

State of Minnesota  
Department of Commerce

In the Matter of the Proposed Adoption of Rules Relating to Financial  
Institution Audit Control Policies

Notice of Intent to Adopt Rules Without a Public Hearing

Notice is hereby given that the Department of Commerce proposes to adopt the above-entitled rules without a public hearing. The Commissioner of Commerce has determined that the proposed adoption of these rules will be noncontroversial in nature and has elected to follow the procedures set forth in Minnesota Statutes, Section 14.21.<sup>1</sup>

Persons interested in these rules shall have 30 days to submit comments in support of or in opposition to the rules.<sup>2</sup> Each comment should identify the portion of the proposed rule addressed, the reason for the comment, and any change proposed.<sup>3</sup> The proposed rules may be modified if the modifications<sup>4</sup> are supported by the data and views submitted to the Department and does not result in a substantial change.

No public hearing will be held unless twenty-five (25) or more persons make a written request for a hearing within the 30 day comment period.<sup>5</sup> In the event a public hearing is required, the agency will proceed according to the provisions of Minnesota Statutes, Section 14.14, subd. 1.<sup>7</sup>

Persons who wish to submit comments or a written request for a public hearing should submit them to Richard G. Gomsrud, Department Counsel, Department of Commerce, 500 Metro Square Building, St. Paul, MN 55101 telephone (612) 296-5689.<sup>8</sup> Any person requesting a public hearing should state her or his name and address and is encouraged to identify the portion of the proposed rule addressed, the reason for the request and any change proposed and send this information to the above address.<sup>9</sup>

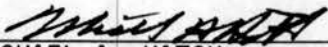
Authority for the adoption of these rules is contained in Minnesota Statutes, Sections 45.023 and 46.01. Additionally a Statement of Need and Reasonableness of each provision and identifying the data and information relied upon to support the proposed rules has been prepared and is available upon request.

Pursuant to Minnesota Statutes Section 14.115, subdivision 2, the impact on small business has been considered in the promulgation of the rules. Anyone wishing to present evidence or argument as to the rules' effect on small business may do so. The Department's position regarding the impact of the rules on small business is set forth in the Statement of Need and Reasonableness.

Upon adoption of the final rules without a public hearing the proposed rules, this Notice, the Statement of Need and Reasonableness, all written comments received, and the final Rules as Adopted will be delivered to the Attorney General<sup>6</sup> for review as to form and legality,

including the issue of substantial change. Persons who wish to be advised of the submission of this material to the Attorney General, or who wish to receive a copy of the final rules as proposed for adoption, should submit a written statement of such request to Richard G. Gomsrud, Department Counsel, Department of Commerce, 500 Metro Square Building, St. Paul, MN 55101.

A copy of the proposed rules is attached to this Notice. Copies of this Notice and proposed rules are available and may be obtained by contacting Richard G. Gomsrud at the above address.

  
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MICHAEL A. HATCH  
Commissioner of Commerce

STATE OF MINNESOTA  
DEPARTMENT OF COMMERCE  
DIVISION OF FINANCIAL EXAMINATIONS

In the Matter of the Proposed Rules  
Relating to Financial Institutions  
Audit Control Policies

STATEMENT OF NEED  
AND REASONABLENESS  
OF PROPOSED AMENDMENTS

**STATEMENT OF AUTHORITY**

Minn. Stat. § 46.01, subd. 2 (1984) as amended, provides that the Commissioner of Commerce (hereinafter "Commissioner") has the power to promulgate rules as necessary to administer or execute the laws relating to financial institutions subject to the Commissioner's supervision and examination. Commercial banks and savings banks are organized pursuant to Minn. Stat. Chs. 45, 47, 48, 50 and 300 and are subject to the constant supervision and examination by the Commissioner as directed in Minn. Stat. § 46.04. These rules are proposed by the Commissioner pursuant to this authority.

On May 27, 1985, the Commissioner published Notice of Intent to Solicit Outside Opinion regarding the proposed amendment.

**FACTS ESTABLISHING NEED AND REASONABLENESS**

Minnesota Statute § 48.10, anticipates the need for the board to be fully informed on the bank's activities by requiring that they conduct or have conducted an annual examination of the bank's books. However, the statute lacks definition to insure a meaningful examination. These proposed rules amend the guidelines for carrying out the intent of the statute. The need for these rules focuses on and is

directly responsive to two major concerns of the Commissioner in fulfilling the responsibility in Minnesota Statutes, Section 46.04, to maintain the constant supervision over Minnesota state chartered banks. The primary supervisory role of the Department is accomplished through on-site examinations which are conducted at least every 18 months. This on-site examination is supplemented by quarterly reports from the bank which are made in March, June, September, and December. These examinations and quarterly reports are structured to address current conditions, operations and potential areas of chief concern as primary regulator.

A secondary mechanism to monitor banks is through the requirement that the bank conduct an annual audit and report under Minn. Stat. § 48.10. This requirement was designed to be useful to the board in its duty to oversee the bank's operation. In addition, a copy of the report, together with the board's response to the report, is submitted to the Commissioner, who uses the report as a means of off-site inspection.

The amendments will hopefully promulgate a more uniform annual audit and report. Under current rules the bank board may perform its own audit. In such a case, a two sided report is commonly used and submitted, but in many cases the report is incomplete and outdated for current bank purposes. In addition, many banks create different audit formats, which do not fulfill any meaningful purpose under the statute.

The bank board may also use public accountants and certified public accountants to complete the annual audit

and report. These reports, however, are also inconsistent and vary considerably in terms of meaningful comment for either the bank board or the department. Some of the reports serve little useful purpose in large part without rules setting forth minimum standards.

In addition to uniformity, the second purpose of the amendments is the increased concern of the Commissioner and bank boards as to the frequency of losses to banks through employee and official misconduct, errors, and lack of systematic oversight. The solvency of many banks has been threatened in part due to the ineffectiveness of the audit system. As has been seen over the last year in the media, at least a half dozen banks have discovered defalcation and embezzlement of funds by company officers. In some cases the discovery was accomplished through the annual audit, and the matter was resolved without effecting the bank's condition. In other cases the discovery was not made until the on-site examination, and in at least one case the discovery was too late to save the bank. Accordingly, the amendments do set minimum standards concerning the audit, with the intent being that the audit focus in some part on the conduct of bank employees and officials.

The need for these rules is not only demonstrated through the recent proliferation of embezzlement charges against bank employees, but also through the difficulty banks currently have in obtaining bond coverage from insurance companies. In 1984 over 59 state banks received bond cancellation notices, and through the first months of 1986, 16

banks received such cancellation notices. The use of internal audit controls and procedures, together with the external audits promulgated under the rules, would contribute toward minimizing risks to banks and their insureds, and hopefully would reduce the cost of bond coverage as well as increase the availability of such coverage. Discussions with insurance companies indicate that one of their concerns in underwriting such risks deals with the lack of uniformity in internal bank audits.

Bank closings in the United States have escalated to unprecedented numbers. In the aftermath of a bank failure, the bank's board of directors are often named as defendants in a lawsuit by the Federal Deposit Insurance Corporation. The charges in the lawsuit generally state that the bank board was not aware of improprieties which, through the use of reasonable audit controls, they should have discovered. As a result of these lawsuits and the increased responsibility associated with being a director, it is becoming increasingly difficult to find qualified directors willing to serve in this position of community interest. Thus, with a more standard uniformity in the audit structure, it is hoped that the chances of such litigation will be reduced.

To take responsible action under specific rule making authority is incumbent upon the Commissioner as follows:

MINNESOTA RULE 2675.2600 requires each bank to develop its own internal audit control policy and establishes a mechanism for reporting to keep the board informed on the degree of compliance with established policies and controls.

Additionally, it provides for review and update of the system on an ongoing basis. This is an expected and prudent banking practice which is now being included in rule form.

MINNESOTA RULE 2675.2610 establishes minimum guidelines and minimum requirements for the completion of an annual directors' examination as required by Minnesota Statutes, Section 48.10. In addition, the rule provides a mechanism to insure that the board is informed of the examination findings and that it properly addresses disclosed deficiencies and so informs the Commissioner.


MINNESOTA RULE 2675.2620 establishes who may perform the annual examination as well as conditions which may preclude certain individuals from qualifying to conduct the examination. This rule provides that the examination may be done by an examining committee appointed by the board, an internal auditor, a certified public accountant or qualified licensed public accountant or the board of directors, provided these bodies conform to conditions established by the rule. Additionally, this rule provides that every fourth year the examination must be performed by outside auditors who are certified public accountants or qualified licensed public accountants.

MINNESOTA RULE 2675.2630 requires financial statements from persons controlling more than 25% interest in the bank and who are directors or active officers of the bank or its holding company. Highly leveraged bank owners are often unable to correct deficiencies requiring the addition of capital. Additionally, these individuals sometimes have a difficult time servicing debt secured by equity interest

in the bank. In such situations, it may be advisable for regulatory authorities to investigate the advisability of the individual serving in the capacity of active officer or director of the bank.

#### CONCLUSION

For the reasons stated above, it is in the public interest to adopt these rules. These rules are deemed noncontroversial and offer positive impact on small business constituting banks under our supervision and control. These rules and their enforcement will not require additional expenditures by this supervisory agency and any additional costs to the supervised banks will be offset by contemplated savings in bond costs, Federal Deposit Insurance Corporation insurance premiums, examination fees, audit fees and overall efficiency. It is believed to be clear that the proposed rules reasonably effectuate the above stated need.

  
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MICHAEL A. HATCH  
Commissioner of Commerce