As a result, OCFR did not always timely refer delinquent accounts to CCU.

CCU's regulations require that debtors shall be sent three payment notices in 30-day intervals and that accounts remaining unpaid thereafter shall be declared delinquent and referred to CCU for collection assistance.

According to OCFR records, during fiscal years 2008 and 2009, mortgage license examination fees billed totaled approximately \$1 million. As of December 31, 2009, the unpaid balance totaled approximately \$174,000.

Recommendation 4

We recommend that OCFR

- a. timely refer all delinquent accounts to CCU for collection assistance as required, and**
- b. ensure that the referral status of all unpaid accounts is accurately identified in records.**

Audit Scope, Objectives, and Methodology

We have audited the Department of Labor, Licensing and Regulation – Office of the Commissioner of Financial Regulation (OCFR) for the period beginning May 7, 2007 and ending October 25, 2009. The audit was conducted in accordance with generally accepted government auditing standards.

As prescribed by the State Government Article, Section 2-1221 of the Annotated Code of Maryland, the objectives of this audit were to examine the Office's financial transactions, records and internal control, and to evaluate its compliance with applicable State laws, rules, and regulations. We also determined the status of the findings included in our preceding audit report.

In planning and conducting our audit, we focused on the major financial-related areas of operations based on assessments of materiality and risk. The areas addressed by the audit included cash receipts; consumer credit; oversight of financial institutions, including examinations and licensing; and special funds. Our audit procedures included inquiries of appropriate personnel, inspections of documents and records, and observations of the Office's operations. We also tested transactions and performed other auditing procedures that we considered necessary to achieve our objectives. Data provided in this report for background or informational purposes were deemed reasonable, but were not independently verified.

Our audit did not include certain support services provided to OCFR by the Department of Labor, Licensing and Regulation – Office of the Secretary. These support services (for example, payroll, purchasing, maintenance of accounting records, and related fiscal functions) are included within the scope of our audit of Office of the Secretary.

OCFR's management is responsible for establishing and maintaining effective internal control. Internal control is a process designed to provide reasonable assurance that objectives pertaining to the reliability of financial records, effectiveness and efficiency of operations including safeguarding of assets, and compliance with applicable laws, rules, and regulations are achieved.

Because of inherent limitations in internal control, errors or fraud may nevertheless occur and not be detected. Also, projections of any evaluation of internal control to future periods are subject to the risk that conditions may change or compliance with policies and procedures may deteriorate.

Our reports are designed to assist the Maryland General Assembly in exercising its legislative oversight function and to provide constructive recommendations for improving State operations. As a result, our reports generally do not address activities we reviewed that are functioning properly.

This report includes conditions that we consider to be significant deficiencies in the design or operation of internal control that could adversely affect OCFR's ability to maintain reliable financial records, operate effectively and efficiently and/or comply with applicable laws, rules, and regulations. Our report also includes findings regarding significant instances of noncompliance with applicable laws, rules, or regulations. One other less significant finding was communicated to OCFR that did not warrant inclusion in this report.

The Department of Labor, Licensing and Regulation's response, on behalf of OCFR, to our findings and recommendations is included as an appendix to this report. As prescribed in the State Government Article, Section 2-1224 of the Annotated Code of Maryland, we will advise the Department regarding the results of our review of its response.

August 10, 2010

Mr. Bruce A. Myers, CPA
Legislative Auditor
301 West Preston Street, Room 1202
Baltimore, MD 21201

RE: Response to Draft Legislative Audit Report, July 2010

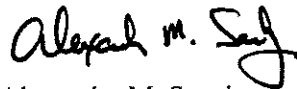
Dear Mr. Myers:

I am enclosing the Department of Labor, Licensing and Regulation's response to the draft audit report on the Office of the Commissioner of Financial Regulation (OCFR). We appreciate the additional time you afforded the Department to submit our response. We take the auditor's findings with all due seriousness and wanted to allow sufficient time for internal review so that we could provide responses that adequately address the concerns raised.

Our Office of the Commissioner of Financial Regulation performs a critical regulatory role to protect Maryland consumers and to ensure the stability and viability of our financial institutions. As the chief regulator of the mortgage industry, OCFR remains on the frontline of the foreclosure crisis we are experiencing in Maryland and throughout the nation. At such a time, the Department is especially eager to ensure that OCFR's internal systems and processes are sound and that we identify any procedures and resources necessary to support its essential regulatory function.

Thank you for the opportunity to respond to the draft audit report. If you have any questions, please contact me or you may call Commissioner Sarah Bloom Raskin, at 410-230-6101 with any concerns or questions.

Very truly yours,



Alexander M. Sanchez
Secretary

Enclosure (1)

cc: Daniel Savery, Director of Performance Management and Consumer Protection
Irby Cole, Director, Office of Budget and Fiscal Services
Sarah Bloom Raskin, Commissioner of Financial Regulation
Mark Kaufman, Deputy Commissioner of Financial Regulation

Memorandum

To: Bruce A. Myers, CPA
From: Sarah Bloom Raskin, Commissioner of Financial Regulation
Re: Response to Draft Legislative Audit Report, July 2010
Date: August 10, 2010

As Commissioner of Financial Regulation, I am pleased to provide you and members of the Joint Audit Committee with the Office of the Commissioner of Financial Regulation's ("OCFR") response to the draft audit report dated July 2010. We appreciate the thoroughness and consideration displayed by your staff in conducting the audit and believe that the process will assist OCFR in maintaining policies and procedures that ensure the highest performance standards.

The two and one-half years since the previous audit of OCFR have brought unprecedented challenges as the agency has confronted the twin financial and foreclosure crises. Complaints and investigations have risen to record levels, along with recoveries for consumers, while licensing requirements have been significantly elevated. OCFR has worked diligently to respond to evolving market conditions and increasing demands. This work by OCFR coincides significantly with the implementation of the Nationwide Mortgage Licensing System, a coordinated and comprehensive mortgage licensing system that has dramatically altered the activity of OCFR and necessitated a detailed review of more than 7,000 mortgage license applications from both new and current licensees.

At the same time, we have sought to revamp and refine our internal processes and systems. We have focused particular attention on the areas identified in the prior audit. In areas where findings are repeated, efforts and progress have been material and our commitment to fully addressing the matter is clear. The backlog in mortgage examinations, which has been cited in the prior three reports, has been reduced from 1,600 in 2008 to approximately 300 at November 2009 in this report to 63 as of June 30, 2009 (out of more than 1,500 active licensees). We expect the backlog to be fully addressed by year end. In new areas identified, such as the need to improve the tracking of refunds to consumers, the problems are correlated to improved compliance and enforcement activities that are resulting in more refunds that need to be tracked by agency personnel.

This is a critical time for the regulation of financial institutions. Recent events underscore the need for efficient and effective regulatory oversight. We thank you for the opportunity to respond to your concerns and anticipate that our proposed actions will adequately address the findings noted.

Background

The Office of the Commissioner of Financial Regulation (“OCFR”) protects consumers and regulates financial institutions through its chartering or licensing processes, on-site and off-site examination functions, complaint response teams and enforcement efforts. In the two and one-half years since the last audit, all regulators – state and federal – have been focused on the demands occurring as a result of the global financial crisis. The OCFR, too, has faced unprecedented challenges in virtually all areas of its jurisdiction. Oversight and intense supervision of state chartered banks, credit unions and trust companies has intensified as the economy and credit environment have deteriorated, and these efforts have helped maintain the safety and soundness of all of our depository institutions. With respect to non-depositaries, particularly in the mortgage arena, OCFR has responded to an elevated level of complaints, driven principally by the foreclosure crisis. In this time period, OCFR has completed a record volume of examinations, shifted licensing to the Nationwide Mortgage Licensing System and implemented an outreach program that has directly provided over 260,000 severely delinquent Maryland borrowers with information about housing counseling and scam prevention. Investigation and enforcement activity has resulted in a record level of fines and recoveries for Maryland consumers that are each more than two times the levels that were exhibited in the period after the prior audit.

Significantly, the OCFR has delivered these results while reducing staffing to meet the realities of an extremely difficult budget environment. With the decline of the mortgage industry, licensing revenue has declined significantly while demands, in the form of complaints, investigations etc, have remained high. While meeting this challenge, OCFR has simultaneously reduced headcount by approximately 15% since the last audit.

Agency Response

Finding # 1

Controls over cash receipts were not adequate.

Auditor’s Recommendation #1

We recommend that OCFR ensure that

- a. access to the automated check log is restricted to the employee that receives the collections (repeat),**
- b. accounts receivable records are maintained by an employee who does not have access to cash receipts (repeat), and**
- c. an employee independent of the cash receipts function verifies that all exam fee checks received by OCFR are forwarded to the lockbox for deposit (repeat).**

We advised OCFR on accomplishing the necessary separation of duties using existing personnel.

Agency Response #1

The agency agrees that there are certain inadequacies in its internal controls over cash receipts and took significant steps to address these issues following the preceding audit and has implemented additional steps since this audit that the agency believes fully resolve the problems.

Specifically, with respect to the check log (a), the agency implemented a duplicate check log process following the prior audit whereby initial receipt is noted in a separate record that is totally distinct from the one used by collections to receive and track the payments. This second log is restricted from collections personnel completely. Notwithstanding, this audit noted that within the collections function, the individual recording collections and the supervisor validating those collections had access to the checks themselves. At the suggestion of the auditor, the supervisor no longer has access to the actual checks themselves, but rather approves the actions based on copies of the checks.

The accounts receivable records (b) relate to fines assessed by OCFR. In response to the prior audit, OCFR developed and implemented a new penalty tracking system. The assessment and payment of penalties were recorded by different staff members, neither of whom could alter the records created by the other. While recognizing these improvements, this audit noted that the person recording payment also had access to the check itself. At the suggestion of the auditor, OCFR has re-allocated duties such that recordation of payment is made based on a copy of the check rather than the original.

The verification of exam fees sent in error (c) relates to only a small portion of the exam fees collected. OCFR aggressively seeks to minimize the portion of exam fees received by check and actively encourages payment directly to the lockbox. As a result, more than 95% of exam fees are paid directly to the lockbox and do not require verification. However, the compliance supervisor is responsible for validating the disposition of the checks received by comparing checks sent to the lockbox with the daily statements. The agency will verify this disposition quarterly given the small number of checks involved. It is worth noting that the audit found no evidence that any checks sent to OCFR in error were improperly forwarded and credited.

Finding # 2

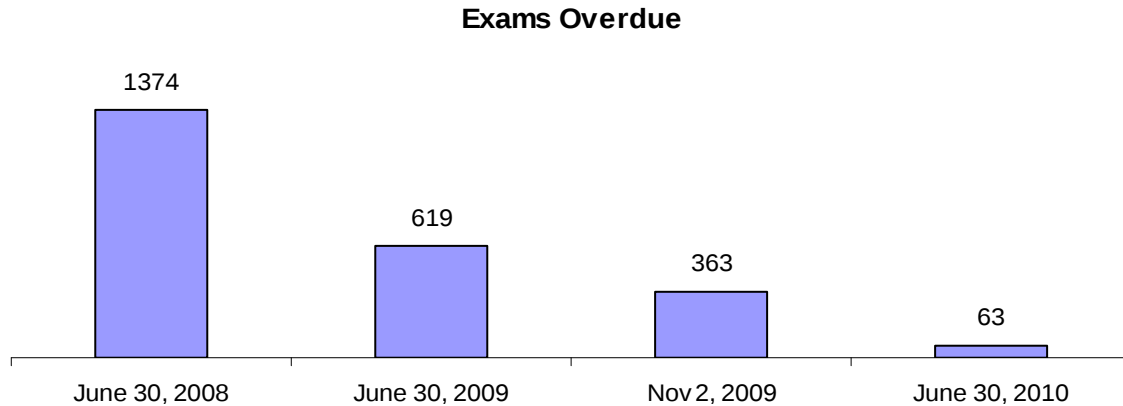
Examinations of mortgage lenders were not being performed within the time frame required by State law.

Auditor's Recommendation #2

We recommend that OCFR examine all mortgage lenders within the timeframe required by law.

Agency Response #2

The agency concurs with this finding and continues to devote significant resources to remedying this problem since the prior audit. In FY 2008 and FY 2009, for example, the agency completed 2,761 examinations, 58% more than the prior two year period. OCFR achieved this increase even though the examination process has been lengthened to incorporate recent enhancements in the law (such as the requirement to validate the ability of a borrower to repay a mortgage prior to origination). This increased volume, combined with a reduction in licensees due to the shrinkage of the industry, has enabled the agency to drastically reduce the backlog as detailed below.



OCFR believes that the backlog will be effectively eliminated by the end of CY2010. One large impediment, however, has been and continues to be examinations of mortgage servicers. Maryland is one of the few states to license and examine servicers, which receive the same license as other lenders under Maryland law. While these servicers have been licensed as “lenders” since 2005, no examinations were launched until 2008 so all were overdue. Launching an examination program is challenging because it has required specialized personnel and protocols, and most mortgage servicers are out of state. At the conclusion of FY2010 (June 30, 2010), there were 63 overdue exams. Exams for 15 companies were more than 12 months overdue at June 30, 2010 - and 7 of the 15 companies are servicers. Six of those seven servicers are located out of state, including one in Bangalore, India.

At the same time, the servicing initiative has yielded significant results. Since 2008, the servicing exams undertaken by OCFR have resulted in over \$900,000 in refunds to Maryland consumers.

Finding # 3

OCFR did not adequately verify that refunds due to consumers from mortgage lenders were received.

Auditor's Recommendation #3

We recommend that OCFR

- a. take appropriate action to obtain copies of cancelled refund checks from lenders for all refunds due, or obtain written confirmation from applicable consumers that the related payments were received; and**
- b. in those instances in which a copy of a paid refund check or written confirmation is not obtained from the applicable consumer, document the follow-up efforts made and retain such documentation for audit verification.**

Agency Response #3

The agency concurs that there are inadequacies in the current process in following up on refunds that mortgage lenders are directed by OCFR to make to consumers. The audit reveals that greater efforts need to be made to ensure that consumers receive what they deserve and to achieve a deterrent effect for the future.

OCFR notes that copies of refund checks payable to the consumer were received and were verified by the agency as written on the relevant lender's institution for all examinations cited in the finding. The agency received check copies payable to the consumer for every refund totaling the approximately \$32,000 in the finding.

The agency agrees, however, that it did not obtain copies of the cancelled checks for the approximately \$32,000 as required. Subsequent to the audit, the agency obtained checks for more than 80% of the \$32,000. Of the \$32,000 cited in the finding, OCFR has since validated that checks for over \$25,000 were indeed cashed by the consumer.

More generally, the agency notes that achieving 100% compliance is likely impracticable to achieve. As lenders are examined only once every three years and then evaluated based on past transactions, refunds often relate to transactions that were completed years in the past, making it difficult to locate and reach consumers who often move locations. Many involve mortgages that have been paid off years ago. Likewise, these refunds may be small, making it more likely that the consumer may not pay attention, even if contacted.

OCFR has reviewed this situation with other states and none of the states contacted validate every refund as doing so would be impractical. Some revert to fines by consent. North Carolina and Massachusetts have implemented an approach whereby lenders must pay and validate refunds within a fixed period or submit the amounts to the state treasurer as unclaimed property. OCFR has reviewed with this latter approach with the Office of the Comptroller and, based on preliminary feedback, is moving to implement such a process in order to resolve this issue most efficiently.

Finding # 4

Delinquent accounts resulting from unpaid exam fees were not always referred to the Central Collection Unit (CCU) for collection assistance as required by state regulations.

Auditor's Recommendation #4

We recommend that OCFR

- a. timely refer all delinquent accounts to CCU for collection assistance as required, and**
- b. ensure that the referral status of all unpaid accounts is accurately identified in records.**

Agency Response #4

The agency agrees with the finding that delinquent invoices were not consistently referred to CCU for collection. The agency also notes that it had discovered this issue prior to the audit and was in the process of rectifying the problem.

With the contraction in the mortgage industry and literally thousands of companies leaving the business, unpaid exam fees has been a growing problem. In FY2009, the agency referred 114 unpaid invoices totaling \$117,459 to CCU. In FY2010, the agency referred 219 totaling \$101,765. The agency believes it is substantially caught up in these referrals.

Further, in the case of these non-compliant licensees, the OCFR has heeded the suggestion of CCU in Code of Maryland Regulations ("COMAR") 17.01.01.03(I), and has pursued regulatory action to suspend or revoke their licenses while also attempting to collect on the outstanding invoices. This is a new effort launched late 2009 which accounts for the initial confusion in the referral process. As noted in the finding, OCFR has referred numerous invoices to the legal division for administrative action against the licensee. These in-house administrative actions have resulted in significantly higher recoveries than referrals to CCU. OCFR has typically recovered less than 10% of the amounts referred to CCU. The recovery rate for delinquent fees pursued in this fashion has exceeded 30%. It should also be noted that these actions have resulted in the revocation of more than twenty non-compliant licensees.

However, it is not possible for OCFR to pursue its administrative remedies without a waiver from CCU as the timing required to do so is greater than the time frames for collection of delinquent accounts allowed by CCU regulations. It is for this reason that OCFR has requested approval pursuant to COMAR 17.01.01.02 to permit the agency to deviate from the standards established by CCU. OCFR is confident that CCU will grant this request as it is the most practical and efficient approach to deal with these specific debts. By allowing OCFR to complete the regulatory process, exhaust administrative remedies, and issue final orders, CCU would be receiving a complete file with the total fees and penalties owed by a specific licensee.

AUDIT TEAM

Peter J. Klemans, CPA
Audit Manager

Menachem Katz, CPA
Senior Auditor