WASHINGTON STATE
DEPARTMENT OF
FINANCIAL
INSTITUTIONS

STRATEGIC PLAN
07-09 BIENNIUM

SCOTT JARVIS
DIRECTOR

DEPARTMENT OVERVIEW

The Department of Financial Institutions (DFI) was established in October 1993 by RCW 43.320. Its historical roots date back to the early 1900s with the organization of the Division of Banking in 1907 and the Division of Securities in the 1930s. The Department will celebrate the 100th year anniversary of its banking division in 2007.

The Department is composed of five divisions: Administration, Banks, Consumer Services, Credit Unions, and Securities. The Department is self-supported. Fees paid by regulated institutions fund all agency activities. No funding is received from the state General Fund or other tax revenue, however, the agency contributes to the General Fund through its Division of Securities, which collects significant revenues in connection with its primary functions of registration, licensing, and enforcement. The Division retains 13 percent of the revenue it receives to fund its activities. The remaining 87 percent of the funds collected are contributed to the Washington State General Fund and are used to fund other areas of state government.

The Department regulates our state's financial services industry. This responsibility includes examining and supervising state-chartered commercial banks, credit unions, savings and loan associations, savings banks, and foreign banks. In addition, the Department regulates the securities industry in Washington, issuing licenses, permits and exemptions for securities broker-dealers, investment advisers and their agents, securities issuers, franchises, franchise brokers, and business opportunities. The Department also regulates consumer loan companies, check cashers and sellers (which include payday lenders), money transmitters and currency exchangers, as well as mortgage brokers and escrow agents and officers operating in this state. As a result of recent legislation, the Department has begun registering entities that offer tax refund anticipation loans. The Department is also writing rules to the 2006 amended Mortgage Broker Practices Act, which established licensing requirements for loan originators working for mortgage brokers. The rules are expected to be implemented in November 2006, prior to the license requirement date of January 1, 2007.

The Department conducts four core program activities:

- **Chartering, Licensing and Registration**

  DFI evaluates and approves bank and credit union applications, mergers, conversions, branches, and corporate governance changes. The Department also conducts licensing, registration and exemption activities for the following financial entities and persons: broker-dealers, broker-dealer representatives, investment advisers, investment adviser representatives, securities issuers, franchises, franchise brokers, business opportunities, escrow agents, escrow officers, mortgage brokers, check cashers and sellers (payday lenders), money transmitters, currency exchangers, consumer loan companies and providers of tax refund anticipation loans.

- **Examinations**

  The Department performs three primary types of examinations: (1) Compliance and for cause examinations of securities broker dealers, mortgage brokers, investment advisers, escrow agents, debenture companies, check cashers and sellers (payday lenders), consumer loan companies, money transmitters, and currency exchangers; (2) safety and soundness examinations of banks, credit unions, debenture companies, money transmitters, trust companies, Small Business Association (SBA) lenders and industrial development corporations; and (3) information system examinations of banks and credit unions.

- **Enforcement**

  The Department conducts various types of supervisory, surveillance and enforcement activities to detect and take corrective action for violations of the regulatory and anti-fraud statutes applicable to financial institutions. Activities include: complaint processing, investigation, and pursuit of appropriate action against securities issuers and brokers, investment advisers, mortgage brokers, check cashers and sellers (payday lenders), money transmitters, currency exchangers, consumer loan companies and escrow agents. DFI also provides assistance and coordinates with other law enforcement agencies and prosecutors – including providing subject matter expert testimony during trials.

- **Education and Public Outreach**

  DFI conducts numerous consumer education and outreach activities, and also provides technical assistance and regulatory guidance to banks, credit unions, securities and mortgage brokers, check cashers and sellers (payday lenders), money transmitters, currency exchangers, consumer loan companies and escrow agents.

DFI VISION

Safe, honest and reliable financial services.

DFI MISSION STATEMENT

DFI regulates financial services in our state to protect the public and promote economic vitality.

DFI VALUES

We value:

- Employees – our most important resource
- Empowerment with accountability
- Diversity
- Fairness and respect for individuals and institutions
- Sharing information and knowledge
- Professionalism and integrity
- Providing quality services

STATUTORY REFERENCES

The following statutes authorize the establishment and operation of DFI programs:

General	Ch. 43.320 RCW
Securities Division	
Securities Act	Ch. 21.20 RCW
Franchise Act	Ch. 19.100 RCW
Business Opportunity Act	Ch. 19.110 RCW
Commodities Act	Ch. 21.30 RCW
Division of Banks	
Banks and Trust Companies	Ch. 30 RCW
Mutual Savings Banks	Ch. 32 RCW
Savings and Loan Associations	Ch. 33 RCW
Federally Guaranteed Small Business Loans	Ch. 31.40 RCW
Industrial Development Corporations	Ch. 31.24 RCW
Agricultural Lenders, Loan Guaranty Program	Ch. 31.35 RCW
Division of Credit Unions	
Credit Union Act	Ch. 31.12 RCW
Central Credit Unions Act	Ch. 31.13 RCW
Division of Consumer Services	
Mortgage Broker Practices Act	Ch 19.146 RCW
Consumer Loan Act	Ch. 31.04 RCW
Check Cashers and Sellers Act	Ch. 31.45 RCW
Uniform Money Services Act	Ch. 19.230 RCW
Escrow Agent Registration Act	Ch. 18.44 RCW
Tax Refund Anticipation Loan Registration	Ch. 19.265 RCW
Mortgage Lending Fraud Prosecution Account	Ch. 43.320 RCW

07-09 DFI GOALS

GOAL 1:	Promote a stable and competitive financial services industry that enhances economic vitality.
GOAL 2:	Enhance protection of citizens' financial interests.
GOAL 3:	Provide information and education on financial services to the public and those we regulate.
GOAL 4:	Leverage technology and other resources to operate efficiently and effectively.
GOAL 5:	Support a highly skilled and diverse workforce.

07-09 DFI OBJECTIVES AND STRATEGIES

GOAL 1: Promote a stable and competitive financial services industry that enhances economic vitality.

OBJECTIVE 1-1: Assure an efficient and effective examination program for state chartered financial institutions.

Strategies:

- Ensure that all state chartered depository institutions are examined at least every 18 months.
- Ensure that all new or problem depository institutions are examined on a 12 month cycle.
- Provide technical assistance to new financial institutions within the first six months of charter to improve their chance of success.
- Take informal or formal enforcement action when an institution reaches a weakened financial condition or is engaged in an unsafe or unsound practice.
- Upgrade examiner training programs to support a cadre of well-trained examiners who will apply their skills and knowledge consistently across all depository institutions.

DFI's supervision program consists of activities geared toward ensuring public confidence in the financial marketplace. Routine examinations are performed to assess the safety and soundness of individual financial institutions. Through the examination process, DFI evaluates the financial condition and risk profile of each institution, appraises the quality of management, determines compliance with laws and regulations, and addresses areas where corrective action is required.

DFI takes corrective action when we find unsafe and unsound practices, violations of laws and regulations, and non-compliance with policies and practices. All problem rated institutions receive either formal or informal enforcement actions to help them improve their operations, and to prevent problems from threatening the viability of the institution. If circumstances deteriorate we can raise the level of enforcement to include: removing officers, imposing monetary penalties, entering into cease and desist orders, and ultimately close failing institutions.

Depository institutions and trust companies are rated based on a uniform financial institution rating system that measures their soundness in a comprehensive manner. The ratings are used to focus attention on institutions that are exhibiting weaknesses or experiencing adverse trends. It is important for the ratings to be consistently applied by both state and federal regulators. For the rating system to be effective, examiners need to be well trained in examination processes, must be able to identify current and potential risks, and must keep up to date with current industry practices. DFI is committed to maintaining a professional examination staff that meets all regulatory examination standards.

OBJECTIVE 1-2: Optimize the examination program for non-depository institutions.

Strategies:

- Implement a coordinated risk-based methodology for selecting and setting examination and inspection cycles for securities brokers, investment advisers, consumer loan companies, payday lenders, check cashers and sellers, mortgage brokers, money transmitters, currency exchangers and escrow agents.
- Automate the remaining examination modules and implement an electronic based initial record review system to maximize offsite efficiencies and minimize onsite burden to licensees.
- Design, enhance and share modernized examination standards with non-depository entities by August 2008.

DFI regulates over 100,000 non-depository licensees including: money services providers, consumer loan companies, check cashers and sellers, payday lenders, mortgage brokers, refund anticipation loan facilitators, escrow officers, loan originators, investment advisers and securities broker dealers and agents. The sheer numbers of licensed entities makes it impossible to examine all licensees in a comprehensive manner. To effectively serve the industries we regulate as well as the public, we must use our resources efficiently and focus on areas of highest risk.

We will optimize existing examination programs in three major phases:

1. By implementing enhanced procedures for selecting licensees to be examined through an assessment of the risk posed to the public by the licensee.

2. By completing the full automation of examination modules and instituting an offsite review system.
3. By the creation and publication of “open source” examination manuals available to licensees and independent examiners/auditors.

Each of these phases is expected to provide greater agency efficiencies while significantly reducing examination burden on licensees.

OBJECTIVE 1-3: Improve service to customers.

Strategies:

- Automate remaining licensing processes for uniformity and facilitation of on-line licensing.
- Increase the use of on-line licensing by integrating the mortgage broker and loan originator licensing program with the CSBS national database by January 2008.
- Increase the average number of surveys completed and survey ratings for the licensing services provided by DFI.
- Provide timely public access to database information by increasing the number of on-line self-service options to allow for more effective use of staff resources.
- Implement automated workflow processes to reduce processing time for applications and to reduce errors.
- Expand the use of imaging and electronic document handling to provide more timely response to public disclosure requests.
- Optimize our call centers by providing cross-training and increasing call center resources to better respond to public inquiries.

On February 10, 2006, Governor Christine Gregoire issued Executive Order 06-02 on Regulatory Improvement. The Executive Order directs state agencies to make on-going improvements that will make permitting, licensing and regulatory processes easier and more effective. DFI will continue its efforts to improve the delivery of service to all our customers through a combination of automation, uniformity, licensing technologies, document retention technologies and call center controls. Customer service enhancement will be realized in faster license issuance, increased public access to information and better agency response to customer needs.

OBJECTIVE 1-4: Identify and mitigate excessive risk.

Strategies:

- Conduct forums to discuss and formulate strategies on common issues such as identity theft, money laundering, predatory lending and competitive challenges.

- Establish an annual cross-training event for bank and credit union examiners in the newest regulatory requirements, risks and issues faced by depository institutions.
- Develop a plan by January 2008 to respond in the event of an individual or systemic emergency facing regulated entities.

An important part of DFI's mission is to identify systemic issues and mitigate excessive risk taking by financial institutions operating with a Washington State charter. In order to carry out this mission we must maintain close dialogue and communication with a wide variety of stakeholders, including: the public, executive and legislative branches of government, regulated entities, trade groups, national regulatory associations, federal regulators, and DFI staff.

Industry products, services, and delivery channels have become more numerous and sophisticated over time. Examiners must have the resources and the knowledge base needed to keep up with an evolving financial services industry.

Economic troubles, natural disasters, or man made incidents can lead to widespread problems that disrupt the financial marketplace. Emergencies can take many forms and can strike at any time. DFI must be in a position to respond to events that may adversely affect individual institutions or a multiple number of institutions. We must develop guidelines and plans to manage our resources to ensure that financial service disruptions are minimized in the event of a problem.

OBJECTIVE 1-5: Protect and preserve the "state" component of the dual-charter system so that Washington businesses and citizens have ample community access to financial institutions and services.

Strategies:

- Implement an ongoing interactive stakeholder working group to maintain the viability and relevance of the Washington State Charter by Fall 2008.
- Assist individuals and financial institutions in forming successful economic development projects.
- Establish a technical assistance program to promote and work with community banks in economically challenged communities to promote projects that meet the requirements of the Community Reinvestment Act.

All states operate under a dual-chartering system. Banks and credit unions have a choice of operating under a state or federal charter. Many state-chartered banks are community banks that provide individuals and businesses with the competitive financial services they need. DFI regulates only state chartered banks and credit unions. Advantages of state regulation include accessibility and responsiveness of state regulators who understand the needs of citizens and institutions operating in Washington State. The ability to respond to particular local needs coupled with timely decision making ensures more protection for Washington citizens. Federal preemption of state financial institutions and regulation, and other consumer protection laws continues to create conflict, and in the case of banks and credit unions threatens the viability of the dual-charter system. Federal agencies, through rule making and interpretation, seek to dominate areas of traditional state regulation. Increasingly, state regulators must deal with the complaints of Washington State residents without the means and jurisdiction to effectively deal with the complaints. DFI must participate in various forums to ensure a viable state program and to ensure that communities have ample access to financial services.

The legislature recently modernized an innovative type of *financial institutions charter*, which encourages banks, thrifts and/or credit unions, the investment community, private entrepreneurs, and even government-sponsored entities (GSEs) to form business development companies that will lend to or invest in small business, agriculture, community development and/or historical preservation in Washington. Our plan is to actively reach out to the appropriate communities to let them know about the program and offer assistance when appropriate.

OBJECTIVE 1-6: Reduce the burden of those we regulate by ensuring our laws, regulations and regulatory processes are current and necessary.

Strategies:

- Modernize statutes and rules to anticipate and respond to changing financial services by ensuring rules are flexible and relevant, follow Plain Talk requirements, and do not impose undue burdens on regulated industries.
- Where prudent, reduce examination time spent in smaller institutions where prudent.
- Use information and media technology to increase and improve public involvement in DFI rulemaking.

DFI supports the needs to reduce regulatory burden for the industries we regulate. We plan to focus our efforts over the next several years on modernizing statutes and rules where possible, prudently reducing the amount of time we spend in institutions, and using technology to ease the burden on staff, regulated entities and citizens. We will also continue to reduce regulatory burden by coordinating our activities and alternating or sharing examination responsibilities with other regulatory counterparts.

With regard to our examination function, we must continue to seek ways to better assess risk and target examiner resources towards the highest risk areas. DFI supports proposed legislation to extend the mandatory federal examination schedule from 12 months to 18 months for healthy well-managed financial institutions with assets under $1 billion. The present $250 million cutoff for an extended examination cycle has not been changed since 1994. Raising the threshold to $1 billion in assets will allow for more effective allocation of examiner resources, as well as relieve regulatory burden and costs for small healthy institutions.

GOAL 2: Enhance protection of citizens' financial interests.

OBJECTIVE 2-1: Focus investigation and enforcement resources to specifically target areas of highest impact on Washington residents.

Strategies:

- Increase the number of administrative, civil and criminal actions against individuals or entities that conduct fraudulent or illegal financial services activities.
- Improve prioritization of complaints, investigations and enforcement actions with the highest impact.
- Reduce the response time for examinations of licensees 'for cause'.
- Allocate and train staff to respond on a priority basis to complaints from unsophisticated or vulnerable citizens.

DFI endeavors to increase the protection of its citizens in financial transactions. To accomplish this, DFI will increase the number of enforcement actions it takes against fraudulent or illegal financial services activities. DFI will focus its enforcement resources where those resources will have the greatest impact for the protection of Washington residents. By improving its system for prioritizing complaints and cases, DFI will deploy resources to the cases where DFI can do the most good. Better coordination of licensing, examination, and enforcement activities, in part, through integration of information systems will improve enforcement effectiveness. One priority will be enhanced response to consumer complaints from unsophisticated, elderly and vulnerable citizens. DFI will train its staff on the most effective ways to assist such citizens. Another initiative is to reduce the time to get on-site to do an examination after receipt of a serious consumer complaint about a licensee. These focused examinations are referred to as "for cause" examinations. Not all consumer complaints against licensees result in such examinations.

OBJECTIVE 2-2: Increase the number of criminal cases filed and prosecuted.

Strategies:

- Train more DFI personnel and external partners to investigate potential criminal cases within DFI jurisdiction by June 30, 2008.
- Expand and enhance relationships with prosecutors and law enforcement agencies to increase the use of dedicated prosecution funds.
- Leverage resources with other state, federal and foreign governments and organizations to increase the number of multi-jurisdictional cases by June 30, 2008.

By working closely with prosecutors, DFI will increase the number of criminal cases filed and prosecuted. In doing so, DFI will train its staff and the staff of its external partners on investigating financial services cases for criminal prosecution. DFI will continue to develop its relationships with prosecutors and law enforcement and encourage them to use DFI's two dedicated prosecution funds for the prosecution of criminal cases in the mortgage fraud and securities fraud areas. DFI will partner with other state, federal, and foreign jurisdictions and organizations to increase the number of multi-jurisdictional enforcement cases brought during the biennium.

GOAL 3: Provide information and education on financial services to the public and those we regulate.

OBJECTIVE 3-1: Expand education and outreach to consumers.

Strategies:

- Develop consumer education focused initiatives aimed at diverse and underserved communities.
- Develop and market initiatives aimed at assisting and educating licensees and businesses.
- Build partnerships with SPI, CTED and other agencies and associations that support financial literacy training, to better educate consumers.

DFI has developed a strong reputation as a provider of financial education. Having consumers and businesses that make informed financial decisions supports the economic growth and viability of the 100,000-plus financial services licensees operating in our state. The need for personal finance skills continues to grow among consumers, young and old. In the past year, the United States reached the lowest national savings rate in the industrialized world -- American's annual savings totaled 0%. A DFI survey found that 50% of mortgage fraud victims in Washington State made financial decisions in moments of desperation without understanding the costs of interest rates or fees. We believe that providing education and information about using financial services can assist consumers in making better decisions about money. We will continue our efforts to reach out to elementary, high school, college students, and working adults. To reach the largest audiences, the Department will implement innovative and creative educational initiatives that use DFI's resources wisely. Through partnerships with organizations sharing in our goal to educate consumers and businesses, we will also continue to serve diverse communities throughout our state.

GOAL 4: Leverage technology and other resources to operate efficiently and effectively.

OBJECTIVE 4-1: Implement efficient and cost effective agency financial systems and business processes.

Strategies:

- Conduct a feasibility study by June 30, 2008 to centralize DFI administrative business processes (procurement, bill paying, etc.). Develop project plans to implement recommendations by June 30, 2009.
- Explore new allocation methodologies to ensure a rational distribution of costs across the agency. Develop recommendations by October 2008.
- Complete work flow for the DFI revenue process by June 30, 2008.
- Implement new statewide enterprise systems within the agency (HRMS, Roadmap, Procurement, Asset Management, Accounts Receivable).

In order to achieve our mission, we must ensure that our internal support processes operate efficiently and effectively. Operating at a peak level allows us to free up scarce resources to focus on areas of highest need. Because of the industry environment, the Department was historically formed with distinct programs which were very autonomous from one another. This also resulted in many of our administrative support functions operating in a decentralized manner. Currently, the industries we regulate are undergoing tremendous change. The dividing lines between one industry and another are becoming blurred. In addition, state government is also going through an evolution from a program focus to an activity-based focus, and from unique agency systems to enterprise-wide systems for the state as a whole. These factors underlie the need to examine how we operate to ensure we are in alignment with the changing landscape. Over the next two to five years, we will explore centralizing administrative processes where it makes sense. In addition, during the last two biennia DFI has focused on implementing imaging technology and looking at electronic workflow to support core activities and processes. We will examine the feasibility of employing these new technologies in our administrative support functions.

OBJECTIVE 4-2: Provide all DFI staff access to the information they need to perform their duties when and where they need it.

Strategies:

- Reduce the amount of travel necessary by staff in performance of their duties through technological solutions.
- Manage and improve use of data as an agency resource and minimize redundancy and maximize re-use.

As part of our efforts to operate efficiently and effectively and also to reduce regulatory burden on our regulated entities, we continue to explore ways to reduce the amount of travel required by our examiners. Historically, examiners at DFI travel up to 60 percent of the time. The travel requirements have presented challenges in recruiting and retaining these staff. We will explore using technologies like video conferencing and portable scanners to facilitate one person going to a regulated entity's site and the rest of the team collaborating through video conferencing and reviewing documents or maybe even doing the entire exam remotely.

We will continue our efforts to manage data as a single database structure for storing regulated entity data and managing a single imaging system for storing electronic copies of our paper documents. Historically, each division stored this data separately. As stated above, the environment in which we operate has become less defined and entities can cross industry lines. Problem licensees will often jump to new industries if barred from others. The need to effectively search the entire universe of DFI's data is essential to our mission of protecting the public.

OBJECTIVE 4-3: Provide easy to use methods to improve business processes and share information with consumers and regulated entities.

Strategies:

- Implement Workflow for major Securities and Consumer Services processes by the end of the biennium.
- Expand STAR (Securities Tracking and Registration) examinations to appropriate programs.
- Integrate STAR with other external systems.
- Participate in the statewide business portal.

A big focus of our technology efforts in the 07-09 biennium will be to continue to use workflow software technology for the movement and tracking of information and documents through our business processes. This provides improved service delivery and adds controls for tracking and auditing purposes.

STAR is the agency's core database system that contains several applications modules for licensing, enforcement (complaint processing and investigations), revenue, and examinations. The Examinations Module is in production in the Consumer Services Division. The plan is to expand its use to the Securities Division.

STAR also needs to integrate, primarily through the automatic sharing of data, with other external systems. DFI needs to automatically share data with our regulatory counterparts with other states through National databases such as the Investment Adviser Registration Depository (IARD) and Central Registration Depository (CRD) and, in the future the CSBS mortgage brokers' database and the State's Business Portal project.

Although DFI is not a charter member of the business portal project, we are participating to the extent possible. We are aligning our applications and databases so that we can achieve a relatively easy transition.

OBJECTIVE 4-4: Provide a secure agency technology environment where data and systems are available and protected from unauthorized access or corruption.

Strategies:

- Implement secure email with stakeholders and external partners.
- Implement Federal Information Processing Standards (FIPS) by June 2008.
- Implement appropriate laptop security as new technology becomes available.
- Implement technology to securely share information and data with our stakeholders.

The security of our systems and the data we are entrusted with continues to be a major focus of our technology efforts. In carrying out our mission, our staff gains access to large amounts of private and confidential information that we have the utmost fiduciary duty to protect.

DFI will explore and implement technology to allow us to share confidential information with our federal and state counterparts as well as the entities that we regulate. One of the outcomes that we hope to accomplish is our ability to perform off-site examinations. This goes hand in hand with reducing travel necessary by our staff but will also improve the business processes that we use today for collecting and disseminating information.

DFI also currently has a secure email server-to-server connection with the Federal Deposit Insurance Corporation (FDIC), one of our federal regulatory counterparts. We plan to expand this type of connection as appropriate with other regulatory partners and stakeholders.

DFI plans to implement FIPS compliant security technology for authenticating users of our systems and protection of our data. These federal standards are mandated for federal agencies. The key technologies that DFI will explore using are Smart Cards and Biometrics (fingerprints) for authenticating access to our systems and encryption of our data as necessary.

Along with the use of FIPS compliant technology, DFI will continually look for ways to reduce the risk of unauthorized access or loss of our confidential data, particularly that which resides on laptop computers of our field examiners and investigators.

GOAL 5: Support a highly skilled and diverse workforce.

OBJECTIVE 5-1: Recruit and retain employees who have the skills, knowledge and opportunities to be successful.

Strategies:

- Implement a successful recognition pay plan for DFI by June 30, 2009.
- Implement workforce management goals around workforce issues such as sick leave and overtime usage, employee performance, diversity, turnover, etc. by using the HR Management Report.
- Complete a study with recommendations for viable options for competitive pay for targeted unique job classes by June 30, 2008.
- Utilize HRMS, when it becomes available, in recruitment efforts to reach a broader pool of qualified candidates.

Workforce challenges continue in the agency due to recruitment and retention issues primarily in the Financial Examiner job classes. In the past, DFI has successfully utilized the entry-level class of the Financial Examiner series in recruiting high-quality candidates directly from college. Tuition reimbursement and professional development programs have also been useful tools in attracting new staff. However, recent trends indicate higher entry-level salaries offered by competitors are having an impact on this recruitment strategy, and compensation is limited by a statewide salary schedule. Additionally, higher salaries and less travel offered by competitors to seasoned and experienced staff create retention issues along with retirement of some experienced workers.

In addressing these challenges we must review the effectiveness of DFI’s strategies to recruit, hire and retain a broad spectrum of candidates for employment, and recommend changes as appropriate. Implementation of a new Human Resources Management System (HRMS) with an E-recruiting component, as well as new flexibilities resulting from Civil Service Reform (e.g. use of desirable rather than minimum qualifications, recruitment and retention premium pay, locality premium pay, implementation of performance pay, etc.) will allow us to explore and utilize new tools to aid in recruitment of high-quality candidates and remove the barriers addressing hard-to-fill hiring needs.

DFI PERFORMANCE MEASURES

DFI conducts four core program activities in carrying out its statutory responsibilities: Chartering, Licensing, and Registration; Examinations; Enforcement; and Education and public outreach. The following table of measures covers each of our core activities.

ACTIVITY	MEASURE	DIVISION	REPORTING FREQUENCY	TARGETS	
				FY08	FY09
Chartering, Licensing, and Registration	Turnaround time in calendar days for initial response to securities and franchise registration applicants.	Securities	Quarterly	20 days	20 days
	Average number of business days to process and issue a license.	Consumer Services	Quarterly	5 business days	5 business days
Examinations	Percentage of banks with satisfactory examination ratings.	Banks	Quarterly	90%	90%
	Percentage of banking assets held at institutions with satisfactory ratings.	Banks	Quarterly	95%	95%
	Percentage of credit unions with satisfactory examination ratings.	Credit Unions	Quarterly	80%	80%
	Percentage of credit union assets held at institutions with satisfactory ratings.	Credit Unions	Quarterly	95%	95%
Enforcement	Average number of business days to assess, investigate and resolve consumer complaints.	Consumer Services	Quarterly	120 days	120 days
	Number of Enforcement actions taken per year.	Combined measure for Consumer Services and Securities Divisions	Quarterly	200/yr	200/yr
Education and Public Outreach	Percent of consumers who rate DFI outreach programs and materials as helpful.	Admin/ Communications	Quarterly	80%	85%

PERFORMANCE ASSESSMENT

The Department's mission is to regulate financial services in our state to protect the public and promote economic vitality. We use several types of measures to gauge our performance in achieving our mission.

Measures of Institutions' Financial Health

The health of our financial institutions, banks and credit unions in particular, contributes to economic vitality thus it is crucial to measure the safety and soundness of these institutions. We use the Uniform Financial Institutions Rating System, more commonly known by the acronym "CAMEL", to gauge safety and soundness of financial institutions. This system is an examination tool designed to help reflect the financial condition and overall operating soundness of an institution in a comprehensive, relatively uniform (and therefore comparable) fashion.

The CAMELS rating consists of the following six factors:

1. Capital Adequacy
   Rated in relation to the volume of risky assets; the volume of marginal and inferior quality assets; the adequacy and prudence of policies; and new loan volume. Overall growth rates and the strength of management are also considered.
2. Asset Quality
   Rated in relation to the level and severity of classified assets; adequacy of reserves and loss allowance; quality and volatility of investments; and level of non-earning assets.
3. Management
   Rated in relation to technical competence, leadership, administrative ability, involvement, compliance with rules and statutes, ability to plan and respond to changing circumstances, adequacy of and compliance with internal policies, and the depth and succession of management. The quality of internal controls, lending, investment and operating policies and the involvement of the directors and/or committees are taken into consideration.
4. Earnings
   Rated by their ability to cover losses and provide adequate growth in equity relative to overall growth. Also considered are earnings trends, peer group comparisons, quality and composition of net income, cost of funds, the equity growth, and the extent to which extraordinary items contribute to net income.
5. Liquidity
   Based on more than just whether ample cash reserves are available. Included is the overall effectiveness of asset-liability management strategies. Considerations include the volatility of deposits; degree of reliance of interest-sensitive funds; frequency and level of borrowing; liabilities structure; and efficiencies of idle funds investment. All are considered in relationship to the availability of assets readily convertible to cash and access to other readily available sources of funds. The liquidity position is appraised over a period of time as well as on any given

date. Liquidity policies are also considered in reference to adequacy and compliance.

6. Sensitivity to Market Risk
   This additional factor is used in the examinations of banks and reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or economic capital. When evaluating this component consideration is given to: management's ability to identify, measure, monitor, and control market risk; the institution's size; the nature and complexity of its activities; and the adequacy of its capital and earnings in relation to its level of market risk exposures.

   DFI staff assign ratings in the examination process. We do not have complete control over this measure; however we do have the ability to influence institutions' actions through our examination process. Currently, we exceed our targets for satisfactory ratings in both Banks and Credit Unions Divisions. At this point in the economic cycle banks and credit unions are healthy, have good earnings, strong capital positions, and minimal asset quality problems. As of March 2006, 97.5% of banks assets and 98.8% of credit union assets were in institutions with satisfactory ratings, exceeding our goal of 95%. We continue to work with institutions that have below standard ratings to return them to satisfactory condition.

Customer Satisfaction Measures

Although good outcome based measures for regulatory agencies are difficult to find, we are able to monitor the satisfaction of our customers with our business processes. The divisions of Banks, Credit Unions and Securities monitor the institutions' satisfaction with our examination process to improve the process and to increase communication with industry stakeholders. We do this through surveys of the institutions after completion of an examination. Our Consumer Services Division measures customer satisfaction with licensing and complaint processing services through use of survey cards. Currently, we exceed targets for customer satisfaction in all areas.

Measures of Output and Turnaround

The Department also measures performance with various output measures and measures of turnaround times. We measure turnaround times for licensing and registration processes as well as the number of examinations and enforcement actions completed. How long it takes us to turn licensing and registration applications around is particularly important in the non-banking financial services and securities industry because these actions have a large positive effect on the lives of consumers inside and outside of Washington. Often the upshot of the enforcement or examination is that a licensee must make refunds to consumers and implement significant reforms in their business practices. Such actions may also result in business closure, removal of officers or criminal convictions. All of these actions directly contribute to the consumer protection side of our mission.

DFI is viewed by other state regulators as a top performer and leader in the depth of our examinations. In 2002 – 2003, our Division of Consumer Services was a multi-state leader in the largest predatory lending case in national history. Again, in 2004-2005, the Division was a lead in the second largest mortgage predatory lending enforcement action in the history of the US. Our Securities Division's examination program is one of the most sophisticated in the nation, and is often called upon to perform specialized or particularly complex analysis on behalf of other jurisdictions, or to provide training to other state examiners. Our Securities' enforcement section, despite its size, is one of the most productive in the country, with a reputation for taking on large cases and being able to bring resources to bear on complex investigations that other regulators are unable to perform. Prosecutors and law enforcement at all levels seek our participation in their cases.

Our Securities Division has been able to meet its performance measures in all of its major activities in the current biennium. It has processed initial applications for securities and franchise registration within statutory timeframes. It has taken enforcement actions against violators of financial services laws at the rate of 90 or more actions a year. It has decreased the time from registration of an investment adviser until the investment adviser receives a technical assistance visit from a DFI financial examiner.

Although currently slightly above its desired target for turnaround time for processing complaints, our Consumer Services Division enforcement unit is making significant progress handling the high complaint volume and is steadily reducing the turnaround time. Modifications to the database reporting system are in process; this coupled with newer staff obtaining necessary training will result in the continued reduction in the complaint turnaround time. This unit does not expect to meet its performance measure relating to the number of enforcement actions taken (target of 110 per year) because of the number and extent of complex fraud investigations underway. These matters pose a greater risk of harm to consumers and at the same time involve greater resources and additional time to generate enforcement actions. In conjunction with the agency efforts to focus resources to the highest risk areas, this unit accordingly may adjust or further clarify its target.

Performance results in our Consumer Services licensing unit far exceed neighboring states. The Licensing unit has consistently met license application review turnaround time targets for all license types for nearly two years. Washington license application turnaround times are significantly faster than Oregon, California, Idaho, and Montana. Survey reports from license applicants indicate Washington is faster and easier to deal with than other states across the country. Although the licensing unit has met performance targets, we are embarking on two long-term projects that should all but eliminate the need to measure license application turnaround times. One is the merger of two on-line license application initiatives, one DFI produced and the other a combination of our effort and a multi-state on-line licensing program allowing applicants to cover several state licensing efforts in one stop. When completed and merged, the two on-line licensing programs will allow applicants nearly real time application delivery, payment and review.

Although we are meeting most examination targets in our Banks and Credit Union divisions, an area that remains a challenge to us is the examinations process in our Consumer Services division. We currently do not meet targets in this area both in terms of the number of examinations performed and turnaround times for examination reports. The limited number of experienced examiners, in proportion to the number of licensees and those categorized as "high-risk" restricts the quantity of examinations performed. Although, the examination unit is on target to perform 100 "high-risk" examinations of licensees by the end of FY 2006, they have not met their target of 30 days for completing examinations due to the inexperience of examiners and the large amount of time allocated to their training. Training conducted by experienced examiners reduces the number of examination reports they can produce. New examiners are expected to be slow until they have the experience necessary to produce in depth reports within targeted timeframes. Turnover is also an issue due to large amounts of travel and, travel to out-of-state locations limits the number of exams completed. We will closely monitor the efficiency of examinations completed with the goal of achieving our examination targets. We intend to improve efficiency in this area by implementing new technology, conducting joint examinations with other states or federal agencies, conducting off-site examinations for at least some out of state licensees, and by increasing training and improving efficiencies with in-house and contracted examiners.

Education and Outreach Measures

Another important role in support of the consumer protection side of DFI's mission is education and outreach. We continue to increase our efforts in these areas as a preventative measure in the war against predatory lending practices and to assist consumers in making wise financial choices. We also continue to expand the range of information available to consumers on our website. We currently measure our performance in this area by the percentage of consumers who rate our outreach programs and materials as helpful and we also track the number of unique visitors to our website. Our increased outreach efforts, through participation in literacy projects, media campaigns, newsletters, presentations and other outreach activities is resulting in more people visiting our website as they become familiar with DFI. In March 2006, we hit an all time high of over 30,000 unique visitors to our website, an increase of almost 6,000 visitors from the year before. The percentage of consumers who rate our materials as helpful continues to increase. We are currently at 78% satisfaction, below our intended target of 85%, however we will continue to improve as we implement many consumer suggestions as to how to increase the helpfulness of our materials.

Learning from GMAP Process

The GMAP process has been instrumental in bringing issues to the forefront through the development of logic models and through comparison of processes and performance measures used in the various divisions of our agency. Specifically, the GMAP process has allowed us to:

- Quantify and demonstrate growth in the number of entities and licensees we regulate and quantify resource needs around that growth.
- Identify common issues and trends from an agency-wide perspective.
- Re-think and improve how resources are allocated by allocating resources to higher risk areas.
- Monitor operating revenues and expenditures, FTE levels and turnover in an all agency forum.
- Look at new measures including:
    - time it takes to process consumer complaints,
    - time from the completion of field work for a broker-dealer and investment adviser examination until the examination report is completed
    - percentage of telephone inquiries that are answered by a staff member within a certain time.

- Improve performance by developing new tools for collecting data, new processes for distributing that data to staff, changing work processes and focusing more resources to address issues. One example is the use of a call center process to deal with inquiries from the public that are not directed to a particular staff member. We have changed our work processes and focused more resources on customer service as a result of the data we have been able to obtain from the call center software we obtained through Department of Information Services. Call center information is continuously monitored and measured, and the results reported at our GMAP forums. Because of the focus placed on this issue, performance is improving.

APPRAISAL OF THE EXTERNAL ENVIRONMENT

The operating environment for DFI has undergone significant changes over the last decade. There are many opportunities and challenges facing our industries today. We must be able to meet the growing complexity and changes that are taking place in the industries we regulate and we must closely monitor, and be prepared to respond to: economic changes; innovation of products and services, and technological advances; legislative and regulatory changes, and actions by federal regulators.

The Economy

The national and state economies are healthy with solid growth in productivity and employment. Nationally the unemployment rate is below 5% and the gross domestic product is expected to remain in a healthy growth range. The state's economy has turned around over the last two years. It has been lifted by strong real estate markets, a rebounding aerospace industry, and continuing growth in high technology. Construction jobs grew by 8.6% in 2005 and accounted for one in every five new jobs. Areas of weakness remain in the agriculture sector and manufacturing both of which face stiff competition from foreign markets.

Inflation remains low by historical terms but is experiencing some pressures from higher commodity prices, employment, and wages. The Federal Reserve has increased interest rates in measured steps over the last two years to try to stem inflationary concerns. Many expect that future rate hikes are nearing an end as the flat yield curve may be signaling a slow down of economic growth to a more sustainable rate.

The State banking industry is strong. Washington State chartered depository institutions are healthy and have enjoyed strong growth in earnings, total assets, loans, deposits, and capital over the last year. Inquiries for new banks increased in 2004, and once chartered will help to offset the number of banks lost to mergers and acquisitions. Banks have been able to strengthen their conditions due to a rebounding state economy. Nationally there have been no bank failures since June 24, 2004 and no bank failures in Washington since July 2, 1993. The number of problem state chartered banks in Washington has declined sharply in the last 12 months.

In 2005 total assets of Washington State chartered institutions rose by 10.5% and net income by 21.5%. Return on assets improved to 1.30%, while asset quality remained excellent. Net interest margins increased in 2005, as interest income increases offset higher funding costs. Non-current loans declined as a percentage of total loans to 0.37%, while loan charge-offs were low at 0.13%. Both asset quality measures are better than national averages.

Loan demand has been fueled by strong growth in commercial real estate and construction lending. Construction and development portfolios grew by 45.7% in 2005. Economic growth in the Puget Sound area led to strong growth in commercial real estate. Vacancy rates have declined to their lowest levels since 2001, and lease rates are rising in the region.

One of the cautionary concerns voiced by regulators is real estate growth and the levels of real estate concentrations in the banking industry. In Washington, real estate concentrations are far higher than national averages. As of December 31, 2005, Washington State chartered banks and thrifts had average concentrations in commercial real estate as compared to capital measures exceeding 500%. Recent federal banking guidance warns that institutions that go above 300% need to provide for better risk management practices.

Competition for deposits is becoming increasingly price sensitive. Short term interest rates continue to rise which has resulted in the yield curve becoming flat and in some cases inverted. Traditionally bank performance has been best when there is a healthy spread between short term and long term rates. In order to compete for deposits, banks have raised short term CD rates which places pressure on banks’ net interest margins.

There is also increasing competition for checking accounts as banks seek to grow these low costs funds by providing additional services tied to the accounts. As interest rate spreads come under pressure there may be a tendency on the industry's part to lower underwriting standards and accept higher risk loans. If this occurs there will be a greater level of asset quality issues that will surface in the coming years.

The "housing boom" over the last five years has led to rapid growth in the mortgage industry. Consumer Loan (primarily mortgage banks and subprime lenders) and Mortgage Broker licensees benefited from this growth. The result has been increased licensing activity as new companies entered the business and existing firms expanded. The boom also created increased income for our regulated industries with a resulting expanded fee base for DFI. There is now concern over real estate price appreciation and the possibility of the real estate bubble bursting. Housing prices in the state rose by 18.4% in the fourth quarter of 2005. In King County the median price of a house has risen to $405,000. Nationally, real estate markets appear to be softening with slower sales and appreciation rates, and higher inventory levels. As rates rise, consumers from these segments of the market may be unable to maintain the payments for which they have contracted, especially those consumers with adjustable rate mortgages. This suggests the possibility of increased delinquency and loan charge offs in coming years. In addition, rising rate environments often result in a surge of consumer complaints as interest rate locks expire and consumers are faced with higher interest rates than they were originally promised.

As interest rates rise, risk for financial service providers also increases. Regulated industries are experimenting with non-traditional mortgage products to expand their mortgage business. These include forty year mortgage loans and interest-only mortgage loans that may ultimately prove damaging for lenders and borrowers if borrowers are unable to meet these financial obligations. Reduced cash flows for regulated entities also increase the risk of embezzlement or other fraudulent activities against consumers. Such problems may call for additional regulatory attention focused on the management and health of financial institutions at a time when our revenues are likely to decline. This problem will be significantly compounded with home value readjustments.

New threats to the economy in the form of natural disasters of enormous magnitude and pandemic virus vulnerabilities that have not been previously addressed must now be evaluated for risk. The lost productivity and earnings from such disasters could represent a significant threat to economic growth as the country and the state work their way through any after effects.

In the securities industries, increases in personal income and in the employment rate among Washington residents have created favorable conditions for investment in the stock market. Most of the revenue collected by the Securities Division is from the sale of mutual fund shares to Washington residents. The population of Washington State is growing, which contributes to growth in mutual fund share purchases by Washington residents. Stock market prices are forecasted to continue to rise in the near term although growth in stock prices is predicted to slow in the next biennium.

Demographics

There has been a great amount of attention paid to the country's low rate of savings. Data released by the U.S. Commerce Department reported that Americans had a negative savings rate in 2005. This means that we are spending more than we are earning. There has been explosive growth in sub-prime lending from a wide variety of financial service providers as consumers are increasingly living pay check to pay check. Banks have expanded overdraft protection products that cover short term consumer spending difficulties. The low savings rate is problematic for the banking industry which has seen a rise in personal bankruptcy filings and also from a funding standpoint. Banks use consumer savings in deposit accounts to fund loan and investment growth.

More citizens have greater access to more credit than ever before in the history of this country. With great opportunity also comes increased risk. While home ownership is at the highest level ever in the history of this country, many citizens find themselves entering a cycle of debt that can lead to bankruptcy or loss of the home they worked so hard to obtain. Unsophisticated borrowers face greater exposure to predatory lending practices that target groups such as senior citizens and low-income individuals and prey on individuals' sense of desperation. The array of new products such as non-traditional mortgages will only add to the potential of consumers being subject to predatory practices. The Department must continue its aggressive enforcement against predatory lenders and we must become more visible to low and moderate-income communities, immigrant communities, and the public as a whole.

The need for financial services is expected to increase in the coming years as individuals are being required to take more personal responsibility in planning for their futures. More citizens manage their own investments than ever before and have a larger percentage of their funds exposed to market risk than has historically been the case. Pension systems are disappearing and more reliance is placed on self-directed retirement accounts. Defined benefit plans, in which participants' funds were managed centrally, are no longer the norm for retirement plans. As defined contribution pension plans continue to crowd out defined benefit pension plans, older citizens will become more dependent on funds from their own investments. Older citizens have been putting more assets in self-directed IRA accounts, but they have also been purchasing more investment advisory services. Baby boomers have begun to retire and more will be retiring each year for many years to come. There is expected to be a large transfer of wealth over the next decade between pre-baby boom and post baby boom generations.

Retirees hold financial assets but those assets may not be sufficient to sustain them for a long retirement especially given the continuing rise in health care costs. These conditions are conducive to investment fraud because members of the public are vulnerable to promises of high returns when they feel that they need to make up for lost time in saving for retirement. As a result, the number of complaints we receive from consumers about investments is likely to continue to rise. The additional complaints may involve fraudulent investments such as high yield investment programs but may also involve allegations of sales practice abuses by licensed professionals, such as investment advisers, broker-dealers, and their representatives and sales persons.

Population growth will continue to be driven by non-white, non-English speaking immigrants and minorities possessing an increasing share of economic influence. These minority groups are forecasted to comprise 50% of the US population by the year 2020. We will continue our efforts to improve accessibility to our services, especially for customers that do not speak English or speak English as a second language.

Industry Trends

Because the citizens of the State of Washington are the primary beneficiaries of our work, much of the Department's effort is devoted to evaluating the safety and soundness of the financial institutions where citizens entrust their money.

The citizens of Washington are increasingly demanding a broader array of financial services from their financial institutions. At the same time, financial institutions must address new demands for protection of individual privacy and increased federal government regulation. These factors increase the pressure on small institutions to provide more services and protection with fewer resources. Larger institutions with more staff and money are better equipped to meet theses challenges.

The banking and credit union industries continue to consolidate. Over the past five years the number of banks in the country declined by 10.8%, while total banking assets grew by 45.7%. As of December 31, 2005 there were 8,832 FDIC insured depository institutions, compared to 9,904 on December 31, 2000. In the State of Washington the total number of state chartered banks declined by two, going from eighty to seventy-eight. On January 1, 2003 there were 92 state chartered credit unions in Washington. As of January 1, 2006 we have 79 state chartered credit unions. The reductions have been from credit unions under $50 million in assets, those with limited resources to adjust to regulatory and competitive pressures.

We have seen a recent surge of new applications for commercial banks. The applications are primarily along the I-5 corridor, which is experiencing strong economic growth. Many of the applications are for institutions that cater to specific underserved markets. Three of the new banks in formation are targeting ethnic communities. The banks are being capitalized at high levels and the organizers are not experiencing difficulty raising sufficient capital amounts. The new banks have a harder time finding qualified candidates to fill key lending and financial positions. Competition for loan officers is increasing as banks are seeking individuals who have established loan portfolios.

An area of concern is the ability of citizens to go to banking branches in remote rural areas. Republic, Washington faced this dilemma when Bank of America announced it was going to close the only bank branch in town. This problem is symptomatic of what is happening to communities across the nation. Slow economic growth and out-migration from rural areas is reducing the number of banks in rural communities. Some of the state's eastern Washington banks have relocated to Spokane in order to find profitable growth opportunities, while others have merged into larger institutions.

Consolidation is an important concern for DFI. The loss of large banks or credit unions or a large number of banks and credit unions adversely affects our revenues and personnel requirements.

Industry pressures are also adversely impacting the traditional cooperative nature of credit unions. In the past, smaller credit unions have been able to pool their efforts or to request assistance of larger credit unions to address certain issues. This cooperative spirit is no longer as strong. Larger credit unions and the Washington Credit Union League now increasingly see the small credit unions as a long-term drain on resources with limited benefits. With fewer credit unions, there is even less opportunity to pool resources.

In addition to industry pressures, Banks and Credit Unions are finding increasing competition from non-bank financial services companies that continue to control an increasing share of the financial services market. Banks and Credit Unions that historically have competed against each other now face heightened competition with insurance companies and brokerage houses, as well as non-traditional financial service providers, such as auto dealers and technology companies offering a variety of financial services. Many of these competitors have better financial resources, technology and expertise to offer a variety of services at the point of purchase. This increased competition has led to an increase in consolidations with many financial institutions branching out across state lines, which in turn has increased our need to conduct more multi-state and out-of-state examinations.

Mortgage Brokers now originate two thirds of all mortgage loans in the country (68% of all home loans originated in 2004). Sub-prime mortgage lending, accomplished primarily under the Consumer Loan Act in Washington, exploded in the late 90's. While there has been some retrenchment, sub-prime mortgage lending is here to stay at historically unprecedented levels. Check cashers and payday lenders continue to provide an increasing array of services and products.

The Uniform Money Services Act (UMSA) became effective in late 2003, calling for the licensure and regulation of money transmitters and currency exchangers.

The Department was provided examiner staff to implement a regulatory program overseeing the activities of this growing industry. Additional resources will have to be devoted to review Washington-based money transmissions, providing a regulatory presence aimed at reducing the possibility that money is transmitted to terrorist organizations or to locations banned from receipt of such funds under the USA Patriot Act. This will include working with foreign, state and federal regulatory authorities to attempt to stop money laundering and potential financing of terror organizations.

Legislative and Regulatory Changes

Legislative and regulatory changes alter the way financial institutions conduct business and the manner in which DFI operates. The financial services industry remains one of the most highly regulated industries, and is continuously subject to legislative and regulatory changes.

At the state level, two bills passed in the last legislative session that impact our operations. One bill modernizes the Business Development Company Act in order to stimulate the availability of financial assistance for small businesses and for local economic development. Part of the bill requires the Division of Banks to examine business development companies on a twenty four month cycle. The other bill allows banks to become limited liability companies. There may be future tax benefits if banks convert to limited liability companies.

At the federal level a number of new laws have been passed over the last year. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 make it more difficult for individuals to file for Chapter 7 bankruptcy. The law requires a means test, requires mandatory credit counseling, and also provides for more disclosure of a debtor's financial resources.

Regulatory Relief bills are at various stages in Congress. Some of the more important recommendations to ease burden include: expanding timeframes for examinations of banks with less than $1billion in total assets, adoption of full interstate branching, and reducing the frequency of currency transaction reports that banks must file.

Government sponsored enterprises (GSEs) have been the subject of great debate in Congress. Bills have been introduced that would create a new regulator for GSEs, would place limits on the size of mortgage portfolios, and would give the federal regulator the authority to mandate higher capital requirements and put GSEs into receivership.

Deposit insurance reform legislation was enacted which raises the limit to $250,000 for individual retirement accounts and similar types of accounts. The legislation also requires increases for regular deposit account insurance based on inflation rates beginning in 2010. The legislation merges the bank and thrift insurance funds and gives the FDIC flexibility in setting the reserve ratio of the combined fund. It also creates a new risk rating system in which insurance premiums can be adjusted according to a bank's risk profile.

Other national banking industry legislation under development addresses three key subjects: Postal reforms capping rate increases to the level of inflation, flood insurance programs, and data security requiring companies to take steps to safeguard information and notify customers of security breaches.

DFI works closely with the Federal Deposit Insurance Corporation (FDIC), Federal Reserve Board (FRB), and the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) to oversee the operations of state chartered depository institutions. One of the most controversial issues facing the FDIC at this time is the application by Wal-mart for an industrial loan company charter. The banking industry has voiced opposition to the application. There is fear among the community banks that Wal-mart will place branches in their stores throughout the country. Many fear the economies of scale that Wal-mart may be able to achieve could have a devastating affect on community banks, and also damage the long held separation of banking and commerce.

Commercial real estate is also a growing concern among federal banking regulators. In response, the federal agencies have proposed guidelines addressing sound risk-management practices for concentrations in commercial real estate lending. The guidance warns against unanticipated earnings and capital volatility in the event of adverse changes in general commercial real estate markets. The guidance recommends that institutions with high concentrations of commercial real estate lending have heightened risk management practices and higher levels of capital to help mitigate risk.

Another issue receiving scrutiny by federal banking regulators pertains to alternative residential real estate mortgage products. Draft guidelines for alternative mortgages have been submitted for comments. The draft recommends that banks address the potential for heightened risk levels associated with nontraditional mortgage lending and the importance of carefully mitigating those risk exposures. The draft recommends institutions pay close attention to product development, underwriting, compliance and risk management functions. Recommendations include the use of conservative assumptions in assessing borrowers' ability to make monthly payments after initial teaser rates have expired. The guidelines also recommend clear disclosures of the problems associated with alternative mortgages prior to submission of a loan application.

International bank regulators have been struggling with the adoption of new risk based capital measures. New capital requirements are expected to be adopted in the next biennium. The new capital measures are required for the largest banks in the country, but will impact the banking industry as a whole. The new requirements place greater reliance on internal risk measurement tools and practices, and is expected to lower capital requirements for the largest banks. This has prompted the federal regulators to develop a parallel revised capital requirement for remaining domestic banks. These proposals make more risk categories for asset classes and is also expected to lower overall industry capital requirements which can increase risk.

On the credit union front, the Internal Revenue Service has begun a process to tax certain income of state chartered credit unions. Should this approach be upheld, state charters may no longer be a realistic alternative for many credit unions. Currently federally chartered credit unions are exempt from all federal income tax. In Connecticut where the IRS began the process, most of the state chartered credit unions have changed to federal charter. With the demise of state charters, certain options for creativity in meeting the needs of members will be eliminated.

A recent proposed change to the accounting rules used by CPAs could also have profound effects on credit unions in Washington. The proposal to change the options in accounting for mergers could virtually eliminate mergers of credit unions. This proposal is harmful in two ways. It renders capital from the acquired credit union useless in computing capital ratios in compliance with federal deposit insurance standards. It would also require the assets and liabilities of acquired credit unions be marked to market value requiring additional time and expense. Mergers have long been a primary tool in dealing with weak credit unions. The weak or problem credit union that is unable to resolve its problems is merged into a financially strong one with credit union members benefiting from uninterrupted financial services provided by the financially strong merger partner. Should this accounting proposal be implemented, this merger tool will no longer be available in most circumstances. The regulator would be required to use more complex and time-consuming alternatives such as liquidation or conservatorship.

Over the next few years, credit union volunteer board members will continue to ask for more regulatory guidance about corporate governance issues and problems. Credit union members elect volunteers from their membership to be on their board of directors and supervisory committee (audit committee). While many boards work hard at training new directors, individuals on boards may vary significantly in the knowledge and skills necessary to direct the credit union. In addition, boards face litigation when credit union members allege breach of fiduciary duty. One area of requested board training is on corporate governance, defined as the framework in which an organization decides where it is going, monitors its performance, and allocates power and resources.

Another major controversial issue that is the center of attention is the Office of the Comptroller of the Currency's (OCC) rule on preemption. The OCC adopted rules to preempt a number of state laws. The rules include subsidiaries of national banks. The rulings have consistently been upheld through court challenges. The impact of the change may alter the dual banking system in place today. Banks that operate in multiple states may choose to switch charters to a national charter to avoid state regulations. Opposition to the OCC's rule has been voiced by a number of groups including, the Conference of State Bank Supervisors, National Governors Association, National Conference of State Legislatures, National Association of Attorney Generals, North American Securities Administrators Association, and various consumer advocacy groups.

Similar concerns exist over the Office of Thrift Supervision's (OTS) position that so called "exclusive agents" of federal savings banks are exempt from the coverage and jurisdiction of state law. The American Association of Residential Mortgage Regulators, Conference of State Bank Supervisors and the State Financial Regulators Roundtable have all filed objections with the OTS on this preemption position.

Also, perceived overregulation under the federal Sarbanes Oxley Act could lead to backlash against financial services regulation which might include various deregulatory initiatives especially with regard to small business regulation. We will continue to participate in forums around these issues and monitor their impact on all of the industries we regulate.

Federal regulators have also issued guidance regarding authentication of internet banking. The guidance describes methods that regulators expect banks to use when authenticating the identity of customers using internet channels. Financial institutions are expected to comply with the guidelines by the end of 2006.

The SEC recently enacted rules and interpretations relating to investment adviser registration for the advisers of hedge funds. It also enacted regulations concerning when broker-dealers must register as investment advisers. Although oversight of investment advisory services was split between federal and state authorities ten years ago, interpretive and rulemaking activities at the federal level still have an effect on the work load at the state level. As a result of the SEC rulemaking and interpretive activities, the Securities Division's staff is spending more time on interpretive issues relating to investment adviser licensing. The Securities Division must also train its examination and enforcement staff on new issues relating to investment advisers.

The private civil remedies for those defrauded in securities transactions have continued to erode. Federal legislation, including the Securities Litigation Uniform Standards Act of 1998 (SLUSA), has made it more difficult to bring class actions for securities violations. In March 2006, the U.S. Supreme Court held, in Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, that SLUSA preempted class actions for violations of state securities laws. Defrauded investors are therefore going to be more dependent on state securities regulators, such as DFI, to take action on their behalf if they become victims of securities fraud.

Major Partners

The Department has major partnerships with several national and state entities, including:

- The American Association of Residential Mortgage Regulators (AARMR), the National Association of Consumer Credit Administrators (NACCA), and the Money Transmitter Regulators Association (MTRA). These are non-profit organizations whose memberships are made up of state regulatory agencies and with whom regulatory issues are discussed. .

- The Consumer Protection Division of the Office of the Attorney General, the Office of the Insurance Commissioner and the Board of Accountancy with whom we frequently share information and cooperate on cases.

- o Federal and state law enforcement agencies in cases where criminal charges are likely. We can provide investigative expertise and law enforcement can assist us in obtaining investigative materials. In addition, we assist local prosecutors in presenting their cases. The Securities Division is also a frequent participant in criminal investigations with the Federal Bureau of Investigation (FBI).

- o State and federal prosecutors with whom the enforcement staff of the Securities and Consumer Services Divisions work closely on criminal cases. Prosecutors frequently refer cases to the divisions for investigation and preparation. The Securities and Consumer Services Divisions also investigate and prepare cases it receives from other sources for referral to the appropriate prosecuting authority. The divisions then work closely with the prosecutor to provide additional investigation, create visual aids for trial, supply trial briefs, and other pre-trial, trial, and post-trial assistance. The divisions' enforcement attorneys at times may participate in the prosecution as Special Assistant United States Attorneys or Special Deputy Prosecuting Attorneys. These partnerships normally proceed on a case-by-case basis. In recent years, the Securities Division has joined corporate and investment fraud task forces directed by the offices of the US Attorneys. Also, the Consumer Services Division recently joined a mortgage fraud task force whose members include staff from the office of Attorney General of Washington, King County Prosecutor's Office, US Attorney's Office, HUD, IRS, FBI, and local law enforcement agencies. The cases and assignments the divisions receive have become more complex such that these partnerships can last for years and involve many law enforcement agencies.

- o Federal banking partnerships that involve joint examinations and acceptance of each other's reports to meet examination requirements including:
  - Federal Deposit Insurance Corporation, FDIC, who oversees the deposit insurance fund for all banks, and is the primary federal regulator for state nonmember banks.
  - Board of Governors of the Federal Reserve System, FRB, who regulates financial and bank holding companies, foreign banks, and state chartered banks that are members of the Federal Reserve Board System.
  - State banking Departments in the other 49 states, District of Columbia, and United States territories.
  - Office of Thrift Supervision, OTS who regulates thrift holding companies, and is the primary federal regulator for state chartered savings associations.
  - Office of the Comptroller of the Currency, OCC, who regulates national banks.
  - Conference of State Bank Supervisors, CSBS, the nation's leading advocate for the state banking system.
  - Federal Financial Institution Examination Council (FFIEC) who prescribes uniform principles, standards, and report forms for the federal examination of financial institutions and who makes recommendations to promote uniformity in the supervision of financial institutions.

- The National Credit Union Administration (NCUA), the federal regulator and insurer of federally insured credit unions, such as our state credit unions; and the National Association of State Credit Union Supervisors (NASCUS), an association of state regulators. In addition, we partner with credit union regulators in other states when examining out-of-state credit unions that have branched into Washington, or into neighboring states.

- Other state securities regulators with whom we participate in various coordinated registration efforts. Under the Coordinated Review program, issuers of securities and franchises may elect to have the state registration process for those offerings coordinated among the states in which they are registering. The company registering its securities or franchise offering will receive only one comment letter representing the comments of all participating states. This simplifies the registration process for the company and results in greater uniformity of regulation. The Securities Division has entered into a memorandum of understanding with the other participating states agreeing to a reviewing protocol. The Securities Division is also a member of specific review groups, including the Western Regional Review programs, which offer similar coordination for direct participation programs and small business offerings.

- Securities and Exchange Commission (SEC) and the National Association of Securities Dealers (NASD) with whom we routinely coordinate the examination of broker-dealer offices and headquarters. To a lesser extent, the Securities Division also coordinates such examinations with the New York Stock Exchange (NYSE). The Securities Division meets regularly with the SEC and NASD on individual examinations and participates in semi-annual examination summits, where schedules, findings, and plans are discussed. Additionally, the Securities Division has entered into a memorandum of understanding with other state securities regulators agreeing to cooperate and coordinate in the registration, licensure, and examination of investment advisers and investment adviser representatives. The memorandum also concerns the coordination of investigations and examinations in the instance of fraud by investment advisers that are registered with the SEC. The Securities Division engages in frequent "sweeps" and joint investigations with the SEC, NASD, the Federal Trade Commission (FTC), and other state regulators. The Securities Division participates in the Washington Economic Crime Task Force, a Regional Economic Crime Information Center, and the Corporate Fraud Working Group.

Trends Affecting our Partnerships

DFI's partners, including county prosecutors, local law enforcement, federal prosecutors, federal law enforcement, other state regulators, and the U.S. Securities and Exchange Commission (SEC), face challenges that are likely to make our efforts more critical in the fight against investment and mortgage fraud. Fraudsters are increasingly taking advantage of new technology, the Internet and ability to operate in foreign countries to commit frauds on state citizens, escape detection and avoid prosecution. In the meantime, county prosecutors and local law enforcement have been faced with diminishing resources. The Securities Prosecution Fund and Mortgage Lending Fraud Prosecution Fund have provided resources for prosecution of securities and mortgage fraud but the workload issues for state and county prosecutors still negatively affects their ability to bring white collar crime cases. Federal prosecutors also have resource issues. After a period of expansion, the SEC is now facing a budget crisis.

At both the state and federal level, courts have imposed additional constraints where there are parallel proceedings (administrative or civil and criminal). Because of these constraints, DFI will be less able to get help from partners to prepare criminal cases. In some cases, separate investigative teams will be required for the administrative and criminal aspects of the same case. DFI will continue to be asked to do larger and more complicated cases. To work such cases effectively DFI will have to increase training for staff and upgrade and apply additional technology such as forensic accounting software, case management software, and computer forensics equipment.

Anti-money laundering efforts have received more attention at the national level as part of the war against terrorism. The Securities and Consumer Services Divisions have incorporated an anti-money laundering component into its examination programs. Since October 2005, the Securities Division contributes to DFI's quarterly report to the Financial Crimes Enforcement Network (FinCEN) submitted pursuant to the Bank Secrecy Act and a memorandum of understanding between DFI and the Internal Revenue Service (IRS).

Investment products offered to the public continue to increase in number and complexity. One example of a new and complex product that has raised regulatory concern is a tenancy in common investment in connection with a tax free exchange under Section 1031 of the Internal Revenue Code. Many hybrid products are being offered, especially products involving insurance and commodity aspects. These products will require additional cooperation among regulators if the products are to be regulated effectively as well as more training for DFI staff members concerning the new products. Industry groups are attempting to divide and conquer, especially in the area of annuities. Variable annuities are sold by agents who have both securities and insurance licenses. Many of the agents are employed by securities broker-dealers. Insurance industry groups have successfully blocked efforts to adopt functional regulation of the sellers of variable annuities as part of the modernization of state securities laws, through the adoption of the Uniform Securities Act of 2002.

INTERNAL CAPACITY AND FINANCIAL HEALTH

Human Resources

The Department will continue to require a highly educated, highly skilled staff to conduct our examination, enforcement, registration, and licensing activities. Legislative changes, market forces, new products, and specialized services are rapidly changing the nature of regulation. This rapid change requires constant recruitment and training of professional staff and that continues to be a major challenge for us.

We continue to lose staff to private industry and our federal counterparts at much higher salaries. The cause of the turnover is generally threefold. Salary and benefits are significantly below the federal banking agencies and banking industry. Federal bank examiners for example are paid up to 84% more than comparable state examiners. The travel burden is heavy with examiners averaging 30-50% of their year in overnight travel status. Finally, the workforce is aging at the experienced examiner level. A number of retirements and unexpected health concerns have hit the Department over the last five years.

This presents a challenge in the time and resources required to train new staff. For example in our Division of Banks and Division of Credit Unions, it takes 3-4 years for an examiner to gain the basic training and on the job experience necessary to independently examine a financial institution. In addition, new products and technology can present challenges for less experienced staff. Many of the examiners who have left or retired had specialized skills that are not easily replaced.

The high cost of living in the Seattle metropolitan area is adding to the turnover problem for the Department. The median sales price for a house in King County has risen to over $400,000. It is difficult for our new examiners to find affordable housing, pay off college debts, and cover daily living expenses given the existing examiner pay levels.

The staffing trend going into the 07-09 biennium is likely to remain problematic. The economy has improved and the competition for college graduates has become more intense. We will explore ways to reduce travel time, provide educational and career opportunities for meaningful employee development, and seek ways to provide for prevailing compensation and benefits using new tools available from civil service reform. Reducing travel can be accomplished if we can utilize technology such as digital imaging and teleconferencing to conduct remote examinations.

DFI has been trying to develop staff in order to handle the workload in a healthy banking environment. At this point in the economic cycle, financial institutions are healthy and problems are manageable. We must however be prepared for an event or change in the economy that will adversely impact our industries and individual institutions. We will work on a contingency plan to handle problems that may come up that are outside the normal scope of operations.

We have also managed our examiner shortages by relying on federal regulators to cover more of our examination responsibilities in our Banks Division. This alternative may be limited in the future, as federal regulators are seeking ways to hold or even reduce examiner FTEs. There is a danger to the state bank regulatory system if increasing reliance is being placed on federal regulators. We must have the necessary skills and available resources in order to maintain our credibility with the banking industry, the federal banking agencies, and with the public.

In our non-depository divisions, we have increased our capacity to handle large and complex examinations and investigations through the application of technology to document management, case management, and to forensic accounting, and through additional training provided to staff. Performance management practices, including use of new personal development plans and department wide competencies, have helped staff understand what is expected of them so that they can perform at a high level. Better hiring practices have brought us a very capable crop of new professional staff, but have strained our supervisory resources. Cooperation among programs has allowed us to use our resources more effectively. We will have to continue to train staff to help them to keep up with the changing financial services industry which is constantly coming up with new products and services and new methods of delivering and marketing those products and services.

Funding

Because the Department operates from a non-appropriated/allotted fund and is self-supported by fees and assessments from regulated entities, fund balance and cash position are monitored closely to ensure adequate funding to carry out our statutory mission. This is crucial while operating under an Initiative 601 environment and because our revenues can be volatile due to volatility in the financial markets and economic conditions.

Because of the characteristics of our revenues, the Department has also traditionally asked for a larger than the standard two month working capital reserve. We feel it necessary to ensure our services are not jeopardized from a deep or sudden decline in revenues. In addition, because our securities revenues are set in statute, it is also not possible to react quickly to adjust fees should a sudden decline in revenues occur.

Operating revenues have been hurt by the loss of large bank institutions to mergers. Washington Mutual Bank and Pacific Northwest Bank, two of our largest banking institutions, merged into national charters, a loss of over $400,000 in assessment revenues. The industry has historically been supportive of maintaining a strong banking regulatory program and is expected to agree to future rate increases if needed to fund operations.

With regard to credit unions, the Washington Credit Union Act authorizes us to charge fees to credit unions in order to cover the costs of operation of the Credit Union Division, as well as establish a reasonable reserve. Fee levels are set by rule. The primary source of credit union revenues is quarterly asset assessments paid by credit unions. The division does not generally rely on hourly fees for examinations. For Fiscal Years 05-07, the Division of Credit Unions will receive 100% of our credit union revenues from asset assessments fees. We do rely on typical credit union asset growth, 4 -10% annually, to adequately fund the Credit Unions Division.

If a significant amount of credit unions or banks convert to federal charter these funding sources could be at risk.

While the Consumer Services Division has continues to realize revenue growth due to the real estate boom in recent years, a forward caution must be given to budget forecasts. Any decline in the residential mortgage market will have a direct and corresponding decline in the Division's revenues and our ability to continue a significant regulatory presence with non-depository financial institutions.

Service Delivery

DFI continues to work on ways to improve service to our customers. We recently implemented call centers within the agency to improve service to call-in customers. Implementation of call centers has required some re-organization of work processes in order to meet the challenge of improving customer service for call in customers, while maintaining service levels on the review of licensing, registration, and exemption applications. In addition, we will continue to look for new methods of communicating with our customers, including expanding the use of online licensing and lookup systems and exploring offering an extranet to some licensing and registration customers through which they can communicate with the agency. We will also participate in the statewide business portal project and ensure that applications we build meet the requirements of the business portal.

In order to communicate effectively with groups such as seniors, baby boomers, and underserved populations, we will need to provide additional training for our staff and develop in-house experts on the needs of members of those groups. We may also need to recruit staff members who combine financial analysis, legal, or customer service skills with ability to communicate effectively in foreign languages.

Despite the application of new document management technology, the increased demand for disclosure of public records has strained Department resources. More resources, including a new member of the executive team and a new database, have been devoted to public records disclosure, but the number and size of requests have increased and with them the potential liability to DFI. DFI has tried to deal with requests for routine information by making that information available through our website.

TECHNOLOGY

Expanding technology is changing the way the financial services sector structures, delivers, and services its products. For example, the Check Clearing Act for the 21st Century (Check 21) is a major priority for the banking industry. Check 21 revolutionizes check processing by allowing digital images of checks ("substitute checks") to replace original paper checks. Banks can electronically clear checks because the original check no longer has to travel from the bank of deposit to the paying bank. The substitute checks will have the legal equivalence of the original checks.

The National Credit Union Administration's (NCUA) expects "credit unions will increasingly use the Internet and World Wide Web to deliver financial services. Websites will continue to shift from information/interactive to transactional thus increasing transactional and reputation risks." They also expect "the more complex the systems and services become, the less likely credit unions (primarily small to mid-sized) will be able to effectively secure and manage those systems."

The use of technology in financial transactions continues to raise a host of issues such as licensing Internet based mortgage companies, educating consumers about refund anticipation loans, evaluating consumer risks with stored value cards and regulating Internet money transfers and payment systems. All of these issues present us with a host of legal, policy, examination and enforcement questions.

As the lines between the providers of financial products are blurred by technology, we must be prepared to realign and cross-train our workforce. Licensees who today offer only check cashing and check selling services may tomorrow offer stored value cards, electronic bill payment services and money transmittal services from a single kiosk or store front location. Entities that previously avoided offering products such as payday loans are now beginning to move into this market area. This means the integration of safety and soundness examinations, compliance examinations and consumer protection will continue to be crucial to successfully regulate the financial services industries under our authority.

The growth of electronic banking must also be responsive to the concerns raised for privacy and the issues surrounding the USA Patriot Act. The ease and speed of obtaining information highlights the need to protect customer privacy and provide guidance on information sharing. Security must be addressed to prevent identity theft, breaches, frauds, and other vulnerabilities associated with electronic systems. Dependency on computer systems is a key issue facing financial institutions, as disruptions caused by computer viruses have grown and terrorist threats loom.

The major regulatory challenge that lies ahead will be to ensure that regulated entities are equipped to secure and manage new technological solutions while at the same time ensuring that the regulatory structure does not inhibit change that is in the consumers' best interest.

As the volume and complexity of our work grows, the need for document management and imaging systems has become obvious. We have recently begun to use document management technology for hearing preparation and for responding to discovery requests. We are integrating document management technology with our imaging systems. Also, due to the emphasis placed on providing responses to public records requests in a timely and efficient manner, we have embarked on efforts to create electronic images of most all of our paper documents. We have also invested in software to facilitate the locating, redacting, and producing of electronic copies of public records to fulfill requests. This effort to image documents and provide search tools to assist in their retrieval will continue through the 07–09 biennium. We also have projects planned to provide public access to the public records over the Internet.

Along with the imaging of documents we will be investing in workflow software development to create more effective business processes. The workflow software will be used to track the flow of the electronic documents through the business processes so at any point in time we can determine the status of a document and who is responsible for taking action on it. Our Securities Division has been imaging documents for several years but still needs to incorporate this technology in order to distribute and manage the documents it images. Currently, the Securities Division's imaging system only allows for the scanning, storing, and retrieving of images. The Securities Division is starting to work on automated workflows for the two or three highest volume areas. It expects to implement these workflows in FY 07. In order to continue to keep up with its workload, the Securities Division will need to develop automated workflows for the remaining areas in the coming biennium.

DFI has made great progress in its ability to share information and data resources. In order to make the best use of these resources, we will need to improve our knowledge management so we can coordinate our registration, licensing, examination, and enforcement activities. This will require improving the integration of our database resources and developing a more comprehensive database for examination activities. The Consumer Services Division has implemented an examinations database, but this database needs to be expanded to provide better decision support tools for targeting examinations. These tools also need to be expanded to support similar functions in other divisions.

In order to meet the need for additional "for cause" examinations and to respond to consumer complaints, we will have to improve our risk-based targeting methods. We will have to have an examinations database that can extract data about consumer complaints and investigations from our licensing process, and prior examinations in order to select locations for examination. This will require the agency to keep its examination programs and systems current.

As the enforcement cases have become larger and more complex, the agency has had to acquire new technology and train staff to meet the challenges of larger cases. The agency has acquired a new database system for forensic accounting that incorporates scanning of account documents and the use of optical character recognition to eliminate some data entry. This new system is going into production in late FY 06, but the agency will need to continue to develop new work methods to get the best use out of the system. The agency will have a continuing need for enhancements to the system and for training staff on the use of the system and how to testify in hearings or trials about the financial account reconstructions created with the system.

The number of financial institutions has grown significantly over the past several years and the trend seems to be increasing. Some of this growth has come from legislation requiring the regulation of industries and individuals such as: money services providers, refund anticipation loan lenders, and loan originators. There has also been significant growth in existing regulated industries. Because of the increase in workload and the expansion of the number of locations, travel has become a significant burden on staff and workloads. The agency over the remainder of the 05–07 biennium and stretching into the 07-09 biennium will begin exploring technologies that will provide the ability to perform remote examinations. This will include technologies such as video conferencing and implementing solutions for securely sharing information and data.