PRESENTATION OF THE DEPARTMENT OF COMMERCE AND CONSUMER AFFAIRS
TO THE SENATE COMMITTEE ON COMMERCE, CONSUMER PROTECTION
AND AFFORDABLE HOUSING
SUPPLEMENTAL BUDGET REQUEST FOR FISCAL YEAR 2009

TWENTY-FOURTH STATE LEGISLATURE
REGULAR SESSION

JANUARY 18, 2008

TO THE HONORABLE RUSSELL S. KOKUBUN, CHAIR
AND MEMBERS OF THE COMMITTEE

Program Structure Number: 10 01 03 03
Program ID: CCA-104
Program Title: Financial Institution Services
Page References in the Multi-Year Program and Financial Plan:

1. Introduction:

a. Summary of program objectives.

To ensure the safety and soundness of state-chartered and state-licensed financial institutions by fairly administering applicable statutes and rules in order to protect the rights and funds of depositors, borrowers, consumers, and other members of the community, and to supervise escrow depositories.

Statutory reference: Chapters 412, 449, and 489D, HRS.

b. Description of program objectives.
Present your summary of objectives and activities as discussed in the Multi-Year Program and Financial Plan.

The program charters and licenses financial institutions and examines those financial institutions licensed and chartered in the State to ensure safe and sound financial conditions, business practices and compliance with applicable statutes and rules. The program also licenses and supervises escrow depositories and money transmitters (MTs) to ensure compliance with applicable statutes and rules.

c. Explain how your program intends to meet its objectives in the upcoming supplemental year.

The Division of Financial Institutions (DFI) has been short-staffed over the past several years. DFI has been able to fill some of its vacant positions, but continues to experience difficulty in filling vacancies on a timely basis. Key initiatives continue to be filling of the vacant positions and the implementation of intensive programs for training new employees and ensuring that existing employees continue to have current skills and abilities to deal with the changing legal, regulatory, economic and technological environment in which financial institutions and financial institution regulators operate.

2. **Program Performance Results:**

a. **Discuss the performance results achieved by the program in FY07.**

In FY 07, DFI devoted a significant amount of resources to implement Act 153, Session Laws of Hawaii 2006, (now Chapter 489D, HRS) which required DFI to license MTs by July 1, 2007. In addition to drafting and adopting rules, DFI finalized application, bond, and other forms and application processing procedures, and then devoted a substantial amount of time processing the applications that came in. Over 45% of the MT applications were received within 2 weeks of the July 1, 2007 licensing date, requiring DFI's licensing branch to work almost exclusively on these applications to be able to deem the applications complete by July 1 in order that the MTs could continue to operate while DFI completed processing of the applications. DFI also devoted resources to begin drafting its MT examination program.

Although DFI had projected an increase in applications in FY 07 due to the requirement to license MTs, the number of actual applications received significantly exceeded those projections. The variance over the projected number was due primarily to an increase in applications from financial institutions and escrow depositories to open, relocate, and close offices and for approval for various other activities and transactions. Despite this increase, DFI was able to process 89% of the applications in a timely manner

In FY 07, DFI was able to examine 88% of the financial institutions and escrow depositories, respond to 96% of written inquiries within 30 days, and renew 100% of the licenses in a timely manner (30-60 days depending on the type of license). In FY 07, DFI reviewed 79% of audited financial statements within 30 days of receipt, which was below DFI's planned level of 85%. This was in part due to the implementation of the new MT law which required DFI to create procedures and checklists before the audited financial statements could be reviewed. Developing these forms as well as the large volume and complexity of MT applications received resulted in some financial statements not being reviewed within 30 days of receipt.

b. **Explain how these results relate to the program's objectives and department's mission.**

The mission of the DCCA includes upholding "fairness and public confidence in the marketplace". The mission of DFI is to ensure the safety and soundness of Hawaii state-chartered financial institutions and to maintain public confidence in such institutions.

Through its on-site examinations, application review and processing, and off-site review of audited financial statements and other reports, DFI has and continues to devote significant resources to assisting and ensuring that financial institutions are operated in a safe and sound condition, and that financial institutions, escrow depositories, and MTs are in compliance with state and applicable federal laws such as those relating to privacy, money laundering and bank secrecy.

DFI has experienced a tremendous increase in workload due to the complexity of applications, complaints and inquiries it receives; the changing nature of the examinations it conducts to deal with new laws and regulations and the evolving nature of the financial services industry; and the new requirement to license MTs.

c. Explain how the effectiveness of the program is measured (i.e.: outcomes, measures of effectiveness, benchmarks, etc.) and discuss the performance results achieved during the past two years.

The relative soundness of Hawaii's regulated financial institutions may be considered the best evidence of the effectiveness of DFI's programs.

DFI has historically measured its effectiveness based on the timeliness of conducting examinations, reviewing applications and audited financial statements, renewing licenses, and responding to inquiries.

In FY 06, performance results were satisfactory in all areas, with the exception of the review of annual audited financial statements in which only 47% of the audited statements were reviewed within 30 days of receipt due to the time needed to train newly hired staff to do the review and analysis. However, for most audited statements, the delay was not significant since 82% of the audited statements were reviewed within 35 days of receipt.

In FY 07, performance results were satisfactory in the areas of examinations, application processing, license renewals and responding to written inquiries. The review of annual audited financial statements improved significantly from 47% in FY 06 to 79% in FY 07.

d. Discuss the actions taken by the program to improve its performance results.

In FY 07, DFI has continued its effort to fill its vacant positions. Although DFI was able to fill several of its vacancies, other vacancies were created when staff resigned. Due to the highly specialized nature of the work, it is often difficult to find qualified individuals willing to accept the level of compensation offered by DFI. DFI has generally hired staff at lower levels and then provided both extensive on-the-job and formal training (including on-line courses) through federal banking agency, regulatory agency association, and industry trade association programs. DFI has recently expanded its recruiting efforts to also seek experienced applicants exploring opportunities to expand their work experience in the financial services field and these efforts are continuing in FY 08.

Training of staff continues to be the key priority of DFI, not only for new examiners, but to also train all examiners to deal with new laws, rules, regulations, and changes in the financial services industry. DFI continues its efforts to prioritize and reassign work within both the examination and licensing areas where possible. In addition, DFI is evaluating its work processes and procedures and reviewing options to increase efficiencies.

e. Identify all modifications to your program's performance measures and discuss the rationale for these modifications.

None.

3. Problems and Issues:

a. Discussion of problems and issues encountered, if any.

Over the last decade, the financial services industry and the federal and state regulatory agencies that supervise and regulate the industry continue to undergo dramatic and unprecedented changes. Increased competitive pressures, both within the industry itself and from unregulated competitors; a volatile economy; dramatic advances in technology; a growing international market for financial services; and increased consumer pressures have all contributed to the dramatic and unprecedented changes.

The financial services industry also continues to undergo phenomenal changes in size, structure, delivery systems, products, geographic areas of operation, and increased dependence on technology.

Congress continues to pass legislation impacting the powers, operations, and structure of financial institutions. Congress passed the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 to authorize interstate banking and branching; the Gramm-Leach-Bliley Financial Services Modernization Act of 1999 to eliminate legal barriers to affiliations among banks and securities firms, insurance companies and other financial services companies and to establish federal standards for financial privacy; the United and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 to address terrorism in the aftermath of the September 11 tragedy; the Sarbanes-Oxley Act of 2002 to address corporate governance issues raised by the Enron and other corporate scandals; the Fair and Accurate Credit Transactions Act of 2003 to address issues related to credit reporting and to combat identity theft; and the Check Clearing for the 21st Century Act in 2003 to facilitate check truncation and electronic check exchanges.

In response to the passage of these laws and the adoption of implementing regulations by various federal agencies, DFI has had to submit legislation to change conflicting or inconsistent State laws relating to interstate banking and branching and foreign banking; adopt supervisory protocols and agreements with other state and federal banking agencies for the cooperation and coordination of regulatory activities; increase coordination and cooperation with other federal and state agencies that serve as the functional regulators of certain financial institution activities; and implement new examination procedures and enhance other program activities to ensure institutions are in compliance with the new laws and regulations.

Further legislation and regulation are expected at the federal level by both Congress and the federal banking agencies. Among issues that still must still be dealt with are implementing the Basel II capital accords for large internationally active banks and the revision of the Basel I capital standards for all other banks. Other issues include the reform of regulation of the Federal Home Loan Bank System and the government-sponsored housing agencies, security of sensitive consumer data, and increased supervision and regulation of the mortgage industry.

Homeland security continues to be a critical issue that will require DFI to work closely with the private sector and with law enforcement and other state and federal agencies to protect the financial sector. In July 2005, DFI signed a Memorandum of Understanding (MOU) with the U.S. Department of Treasury's Financial Crimes Enforcement Network (FinCEN) and a Letter Agreement with the federal banking agencies to set forth the procedures for sharing information relating to compliance with the Bank Secrecy Act by Hawaii financial institutions. The MOU and the Letter Agreement provide for enhanced collaboration and information sharing that will allow FinCEN to better administer the Bank Secrecy Act while simultaneously assisting DFI to better fulfill its regulatory role. DFI is currently reviewing for possible signature a MOU with the U.S. Department of Treasury's Office of Foreign Assets Control (OFAC). The OFAC MOU would facilitate the sharing of information between OFAC and DFI relating to violations of U.S. economic and trade sanctions.

The foregoing major federal initiatives, changes in the geopolitical and economic environments, as well as financial services industry changes in the structure and diversity of its business models, delivery systems, and products have had a major impact on financial institutions in Hawaii and made supervision and regulation of these organizations more sophisticated, complex, and specialized. In the past several years there had been increased consolidation in the industry as institutions struggled to comply with new laws and regulations, expansion of products and services, increased geographical diversity, and other competitive factors. More recently, DFI has seen an increase in the number of institutions and offices it regulates (two new state-chartered banks, the first since 1959, and an intra-Pacific bank branch opened in 2006), indicating an increased interest in forming de novo institutions and in commencing or expanding operations in Hawaii; however, recent events in the mortgage area have resulted in several institutions either pulling out of Hawaii or planning to significantly scale back their presence in Hawaii.

The licensing of money transmitters has increased DFI's workload. DFI has licensed 40 MTs with over 1,200 locations in Hawaii, resulting in increased applications, notices, inquiries, and audited financial statements filed with DFI. Examinations of the MTs, of which 27 are located out of state, will also need to be conducted.

To continue DFI's mission, DFI must evolve with changes in the industry it supervises as well as the changes in federal and state law. It faces the challenge of strengthening its operations and must maintain the independence and flexibility to address the current banking environment as well as deal effectively with problem financial institutions, privacy law compliance, terrorist/emergency contingency and business resumption planning, anti-money laundering laws and regulations, and other future challenges.

b. Program change recommendations to remedy problems.

The funding of DFI by special funds rather than general funds, consistent with model state supervision/regulatory practice and recommendations of the national association of state bank regulators (i.e., Conference of State Bank Supervisors - CSBS), provides DFI with an independent standing from which to implement, interpret and enforce appropriate and contemporary financial service specific industry regulation.

Increased staffing and other operating funds are needed to fully implement the MT licensing program. Although DFI has begun implementing the program, it has become clear, based on the number of MTs currently licensed and the number of locations from which they operate, the issues involved in the licensure of MTs, and the type of examinations that will need to be conducted, that additional positions and funding are required to implement the MT licensing program without negatively affecting DFI's ability to fulfill its primary objective of ensuring the safety and soundness of state-chartered and licensed institutions.

DFI needs to continue to strengthen its operations and technology skills and equipment, improve and maintain the technical competence of its examiners, improve the efficient use of its resources, maintain its CSBS accreditation, and ensure that it has the maximum flexibility to meet the challenges imposed by the changing industry it regulates.

c. Identify any program issues or problems that have affected or will affect the implementation of the program, and the corrective measures or remedies established or planned.

The dramatic changes described above in the financial services industry (size, structure, delivery systems, products, geographic expanse), in the laws and rules impacting the industry, and in the geopolitical and economic environments all increase the complexity of the examinations DFI conducts, and the applications, complaints and inquiries that DFI receives. In addition, DFI's workload has increased because it now licenses money transmitters pursuant to Chapter 489D, HRS.

All of these factors require DFI to aggressively employ its resources to more effectively deal with these changes. Training of staff therefore continues to be one of DFI's highest priorities to ensure staff has the knowledge and skills to deal with the increasing complexity of DFI's workload. DFI's efforts to fill many of its vacant positions continued in FY 07, and are continuing in FY 08. The newly hired examiners need extensive on-the-job and formal training due to the highly specialized nature of the work.

4. Expenditures for FY08:

Provide the appropriation data, transfers, restrictions, available resources, and the estimated expenditures for FY08. For new Program I.D.'s, please present the data as best as can be determined.

	FY 08 Apprn (Act 213/07)	Collective Bargaining	Transfers	Restrictions	Ceiling Increase	Estimated Total Expenditure
(Position Count)	(29.00)	-	-	-	-	(29.00)
Personal Services	2,253,522	146,487		-	-	2,400,009
Other Current	324,759	-	-	-	-	324,759
Equipment	-	-	-	-	-	-
Leases	-	-	-	-	-	-
Motor Vehicles	-	-	-	-	-	-
TOTAL	2,578,281	146,487	-	-	-	2,724,768
(Position Count)	-	-	-	-	-	-
General Funds	-	-	-	-	-	-
(Position Count)	(29.00)	-	-	-	-	(29.00)
Special Funds	2,578,281	146,487		-	-	2,724,768
(Position Count)	-	-	-	-	-	-
Trust Funds	-	-	-	-	-	-
(Position Count)	-	-	-	-	-	-
Other Funds	-	-	-	-	-	-

a. Explain all transfers within the program I.D. and the impact on the program.

None.

b. Explain all transfers between program I.D.'s and the impact on the program.

None.

c. Explain all restrictions and the impact on the program.

As applicable, provide a description of the impact of the transfers that have occurred within the program I.D. between the various cost elements, transfers occurring between different program I.D.'s, and restrictions imposed.

None.

5. Supplemental Budget requests for FY09:

	MOF	FY09 Apprn (Act 213/07)	Supplemental Request	Total FY09 Exec Supp Budget
(Position Count)	B	(29.00)	(4.00)	(33.00)
				-
Personal Services	B	2,253,522	319,693	2,573,215
Other Current	B	324,759	43,750	368,509
Equipment	B	-	16,200	16,200
Leases	B	-	-	-
Motor Vehicles	B	-	-	-
TOTAL	B	2,578,281	379,643	2,957,924

Provide the total position counts and funds requested.

a. Workload or program request:

For each program package or item requested within the Program I.D., provide the following (if no request is being made, indicate "none"):

i. A description of the request, the reasons for the request, and the desired outcomes or the objectives to be accomplished by the proposed program.

MOF B. Authorize 2.00 FTE exempt financial institution examiners, 2.00 FTE exempt money transmitter examiners, and funds of $379,643 for personal services, other current expenses, and equipment.

Act 153, 2006 SLH required the DFI to license MTs by July 1, 2007, but did not provide any positions or funds to implement the program, in part because there were no reliable estimates of the number of MTs operating in Hawaii. DFI has begun implementing this new law using existing staff, but it has become clear, based on the number of MTs currently licensed, the issues involved in the licensure of MTs, and the type of examinations that will need to be conducted, that additional positions and funding are required to fully implement the MT licensing program without negatively affecting DFI's ability to fulfill its primary objective of ensuring the safety and soundness of state-chartered and licensed financial institutions.

ii. A listing/description of the positions requested, and funding requirements by cost category and source of funding.

#99001R Financial Institution Examiner III, Exempt	$ 60,024
#99002R Money Transmitter Examiner III, Exempt	55,500
#99003R Money Transmitter Examiner III, Exempt	55,500
#99004R Financial Institution Examiner II, Exempt	55,500
Fringe benefits @ 41.13%	93,169

Total Personal Services	319,693
Total Other Current Expenses	43,750
Total Equipment	16,200
Total Request – MOF B	$379,643

iii. **For all lump sum requests, please provide a detailed breakout indicating specific purposes for all planned expenditures.**

None.

b. **For all position count reductions, please specify whether the positions were filled or vacant.**

None.

6. **Program restrictions:**
Identify restrictions carried over from FY08 as well as additional reductions due to the Department of Budget & Finance budget ceilings for FY09. If no reduction is being proposed, please indicate "none".

None.

7. **Capital Improvement Program (CIP) requests for FY09:**
CIP data for all projects within the agency being heard shall be combined into a single appendix in the department's testimony (if no request is being made, please indicate "none").

None.

8. **Proposed lapses of CIP projects:**
Any CIP project identified for lapse shall include the following (if no lapses are being proposed, please indicate "none").

None.