STATE OF ARIZONA
FY 2010 BUDGET REDUCTIONS – OVERVIEW

DEPARTMENT OF FINANCIAL INSTITUTIONS ("DFI")

During the current downturn in Arizona's economy, effective and meaningful regulation of Arizona's banks, credit unions and mortgage lending is necessary to provide stability and consumer confidence.

Arizona's recovery from this real estate and credit crisis depends on consistent and dependable supervision of these financial institutions. Now is not the time to cut DFI's budget to the point of debilitation.

DFI's core services have already been severely eroded by the combined impact of the FY 2009 and FY 2010 budget reductions, putting financial institutions' safety and soundness and consumer protections at risk.

With an additional 15% budget reduction in FY 2010, the core mission of DFI will be impossible to achieve, in essence "sunsetting" DFI and making the case for elimination of the state-chartered banking and credit union system.

Result of the FY 2009 and FY 2010 Budget Reductions

DFI is currently operating with only 39 filled, appropriated FTE, compared to 48.1 FTE appropriated in the FY 2010 budget (57.1 FTE appropriated in FY 2009). An additional budget reduction of 15% - which equates to roughly 30% based on a January 1, 2010 implementation date - will result in the termination of approximately 18 additional General Fund employees; reducing the total number of filled, appropriated FTE to 21.

- There are no discretionary funds available to cut
- Salaries, ERE, rent, and risk management expenditures account for 93% of DFI's current budget
- General Fund employees/positions affected by this Budget Reduction Plan: 10 examiners, 4 managers, 4 administrative support staff, 1 licensing CSR.

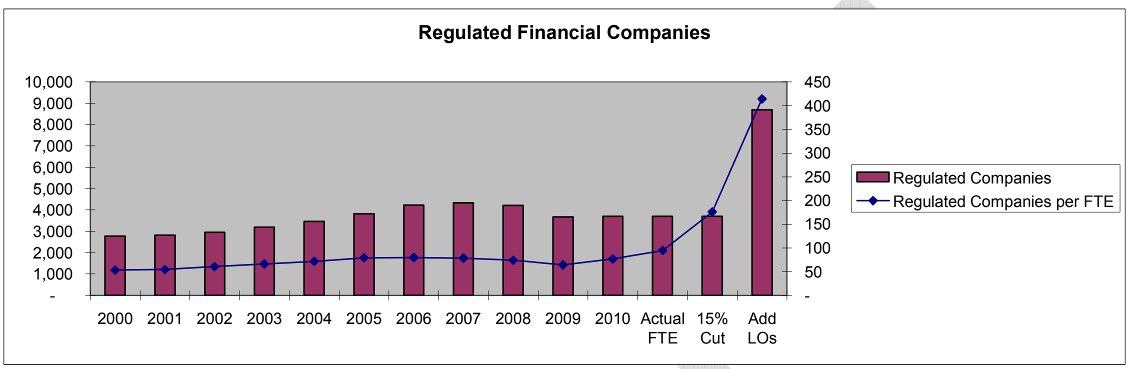
The RIF/layoffs will also include 6 employees currently paid from non-appropriated funds – increasing the size of the RIF/layoffs to 24 employees (or 51% of overall staff size).

The following chart compares the growth in regulated licensees against DFI authorized staff since 2000. The chart has been updated to reflect the projected impact of an additional 15% budget reduction for FY 2010 and the addition of a new - currently unfunded - Loan Originator Licensing Program.

Arizona State DFI: Doing More with Less, Fiscal Years 2000 through Projected 2010

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Current Actual FTE	Add 15% Cut	Add LOs
Regulated Companies	2,772	2,829	2,960	3,185	3,463	3,820	4,226	4,333	4,221	3,679	3,700	3,700	3,700	8,700
Employees (Authorized FTEs)	52.0	52.0	49.0	48.1	48.1	48.1	53.1	55.1	57.1	57.1	48.1	39.0	21.0	21.0
Regulated Companies per FTE	**53**	**54**	**60**	**66**	**72**	**79**	**80**	**79**	**74**	**64**	**77**	**95**	**176**	**414**

Note: Data reflect fiscal year-end counts (FY 2010 regulated companies data is projected).



As shown above, the reduction will increase the number of regulated companies per FTE to 176, compared to 53 per FTE in 2000 (a 232% increase). With the addition of an estimated 5,000 newly licensed loan originators by July 1, 2010, the number spikes to 414 per FTE.

Impact of Budget Reductions on Examiner Positions

At the outset, it must be pointed out that Financial Enterprise examiners (i.e., excluding Bank, Credit Union, and Consumer Affairs Division examiners) pay for themselves through examination fees. With fewer examiners, there will be an offsetting decline in general fund revenue, since DFI is authorized by statute to charge $65 per hour for time spent performing each examination.

Prior to the enacted budget cut for FY 2009, DFI was appropriated a total of 57.1 FTE – including 30 examiner positions. In addition, 8 examiners were being paid out of non-appropriated funds - for a total of 38 examiner positions. After the FY 2010 enacted budget cut, DFI is operating with 50% of total examiner positions vacant. **DFI currently has only 19 examiners left (15 GF; 4 Other Funds) for nearly 3,700 license holders.**

An additional 15% budget reduction for FY 2010 cannot be accomplished without further reducing the size of DFI's examination team. As shown on the following page, **under this reduction plan DFI will lose 14 additional examiners, leaving only 5 examiners (all General Fund) for nearly 3,700 license holders. Based on the 57.1 FTE appropriated prior to FY 2010, 87% of total examiner positions will be vacant.**

The following chart illustrates the devastating impact of both recently enacted and additional projected budget reductions on DFI's examination team (by industry/licensee type):

* Licensee Counts as of 7/31/09				**FY09 Before Enacted Budget Cut**	**FY 2010 Final Enacted Budget**	**FY 2010 15% Reduction Target**
License Type	Current # Licensees *	Initial # of Examiners (**General Fund)**	Initial # of Examiners **(Other Funds)**	Total # of Examiners (**All Fund Sources)**	Resulted in 13 fewer Examiners	Will Result in 14 fewer Examiners
Banks (34) and Trust Cos. (4)	38	4	0	4	3	2
Credit Unions	25	4	0	4	2	0
Mortgage Brokers/Bankers	1,455	5	4	9	3	0
Escrow Agents	93	4	2	6	3	0
Collection Agents	655	1	0	1	1	0
Payday Lenders	84	1	0	1	0	0
Consumer Lender	22	0	0	0	0	0
Sales Finance Cos	452	0	0	0	0	0
MV Dealers	639	0	0	0	0	0
Money Transmitter	70	0	2	2	2	0
All Other	125	0	0	0	0	0
Enterprise Division - Examiner Pool	-	0	0	0	0	3
Sub-Total	**3,658**	**19**	**8**	**27**	**14**	**5**
Consumer Affairs		5	0	5	5	0
# Filled Examiner Positions		**24**	**8**	**32**	**19**	**5**
Vacant Examiner Positions (GF)		6	N/A	6	15	25
Vacant Examiner Positions (Other)		0	N/A	0	4	8
# Vacant Exam. Positions		**6**	**N/A**	**6**	**19**	**33**
Total Examiner Positions		**30**	**8**	**38**	**38**	**38**
Total Vacant Examiner Positions (%)		**20%**	**N/A**	**16%**	**50%**	**87%**

<u>Impact on Non-Appropriated Examiner Positions</u>

In addition to a decline in General Fund revenue, due to a reduction in examination fees, the dramatic increase in the number of <u>vacant</u> examiner positions will have another critical consequence. Specifically, the State will forgo Civil Monetary Penalties ("CMP") that may otherwise have resulted from administrative actions based on examination findings. Although CMPs are deposited to the Department's Special Revolving Fund ("SRF"), rather than the General Fund, CMPs may be expended by the Department "…for investigative proceedings or for the purpose of instituting and prosecuting civil actions…"

Over the past several years, DFI has not received adequate appropriations to handle the explosive growth in the mortgage broker and mortgage banker license categories. As a result, DFI has had to supplement its understaffed examination team with limited status positions paid out of the Special Revolving Fund.

Fewer examiners will likely generate less in CMPs. When coupled with a 15% budget reduction on all non-appropriated funds, 6 additional examiners/investigators will be terminated as part of this Reduction Plan.

Additional Risks and Impacts

DFI received no funding for the Loan Originator Licensing Program mandated by SB 1028 (in 2008) or HB 2143 (in 2009):

- 5,000 to 8,000 loan originators must be licensed by July 1, 2010
- Mortgage companies must employ only licensed loan originators as of July 1, 2010
- Without adequate staffing, license applications will be backlogged causing delay in issuing qualified applicants' licenses and increasing the likelihood unqualified applicants will get a license, exposing the state to liability
- With further budget cuts in FY 2010, DFI will have even less resources at its disposal for implementation of the loan originator Licensing Program (i.e., no mortgage examiners to review applications).
- Delays in processing – beyond statutory licensing timeframes - require a refund of the applicants' fees.

DFI Cannot Absorb Further Budget Cuts

This document will show that an additional 15% reduction in DFI's budget is the equivalent of "sunsetting" the agency, as license holders will have virtually no supervision. This is a great disservice to Arizona business and residents who prefer doing business with local community financial services providers that are regulated in a meaningful manner.

The high foreclosure rates and the drastic drop in Arizona real estate values is largely the result of an unchecked mortgage lending industry (which was permitted to hire individuals that had no minimum educational background or qualifications) under DFI's supervision. During the boom years of the real estate market, DFI did not have adequate resources to handle the explosive growth in mortgage broker and mortgage banker licensees. Inadequate supervision leads to unchecked conduct that negatively impacts Arizona's economy, which is heavily reliant on real estate. Continuing down the path of less regulation, when consumers and industry are clamoring for more accountability, is foolhardy and will act as a magnet for wrong doers across the West.

Alternative Funding Sources

1) The new Loan Originator Licensing Program provides an alternative source of funding for mortgage examiner positions that would otherwise be eliminated. During the FY 2009 legislative session, DFI introduced legislation to provide for a financial structure that would allow this new licensing program to become self-sustaining and minimize support from the General Fund. HB 2143 – signed into law on July 13, 2009 - provides this structure. The bill establishes the Financial Services Fund, consisting of loan originator licensing fees collected by DFI. Under A.R.S. § 6-991.21(A), the monies in this fund – which are subject to annual legislative appropriation – shall be used "…for the supervision and regulation of loan originators". If DFI

receives an adequate appropriation from this new Fund in FY 2011, monies can be used to replenish the Mortgage examination staff, partially mitigating the impact of a budget reduction.

2) DFI's long-term strategic goal is to become a self-supporting agency. Arizona remains one of only 6 states that do not have a self-supporting financial institutions regulator.

3) DFI will continue to seek the removal of the $50K cap that currently exists on its Special Revolving Fund (SRF). Removing the fiscal year-end cap will serve to increase the funds available to DFI, that may be used to fund examiner positions.

Opportunities for Innovation/Restructuring

DFI is a small agency with a simple organization structure. It has only three active Programs/Divisions: Office of Supervision (examinations), Office of Regulatory Affairs (licensing and consumer complaints), and Receiverships. Exploring opportunities for innovation in service delivery, program reform or funding structure is an ongoing effort of management. However, given the size and structure of our agency, opportunities are limited. An example of past innovation is demonstrated by our examination program, where examinations are conducted by mail in areas where risk to the public is assessed to be low.

Faced with urgent regulatory challenges, based on raw year-over–year growth in licensees and increased industry volatility, DFI is currently exploring ways to change its funding structure to acquire new resources. The new Loan Originator Licensing Program (see "Alternative Funding Sources" above), will provide new fees and therefore a source of new funds to DFI. Self-Funding is a longer-term opportunity being explored by the Department, where monies generated from banks, credit unions, and licensees' fees and assessments can be used to underwrite DFI's operations entirely. This mode of funding is fiscally conservative, letting the market dictate the amount of resources available to DFI. When license holders grow in number, the demand on DFI for services, both to the regulated community and consumers, grows commensurately. When the market contracts, and the number of licensees decreases, less fees are available for regulation.

Opportunities for reorganization, given the size and structure of our agency, are limited. The FY 2009 enacted budget reduction resulted in the elimination of DFI's Regulatory Enforcement Unit. This unit oversaw investigations and assisted the Attorney General's office in expediting administrative actions.

FY 2010 BUDGET REDUCTIONS - SUMMARY OF ISSUES
DEPARTMENT OF FINANCIAL INSTITUTIONS

GENERAL FUND

	FY 2010 General Fund Budget	**3,214,100**
	AGENCY REDUCTION TARGET - GENERAL FUND	$482,100

Priority	Issue Title[1]	Reductions Amount
1	Administration Division - Reduction in Force	$23,800
2	Rules & Administrative Counsel - Eliminate Position	$35,400
3	NMLS Project Manager - Eliminate Position	$33,600
4	Deputy Superintendent - Eliminate Position	$50,000
5	Eliminate Outside Investigations	$0
6	Reduction in Travel Expenditures	$0
7	Consumer Affairs Division - Eliminate Division	$116,300
8	Credit Union Division - Eliminate Division	$97,100
9	Bank and Trust Division - Reduction in Force	$0
10	Financial Enterprises Division - Reduction in Force	$136,900
11	Licensing Division - Reduction in Force	$14,300
	Less: Estimated Final Leave Payouts (RIF/Layoffs) - See Note below	($25,000)
	Issue Total	**$482,400**
	Fund Total as a Percentage of General Fund Reduction Target	100%

[1] Please complete the attached Description and Impact Statement for each issue.

Note: The cost of final leave payouts is not yet known; however, the cost is expected to be well in excess of $25,000. DFI plans to utilize furloughs thru fiscal year end to cover this added cost.

FY 2010 BUDGET REDUCTIONS - SUMMARY OF ISSUES
DEPARTMENT OF FINANCIAL INSTITUTIONS

ALL NON-GENERAL FUNDS

FY 2010 All Non-General Funds Budget (less Federal Funds) **1,697,100**

AGENCY REDUCTION TARGET - ALL NON-GENERAL FUNDS (w/o Federal Funds) $254,600

Fund	Reductions Amount	Percent Reductions
Banking Department Revolving Fund	$198,500	78.0%
Receivership Revolving Fund	$0	0.0%
IGA and ISA Fund	$56,100	22.0%
Arizona Escrow Guaranty Fund	$0	0.0%
Issue Total	**$254,600**	

All Non-General Funds Total as a Percentage of Agency Non-GF Reduction Target 100%

FY 2010 BUDGET REDUCTIONS - SUMMARY OF ISSUES
DEPARTMENT OF FINANCIAL INSTITUTIONS

BANKING DEPARTMENT REVOLVING FUND

FY 2010 All Non-General Funds Budget (less Federal Funds) **1,697,100**

AGENCY REDUCTION TARGET - ALL NON-GENERAL FUNDS (w/o Federal Funds) $254,600

Priority	Issue Title[1]	Reductions Amount
5	Eliminate Outside Investigations	$81,600
6	Reduction in Travel Expenditures	$50,000
9	Bank and Trust Division - Reduction in Force	$27,400
10	Financial Enterprises Division - Reduction in Force	$39,500
	Issue Total	**$198,500**

Fund Total as a Percentage of Non-General Fund Reduction Target 78%

[1] Please complete the attached Description and Impact Statement for each issue.

FY 2010 BUDGET REDUCTIONS - SUMMARY OF ISSUES
DEPARTMENT OF FINANCIAL INSTITUTIONS

ARIZONA ESCROW GUARANTY FUND

FY 2010 All Non-General Funds Budget (less Federal Funds)	**1,697,100**
AGENCY REDUCTION TARGET - ALL NON-GENERAL FUNDS (w/o Federal Funds)	$254,600

Priority	Issue Title[1]	Reductions Amount

Note: Monies in this Fund may only be expended for administrative costs and, if the court grants a petition for receivership, the amount of additional funds needed to enable the receiver to pay covered claims against the impaired escrow agent. As such, DFI has no ability to reduce expenditures from this fund.

Issue Total	**$0**
Fund Total as a Percentage of Non-General Fund Reduction Target	0%

[1] Please complete the attached Description and Impact Statement for each issue.

FY 2010 BUDGET REDUCTIONS - SUMMARY OF ISSUES
DEPARTMENT OF FINANCIAL INSTITUTIONS

IGA AND ISA FUND

FY 2010 All Non-General Funds Budget (less Federal Funds) **1,697,100**

AGENCY REDUCTION TARGET - ALL NON-GENERAL FUNDS (w/o Federal Funds) $254,600

Priority	Issue Title[1]	Reductions Amount
10	Financial Enterprises Division - Reduction in Force	$56,100

Note: This Fund was established as a clearing account to properly account for, control, and report receipts and disbursements associated with DFI's interagency service agreement with the Attorney General's Office. The FY 2010 expenditure plan includes the costs associated with two (2) Financial Institutions Examiners who specialize in the examination of Money Transmitters.

It is important to point out that, although expenditures are reduced, monies are not retrievable in the form of Fund Transfers to the General Fund, since incoming monies represent monies reimbursed to DFI by the AG's office in amounts equal to the actual expenditures. Therefore, the Fund cash balance always remains zero.

Issue Total **$56,100**

Fund Total as a Percentage of Non-General Fund Reduction Target 22%

[1] Please complete the attached Description and Impact Statement for each issue.

FY 2010 BUDGET REDUCTIONS - SUMMARY OF ISSUES
DEPARTMENT OF FINANCIAL INSTITUTIONS

RECEIVERSHIP REVOLVING FUND

FY 2010 All Non-General Funds Budget (less Federal Funds) **1,697,100**

AGENCY REDUCTION TARGET - ALL NON-GENERAL FUNDS (w/o Federal Funds) $254,600

Priority	Issue Title[1]	Reductions Amount

Note: Monies in this Fund may be used to pay any costs incurred by the Department arising out of the administration of a receivership in which the superintendent is the receiver. Due to the nature of this Fund, DFI has no ability to control the level of expenditures for FY 2010. Therefore, DFI cannot achieve any reduction target for this fund.

DFI is currently administering a sizeable receivership (Landmarc Capital & Investment Company). FY 2010 expenditures also include the outside attorney costs associated with the recent closure of two Arizona state-chartered banks (Community Bank of Arizona and First State Bank of Flagstaff, Arizona), where the FDIC was appointed receiver.

Issue Total **$0**

Fund Total as a Percentage of Non-General Fund Reduction Target 0%

[1] Please complete the attached Description and Impact Statement for each issue.

STATE OF ARIZONA
FY 2010 BUDGET REDUCTIONS - ISSUE DESCRIPTIONS

Department of Financial Institutions

Issue Title: Administration Division – Reduction in Force

Issue Priority: 1

Reduction Amounts:
General Fund: $23,800 (2 FTE)

Total: $23,800

Issue Description and Statement of Effects

DFI's FY 2010 budget includes funding for the following positions, which will be the first to be eliminated under this reduction plan:

- Accounting Technician II (1 FTE)
- Clerk Typist II (1 FTE)

The employee in the Clerk Typist II position serves as DFI's receptionist, greeting and directing licensees, complainants, and consumers who either contact the Department by telephone or visit in person. The elimination of this position will result in many callers being directed into voice mail, rather than being able to speak with a live person. This will negatively impact workflow, and licensee and consumer satisfaction levels will deteriorate, as inefficiencies are added to the system.

The responsibilities of the Accounting Technician III position, which is currently vacant, will be absorbed by existing staff permanently. With the elimination of this position DFI is no longer able to ensure that adequate internal controls are maintained over accounting and payroll functions.

Alternative Ways to Fund Program or Function

There are no alternatives. In order to meet a reduction target of 15%, across the board reductions are necessary.

STATE OF ARIZONA
FY 2010 BUDGET REDUCTIONS - ISSUE DESCRIPTIONS

Department of Financial Institutions

Issue Title: Rules & Administrative Counsel – Eliminate Position

Issue Priority: 2

Reduction Amounts:
General Fund: $35,400 (1 FTE)

Total: $35,400

Issue Description and Statement of Effects

Under this Reduction Plan, DFI's Rules & Administrative Counsel will be eliminated. Reporting directly to the Superintendent, the attorney in this position performs several functions. Briefly, they are rules, public information officer, custodian of records and administrative counsel.

Rules Attorney. The rules attorney is responsible for DFI's compliance with Arizona's Administrative Procedure Act (A.R.S. §§ 41-1001, *et seq.*) This work includes rulemaking, five year rule review reporting, compilation and indexing of Substantive Policy Statements, reporting on compliance with licensing time frames, and all other interactions with the Governor's Regulatory Review Council ("GRRC").

Of these tasks, the most critical is the rule review reporting. Failure to produce the review reports in a timely manner causes the unreviewed rules to lapse, rendering them void and unenforceable. There is a rule review report, originally due 9/30/09 that has been extended to 1/28/10. That review will cover Articles 6, 7, 8, 10 & 11 of our administrative rules. In addition, there is a rule review report on Articles 12, 14, 15, 16 & 17 due in 11/10.

Second in importance, especially in light of our new LO licensing program and other revisions to mortgage lending statutes, is the rulemaking function. There are new rules needed with regard to the new Commercial Mortgage Broker license, the conversion process of Mortgage Banker to Mortgage Broker, and a "regular" rulemaking that must be begun promptly as soon as the LO Emergency rules are approved by the AG's office. The need for these rules is critical because the lack of rules means the understaffed Department must spend more time on the telephone explaining the Department's enforcement criteria and policies.

Administrative Counsel. DFI's Administrative Counsel reviews Administrative Law Judges' ("ALJs") recommended decisions, and performs legal research to aid the Superintendent in revising ALJs' recommended decisions. This task has increased in importance because the current Interim Superintendent is not a lawyer capable of doing the work himself, as the previous Superintendent did. DFI's Administrative Counsel also supplies legal research in various other contexts as the need arises. Historically, those requests have come only from the Superintendent. Research is also provided to aid examiners in answering questions from licensees, and also in similar situations for Consumer Affairs. Finally, this employee may be asked to analyze a bill or statute to determine what new or different burden it might place on DFI. It is prudent to have this work done by a licensed member of the State Bar of Arizona.

If this position is eliminated, the functions of administrative counsel will be served by the Office of the Attorney General (AG), if at all. The existence of an administrative counsel is very helpful in ensuring the availability of qualified legal advice as needed, regardless of the AG's workload.

Public Information Officer/Custodian of Records. The Custodian of Records manages DFI's compliance with the Arizona Public Records Law, A.R.S. §§ 39-101 *et seq*. In the case of DFI, that statute and its broad policy in favor of public records disclosure is limited by the language of A.R.S. §§ 6-129 and 6-129.01 mandating the confidentiality of certain DFI records. The Custodian of Records is best served by having an Arizona lawyer in the post. But the AG's office has supplied the Department with a chart of which records can be disclosed to whom. Using the chart, it is possible for a non-lawyer to do this job. The limiting factor on performance of this function is the lack of support staff. While critical, this function is a clerical nightmare and very time consuming given the lack of clerical help. That factor cannot be mitigated by eliminating the rules attorney position.

The Public Information Officer ("PIO") interacts with the media as well as with consumers and licensees that contact DFI with questions about its operations and records. Much of this work centers around document requests; hence the overlap of PIO and Custodian. It takes training to do this job well because the natural impulse is to be more forthcoming than is, or may be, consistent with the confidentiality of much of DFI's work. While others in the Department have performed this task in the past, the Acting Deputy Superintendent is the only other person on the DFI staff trained to manage media contacts.

Alternative Ways to Fund Program or Function

There are no alternatives. In order to meet a reduction target of 15%, across the board reductions are necessary.

STATE OF ARIZONA
FY 2010 BUDGET REDUCTIONS - ISSUE DESCRIPTIONS

Department of Financial Institutions

Issue Title: NMLS Project Manager – Eliminate Position

Issue Priority: 3

Reduction Amounts:
General Fund: $33,600 (1 FTE)

Total: $33,600

Issue Description and Statement of Effects

In July 2008, President Bush signed the Housing and Economic Recovery Act of 2008, which mandated that States license loan originators within one year or the federal government would take over the right to license, supervise and examine mortgage origination. Title V – Secure and Fair Enforcement of Mortgage Licensing Act (SAFE Act). The SAFE Act requires all states to utilize the Nationwide Mortgage Licensing System ("NMLS"). The NMLS is a web-based licensing system for loan originators, mortgage brokers, bankers, and commercial mortgage bankers.

At the end of calendar year 2008, DFI hired a Project Manager to oversee the overhaul of its current information management system and the interfacing of that system with the mandated NMLS. At that time, due to the volume of licensees and inadequate staffing in the Licensing Division, the uncovered manager was working approximately 100 hours per pay period to keep up with the volume and was unable to assume the additional responsibility of developing the necessary infrastructure and implementation, and information technology expertise necessary to make transition to the NMLS a reality.

The migration of existing licensed mortgage companies to this new system began earlier this year. Since January 1, 2009, mortgage brokers, mortgage bankers, and commercial mortgage bankers have been required to submit their license applications and renewals, and amend their licenses via NMLS. The transition has not been smooth, complicated by the fact that DFI's licensing database is so antiquated it will not interface with NMLS, thereby, creating the need for double processing.

Under this reduction plan, the NMLS Manager will be eliminated, with responsibilities absorbed by the Licensing Division Manager, stretching limited resources even further, as DFI must implement a newly mandated Loan Originator Licensing Program (projected to result in 5,000 new license applications that must be processed by July 1, 2010) without any additional resources appropriated for the program. At the same time, a project is now underway to convert DFI's existing Licensing System to a new database (Phase I target date is March 1, 2010).

Alternative Ways to Fund Program or Function - There are no alternatives. In order to meet a reduction target of 15%, across the board reductions are necessary.

STATE OF ARIZONA
FY 2010 BUDGET REDUCTIONS - ISSUE DESCRIPTIONS

Department of Financial Institutions

Issue Title: Deputy Superintendent – Eliminate Position

Issue Priority: 4

Reduction Amounts:
General Fund: $50,000 (1 FTE)

Total: $50,000

Issue Description and Statement of Effects

Arizona Revised Statutes provides that the Superintendent "shall appoint a deputy superintendent who shall have the power and perform the duties of the superintendent." A.R.S. § 6-112.

The Deputy Superintendent position is mission critical, required by statute, and crucial to the implementation of many programs, including the supervision and examination of Loan Originators. With the recent resignation of Superintendent Rotellini, the Deputy position has become even more critical. The current Interim Deputy Superintendent has extensive experience in real estate, title and escrow, as well as an extensive legal background. In his current role, he is also in charge of the Department's Regulatory Enforcement Unit, Consumer Affairs, Information Technology, and is overseeing the overhaul of our database. With his legal background, he also works closely with the Assistant Attorneys General assigned to DFI, dealing with statutory interpretation issues, administrative law proceedings and the challenges related to the new loan originator licensing program.

Under this reduction plan, the Deputy Superintendent position will be eliminated and responsibilities will be shifted to other managers within the agency. Additional burden will also fall on the Interim Superintendent, who is also still performing his previous duties as Banking Division Manager. The transition of responsibilities will be complicated by the fact that the Deputy Superintendent was recently appointed Deputy Receiver of Landmarc Capital & Investment Company. A considerable amount of the Deputy's time is currently consumed by this new role. Resources are not currently available within the agency for the transition of this responsibility to another manager.

Alternative Ways to Fund Program or Function

There are no alternatives. In order to meet a reduction target of 15%, across the board reductions are necessary.

STATE OF ARIZONA
FY 2010 BUDGET REDUCTIONS - ISSUE DESCRIPTIONS

Department of Financial Institutions

Issue Title: Eliminate Outside Investigations

Issue Priority: 5

Reduction Amounts:
Special Revolving Fund: $34,600 (0.5 FTE)
Special Revolving Fund: $47,000

Total: $81,600

Issue Description and Statement of Effects

Due to recent budget reductions, DFI eliminated its Regulatory Enforcement Unit at the end of FY 2009. However, there remains one (1) part-time Financial Institutions Investigator who is currently funded from our Special Revolving Fund (SRF). In addition, while DFI has stopped many of the investigations that were being conducted by Independent Contractors in FY 2009, certain critical investigations have continued into FY 2010.

The FY 2010 expenditure plan for the SRF includes the payroll costs associated with this one part-time employee, and the costs associated with utilizing Outside Independent Contractors for Investigative Services. Under this reduction plan, DFI proposes to eliminate the remaining part-time employee and eliminate (or reduce) the expenditures for Outside Independent Contractors. Projected expenditure reductions are as follows:

- Financial Institutions Investigator: $34,600
- Outside Independent Contractors: $47,000

Background:

DFI regulates financial institutions and enterprises in Arizona. We make sure the state chartered banks and credit unions are operated in a safe and sound manner. We also license, examine and supervise 15 other types of financial services including mortgage brokers, mortgage bankers and escrow companies that directly impact the viability and health of Arizona's real estate market and, ultimately, the health of Arizona's economy. In fact, the current budget deficit and the decline in Arizona's economy can be directly traced to the lack of accountability in real estate transactions and mortgage lending.

This lack of accountability and resulting breakdown in consumer confidence was partially caused by a lack of adequate regulation, resulting in poor lending and underwriting practices, reckless placement of borrowers in loans they could not afford and mortgage fraud.

The funds in the SRF are utilized for examination and investigation of licensed mortgage brokers, mortgage bankers and escrow companies. Any reduction in expenses from the SRF will further reduce the resources available for investigations of complaints of mortgage fraud and mortgage lending practices that are in violation of Arizona law. Investigations funded by the SRF have resulted in referrals to law enforcement agencies such as the Arizona Attorney General's Office and the United States Attorney General. These referrals have resulted in indictments of persons facilitating and engaging in mortgage fraud who have harmed consumers (who were mislead by representations and theft of their money) and Arizona banks who have lost money through fraudulent loans.

There are policy makers that believe there should be less regulation and more criminal enforcement of laws already on the books. DFI is trying to achieve that goal by investigating the worst actors and removing them (by administrative action or civil action) from the financial services industry and simultaneously referring these cases to law enforcement for criminal prosecution. The investigators and examiners funded through the Special Revolving Fund work along side law enforcement to assist them with expertise on complicated financial transactions.

<u>Impact of Budget Reduction:</u>

In March of 2009, before the Regulatory Enforcement Unit was eliminated, there was a total backlog of 170 outstanding mortgage fraud related complaints/investigations, divided between three full-time investigators (2 SRF, 1 General Fund). There is currently only one part-time employee to investigate mortgage fraud complaints, and the use of Independents Contractors is extremely limited. Backlogged complaints present a very serious problem because witnesses' and complainants' memories fade, key documents become harder to obtain and find, unpunished bad actors move to different companies, companies close, and consumers suffer from the extraordinary delay in reaching a resolution. Under this Budget Reduction, there will be no funding for investigations, resulting in the following:

- Consumer and industry complaints primarily related to the mortgage industry and mortgage fraud will come to a grinding halt.

- Complaints from banks and consumers will not be investigated. The Department's mortgage fraud complaint/investigation backlog will become dated and unresolved.

- Confidence in the Arizona real estate economy will suffer, along with consumer confidence in the financial services industry.

- Bad actors that cause harm to businesses and consumers will not be removed from the industry, but will remain in Arizona.

- Consumer protection will greatly suffer and consumer confidence will fall.

Alternative Ways to Fund Program or Function

There are no alternatives. The use of the SRF for these expenditures was DFI's only alternative when funds for this purpose were not provided in our General Fund budget.

STATE OF ARIZONA
FY 2010 BUDGET REDUCTIONS - ISSUE DESCRIPTIONS

Department of Financial Institutions

Issue Title: Reduction in Travel Expenditures

Issue Priority: 6

Reduction Amounts:
Special Revolving Fund: $50,000

Total: $50,000

Issue Description and Statement of Effects

DFI's FY 2010 expenditure plan for its Special Revolving Fund includes $100K for employee travel reimbursement (In-State $60K; Out-of State $40K). Under this reduction plan, DFI proposes to reduce such expenditures by $50K. This reduction will be accomplished by placing the following restrictions on employee travel:

- Cease all examinations outside Maricopa County of all banks, credit unions, and other non-depository licensees (a limited restriction is in place currently)
- Cease all out-of-office training
- Curtail travel by management to meetings, seminars, or other programs that would incur travel

Background:

Due to budget reductions in FY2002 and FY2003, DFI lost the funds to pay travel expenses for examinations of banks, credit unions, trust companies, and all non-depository licensees, including payday lenders and mortgage companies. At a time when DFI was experiencing average annual growth in mortgage companies of 12-13%, DFI lost its funding to travel outside Maricopa County to conduct examinations. To avoid a reduction in force - actually firing examiners so that DFI has money to send other examiners on examinations - DFI was forced to fund its employee travel expense reimbursements for in and out-of-state travel using its Special Revolving Fund ("SRF", fund #2126).

By statute, DFI cannot charge credit unions or banks examination fees or travel expenses. Therefore, DFI must have sufficient funds to reimburse state employees for all costs incurred on these in-state, out of Maricopa County examinations.

Prior to FY 2002, DFI received an appropriation of $50.0 In-state and $18.0 Out-of-state (see 2001 GF appropriation). By FY 2007, travel expenditures grew to $137.1. Travel reimbursements have increased significantly due to:

- increased number of licensees
- per mile increases for mileage reimbursement
- lodging and per diem increases
- additional examinations performed (due to growth in licensees)
- additional examiners and training requirements
- airfare increases

In FY 2008, travel expenditures dropped to $71.6 because DFI imposed a midyear travel restriction to address a projected deficit in the SRF due to reduced civil money penalties. Those restrictions placed devastating constraints on DFI's ability to properly oversee its banks, credit unions, and other non-depository licensees. Counties outside Maricopa are neglected because of the lack of funds to reimburse examiners for costs they incur.

In FY 2009, travel expenditures totaled $76.7K. For much of the year, monies in the SRF were adequate to allow travel without restriction. This was due to an extraordinary settlement collected by DFI in October 2008. However, in July 2009, DFI once again imposed certain travel restrictions, since (by statute) the balance in the SRF is reduced to $50K at the start each fiscal year.

Financial Enterprises:

DFI regulates 14 different types of financial enterprises (non-depository entities), including: escrow agents, collection agents, motor vehicle dealers, sales finance companies, mortgage brokers, mortgage bankers, commercial mortgage bankers, money transmitters, debt management companies, consumer lenders, premium finance companies, payday lenders, and advanced fee loan brokers. With the addition of Loan Originators and Commercial Mortgage Brokers, DFI now regulates 16 different types of financial enterprises. By law, DFI cannot charge its in-state licensees the costs of the examination. Without a travel budget DFI cannot adequately supervise financial enterprises.

Banking Division:

The deteriorating economy and the mortgage crisis are affecting banks across the country. More banks are failing across the country. As of August 2009, four (4) banks located in Arizona have failed. Although three (3) of these banks were regulated by other federal and state regulators, the financial condition of Arizona banks is deteriorating. Plummeting earnings are becoming more prevalent, preventing accretion to capital that is required for the banks to remain strong and grow. In fact, DFI closed

Phoenix-based Community Bank of Arizona on August 14, 2009 and First State Bank of Flagstaff, Arizona on September 4, 2009, (both Arizona state-chartered banks), and the FDIC was appointed receiver.

Of the 34 state-chartered banks, 27 or **79 percent reported net operating losses** for the first six months of calendar year 2009. The remaining banks, although profitable, show significantly lower net income year-to-date. We expect this trend will continue for the remainder of this year and well into 2010. These operating losses can be attributed to loan charge-offs, rising delinquencies, and required increases in loan loss reserves. These increases in operating losses cause more risk for the banks and for Arizona.

DFI is directed by statute to examine every bank in a 24 month period. There are currently 34 state-chartered institutions to be examined within that 24 month period, and 13 are located outside of Maricopa County. Given budget constraints, DFI has been restricted on travel to banks and trust companies outside of Maricopa County. This placed severe constraints on the examination schedule in FY 2008, and without a reliable funding source, threatens our ability to provide proper oversight of our banks and trust companies in FY 2009.

As the regulator of state-chartered banks and trust companies, the banking division must be prepared to perform examinations of these entities when risk is identified. We must be able to comply with our statutory mandate and our operating agreements with the Federal insurer of state-chartered banks, the FDIC.

Credit Union Division:

Not only are banks affected by the slumping economy, but credit unions also are suffering the consequences of foreclosures, layoffs, and bankruptcy filings.

The credit union division must also comply with our statutory examination mandate and, similar to the banking division, must comply with our operating agreement with the federal insurer of our credit unions, the NCUA.

Loan losses associated with residential foreclosures, home equity lines of credit, and automobile loans have reached an all-time high – levels we have not seen since the Savings and Loan crisis. With loan losses, earnings continue to plummet, as does net worth (capital/equity).

As of December 31, 2008, all of our 26 state-chartered credit unions reported significant net losses and have not yet recovered. Most of the credit unions do not forecast positive earnings until late 2010 or mid-2011. Unlike banks, credit unions cannot arrange a one-time capital injection from stockholders, because they are cooperative, non-profit entities, "owned" by their members. The only source to cover loan losses is undivided earnings, which dwindle quite quickly when realizing millions of dollars in loan losses, especially in smaller credit unions. DFI must stay on top of these struggling institutions and that means traveling to them regularly to conduct examinations.

Nine of our credit unions are outside of the Phoenix metropolitan area, and require travel expenses for our examiners, including lodging, meals and mileage reimbursement. Because of the asset size of many of these credit unions, we need to assign four examiners to the examination, and DFI only has two examiners due to budget cuts. Depending upon the risks identified, examiners may be required to remain at the credit union from two days (a visitation) to three weeks (a full scope examination).

The lack of necessary funds for travel places debilitating restrictions on DFI's ability to properly oversee our credit unions. **For example, there was a credit union outside of Maricopa County that reported a $634,000 loss as of June 30, 2008. We had to delay the examination of this credit union until after FY 2008, because there were no funds available for travel. It was even questionable whether we could find the funds to examine this credit union during FY 2009.** We also had a credit union in Tucson reporting a net loss of $278 thousand and its loan delinquency has tripled. Examining these credit unions is critical, yet we had no funds available at that time to do so. Their deteriorating condition brought about by large loan losses presents a tremendous risk to Arizona consumers and depositors.

Impact of Reduction:

- The lack of travel funds, places significant constraints on our examination schedule and debilitates our ability to properly oversee our banks, credit unions and non-depository regulated entities, leading to more failures, and placing consumers at risk.

- There have been seventy-seven bank failures nationally so far this year (through mid-August), including the recent failures of Arizona state-chartered banks. Additional failures of Arizona state chartered banks or credit unions will further erode consumer confidence in the financial system, putting more pressure on bank and credit union liquidity and capital levels.

- Counties outside of Maricopa will continue to be neglected, putting consumers in those areas at greater risk as problems continue to go undetected.

Alternative Ways to Fund Program or Function

There are no alternatives. The use of the Special Revolving Fund for these expenditures was DFI's only alternative when funds for this purpose were removed from our General Fund budget.

STATE OF ARIZONA
FY 2010 BUDGET REDUCTIONS - ISSUE DESCRIPTIONS

Department of Financial Institutions

Issue Title: Consumer Affairs Division – Eliminate Division

Issue Priority: 7

Reduction Amounts:
General Fund: $116,300 (5 FTE)

Total: $116,300

Issue Description and Statement of Effects

Given the size of the budget reduction target, DFI will no longer be able to afford a Consumer Affairs Division. As a result, the following positions will be eliminated under this plan:

- Financial Institutions Examiners (4 FTE)
- Administrative Secretary I (1 FTE)

Note: One remaining Financial Institutions Examiners will shift to the Enterprises Division.

The Consumer Affairs Division is the primary contact for the public and licensees to ask questions regarding state statutes, rules, and other authoritative guidance regarding operations of a financial institution or enterprise within the state of Arizona. The Consumer Affairs Division also investigates complaints filed against individuals suspected of engaging in unlicensed activities. Persons conducting business without the proper license are of great concern to the Department.

DFI investigates a significant number of unlicensed activity cases every year. This type of activity is potentially a problem to all concerned because the business of the unlicensed entity is without Department review of the individuals operating the entity and without supervision to control their activities. Unlicensed activity is deterred through the usage of a broad array of administrative sanctions and further prosecution when appropriate.

Lastly, the Division is responsible for reviewing complaints filed against entities licensed by our agency. Nearly 1,000 regular complaints were received by DFI in FY 2009. The responsibility for investigating these complaints resided with five dedicated examiners. Given the current economic crisis, foreclosure and mortgage complaints are increasing. Coupled with the raw year-over-year growth in the number of licensees over recent years, consumer complaints are critically backlogged. Currently, complaints are taking over 100 days on average to complete. That situation will only worsen, as a projected 5,000 licensed loan originators are expected to be added by July 1, 2010.

Risks and Impacts of Eliminating the Consumer Affairs Division:

- Foreclosure intervention and unlicensed activity investigations will stop
- Complaint processing will stop, leaving consumers no where to turn for help
- Frustration among the public will escalate and consumer confidence will plummet
- Complaints will likely flow to State legislators and/or the Governor's Office

Alternative Ways to Fund Program or Function

There are no alternatives. In order to meet a reduction target of 15%, across the board reductions are necessary.

STATE OF ARIZONA
FY 2010 BUDGET REDUCTIONS - ISSUE DESCRIPTIONS

Department of Financial Institutions

Issue Title: Credit Union Division – Eliminate Division

Issue Priority: 8

Reduction Amounts:
General Fund: $97,100 (3 FTE)

Total: $97,100

<u>**Issue Description and Statement of Effects**</u>

Under State personnel rules, DFI's two remaining Credit Union examiners will be among the first to be terminated as part of a Reduction in Force (RIF). With specialized and lengthy training required for examiners to be properly trained in this area, there will be no trained examiners to perform such examinations (other than the current Division Manager). For all intents and purposes, the Credit Union Division will cease to exist, as it will no longer have the capacity to supervise the industry.

It is not by choice that the remaining Credit Union examiners will be terminated and the Division eliminated. Rather, the inclusion of this Issue Priority in DFI's reduction plan reflects the fact that State Personnel Rules will dictate the examiners that will be terminated as part of a RIF. It is the inflexibility of State personnel rules surrounding a RIF that will result in this unintended consequence. The elimination of Consumer Affairs examiners (see Issue Priority # 7) – or most any other examiners within DFI – with higher retention points will "bump" the two (2) Credit Union Examiners from their current positions. Accordingly, the following positions will be eliminated under a reduction plan of this magnitude:

- Financial Institutions Examiners (2 FTE)
- Credit Union Division Manager (1 FTE)

<u>Background:</u>

DFI examines and supervises 24 credit unions with well over $7 billion in assets. Continued asset growth, huge loan losses, negative earnings, and ever-increasing operating expenses have resulted in a significant decline in net worth (capital). All of our credit unions reported huge losses (and enormous provision expense) as of December 31, 2008 and have not yet recovered. Most of the credit unions do not forecast positive earnings until late 2010 or mid-2011. Loan losses stemming from borrowers who are now unemployed or have substantially reduced income are almost the sole contributors to the financial crisis at hand; these borrowers are unable to make their mortgage payments, retain their vehicles, or pay their voluminous credit card debt.

The financial crisis has caused two of our credit unions to merge with larger institutions, and one merger is currently pending. Leaders who have never had to deal with this type of financial crisis are at the helm of many of our credit unions. Capital levels have fallen so low in a few credit unions that they are under capital restoration plans. This creates the necessity for regulators to monitor these credit unions very closely and to ensure failure or liquidation is not imminent.

In previous years, we examined credit unions every 12-18 months, depending upon their asset size and financial condition, but always well within our statutory requirement of 24 months (A.R.S. Section 6-122.B.2). During the last year, we have had to hasten examinations of "at risk" credit unions and (in many cases due to financial issues and loan losses) it has been necessary to examine and/or monitor these credit unions quarterly. Examinations and visitations are taking much longer than previous years due to more complex issues. Credit unions are trying to assist members/customers in modifying their loans to an affordable level, but at the same time sacrificing earnings and capital to do so.

Due to the retirement of examiners and staffing issues caused by budgetary constraints, we are unable to examine all of our credit unions within our statutory mandate. **DFI began FY 2009 with five (5) credit union examiners, but it now has only two (2), both of which have merely two years experience on the job**, thus DFI has been forced to turn over the examination and oversight of some of our credit unions to the Federal regulator/insurer. This has not happened before in the history of this Department and effectively eliminates the dual chartering system, which has been in existence since 1934. This system allows a bank or credit union to choose either a Federal or State regulator.

With the financial crisis at hand and not expected to improve until possibly the end of 2010 or mid-2011, this is not the time to reduce our oversight. We read about one bank closure after another in the newspaper. It is only a matter of time until we start reading about more credit union liquidations – we can only hope this does not happen to one of our Arizona state-chartered credit unions while DFI faces examiner reductions.

<u>Impact of Budget Reduction:</u>

- Elimination of the Division would eliminate the credit unions' option of a dual chartering system which has been in existence since 1934. Credit Unions would be forced to convert to a Federal charter if no State oversight exists.

- Paid assessments would most likely have to be refunded if we were unable to examine our Credit Unions during the current fiscal year. Furthermore, the State would lose all assessment revenue in future years (FY 2010 assessment revenue totaled $534K).

- DFI would fail to meet its statutorily required examination schedule, as no examination would be performed by DFI.

- Examination oversight would shift solely to the Federal regulator thereby eliminating DFI's regulatory oversight of the credit union.

- Inability to respond to a crisis and ensure that Arizona-chartered Credit Unions are fundamentally safe and sound.

- Inability to prevent potential credit union liquidations which pose a threat to Arizona as net losses increase and safety and soundness deteriorates.

Alternative Ways to Fund Program or Function

There are no alternatives. ***Under current State personnel rules we find ourselves with little flexibility and no discretion when formulating strategies.***

A budget reduction of this magnitude cannot be achieved without significant cuts to the examination team. Since all DFI examiners are in the same "class series", State personnel rules dictate that Credit Union examiners will be among the first to be terminated. Due to specialized training requirements, Credit Union examiners cannot be replaced by other DFI examiners.

STATE OF ARIZONA
FY 2010 BUDGET REDUCTIONS - ISSUE DESCRIPTIONS

Department of Financial Institutions

Issue Title: Bank and Trust Division – Reduction in Force

Issue Priority: 9

Reduction Amounts:
Special Revolving Fund: $27,400 (1 FTE)

Total: $27,400

Issue Description and Statement of Effects

Under State personnel rules, one (1) of three remaining Bank & Trust Division examiners will be among the first to be terminated as part of a Reduction In Force (RIF). Under this reduction plan, the following position will be eliminated:

- Financial Institutions Examiner (1 FTE)

DFI charters and examines 34 state-chartered banks with $5.7 billion in total assets. It is essential that we examine all aspects of their operations using specially trained examiners, when necessary, to prevent failures of these institutions and protect Arizona consumers. The examinations process provides a method for identifying weaknesses in bank operations and allows DFI to demand corrective action from bank management and the bank's board of directors.

79 percent or 27 of our state-chartered banks reported operating losses for the first six months of calendar year 2009. Much of these losses are due to defaults on loans and write downs on repossessed real estate loans. Further, total delinquencies have increased 84 percent and non-accrual loans are up 115 percent for the same period. These facts increase our need to examine the banks more frequently to protect against failure and the loss of deposits for our citizens.

Given the current financial crisis, the potential for bank failures has increased, requiring heightened supervision and oversight. The loss of 1 Bank examiner will ensure DFI's inability to supervise effectively because **DFI will have only 2 bank examiners, at a time when 27 out of 34 state-chartered banks are operating at a loss.**

The current economic crisis and the number of failed banks (eighty-one (81) year-to-date across the country), including four (4) so far with banking activities in Arizona is adversely affecting the reputation of the banking industry locally and nationally. In fact, **DFI closed Phoenix-based Community Bank of Arizona on August 14, 2009 and First State Bank of Flagstaff, Arizona on September 4, 2009, (both Arizona state-chartered banks), and the FDIC was appointed receiver**. **DFI sought the receiverships because the banks' financial condition was unsafe and unsound.** We currently have a number of additional state-chartered banks that face the possibility of failure by the end of the 2010 fiscal year. DFI desperately needs the authorization and funding for three (3) additional examiners for fiscal year 2011 to develop expertise in mission critical subject matter and to help prevent failures of our state-chartered banks and trust companies.

By statute (A.R.S. Section 6-122.B.2), banks must be examined every two years. However, their deteriorating financial condition requires constant supervision to ensure that these financial institutions make every effort possible to stabilize their financial condition and protect their depositors. This involves frequent examiner visitations with management and the potential necessity of restricting or limiting certain actions or programs to assist in the recovery of earnings and net worth. Even with our current staffing, DFI often does not have sufficient personnel to monitor our state-chartered banks and credit unions as closely as necessary. A reduction in examiners makes this crucial oversight almost impossible.

There are four independent trust companies operating in Arizona. Independent trust companies must be examined annually due to unique risks. These risks include the limited capital levels required to start, funds that are not FDIC-insured, and lack of strong internal control procedures in place to protect trust customer accounts. Bank trust departments are examined in conjunction with the safety and soundness examination of the bank.

As a result of retirements and departure of trust examiners, DFI has one examiner qualified to examine independent trust companies and bank trust departments. As these institutions increase their volume of assets under management, the complexity of the examination process increases exponentially, requiring additional trained personnel.

The Bank and Trust Division was first accredited in 1996 by the Conference of State Bank Supervisors (CSBS) and re-accredited in November 2001 and again in May 2006. For this latest re-accreditation, the review team presented very strongly worded findings and recommendations to the Division. **Based upon the Accreditation Program guidelines and comparison with the other 44 accredited departments, DFI is materially understaffed and they recommended the staff be doubled. They also stated that "There simply aren't enough resources to go around and to provide the people of Arizona the level of service to which DFI aspires."**

During the first three years of operation, new banks must be examined on a semi-annual or annual basis. Currently there are six (6) new banks operating in Arizona.

New banks take an inordinate amount of supervision time in order to ensure they successfully meet their business plan. Further, given the significant deterioration in the condition of our state-chartered banks since June 2008, the shortage of qualified examiners is placing great hardship on the staff. Not only do regular examinations require more time but visitations between examinations are required due to the conditions of many of the banks.

DFI's goal is to protect the citizens of Arizona that bank with these banks and trust companies, to prevent a banking crisis in Arizona such as experienced during the savings and loan crisis of the 1980's and early 1990's and during the current crisis facing financial institutions around the world. This goal can best be met through adequate staffing of qualified and properly trained examiners. Current staffing for the Division (from both General Fund and non-appropriated fund sources) is three (3) examiners (two (2) with over ten years of examination experience, and the other with two years experience). It takes a minimum of 4 years to train and educate a safety and soundness examiner to the point where he/she can perform the basic examination of a bank. Examinations of specialty areas require additional years of classroom and on-the-job training.

Risks and Impacts of Fewer Bank Examiners:

- Possible increase in bank and trust company failures due to inadequate supervision by DFI;
- Possible loss of uninsured deposits by Arizona customers of a failed bank;
- Possible loss of trust assets by customer of a failed trust company;
- Inability to respond quickly in crisis and ensure that its institutions are fundamentally safe and sound;
- Inability to meet DFI's statutorily-required examination schedule;
- Unable to conduct examinations without reliance on federal regulators;
- Criticism by federal regulatory agencies as to the state's lack of oversight

Alternative Ways to Fund Program or Function

There are no alternatives. In order to meet a reduction target of 15%, across the board reductions are necessary.

STATE OF ARIZONA
FY 2010 BUDGET REDUCTIONS - ISSUE DESCRIPTIONS

Department of Financial Institutions

Issue Title: Financial Enterprises Division – Reduction in Force

Issue Priority: 10

Reduction Amounts:
General Fund: $136,900 (5 FTE)
Special Revolving Fund: $39,500 (1.5 FTE)
IGA and ISA Fund: $56,100 (2 FTE)

Total: $232,500

Issue Description and Statement of Effects

The Financial Enterprises Division is responsible for administering the general program of examination, supervision, and financial analysis of nearly 3,700 licensees spread among 14 different types of regulated entities. With the addition of Loan Originators and Commercial Mortgage Brokers, the Enterprises Division's responsibility will grow to an estimated 8,700 licensees by July 1, 2010, spread over 16 different types of regulated entities. Responsibilities include scheduling examinations (pursuant to statutory requirements), reporting results of examinations, and taking appropriate formal or informal regulatory enforcement action where necessary.

Under State personnel rules, the following positions will be eliminated as part of a Reduction in Force (RIF):

- Financial Institutions Examiners (7.5 FTE)
- Administrative Secretary III (1 FTE)

As illustrated in the Overview section (page 2) of this plan, with the loss of eight (8) additional examiners, the Financial Enterprises Division will be left with a pool of three (3) examiners for nearly 3,700 current license holders. For all practical purposes, DFI's Supervisory Program over licensed Financial Enterprises will be forced to operate in a manner dramatically different than is currently the case. The pool of (3) three examiners will devote time to responding to crises across all regulated industries. The existing examination by mail program will be expanded to replace field examinations, allowing for examinations to be performed in the office.

As of July 31, 2009, escrow agents and mortgage brokers, bankers and commercial bankers accounted for 1,548 of DFI's nearly 3,700 total licenses (42%). With the addition of an estimated 5,000 newly licensed loan originators by July 1, 2010, mortgage brokers, mortgage bankers, and loan originators will account for nearly 75% of all licensees regulated by the Department. Since the impact of examiner reductions will be similar across all license types, only the industries most affected are discussed below.

Mortgage Examiners:

Prior to the budget reductions that first began in FY 2008, DFI had 7 mortgage examiners (4 general fund, 3 special revolving fund). Currently, DFI is operating with only **2 examiners assigned to examine nearly 1,500 mortgage brokers and bankers.** However, by July 1, 2010, an estimated 5,000 loan originators will be licensed for the first time, increasing the total number of mortgage brokers, bankers, and loan originators to nearly 6,500.

It should be noted that since DFI did not receive any additional funding to implement the newly mandated Loan Originator Licensing Program, DFI examiners must also be utilized to assist the Licensing Division review Loan Originator License applications by July 1, 2010 .

Under this Reduction Plan, the Financial Enterprises Division will no longer have a staff of dedicated mortgage examiners. Rather, it will be left with a general pool of **three (3) examiners for nearly 8,700 total licensed Enterprises.**

- For all practical purposes, the supervision of Financial Enterprises will stop;

- Regulation of residential mortgage loan originators will be severely impacted, until Loan Originator funds can be used to hire staff.

DFI is already so substantially short-handed that it is unable to comply with the statutory five-year mandatory examination cycle for mortgage companies, and is in violation of Arizona law (A.R.S. § 6-122(B)). As reported in DFI's FY 2011 budget submission:

- 539 mortgage brokers, mortgage bankers, and commercial mortgage bankers have not been examined within the statutorily mandated five year timeframe (A.R.S. Section 6-122(B).

Further, the five year examination requirement is insufficient to detect existing problems and does not adequately prevent possible business failures and losses to Arizona citizens.

Risks and Impacts of Fewer Mortgage Examiners:

- DFI will fall even further behind on its examination schedule – growth in examination backlog will accelerate with no ability to catch-up.

- The State of Arizona will face continued liability exposure for not complying with the statutory examination requirement.

- General Fund will lose revenues - examiners pay for themselves through examination fees.

- Increased likelihood of Arizona consumers being harmed through illegal or deceptive practices.

- Licensees will fail, mortgage industry jobs will be lost, and consumers will continue to lose money, their homes and confidence in Arizona businesses and its state government.

- Investors will not buy Arizona loans. Arizona consumers will have less access to home loans because the large money centers do not consider Arizona as a safe market for investment.

- The Arizona real estate economy will suffer.

Escrow Examiners:

Prior to the budget reductions that first began in FY 2008, DFI had 7 escrow examiners (5 general fund, 2 special revolving fund). As stated above, under this Reduction Plan, DFI will be left with a general pool of three (3) examiners assigned to all regulated industries. Therefore, their examination responsibilities will also extend to **93 currently licensed escrow companies.**

DFI is already so substantially short-handed that it is unable to comply with the statutorily mandated examination cycle for escrow companies of once every 4 years (every 2 years for accounts held in trust), and is in violation of Arizona law (A.R.S. § 6-122(B)). In fact, **a large majority of escrow companies have not been examined within the statutorily mandated timeframe.**

To illustrate how short-staffed DFI is today, please note that for several years now there have been no examiners dedicated to examine licensed Consumer Lenders and Premium Finance Companies. Examinations of these license types have been conducted by Escrow Examiners.

As of July 31, 2009, there were 22 licensed Consumer Lenders (with 70 total locations) and 39 licensed Premium Finance Companies (with 58 total locations). **Examinations of these license types will stop as a result this Reduction Plan**.

Risks and Impacts of Fewer Escrow Examiners:

- DFI will fall even further behind on its examination schedule of escrow companies - growth in examination backlog will accelerate with no ability to catch-up.
- The State of Arizona will face continued liability exposure for not complying with the statutory examination requirement.
- General Fund will lose revenue - examiners pay for themselves through examination fees.
- Consumer Lenders and Premium Finance Companies will have no supervision.
- Increased likelihood of Arizona consumers being harmed through illegal or deceptive practices.
- Consumers will continue to lose confidence in Arizona businesses and its state government.

Collection Agency Examiners:

The Department currently has one (1) examiner dedicated to conducting examinations of Collection Agencies. While this examiner will be retained under this plan, examinations may stop, as the focus is diverted away from collection agencies to deal with higher priority areas. As with Mortgage and Escrow examiners (described previously), the Department is statutorily mandated to conduct examinations every five years.

Collection Agency complaints equal about 30% of all consumer complaints. Collection Agencies have a history of abusing consumers and dipping into trust accounts when economic times are hard. One of the most frequent exam violations is a misuse of client funds held in trust. Nationally, this type of violation is increasing.

Risks and Impacts of Fewer Examiners:

- Examinations may stop, as resources are shifted to higher priority areas.
- The State of Arizona will face continued liability exposure for not complying with the statutory examination requirement.

- General Fund will lose revenue - examiners pay for themselves through examination fees.

- Increased likelihood of Arizona consumers being harmed through illegal or deceptive practices.

- The likelihood that businesses that use Arizona collection agencies will be short changed will grow. Collection agencies are notorious for misuse of client trust funds.

Money Transmitter Examiners:

DFI currently employs two (2) Money Transmitter examiners that are paid out of DFI's "ISA Fund". All payroll and related expenditures for these examiners are reimbursed to DFI by the Attorney General's Office. Despite the separate funding source for these examiners, under the State personnel rules, both of these examiners will be terminated as part of a Reduction in Force. Therefore, under this Reduction Plan, supervision of Money Transmitters will be severely restricted, as it will be among the other industries that will examined by the remaining pool of three (3) examiners.

Payday Lender Examiners:

As of July 31, 2009, there were 84 licensed Payday Lenders, with 659 total locations. **Examinations of this license type have already stopped as a result of the FY 2009 enacted budget reduction.**

Pre-Need Funeral Trust Examiners:

As of July 31, 2009, there were 47 Pre-Need Funeral Trusts. **Examinations of these license types have already stopped as a result of the FY 2009 enacted budget reduction**.

<u>**Alternative Ways to Fund Program or Function**</u>

There are no <u>immediate</u> alternatives. In the past, DFI has supplemented is understaffed examiner team with funds from the Special Revolving Fund. However, with proposed budget reductions affecting all funds in FY 2010 (including the SRF), across the board reductions are the only way to meet the mandated reduction.

However, there is an alternative for FY 2011. The new Loan Originator Licensing Program provides an alternative source of funding for mortgage examiner positions that would otherwise be eliminated. During the FY 2009 legislative session, DFI introduced legislation to provide for a financial structure that would allow this new licensing program to become self-sustaining and minimize support from the General Fund. HB 2143 – signed into law on July 13, 2009 - provides this structure. The bill establishes the Financial Services Fund, consisting of loan originator licensing fees collected by DFI. Under A.R.S. § 6-991.21(A), the monies in this fund – which are subject to annual legislative appropriation – shall be used "…for the supervision and regulation of loan originators". If DFI receives an adequate appropriation from this new Fund in FY 2011, monies can be used to replenish the Mortgage examination staff, partially mitigating the impact of a budget reduction.

STATE OF ARIZONA
FY 2010 BUDGET REDUCTIONS - ISSUE DESCRIPTIONS

Department of Financial Institutions

Issue Title: Licensing Division – Reduction in Force

Issue Priority: 11

Reduction Amounts:
General Fund: $14,300 (1 FTE)

Total: $14,300

Issue Description and Statement of Effects

As detailed in DFI's FY 2010 budget submission, DFI has received no additional funding in its budget for the additional resources needed to implement a newly mandated Loan Originator Licensing Program. With an estimated 5,000 loan originators that must apply to be licensed by July 1, 2010, DFI is in desperate need of additional staff. Despite this need, the magnitude of an additional 15% budget reduction target for FY 2010 requires that staff reductions also extend to the Licensing Division. Therefore, under this plan the following position will be eliminated:

- Customer Service Representative II (1 FTE)

The Licensing staff is in constant contact with the public and is the face of DFI. Their primary function is to efficiently evaluate license applications to make sure only qualified persons obtain a license and to provide service to current licensees and the general public. Correct decisions made at this level of the department, about who becomes licensed to do business and interact with consumers, is critical. If an unqualified applicant becomes a licensed loan originator, he or she poses a potential risk to consumers and becomes an added burden to other divisions of DFI, including Examinations.

Customer Service Representatives ("CSRs") responsibilities will include the following tasks for approximately 5,000 new license applicants:

- Evaluating new loan originator license applications
- Ensuring compliance with pre-licensing education requirements
- Administering the loan originator license examination, and/or working with an outside vendor to outsource the testing
- Processing annual license renewal applications

- Ensuring compliance with annual Continuing Education requirements
- Updating and approving changes to current licenses (e.g. address changes, changes in employer, etc.)

The CSRs must ensure that all applicable statutes and rules are adhered to, including the requirement that license applications be processed within specific timeframes. Further, it is essential that adequate resources exist within the Licensing Division to ensure that due diligence in the screening and evaluation of loan originator license applicants can be exercised at all times.

Current Licensing Staff Cannot Handle Another License Type

DFI currently has six (6) full time Customer Service Representatives. These six (6) people process renewals for nearly 3,700 current license holders and evaluate new license applications for thirteen regulated entities, including: escrow agents, collection agents, motor vehicle dealers, sales finance companies, mortgage brokers, mortgage bankers, commercial mortgage bankers, money transmitters, debt management companies, consumer lenders, premium finance companies, payday lenders, and advanced fee loan brokers. It should be noted that recently passed legislation creates a new license type for commercial mortgage brokers, which will be in effect starting in October 2009.

In addition, these six people are responsible for updating and approving changes to current licenses (e.g. changes of control, address changes, changes in officers, responsible individual and active manager changes) and processing license renewal applications. Lastly, all financial statements for approximately 3,700 licensees are processed and reviewed by the same six people.

Impact of Budget Reduction:

- **Increases the potential for unqualified persons to be licensed, putting consumers at risk and undermining the recovery of Arizona's economy**

- **State licensing of loan originators may be preempted**

As required by the SAFE Act, Arizona's licensing system will be subject to scrutiny and assessment by HUD. If HUD determines that the licensing program is inadequate and does not comply with SAFE, HUD will implement a licensing system that will preempt all state regulation of loan originators. Regulation of the people who interact with Arizona citizens is local in nature, and the abdication of Arizona's sovereign right to regulate commerce within its border is not an option to be considered.

- **State revenues will be reduced**

Without appropriate staff, DFI will be less able to meet its statutory licensing timeframes, which will result in refunds of application fees to applicants.

- **Performance measure satisfaction levels will deteriorate**

Without adequate staff, there will be increasing frustration among the public, and customer satisfaction levels will deteriorate.

<u>Alternative Ways to Fund Program or Function</u>

There are no alternatives. In order to meet a reduction target of 15%, across the board reductions are necessary.