

**TESTIMONY PRESENTED TO
THE FINANCE COMMITTEE
OF THE TEXAS SENATE
AND TO THE
APPROPRIATIONS COMMITTEE OF THE
TEXAS HOUSE OF REPRESENTATIVES**

**Texas Department of Banking
Appropriations Request**

**By
Catherine A. Ghiglieri
Commissioner**

**January 6, 1997
and
February 12, 1997**

EXECUTIVE SUMMARY

- Budget cuts as recommended by the Legislative Budget Board need to be restored to enable the Department to fulfill its responsibilities.
- The Department's operations are funded entirely by the industries it regulates and are revenue neutral to the State's budget.
- A continuation of the 35% transfer authority is requested to ensure that the public and regulated industries can continue to be served.
- A continuation of the Finance Commission Salary Administration Plan is requested, which has allowed the Department to attract and retain competent

examining personnel.

- A continuation of the contingency rider is requested in the event of a dramatic shift in federal regulatory agencies' responsibilities, an influx of assets into the state banking system, or an increase in problem banks.

OVERVIEW OF THE DEPARTMENT OF BANKING

Mission and Regulatory Responsibility

The primary responsibility of the Department is to ensure the safety and soundness of the state's banking system.

The mission of the Department of Banking 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 philosophy is to provide the highest quality regulation and supervision as efficiently as possible.

The Department's regulatory responsibility covers the following entities in Texas, as of November 30, 1996 except where noted:

Regulated Entity	Number of Entities	Total Assets (in millions)
State-chartered Commercial Banks	448	\$ 51,148*
State-chartered Trust Companies	34	35,042*

Foreign Bank Agencies	16	33,536
Prepaid Funeral Licensees	480	1,230
Perpetual Care Cemeteries	225	106
Sale of Check Facilities	31	322,300
Currency Exchange Operations	78	\$ 49

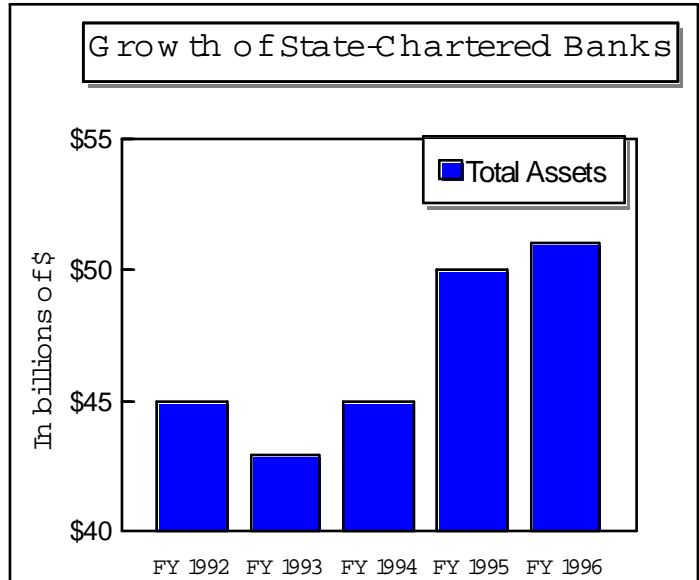
* As of September 30, 1996

The banking commissioner, who is appointed by the Finance Commission of Texas, is the chief executive officer of the Department. The Department performs its mission by chartering and regulating the activity of the entities under its jurisdiction, and performing on-site examinations.

Supervision and Examination of Banks

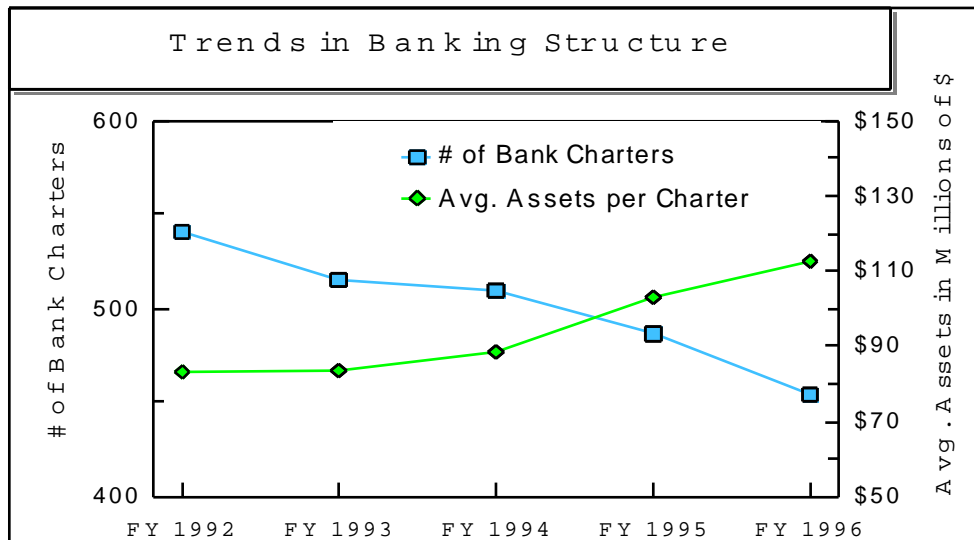
The state banking system continues to expand in size and consolidate into larger entities.

Growth in the banking industry is attributed to increased lending and an expansion into new products and activities fostered by technological developments and a favorable regulatory and economic environment.



A trend toward consolidation in bank charters has led to an increased size

and sophistication in the entities supervised by the Department, and thus a more



challenging regulatory environment.

Banking in Texas was modernized by the 74th Legislature by the

passage of the Texas Banking Act of 1995. The Act reduced regulatory burden and created parity with national banks, while protecting consumers' interests.

Following changes in federal law, the Department instituted an extended examination

frequency cycle in 1995 which moved healthy community banks from a twelve-month to an eighteen-month examination schedule. This policy recognizes the current strength of the banking system and has assisted the Department in reducing regulatory burden and trimming supervisory expenses.

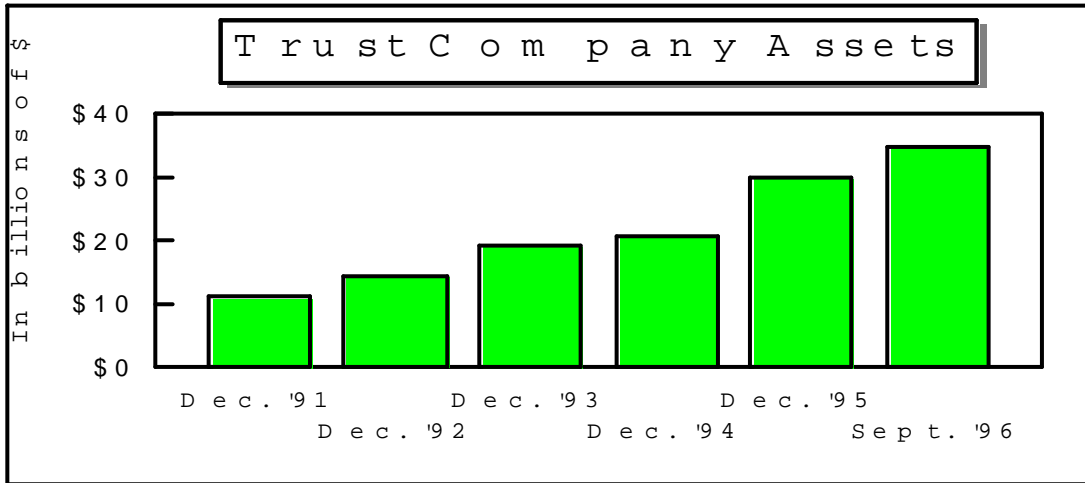
Currently, less than 2% of the state banks are problem institutions as compared to 17% in 1993, reflecting the fact that Texas' banking system is in the best condition it has been in for many years. Given the cyclical nature of the industry and the increased globalization of the Texas economy, however, the banking system is considered vulnerable to a potential downturn in the future. The Department monitors the condition of individual institutions between examinations to detect potential deterioration. Since the Department functions with a minimum of budgetary margin, the contingency rider is an important tool in reacting to any negative trend in the condition of the banking system which may create the need for more frequent examinations.

In fiscal year 1995, the Department of Banking initiated an annual survey of the banks under its supervision to gauge its performance and obtain information on the quality of its services. While the results of the 1995 survey indicated overall satisfaction with the Department, the feedback to a 1996 survey showed improvement in administrative responsiveness. Future surveys will continue to be performed to ensure that performance remains on target.

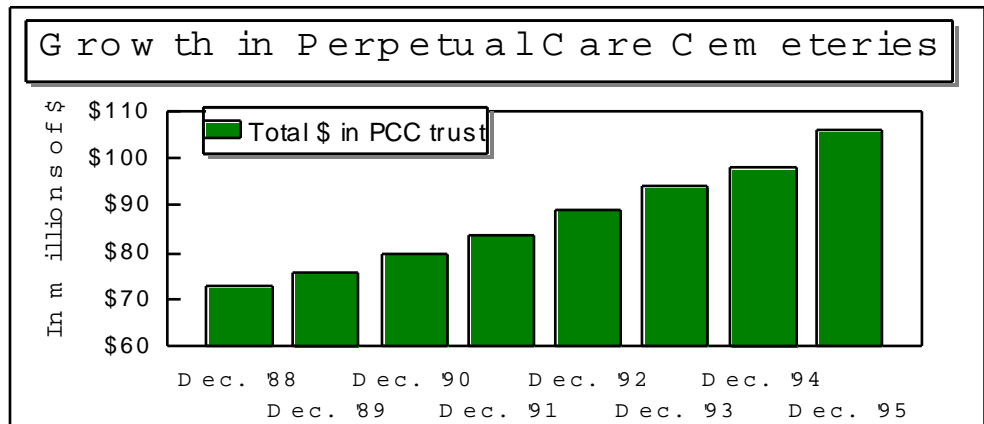
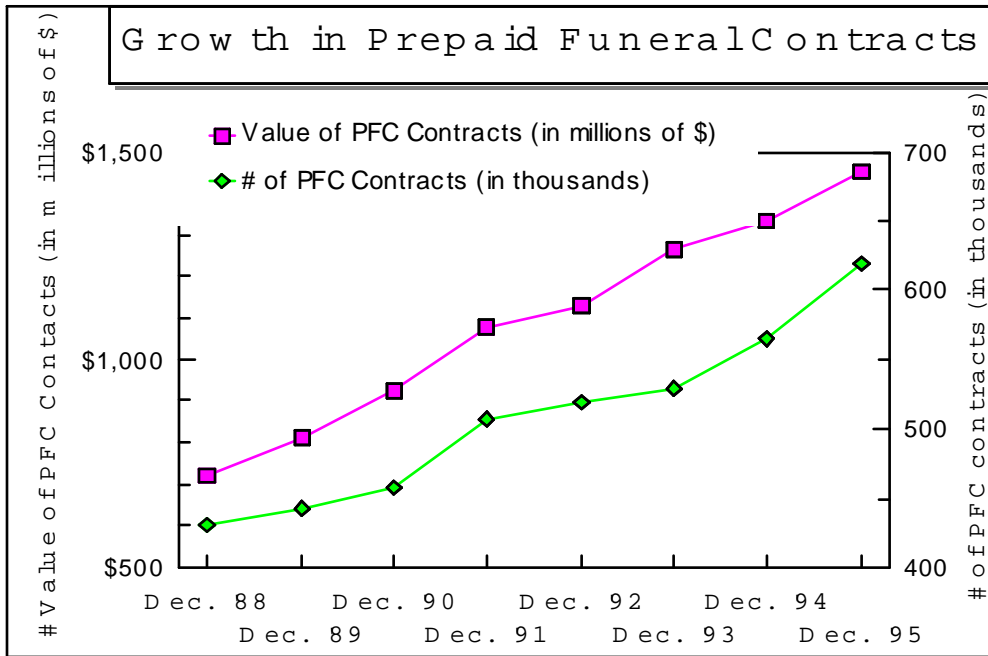
Supervision and Examination of Other Regulated Entities

Strong growth is also evident in both the trust and funeral industries.

High growth in the volume of fiduciary assets managed by state-chartered trust companies is partially due to the aging of the "baby boomer" generation. This trend, along with increased sophistication and activity in this constituency, is expected to continue. As a result of sizable growth, the Department developed examination specialists in this area several years ago.



The funeral industry has likewise experienced growth in volume and value of prepaid funeral contracts and increased perpetual care cemetery sales.



Administration

Testimony of Catherine A. Ghiglieri
 Banking Commissioner of Texas
 Presented to the Senate Finance Committee

The Department's operations are carefully managed.

Personnel is the Department's largest resource, with salary and benefits comprising more than 80% of the agency's total expenditures. The Department manages its workforce through a detailed staffing model combined with a structured performance appraisal system. The staffing model ensures that the number and level of bank and trust examiners are consistent with the agency's existing and projected workload. Job postings for senior examining positions are limited and competitively selected in recognition of the workload needs and to avoid unnecessary salary expense. Each employee receives an annual performance appraisal based upon formal standards in their job descriptions. Any promotion or raise is based upon a defined scoring matrix.

The credibility and expertise of the Department relies on the development and retention of highly skilled examining personnel through extensive formal and on-the-job training. Apprenticeship lasts approximately five years, after which bank and trust examiners are commissioned through an internal testing process. Once commissioned, examiners are considered qualified to independently lead a bank examination and act as team managers.

The increased consolidation and sophistication in the banking industry requires a smaller but more highly skilled examining force. While overall staffing levels have been reduced through managed attrition, the mid-level examination staff of the Department's workforce has been recently threatened by higher-than-desirable turnover. A survey of agency employees in fiscal year 1995 by the School of Social Work of The University of Texas at Austin indicated an overall high level of morale and job satisfaction. However, many examiners tire of the high amount of travel required by the job, creating a challenge for the Department to retain experienced personnel in the current strong job market.

The Department is nationally accredited by the Conference of State Bank Supervisors. This distinction, achieved in 1993, reflects a high degree of administrative sophistication and control as well as excellence in supervision over state-chartered banking entities. The agency's ability to fund its own operations, react to shifting regulatory responsibilities, and employ competent professional personnel are also

important considerations in achieving and maintaining accreditation, which is reviewed every five years.

Funding and Expenditures

Overhead and personnel costs have decreased and remain entirely covered by revenue generated from the regulated entities.

The Department's revenues are derived from assessments and fees paid by the entities under its supervision, with each industry paying its proportional share of the agency's expenses. Collections, which are limited by statute to the amount of the Department's expenses, have always been sufficient to cover costs.

Bank assessments are the primary source of revenue for the Department. Assessments are based on a sliding scale reflecting the institution's size and condition.

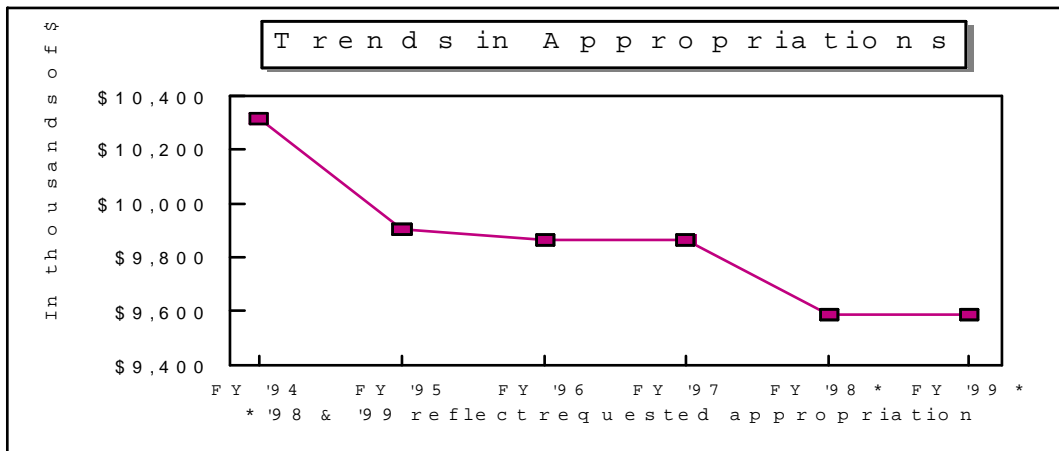
For the past four years the Department has received federal funds to offset a portion of the costs of the currency exchange examination function. The funding was associated with the agency's participation in the Houston High Intensity Drug Trafficking Areas program, which coordinates state and federal agencies' efforts to curtail money laundering. This program has been successful in shutting down many questionable currency exchange operators. Federal funding is expected to decline in this area. Should the Department be unable to locate federal grant monies elsewhere, the cost of supervision to the currency exchange operators may increase.

Appropriations

Declines in operating expenses are evident in lower appropriations requests.

As the Department has curtailed staffing and consolidated operations to meet trends in the banking industry, overall expenditures and attendant appropriations requests have declined. This biennium's request complies with the mandate by the Governor and Comptroller for no new growth. The agency has always kept expenses within

appropriations and made very limited use of its transfer authority.



DETAILS OF LEGISLATIVE APPROPRIATIONS REQUEST

Legislative Budget Board Recommendation

The Legislative Budget Board's (LBB) recommended budget cuts need to be restored to enable the Department to meet its responsibilities, and to ensure the continued viability of the state banking system.

If the Department's appropriations are funded at the reduced level recommended by the Legislative Budget Board, the agency would be unable to meet its performance goals due to inadequate funding to meet staffing needs. The budget cuts would ultimately threaten the Department's accreditation with the Conference of State Bank Supervisors. Should the Department lose its accredited status, there is a strong likelihood that the federal banking regulators would cease to accept its work in lieu of their own examinations, thus imposing a substantial regulatory burden on state-chartered banks. Facing such a burden, it could reasonably be expected that most viable state banks would convert to a national charter. A "nationalization" of the state banking system reduces the Legislature's control over banking and financial markets in Texas, subjects the citizens of the state to a potential flight of capital in a deteriorating economy, and eliminates the competition and innovation that currently mark the dual banking system.

The Department understands that the recommended cuts are centered in a transfer to the Attorney General's Office of \$130,000, a lapsed 1996 appropriation of \$265,000, and a reduction for nonrecurring building charges of \$135,000. The Department's appropriations request was adjusted to eliminate the one-time transfer to the Attorney General. However, this item is included as a transfer from the Department to the Attorney General's Office in the LBB's recommendation for the Attorney General's Office. Thus, the Department would be required to absorb this additional transfer on an already reduced budget.

Regarding the lapsed 1996 appropriations of \$265,000, a reduction of this amount appears unwarranted. The instructions to the 1998-1999 appropriations request mandated agencies to use the average of 1996 actual expenditures and the 1997 budget

to calculate a basis for the 1998-1999 requests. Curtailing the current request by the lapsed appropriations has the effect of reducing the Department's request by this number twice.

In fiscal years 1995 and 1996, the Department incurred the cost of repairing the construction defects of the Finance Commission's Headquarters Building to ensure employee safety. The Department covered this one-time outlay by holding operating expenses down as much as possible in order to avoid raising costs to the supervised entities. For the majority of 1996, the Department held approximately 14 vacant positions unfilled in order to trim expenses. Other cost-cutting efforts included curtailment of training exercises and computer investments. This short-term strategy was successful due to the strong condition of the industry and a related decline in examination work caused by industry consolidation and the extended bank examination cycle. Lacking the requested appropriations, the agency will not be able staff back up to target levels to meet all performance goals, nor reinvest in training and technology to ensure continued efficient and effective operations.

Administrative Law Judge

The administrative law judge needs to be accounted for in the legislative appropriations request of the Finance Commission or returned to the Department of Banking's appropriations.

Due to an apparent oversight, the Legislative Budget Board failed to account for the position of the administrative law judge in either the Finance Commission's (as requested) or the Department of Banking's (as historically funded) appropriations. The Commission requested that this position be shifted from the Banking Department to the Finance Commission in order to implement the Texas Banking Act of 1995. The new Act authorizes the Finance Commission to employ an administrative law judge to preside over matters relating to the Finance Commission agencies. The administrative law judge was formerly an employee of the Department of Banking as authorized by the Texas Banking Code of 1943. However, the performance evaluations have been performed by the Finance Commission to avoid any conflict of interest. Since enactment of the Texas Banking Act, the judge has operated at the Finance

Commission level by hearing cases brought against all Finance Commission agencies. Each agency bears an amount of the judge's salary proportional to their relative use of the judge's time.

In anticipation of a shift in the judge's position from the Department of Banking to the Finance Commission, the judge's salary was excluded from the Department's legislative appropriations request expenditures for 1996, and its appropriations request for 1998-1999. Thus, if not funded by the Finance Commission, this amount should be added to the Banking Department appropriations.

Supplemental Transfer Authority

Authority to transfer 35% between strategies provides a means for the Department to respond to changes in work volumes.

The Department requests a continuation of the transfer authority of up to 35% between strategies to address moderate shifts in resource needs. Because Article IX allows only 25% to be transferred from one appropriation item to another, the Department requests continuation of a rider specifically authorizing the agency to transfer an additional 10% between items. This flexibility has been effectively provided to the Department over the last six bienniums, and is considered especially critical in the current environment of potentially volatile operations and minimal operating margins.

For example, the Department's corporate applications division is operating at full capacity to process the current high volume of banking applications within statutory time frames. Should the volume of applications continue to increase, the Department may need to temporarily shift personnel from the bank and trust examination division into the corporate area to ensure that the activities of the state banking system are not brought to a standstill due to a static allocation of appropriated resources. By maintaining the Department's current ability to transfer funds, the agency can successfully handle an unanticipated influx in related activity and continue to maintain timely and effective service levels.

Salary Administration Plan

The highly structured Finance Commission Salary Administration Program has allowed the Department to attract and retain qualified examiners.

The Finance Commission Salary Administration Program was established in 1989 by S.B. 607 enacted by the 71st Legislature. The program resulted from a study initiated in response to the banking and thrift crisis of the 1980's of staffing levels, turnover rates, education credentials and experience levels of the employees of the Finance Commission agencies. The consensus at that time was that the state's Job Classifications Act was not adequately flexible to allow the Finance Commission agencies to attract and retain competent employees. Since its enactment, the Program has been endorsed by every Legislature with a specific rider in the General Appropriations Act.

Under S.B. 607, the Finance Commission is given authority to set the salaries and determine the number of employees for the Finance Commission agencies, subject to the limits of each agency's total appropriations under the General Appropriations Act. The Position Classification Act is not applicable to Finance Commission jobs in Group 11 or above.

The Finance Commission Salary Administration Program is a highly-disciplined program with close oversight by the Finance Commission. The wide pay ranges for each salary group have resulted in improved control over salaries and upward migration, by allowing employees to enter and remain in an appropriate pay group longer. Under the Finance Commission Program, employees receive a detailed annual evaluation based upon formal job standards for their position. Promotions are restricted to those situations where the employee actually assumes additional responsibilities.

At its June 21, 1996 meeting, the Finance Commission passed a formal resolution supporting and endorsing the current Salary Administration Plan, and strongly urging the 75th Legislature to continue to authorize the Plan as integral to the operations of the Finance Commission agencies. While the health of the banking system is at an all-time high, history has proven that constant vigilance by the regulators must occur during the periods of high growth and expanded activities if the impact of another

banking crisis is to be minimized.

Contingency Rider

The contingency rider is essential to ensuring that examinations can be performed in the event of changes in the banking or regulatory system.

Since the ongoing strategies of the Department of Banking are administered with a minimum of budgetary margin, a contingency funding rider to the Department's Legislative Appropriations Request remains vital to ensuring that the agency is able to accomplish its mission in a rapidly changing regulatory environment. To date the agency has neither requested nor spent any of the contingency funds appropriated. 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. Notwithstanding, any and all contingency funds utilized would be fully funded by revenue generated by the Department from the regulated entities.

The Department has requested and received a contingency funding rider for the last two bienniums to meet the possibility of a dramatic shift in its responsibility. The general circumstances under which the rider might be accessed are: (1) a massive influx of assets into the state system due to conversions or new charters; (2) a substantial decline in the condition of the entities currently under supervision; or (3) a diversion of federal regulatory resources or a change in the federal regulatory structure.

The banking industry is in a state of change and increased volatility. While trends are fairly steady, the potential remains for a substantial increase in the volume of state-chartered banking assets through an acquisition by an existing state bank or the conversion of a single national bank. Volatility is also evident in the large difference in resources required to examine healthy institutions (on an eighteen-month examination cycle) versus problem banks (on a six-month examination cycle). Thus, any downward shift in bank conditions could exponentially expand the Department's examination responsibility and attendant staffing, travel, and equipment costs. Under these two scenarios, the assessment structure currently in place would automatically

generate the additional revenue necessary to cover the increase in regulatory resources required. Therefore, there would be no effect to the General Revenue Fund.

Because of its utilization of an alternate examination program with the federal banking authorities, any change in the structure and responsibilities of these entities would also affect the Department. In the 1980's, the Department had difficulty meeting its examination mandate when the FDIC shifted its examiners to address banking problems in other areas of the nation. The stability of the alternate examination program and scope of the Department's responsibilities under it also remain threatened by the potential of consolidation of the federal banking regulators, which continues to be a perennial topic of debate in the nation's capital. Recent consolidation proposals include a plan that would make accredited state banking departments responsible for examining and regulating *all* state-chartered banks, with the possible exception of problem banks and very large banks. This would approximately double the Department's examination work load in the current environment. Other proposals would make state banking departments responsible for examining for compliance with federal consumer protection laws (such as the Community Reinvestment Act, the Equal Credit Opportunity Act, Truth in Lending, etc.), which would also nearly double the volume of procedures performed by the Department's staff. Should federal legislation significantly expand the Department's examination role, the agency would revise its fee structure if necessary to cover the cost of performing the examination functions formerly performed by the FDIC and Federal Reserve. However, the additional cost would be wholly funded by the additional fees; therefore, there would be no effect on General Revenue.

Imaging Request

The Department requests funding to implement document imaging to enhance efficiency and responsiveness.

The appropriations request for fiscal years 1998 and 1999 contains a new strategy to develop an imaging system with the primary goal of enhancing the efficiency of current operations and expanding the accessibility of information by the public. The Department currently has two staff members substantially devoted to the processing of

a high volume of open records requests. In addition, the corporate area handles in excess of 400 applications/notices and approximately 120 filings on an annual basis. Despite the Department's relatively high use of technology for recording internal analyses and events, this volume of activity creates an enormous amount of paper which is both difficult to store and access. Prompt access is crucial for responding to the high volume of information requests received by the Department from the regulated entities and public.