Texas Department of Banking

Catherine A. Ghiglieri
Commissioner

January 6, 1998

The Honorable Jane Nelson
Chair, Senate Finance Subcommittee on
Articles 2 and 8 Agencies
Texas State Senate
P.O. Box 12068
Capitol Building
Austin, Texas 78711

Re: The Budgeting and Appropriations Process

Dear Madame Chairman:

Thank you for this opportunity to comment on our experiences with the budgeting and appropriations process. The attached testimony addresses items 1-9 of the Subcommittee's charges. We appreciate the fact that the Legislature is reviewing the process at this junction to see which, if any, changes need to occur.

As an entity charged with overseeing financial institutions, the Texas Department of Banking recognizes the importance of financial and performance accountability. We understand the need to provide quality information to the Legislature to facilitate their decision making. We are also aware that the appropriations process is intended to balance agency requests against state-wide needs, and that reviews and decisions are undertaken in the confines of the relatively short biannual Legislative Session.

In general, the process appears to work well. However, we have identified a number of opportunities to make the appropriations process more "risk oriented," and to maximize the effectiveness of the time spent in review of agency requests. We would also like to point out several contradictions in the present system, which, while theoretically imposed to promote efficiency and fiscal restraint, may actually discourage financial conservation and innovation in state services.

The following is a summary of our observations and recommendations:

- We recommend that a "Fast Track" appropriations process be developed to streamline the process for qualifying small agencies. The time spent by legislators and agency staff in the review of small-dollar budgets is disproportionate to the risk to the state and concerns of the Texas citizens. I have attached a separate document (Appendix A) outlining a potential "Fast Track" process.

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- We recommend that you consider revising the order in which appropriations are reviewed by the committees. By having small agencies reviewed during the early part of the session, and the large agency budgets reviewed during the hectic pace of the latter part of the session, a disproportionate focus is given to low dollar, low risk items.

- We recommend that a method be established to revisit and adjust performance targets prior to their final implementation. We also recommend revising the exception criteria from 5% to 10-15% deviation from target. Many deviations occur due to the fact that up to two years can pass between when targets were defined and when they are reported against. In a dynamic environment, two years is often sufficient time to render an otherwise good target obsolete.

- We believe the process could be greatly enhanced by improved information flow and communication between the agencies and the LBB. We suggest that, before the session, the LBB provide the agencies a list of their recommended changes to the agencies' budgets. This will enable the agencies to identify any potential misunderstandings, as well as ensure better adherence to legislative mandates.

- We recommend that the alignment between the strategic planning and appropriations processes be improved by having the LBB review the agency's requests in light of the agency's strategic plan. Agencies are encouraged to have a forward-looking strategic planning process, but are forced to "back into" a budget which is often unresponsive to the agency's projected activities. This can result in static or inflexible government during a period when change is needed to ensure that services are tailored to the state's needs. A brief analysis reconciling the requests and recommendations to the agency's plan would provide legislators a broader framework on which to make their decisions.

I hope these comments will be useful to you in your deliberations. Please contact me or Randall James if there is any other information we may provide.

Sincerely,

Catherine A. Ghiglieri
Commissioner

CAG/cs
Encls.

cc: The Honorable Bob Bullock
The Honorable Bill Ratliff
The Honorable Carlos Truan
The Honorable Royce West
The Honorable David Sibley
Finance Commission Members

bcc: Commissioner Leslie Pettijohn
Commissioner Jim Pledger
Commissioner Harold E. Feeney
Department of Banking Directors
Department of Banking Regional Directors

APPENDIX A

Proposed "Fast Track" Budget Review and Appropriations Process

To Qualify, an Agency Must Have:

- Either:
  - A projected annual budget of $50MM *and* be self-funding OR,
  - A projected annual budget under $15 million.

- No material changes in its prior year budgets (i.e. less than 5% change in any strategy).

- No material unresolved findings from its most recent Comptroller or State Auditor audit.

Any legislator can request that an agency be excluded from qualifying for Fast Track appropriations.

"Fast Track" Process:

1) Agency develops budget, in concert with its strategic plan, and submits to LBB with certification that the agency has complied with all mandates of Legislature.

2) LBB has 45 days to review and negotiate a budget with the agency.

3) If LBB and the agency arrive at a mutually agreeable budget, then it is submitted on a list for approval by a **joint** appropriations committee. Testimony by an agency is not necessary unless requested by a member of the joint committee.

4) If a mutually agreeable budget is not developed by LBB and the agency, the request and LBB recommendations go to a **joint** appropriations committee for resolution.

1. Evaluate the usefulness of the agencies' performance measures.

The Department of Banking strongly endorses the use of performance measures as a means to track activity and progress toward goals. However, because of the inflexibility of the present system in a dynamic environment, performance measures are often not a very meaningful indicator of the agency's effectiveness. Targets are frequently obsolete before they are operative, resulting in a high level of deviation and explanation. Although we are accomplishing our mission and frequently over-exceeding our targets, we are reporting on exceptions. Two recommendations for making the system more effective are: allow for a review and revision of targets before reporting is initiated; and, provide more flexibility to the agencies to add or substitute measures which track *quality* versus *quantity*.

There is a lapse of approximately thirteen to 25 months between when performance targets are defined and when reporting on the targets begins. Due to changes in the statutes over the last several years, many of our performance measures became irrelevant. For example, whereas in the past we generally examined banks on an annual cycle, most of our banks went to an eighteen month examination schedule in 1995 due to a change in the law. We have therefore substantially varied from the "annual" examination target over the last two years, until the measure could be changed for the '98/'99 biennium. A similar revision in our corporate applications rule rendered our measure related to processing within statutory time frames obsolete, resulting in consistent over-achievement of the targets in the last two years before the measure could be adjusted.

In addition to allowing greater flexibility in the establishment of targets, agencies should be allowed to drop or substitute measures when they lose meaning. For example, one of the Department's performance measures is "direct trust liquidation costs as a percent of assets in liquidated trust companies." In general, this has never been a very meaningful measure because some of the highest administrative costs are incurred in trust company liquidations with very little remaining asset value. Notwithstanding, trust liquidation activity has now virtually ceased, causing this measure to be not only misleading, but also irrelevant. Yet, the system generally does not allow measures to be dropped.

During the strategic planning process, we have difficulty reconciling the measures to our mission and vision. We are currently engaged in a thorough review of performance measurement systems (both internal and those reported externally) in an effort to identify more meaningful tracking criteria. In the past several years, we have internally relied more heavily on customer satisfaction surveys than static activity reports to determine whether we are achieving our goals.

2. Analyze the agencies' accuracy in reporting on performance measures.

The Department of Banking has adequate systems to accurately track performance measures, and is confident that all measures are being correctly reported. A State Auditors' review of our measures in 1994 found inaccuracies in two measures out of seven (excerpts attached). The inaccuracies were due to confusion in the definition of the measurement components. Since that time, the Department has compiled a full set of definitions and work papers for each measure. The agency's internal auditor will review performance measures in fiscal year '98 to verify their accuracy.

In fiscal year 1997, we reopened the first three quarters of that year to update a measure on application processing for a change in the statute. However, this is an example of the type of problem caused by tracking compliance with changing statutes, as opposed to reporting inaccuracies.

3. Evaluate agencies' budgets and identify reasons for differences in budget requests and appropriated amounts.

	Amount Requested	Amount Appropriated
FY '98	$9,589M	$9,058M*
FY '99	9,589M	9,058M*

* Net of all contingency riders

In fiscal years 1998 and 1999, the Department was appropriated approximately $531M (or 6%) less than it had budgeted and requested. The reduction was comprised of: a $140M direct transfer to support the Attorney General's office; a cut of $295M in nonrecurring building repair costs; and a $95M deduction due to an anticipated reduction in grant funding. These cuts are not the result of an analysis of the Department's strategic plan or budget request. Rather, they arise from the imposition of Legislative mandates which were applied without consideration of whether an exception may be warranted.

For example, the reduction attributable to lower grant funding assumes that the agency would have to reduce operations to meet a decline in funds. However, the agency was using the grant to effectively subsidize a portion of an essential operation, which could easily have been covered by an increase in fee revenue. Due to the loss in appropriations and lacking availability of funds which could be transferred from other strategies, the services will have to be cut despite the willingness and ability of the regulated entities to sustain operations, and the lack of impact on the general revenue. Similarly, the cut for nonrecurring building repair costs assumes that the Department had been appropriated extra funds to cover these expenses, which would not be needed going forward. Instead, the Department funded the repairs by making short term cuts in other areas. The reduction in appropriations effectively perpetuates these short-term cuts and dissuades the agency from trying to operate as a prudent business; it rewards spending rather than saving.

Because the system discourages direct communication between the agency and the LBB during the appropriations process, we were not able to specifically identify the substance of the cuts until the latter part of the legislative session. An atmosphere of full disclosure would allow everyone to focus on meaningful discussions on agency operations, and possibly assist in avoiding the mistakes which can occur.

The one-size-fits-all appropriations strategy also means that new strategies won't be funded, despite their transparent effect on general revenues and ultimate benefit to the state. For example, the Department requested $245M over the '98/'99 biennium to develop a document imaging system. This one-time investment would have allowed the Department to operate more efficiently and be more responsive to our regulated industries and the public. Despite the availability of funding and support from the regulated industries, however, the request was denied. In the past, we had similar difficulty obtaining appropriations approval for an industry analysis function to monitor the condition of the banks between examinations. While we recognize and support the Legislature's goal of curbing undue growth in the government, when such a mandate is imposed without other considerations, it leaves agencies unable to respond to changing circumstances or take advantage of new technologies.

4. Examine the history of agencies' unexpended balances and the causes for those balances.

Although total assets in state-chartered banks have increased by 18% over the last five years, merger and acquisition activity has reduced the number of bank charters. The decline in supervised entities, coupled with the good health of the financial services industries, have allowed the Department to realize some economies of scale in its examination activity. The agency reacted by reducing staff through managed attrition, resulting in unexpended balances in the last several fiscal years. The Department does not anticipate any further opportunities for contraction, as we consider the current environment to be the apex of the banking cycle.

	Appropriated Amount	Amount Expended
FY '94	$10,322M	$ 9,004M
FY '95	$ 9,901M	$ 9,689M
FY '96	$10,868M	$ 9,437M
FY '97	$ 9,868M	$ 8,819M

To ensure its ability to react to a changing banking environment, the last three Legislatures appropriated contingency funding riders of approximately $1.5MM to $2.MM to the Department. Although they are not included above, these funds could be considered unexpended since we have not accessed them to date.

The Department of Banking considers the contingency rider funds to be vital to our ability to maintain the safety and soundness of the banking system in Texas. Not only do they provide the agency a means to increase staffing to meet a deterioration in bank conditions and/or a massive influx in assets; but, they also protect us from failing to meet our statutory mandate in the case that the federal banking regulators neglect their examination responsibilities in Texas. This latter problem occurred twice in the last decade, and there are indications that the FDIC may be in a similar situation in the near future. Access to the contingency appropriation is formally controlled through the requirement that the Finance Commission make a finding of fact, and no disapproval is issued by the Governor's Office of Budget and Planning and the Legislative Budget Board. Any contingency funds utilized would be fully funded by revenue generated by the Department from the regulated entities.

5. Evaluate agencies' caseload, population or enrollment forecasted methods.

Not applicable.

6. Monitor agencies' responses to State Auditor reports.

The State Auditor reviewed the Department's examination and enforcement functions in January 1989 (89-059) and performance measures in August 1994 (94-136). We have corrected the deficiencies identified in those audits. The Finance Commission, (the board which oversees the Department's operations), monitors the agency's efforts to address all audit findings, including those of the internal auditor.

7. Analyze agencies' line-item strategies and determine if they are essential to and reflective of the agencies' missions.

The Department has four line-item strategies, which we believe to be essential and reflective of our mission.

The Department's mission is *to maintain a financial regulatory system for Texas that promotes a stable banking environment; provides the public with convenient, safe, and competitive banking and other legislatively designated financial services; and allows for economic development within this state*. The agency's line-item strategies to accomplish this mission are summarized as follows:

Bank Examination

The Department supervises and examines state-chartered banks, trust companies, and foreign bank agencies to evaluate the soundness of their operations and the safety of Texas citizens' deposits. This strategy includes monitoring of industry conditions, resolution of consumer complaints, and an ombudsman function. This strategy is completely self-funding through assessments and examination fees.

Non-Bank Examination

The Department supervises and examines pre-paid funeral contract sellers, perpetual care cemetery licensees, sellers of checks, and money exchange operators to determine compliance with state laws and the safety of the funds entrusted by the citizens of Texas. This strategy also covers complaints on these entities and the processing of applications by these entities. This strategy is completely self-funding through assessments and examination fees.

Application Processing

The Department reviews and decides upon applications for new charters, mergers, branches, changes in ownership, etc., of state-chartered banks, trust companies, and foreign bank agencies. This is the means by which the Department seeks to ensure a competitive and well-managed system of financial providers for the citizens of Texas. This strategy is completely self-funding through application fees.

Indirect Administration

This represents indirect and support costs associated with agency operations. It includes a Legal Division (engaged primarily in rule-making, opinion requests, and enforcement actions); a Personnel and Staff Services Division (engaged in recruitment, personnel policy, facilities management, etc.); Accounting (agency reporting, voucher and payroll activities); and the agency's small executive management team. The costs of indirect administration are completely covered by the revenues generated by the three strategies above.

8. Review increases and decreases in the number of agencies' full- or part-time employees and use of consultant/contract individuals.

As mentioned in previous comments, the Department has condensed its staffing over the last several years in response to the consolidation and improved health of the banking industry. The reduction was achieved through managed attrition of high turnover (caused by less than competitive salaries and opportunities in the present banking industry).

	FY 92	**FY 93**	**FY 94**	**FY 95**	**FY 96**	**FY 97**
FTEs	188	183	183	175	159	153

Salary expenses have not dropped as dramatically as FTE numbers, due to the fact that the Department is seeking to retain a more experienced and highly skilled workforce to examine the larger, more sophisticated banks.

There are no part-time positions at the Department, although the agency has a policy allowing part-time work upon request to accommodate an employee's family circumstances. As a part of "managing down," positions have been eliminated or combined to make the most effective use of personnel.

The Department selectively uses private contractors or consultants when expertise is not available internally, or when a job does not justify the retention of a permanent employee. For example, in fiscal year 1997 the Department retained a skilled litigation attorney to handle a high-profile interstate banking case which was declined by the Attorney General. Industry experts have also been retained in the past to manage problem bank situations and assist in trust company liquidations. Additionally, the agency out-sources its internal audit function to review certain high-risk Department functions and determine compliance with the Public Funds Investment Act. Contract programmers will be used to assist in preparations for the year 2000, and bonus contracts have been signed in an effort to retain the three agency information resources staff who are deemed critical to the agency's operations. On a lesser scale, the agency occasionally uses temporary personnel to assist in the completion of short-term special projects.

9. Evaluate all (i) judgments; (ii) settlement agreements; and (iii) pending legal claims, whether or not asserted in a lawsuit, which will or may impact agencies' FY' 1998-2001 budget periods.

There are no judgments, settlement agreements, or pending legal claims, whether or not asserted in a lawsuit, which are expected to *materially* impact the Department's fiscal year 1998-2001 budget.