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We have completed an audit of the Division of Mortgage Lending. This audit is part of the ongoing program of the Legislative Auditor as authorized by the Legislative Commission. The purpose of legislative audits is to improve state government by providing the Legislature, state officials, and Nevada citizens with independent and reliable information about the operations of state agencies, programs, activities, and functions. The results of our audit, including findings, conclusions, recommendations, and the Division's response, are presented in this report.

We wish to express our appreciation to the management and staff of the Division of Mortgage Lending for their assistance during the audit.

Respectfully presented,

A handwritten signature in black ink, appearing to read "Paul V. Townsend".

Paul V. Townsend, CPA  
Legislative Auditor

November 25, 2008  
Carson City, Nevada

STATE OF NEVADA  
DEPARTMENT OF BUSINESS AND INDUSTRY  
DIVISION OF MORTGAGE LENDING

AUDIT REPORT

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# **EXECUTIVE SUMMARY**

## **DEPARTMENT OF BUSINESS AND INDUSTRY DIVISION OF MORTGAGE LENDING**

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### **Background**

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The Division of Mortgage Lending was established in 2003. The mission of the Division is to safeguard public interest by coordinating with industry groups to promote professionalism and ethics in the mortgage lending and escrow industries, and to ultimately provide consumers with a meaningful resolution process.

The division's regulatory activities include (1) licensing mortgage brokers, mortgage bankers, escrow agencies, mortgage agents, and escrow agents; (2) conducting examinations of licensees; (3) handling consumer complaints; (4) investigating unlicensed activity; and (5) initiating action as a result of examinations, investigations, and complaints.

The Division has two offices, with the office of the Commissioner in Las Vegas and the licensing office in Carson City. The Division has one operating budget account and is self funded. In fiscal year 2008, the Division had a total of 40 authorized positions and revenues of about \$3.3 million. Funding was primarily from licensing fees and assessments.

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### **Purpose**

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The purpose of this audit was to determine whether the Division provided adequate regulation of mortgage companies and if activities related to collections, accounts receivable, management information and personnel administration were carried out in accordance with applicable state laws, regulations, and policies. This audit focused on the division's activities for calendar year 2007, and subsequent periods when necessary to complete the audit's objectives.

## EXECUTIVE SUMMARY

### DEPARTMENT OF BUSINESS AND INDUSTRY DIVISION OF MORTGAGE LENDING

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## Results in Brief

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The Division did not always provide adequate regulation of mortgage companies. During calendar year 2007, the Division did not meet its statutory duty to perform annual examinations of licensees. In addition, policies and procedures were not in place for scheduling examinations using a risk-based approach. As a result, companies that are a high risk to consumers did not have timely examinations. Further, the Division did not have a functional hearings process during 2007. Also, licensee financial information was not adequately monitored. Because of these deficiencies, there is an increased risk to consumers that violations of mortgage lending laws and regulatory requirements will not be detected and corrected in a timely manner.

The Division needs stronger controls over its revenue collection process and certain administrative functions. We identified weak collection efforts for about \$1.5 million in unpaid assessments, fees, and fines. In addition, the Division needs better management information to monitor its activities. Better use of information would help management improve program, financial, and administrative practices.

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## Principal Findings

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- The Division did not perform required annual examinations for most of its licensed companies. Our review of division records identified 23 of 30 (77%) companies tested did not have an examination during 2007. This included mortgage brokers and bankers that were randomly selected from a list of all companies licensed on December 31, 2007. When examinations are not performed, there is an increased risk that violations and unethical business practices will not be identified and corrected timely. (page 14)

## EXECUTIVE SUMMARY

### DEPARTMENT OF BUSINESS AND INDUSTRY DIVISION OF MORTGAGE LENDING

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- The Division did not perform a timely follow-up examination for 13 of 15 (87%) companies that received a poor rating on an examination. Upon completion of an examination, each licensee is rated on a scale of “1” (highest) to “5” (lowest). These licensees were rated “4” or “5” on their last examination, which indicates substantial or unsatisfactory compliance with laws and regulations. Some companies went long periods without a timely follow-up examination. This includes one company that received a rating of “5” in November 2002. The Division did not perform a follow-up examination for this licensee until May 2008. (page 14)
- High-risk licensees that maintain certain types of trust accounts or arrange loans funded by private investors were not always examined timely. For 8 of 25 (32%) companies with trust accounts, there was no examination in 2007. Six of these eight companies also arrange loans funded by private investors. The Division indicated brokers who arrange loans funded by private investors, especially those with trust accounts, pose a higher risk to the public. Timely examination of licensees with trust accounts is important because of significant risk to the investors and borrowers whose funds are held in trust. (page 15)
- The Division did not perform timely initial examinations for 38 of 52 (73%) licensees we tested. The untimely examinations ranged from 15 months to 4½ years after the original license date. Licensees without timely initial examinations pose a higher level of risk because little is known about the company’s operations, including proper supervision of mortgage agents, and compliance with laws and regulations. (page 16)
- The Division did not consistently use a risk-based approach for scheduling examinations. Although the Division indicated it had implemented a risk-based

## EXECUTIVE SUMMARY

### DEPARTMENT OF BUSINESS AND INDUSTRY DIVISION OF MORTGAGE LENDING

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approach for scheduling examinations, our testing found that resources were not consistently directed toward high-risk licensees. For example, we found 36% of low-risk licensees had a follow-up examination in 2 years or less. However, only 20% of high-risk licensees, those with a poor rating that remained open for 2 years or more, had a follow-up examination within 2 years. (page 16)

- The division's process to implement biennial examinations is not adequate to ensure licensees meet all statutory requirements to qualify for a biennial examination. In 2007, the Legislature authorized the Division to conduct biennial examinations; however, the Division has not developed policies and procedures to ensure licensees meet all requirements. Although the Division indicated that about 75% of mortgage brokers and bankers qualify for a biennial examination, we believe that many of these licensees do not currently qualify for a biennial examination. Therefore, we have serious concerns that many licensees may be scheduled for a biennial examination when they should be examined annually. (page 17)
- The Division has not maintained appropriate staffing levels to meet its statutory mandate for conducting examinations of licensees. Although the Legislature has expressed concerns over the division's staffing level and authorized 11 new examiner positions during the 2007 Legislative Session, only 1 new examiner was hired. Because of the downturn in the mortgage industry, management is taking a cautious approach to hiring staff. However, the Division still needs to develop a proper staffing plan and hire sufficient staff to ensure it can meet its statutory requirements. The cost of additional examiners can be recovered from the mortgage industry through examination fees. (page 20)

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### DEPARTMENT OF BUSINESS AND INDUSTRY DIVISION OF MORTGAGE LENDING

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- The Division did not resolve cases or conduct hearings in a timely manner. Based on division records, at least five administrative orders issued in 2006 were unresolved at the end of 2007. Further, only one hearing was conducted in calendar year 2007. The Division stated there were many problems with the prior hearings process. Although the Division made improvements to the hearings process during our audit, it is still working to resolve certain cases that date back to 2006. When enforcement actions are not timely, there is minimal deterrent to licensees that commit violations. (page 22)
- The Division did not ensure licensees submitted all required financial statements, including audited financial statements from high-risk licensees. Mortgage brokers and bankers are required by state law to submit annual financial statements to the Division. If the licensee maintains certain trust accounts, audited statements for the company and the trust accounts must be submitted. Overall, 16 of 55 (29%) licensees did not submit all required statements. Further, about one-half of the companies that submitted financial statements were late and about one-third of these statements were not reviewed timely. When financial statements are not submitted by the due date and reviewed timely, there is an increased risk financial concerns will not be identified and corrected timely. (page 23)
- The Division did not always take timely action to resolve complaints once requested documents were provided. Our review of 25 open complaint files found 5 did not have timely follow up by the Division after the respondent had submitted the requested information. Further, the complaint database did not always contain accurate and up-to-date information. For 12 of 25 complaints, there were inconsistencies or omissions in the database. (page 26)

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### DEPARTMENT OF BUSINESS AND INDUSTRY DIVISION OF MORTGAGE LENDING

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- The Division did not collect about \$490,000 in assessments from its licensees during fiscal years 2007 and 2008. This amount includes \$323,000 in costs for legal services that were not assessed for fiscal year 2007. The Commissioner is authorized by state laws to collect an assessment from licensed companies to recover the costs of legal services provided by the Attorney General and to cover all the costs related to the employment of a Certified Public Accountant. However, the Division does not have policies and procedures for assessments and has not established guidelines for collection efforts and monitoring. (page 28)
- The Division does not have a process to ensure its examination fees are collected. About \$50,000 of fees billed between June 2005 and December 2007 were still outstanding in June 2008. For 24 of 25 unpaid fees tested, there was either no evidence of collection efforts or efforts were not timely. Further, the Division did not always receive payment for examinations when a branch office closed, but the company's principal location remained active. (page 30)
- Better monitoring is needed for the collection of administrative fines and settlement agreements. Our review of 37 fines and settlement agreements found untimely collection efforts and incomplete accounts receivable records. This included 18 unpaid fines and agreements with a total due of about \$975,000. The Division has a procedure requiring staff to notify the Commissioner if delinquent settlement agreements are not paid within 30 days. However, this procedure was not followed by staff. Therefore, management was not always notified of unpaid fines. (page 30)
- The division's process to photocopy all checks received and return checks to those who submit incomplete applications is inefficient. We estimate the staff received, copied, and filed about 20,000 checks



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### DEPARTMENT OF BUSINESS AND INDUSTRY DIVISION OF MORTGAGE LENDING

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during 2007. Of these, about 4,000 checks were returned to applicants. After the check was returned, most applicants resubmitted the same check with their revised applications. The process of returning 4,000 checks is inefficient and weakens controls over the revenue collection process. By eliminating unnecessary work, more time would be available for staff to improve billing and collection practices. (page 31)

- The Division operates without the information it needs to effectively manage its regulatory activities. Critical information was not always received by management in a time frame that allows them to take action to prevent problems or correct deficiencies timely. Although data was often captured and recorded by staff, the information was not always used or reported to management. The lack of reliable and timely information contributed to many problems identified throughout this report. (page 32)

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## Recommendations

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This audit report contains 13 recommendations to improve the Division of Mortgage Lending's regulatory and financial and administrative activities. These recommendations include policies, procedures, and other controls to help ensure examinations are performed and improve consumer protection. We also made recommendations to improve controls over revenues, accounts receivable, and other administrative functions. (page 52)

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## Agency Response

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The Division, in response to our audit report, accepted the 13 recommendations. (page 42)

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# Introduction

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## Background

The Division of Mortgage Lending was established in 2003 by Assembly Bill 490. Prior to this legislation, regulation of the mortgage lending industry was performed by the Division of Financial Institutions. The mission of the Division is to safeguard public interest by coordinating with industry groups to promote professionalism and ethics in the mortgage lending and escrow industries, and to ultimately provide consumers with a meaningful resolution process.

The Division is authorized to enforce laws and regulations pertaining to the mortgage lending industry. The division's regulatory activities include: (1) licensing mortgage brokers, mortgage bankers, escrow agencies, mortgage agents, and escrow agents; (2) conducting examinations of licensees; (3) handling consumer complaints; (4) investigating unlicensed activity; and (5) initiating action as a result of examinations, investigations, and complaints.

### Locations, Staffing and Budget

The Division has two offices, with the office of the Commissioner in Las Vegas and the licensing office in Carson City. Staff at both offices perform investigations and examinations. In fiscal year 2008, the Division had a total of 40 authorized positions. The Division has one operating budget account and is self funded. Revenues received are to be used to carry out the programs and laws administered by the Commissioner and the Division. In fiscal year 2008, the division's revenues were about \$3.3 million. Funding was primarily from licensing fees and assessments.

From fiscal years 2005 to 2008, the division's reserves increased from \$2 million to \$6.9 million. During the 24<sup>th</sup> Special Session, in 2008, \$3.5 million was transferred to the State General Fund from the division's reserves.

### Number of Licensees Has Decreased in Recent Years

The number of licensees in the State reached its high point during fiscal year 2006 and has decreased significantly since then. Exhibit 1 shows the number of licensed companies, locations, and mortgage agents for fiscal years 2004 to 2008.

**Exhibit 1**

**Number of Licensees  
Fiscal Years 2004 to 2008**

<b>Fiscal Year</b>	<b>Number of Companies</b>	<b>Number of Locations</b>	<b>Number of Mortgage Agents</b>
2004	881	1,232	5,823
2005	1,085	1,666	8,159
2006	1,383	2,150	11,701
2007	1,295	1,746	9,147
2008	735	902	4,711

Source: Division of Mortgage Lending.

**Overview of the Mortgage Lending Industry and Recent Trends**

The mortgage lending industry consists of primary and secondary markets. Further, there are many types of entities within each of these markets. Mortgage brokers, mortgage bankers, and escrow agencies are entities within the primary market regulated by the Division. However, the Division does not regulate the mortgage related business of banks, savings banks, trust companies, savings and loan associations, industrial loan companies, credit unions, or thrift companies. Many of these entities are regulated by the Division of Financial Institutions. In addition, other parties involved with the mortgage lending process are not regulated by the Division. This includes real estate agents and appraisers.

**The Primary Mortgage Market and the Division's Role**

The Division is charged with regulating the primary market activities of its licensees. The Mortgage Bankers Association estimates that close to 50% of residential mortgage loans are originated by independent mortgage brokers. In addition, it is estimated that 70% to 80% of nonprime loans are originated by these brokers.

According to the Government Accountability Office, the primary mortgage lending market consists of four main segments:

- Prime Market – serves borrowers with strong credit histories and provides the most competitive interest rates and mortgage terms. In 2006, this segment accounted for approximately 57% of mortgage originations in dollar terms.
- Alt-A Market – generally serves borrowers whose credit histories are close to prime, but the loans contain one or more higher-risk factors such as limited documentation of income or assets. This segment accounts for approximately 16% of mortgage originations.
- Sub-Prime Market – generally serves borrowers with blemished credit histories and these loans feature higher interest rates and loan fees than offered in the prime market. This segment makes up approximately 24% of mortgage originations.
- Government Insured or Guaranteed Loans – primarily serves borrowers who may have difficulty qualifying for prime mortgages. These mortgages feature interest rates competitive with prime loans in return for payment of insurance premiums or guarantee fees. The Federal Housing Authority and Department of Veterans Affairs operate the two main federal programs that insure or guarantee mortgages. This market segment makes up approximately 3% of loan originations.

### Secondary Market

As recent as 1968, there was no secondary market for conventional loans. A secondary market was created to stabilize the conventional lending market by adding liquidity so that there would be a steady supply of funds available to lenders. Many mortgage lenders are non-depository institutions that rely on the secondary market. Loans are often sold in the secondary market, that is, they are not held in the lender's portfolio but are sold to investors.

### Foreclosures Have Increased Significantly

Foreclosures have risen sharply in recent years. Nevada is one of only eight states with foreclosure starts above the national average. One industry group reported Nevada had the highest foreclosure rate, with 1 in every 91 households receiving a foreclosure notice in August 2008. That represents an 89% increase from August 2007. "Sun Belt" states such as Nevada, Arizona, California, and Florida have experienced the largest increases in the number and percentage of defaults and foreclosures. Some industry participants and researchers have indicated that mortgage fraud has been a contributing factor in recent default and foreclosure trends.

## Causes of the Current Foreclosure and Default Crisis

The Government Accountability Office reported a combination of economic and market developments contributed to recent increases in default and foreclosure rates.

- First, the rapid decline in the rate of home price appreciation reduced the incentives for borrowers to keep current on their mortgages and made it more difficult for borrowers to refinance or sell their homes to avoid default or foreclosure. This was especially true in states that experienced a sharp decline in house price appreciation following a period of strong growth (e.g., California, Florida, and Nevada).
- Second, in some states with foreclosure rates that were already relatively high in 2005, weak labor markets likely contributed. Two states with the lowest rates of employment growth in recent years, Michigan and Ohio, experienced large increases in the number of foreclosure starts.
- Third, aggressive lending practices reduced the likelihood that some borrowers would be able to meet their mortgage obligations.
- Fourth, growth in the secondary market's mortgage-backed securities provided liquidity to support more aggressive lending practices. Investors were attracted to these securities due to their seemingly high risk-adjusted returns.

## **Scope and Objectives**

This audit is part of the ongoing program of the Legislative Auditor as authorized by the Legislative Commission, and was made pursuant to the provisions of NRS 218.737 to 218.893. The Legislative Auditor conducts audits as part of the Legislature's oversight responsibility for public programs. The purpose of legislative audits is to improve state government by providing the Legislature, state officials, and Nevada citizens with independent and reliable information about the operations of state agencies, programs, activities, and functions.

This audit included a review of the division's regulatory, financial, and administrative practices for calendar year 2007, and subsequent time periods when necessary to complete the audit's objectives. The objectives of our audit were to determine whether:

- The Division provided adequate regulation of mortgage companies, including whether activities were carried out in accordance with applicable state laws, regulations, and policies.
- The Division's activities related to collections, accounts receivable, management information, and personnel administration were carried out in accordance with applicable state laws, regulations, and policies.

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## **Findings and Recommendations**

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The Division did not always provide adequate regulation of mortgage companies. During calendar year 2007, the Division did not meet its statutory duty to perform annual examinations of licensees. In addition, policies and procedures were not in place for scheduling examinations using a risk-based approach. As a result, companies that are a high risk to consumers did not have timely examinations. Further, the Division did not have a functional hearings process during 2007. Also, licensee financial information was not adequately monitored. Because of these deficiencies, there is an increased risk to consumers that violations of mortgage lending laws and regulatory requirements will not be detected and corrected in a timely manner.

The Division needs stronger controls over its revenue collection process and certain administrative functions. We identified weak collection efforts for about \$1.5 million in unpaid assessments, fees, and fines. In addition, the Division needs better management information to monitor its activities. Better use of information would help management improve program, financial, and administrative practices.

### **Mortgage Companies Not Adequately Regulated**

The Division did not provide adequate regulation of mortgage companies in several critical areas. The Division did not: (1) perform an annual examination for most companies during 2007, or use a risk-based approach to ensure available staff focused their efforts on high-risk licensees; (2) adequately plan for the implementation of biennial examinations or prepare a staffing plan to ensure appropriate staffing levels are maintained; (3) ensure serious violations and disputes were resolved timely; (4) monitor licensees to ensure all required financial statements were submitted; and (5) take timely action to resolve some complaints.

#### **Examinations Not Performed When Required**

The Division did not perform annual examinations of its licensed companies as required by law. Our review of division records found most examinations were not timely, including examinations of companies considered a high risk. Our testing was

divided into four general areas: a random selection from all licensees required to have an examination in 2007, and three categories of high-risk licensees. Exhibit 2 is a summary of our examination test results.

**Exhibit 2**

**Summary of Examination Test Results**

<b>Random Selection From All Licensees</b>
<ul style="list-style-type: none"> <li>• 23 of 30 (77%) licensees randomly selected were not examined by the Division during 2007.</li> </ul>
<b>High-Risk Licensees</b>
<ul style="list-style-type: none"> <li>• 13 of 15 (87%) licensees that received a poor rating on their last examination did not have a follow-up examination within 1 year. These licensees were rated 4 or 5 on their last examination, which indicates substantial or unsatisfactory compliance with laws and regulations.</li> </ul>
<ul style="list-style-type: none"> <li>• 8 of 25 (32%) licensees with trust accounts did not have an examination in 2007. These licensees are considered a higher risk because they hold money in trust for others, including funds of private investors.</li> </ul>
<ul style="list-style-type: none"> <li>• 38 of 52 (73%) licensees did not receive a timely initial examination. These licensees operated between 15 months to 4½ years before an examination occurred to determine compliance with laws and regulations.</li> </ul>

Source: Auditor review of division records.

Various statutes require an annual examination of mortgage brokers, mortgage bankers, and escrow agencies.<sup>1</sup> However, the Division does not have procedures for scheduling examinations to ensure it performs required examinations. Effective October 1, 2007, a biennial examination is allowed for mortgage brokers and mortgage bankers if certain criteria are met. There is no biennial examination provision for escrow agencies.

The purpose of examinations is to promote regulatory compliance and ethical business practices. During an examination, the examiner reviews loan files for compliance with federal and state requirements. This review allows the examiner to identify deceptive trade practices such as unearned fees, falsified verifications of employment, and inadequate disclosures. An examination also includes review of monthly loan activity reports, licensing information, financial statements,

<sup>1</sup> See Appendix B for Nevada Revised Statutes applicable to examinations.

advertisements, complaints, office space and signage, policies and procedures for supervision and internal controls, and safeguarding of confidential client information.

#### Examinations Were Not Performed for Most Companies in 2007

The Division did not perform required annual examinations for most of its licensed companies. Our review of division records identified 23 of 30 (77%) companies tested did not have an examination during 2007. This included mortgage brokers and bankers that were randomly selected from a list of all companies licensed on December 31, 2007. When examinations are not performed, there is an increased risk violations and unethical business practices will not be identified and corrected timely.

#### Untimely Examinations of Licensees With a Poor Rating

The Division did not perform a timely follow-up examination for 13 of 15 (87%) companies who received a poor rating on an examination. Upon completion of an examination, each licensee is rated on a scale of “1” (highest) to “5” (lowest). This is based primarily on compliance with laws and regulations and the perceived capability of management to achieve and maintain such compliance. The 15 companies we tested received an examination rating of “4” or “5” and remained active for at least 1 year after the examination. Thirteen did not have a follow-up examination within 1 year.

Some companies went long periods without a timely follow-up examination. This includes one company that received a rating of “5” in November 2002. The Division did not perform a follow-up examination for this licensee until May 2008. Further, two other active companies that received a rating of “4” in 2005 did not have a follow-up examination.

Guidelines for rating licensees on a scale of “1” to “5” have been established in regulations. As outlined in NAC 645B.067 and 645E.340:

- A rating of “4” indicates the licensee has demonstrated substantial lack of compliance with applicable laws and regulations and that immediate remedial action is required for correction of the violations and deficiencies noted. The licensee will be subject to close regulatory supervision.
- A rating of “5” indicates the licensee has demonstrated unsatisfactory compliance with applicable laws and regulations and that immediate remedial action is required for correction of the violations and deficiencies noted and may include action by the Commissioner to take possession of the business and its assets.



As indicated by the division's rating scale, licensees that receive a rating of "4" or "5" should receive close regulatory supervision because of their increased risk of non-compliance.

Untimely Examinations of Licensees With Certain Trust Accounts and Brokers That Arrange Privately Funded Loans

Licensees that maintain certain types of trust accounts or arrange loans funded by private investors were not always examined timely. For 8 of 25 (32%) companies with trust accounts, there was no examination in 2007. Six of these eight companies also arrange loans funded by private investors. Untimely examinations of licensees with trust accounts increases the risk that misuse of funds could occur and not be detected timely.

Timely examination of licensees with trust accounts is important because of significant risk to the investors and borrowers whose funds are held in trust. Trust accounts can contain large sums of money that must be maintained in accordance with laws and regulations. For example, our review of examination reports identified one broker with four trust accounts whose combined balances were about \$13.5 million. The trust account reconciliation showed activity in these accounts exceeded \$28 million for the period examined.

Mortgage brokers are required to establish separate trust accounts for private investor funds and loan servicing.<sup>2</sup> NRS 645B.175 requires all money received by a mortgage broker from a private investor to fund a loan be kept separate from money belonging to the mortgage broker. These funds must be kept in an account appropriately named to indicate the money does not belong to the mortgage broker. Further, all money paid to a mortgage broker in full or in partial payment of a loan funded by a private investor is to be kept separate from money belonging to the broker and from the private investor funds.

Because of risk and associated trust account requirements, an examination will include additional steps for these licensees. For example, the examiner will test for commingling of funds, inappropriate payments, and properly established bank accounts. In addition, the examiner will perform reconciliations of the trust accounts.

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<sup>2</sup> Loan servicing is defined as the act of collecting loan payments.

The Division indicated brokers who arrange loans funded by private investors, especially those with trust accounts, pose a higher risk to the public. For example, complaints from investors were filed against a broker who arranged privately funded loans. In July 2008, the Division ordered the broker to surrender control of the company to the State. According to the Division, this broker conducted business in an unsafe and injurious manner which may have resulted in danger to the public.

#### Licensees Without a Timely Initial Examination

The Division did not perform timely initial examinations for 38 of 52 (73%) of the licensees we tested. The untimely examinations ranged from 15 months to 4½ years after the original license date. The statutory requirement for an annual examination was applicable to these licensees.

Licensees without timely initial examinations pose a higher level of risk because little is known about the company's operations, including proper supervision of mortgage agents, and compliance with laws and regulations. For example, one company we tested had an initial examination 2 years after it was licensed that resulted in a rating of "5". Violations of multiple statutes were noted and files were missing required documents that help protect consumers such as a Good Faith Estimate, Truth In Lending Disclosure Statement, and the HUD-1 Settlement Statement. Had the examination been performed sooner, serious violations noted may have been prevented. Our testing also included an escrow agency that was licensed in February 2004 and has not had an examination, as of April 2008.

#### Risk-Based Approach for Scheduling Examinations Not Consistently Used

The Division did not consistently use a risk-based approach for scheduling examinations. The purpose of a risk-based approach is to ensure available staff resources are allocated to the areas that matter most, such as high-risk licensees. Although the Division indicated it had implemented a risk-based approach for scheduling examinations, our testing found that resources were not consistently directed toward high-risk licensees. For example, we found 36% of low-risk licensees had a follow-up examination in 2 years or less. However, only 20% of high-risk licensees, those with a poor rating that remained open for 2 years or more, had a follow-up examination within 2 years.

The Division did not have policies and procedures for scheduling examinations. Although the Division should perform timely examinations of all licensees, it has not maintained sufficient staff to perform all required examinations. Therefore, procedures could be developed to ensure examinations are scheduled based on risk when sufficient staff is not available to perform all required examinations.

### **Better Planning Needed for Biennial Examinations and Determining Staffing Requirements**

Better planning is needed to implement the biennial examination process and to determine appropriate staffing levels. Because the Division has not developed policies and procedures to implement biennial examinations, we have serious concerns that many licensees may be scheduled for a biennial examination when they should be examined annually. In addition, the Division has not developed a proper staffing plan to ensure it can meet its statutory mandate for conducting examinations of all licensees. Although the Legislature has authorized sufficient staff, whose cost can be recovered from the mortgage industry, the Division does not have a plan to ensure it maintains appropriate staffing levels.

### **Implementation of Biennial Examination Process Not Adequate**

The division's process to implement biennial examinations is not adequate to ensure licensees meet all statutory requirements to qualify for a biennial examination. In 2007, the Legislature authorized the Division to conduct biennial examinations; however, the Division has not developed policies and procedures to ensure licensees meet all requirements. Therefore, we have serious concerns that many licensees may be scheduled for a biennial examination when they should be examined annually.

During our audit the Division indicated it had implemented the biennial examination process. According to management, examinations are scheduled on a biennial basis for licensees that are rated "2" or better on their last examination. However, the examination rating is only one of several criteria that must be met. Therefore, the Division's process does not address all statutory requirements, such as the company's financial condition or complaints resulting in an administrative action.

Pursuant to NRS 645B.060(4) the Commissioner may conduct biennial examinations of a mortgage broker instead of annual examinations if the broker:

- (a) Received a rating in the last annual examination that meets a threshold determined by the Commissioner;**
- (b) Has not had any adverse change in financial condition since the last annual examination, as shown by financial statements of the mortgage broker;**
- (c) Has not had any complaints received by the Division that resulted in any administrative action by the Division; and**
- (d) Does not maintain any trust accounts pursuant to NRS 645B.170 or 645B.175 or arrange loans funded by private investors.**

NRS 645E.300 lists identical requirements for mortgage bankers, except the section regarding trust accounts does not apply.

Because the Division does not ensure licensees meet all requirements for a biennial examination, we have concerns that the Division will significantly reduce the number of scheduled examinations without adequate consideration of the risk to consumers. According to management, about 75% of examinations of mortgage brokers and bankers result in a rating of “2” or better. Therefore, management indicated that about 480 of 640 (75%) licensed brokers and bankers would be subject to a biennial examination instead of an annual examination, as of August 2008.

Although the Division indicated that about 75% of mortgage brokers and bankers qualify for a biennial examination, we believe that many of these licensees do not currently qualify for a biennial examination. Because of the crisis in the mortgage industry during 2007 and 2008, it is likely that many companies do not qualify because of their deteriorating financial condition. Pursuant to NRS 645B.060(4)(b) a mortgage broker cannot qualify for a biennial examination if they have had any adverse change in financial condition since the last annual examination, as shown by financial statements of the broker.

The Division does not have a process in place to monitor adverse changes in the financial condition of licensees. However, the drop in the number of licensees indicates many companies have experienced financial difficulties. According to management, the number of licenses has declined by about 50%. Therefore, many companies, rated “2” or better, have likely experienced an adverse change in financial condition. For example:

- One small company, with assets totaling \$45,000, had a loss of \$104,000 in 2006 and \$371,000 in 2007. To maintain solvency, the owners of this company contributed more than \$400,000 to this business since 2007. Although this company was rated as “1” in April 2008, its losses indicate an adverse change in financial condition.

In addition, the division’s rating system may not always be the best indicator of which entities should receive a biennial examination. Pursuant to NAC 645B.067, a rating of “2” indicates that the mortgage broker and the management of the mortgage broker have demonstrated substantial compliance with applicable laws and regulations and that any deficiencies noted in the report made by the examiner can be corrected by the mortgage broker with a minimum of regulatory supervision. Because about 75% of licensees receive a rating of “2” or better on their examination, the Division should review its rating system as it relates to the biennial examination process. During our audit, we identified some licensees that received a rating of “2” when they inaccurately disclosed the terms of the loan to consumers.

- One mortgage broker with a “2” rating did not accurately disclose the terms of loans to consumers. The Division’s examination found that 6 of 10 loan files contained errors in the Truth In Lending Disclosure statement given to the consumer. In six loan files, the payment disclosure showed a payment stream that was inconsistent with the loan program offered to the consumer. Although the loans were Adjustable Rate Mortgages (ARM’s) the adjustable feature was not shown on the payment schedule. For example, one loan was fixed for 7 years with a 12 month ARM thereafter; however, the disclosure statement showed fixed payments for 30 years.
- In September 2007, the Division examined a broker which resulted in a “2” rating. Examination staff reported that 4 of 13 loan files revealed the Truth In Lending Disclosure had an incorrect Annual Percentage Rate and payment schedule. Two of these files had a blank initial Truth In Lending Disclosure that was signed by the borrower. Further, for eight loan files, a fee paid by the lender to the broker for processing a loan with a higher interest rate was incorrectly disclosed.

Although this broker has maintained a “2” rating since 2005, it has also committed various unethical business practices. In March 2005, the Division fined this broker \$10,000 for two unlicensed agents, dishonest business practices, and submitting loan applications to institutional lenders as owner-occupied properties when the licensee knew or should have known the information was incorrect. In May 2008, the Attorney General of the State of Nevada filed a Criminal Complaint against this company for offenses including theft, forgery, false statements, racketeering, and material misrepresentation. The Division also issued an order in May 2008 to revoke the broker’s license, and imposed a fine of \$20,000.

In addition, the Division does not track complaints as they relate to the biennial examination requirements. According to state law, the Division may not conduct biennial examinations if it has received complaints that have resulted in any administrative action by the Division. Although the Division maintains a database with complaint information, reports are not generated to track which licensees do not qualify for a biennial examination.

#### Staffing Plan Is Needed

The Division has not maintained appropriate staffing levels to meet its statutory mandate for conducting examinations of licensees. Although the Legislature has expressed concerns over the division's staffing level and authorized 11 new examiner positions during the 2007 Legislative Session, only 1 new examiner was hired. Because of the downturn in the mortgage industry, management is taking a cautious approach to hiring staff. However, the Division still needs to develop a proper staffing plan and hire sufficient staff to ensure it can meet its statutory requirements. The cost of additional examiners can be recovered from the mortgage industry through examination fees.

During the 2007 Legislative Session, the Assembly Committee on Ways and Means and the Senate Committee on Finance (money committees) approved funding for 17 new positions over the 2007-09 biennium. This included 11 of the 20 new examiner positions requested by the agency. In approving these positions, the money committees expressed concerns regarding the adequacy of additional staff, since the division's projections indicated that even with 11 additional examiners, it would not be able to meet its statutory requirements for annual branch office examinations.

Because of concerns regarding the division's staffing estimates, the chairmen of the money committees issued a letter of intent instructing the Division to evaluate its fee structure in order to maintain adequate reserve levels and to develop a proper staffing plan to meet the annual branch examination requirements. The plan was to be presented to the Interim Finance Committee after the agency hired the 17 additional staff members approved by the 2007 Legislature and has had adequate time to study the impact of the new positions on the division's operations and its reserve level.

In addition to receiving new positions during the Legislative Session, the Division has been allowed to seek new positions from the Interim Finance Committee (IFC) between sessions. In April 2006, the IFC authorized four new positions for the Division. In addition, the money committees indicated the Division may seek approval from the IFC for additional positions as needed during the 2007-2009 biennium.

The decision not to hire additional staff is under the control of the Division and the Department of Business and Industry. According to management, because of the downturn in the industry:

**...the Division is taking a cautious approach to hiring additional personnel. Other factors attributing to the delay in hiring additional examiners is the state mandated hiring freeze and the Division's inability to relocate to larger office space. Our relocation was originally scheduled for February 2008, but was put on hold because of the Director's office plan to house Business and Industry agencies within a central area. The relocation of our office is still on hold and our current location cannot support additional personnel.**

Although management indicated the state hiring freeze contributed to the delay in hiring additional examiners, the State has a process in place to justify filling vacant positions during the hiring freeze. The Division is more likely to receive approval to fill vacant positions because it receives no General Fund money.

The cost of additional examiner staff can be recovered from the mortgage industry. Because the Division charges an examination fee of \$60 per hour, examiners can generate sufficient revenue to recover examination costs. If an examiner works 70% of the time on examinations, the Division would bill about \$87,300 in examination fees during a year. We estimated that total payroll costs, including fringe benefits, were about \$75,000 per examiner. Therefore, the remaining fees could be used to cover overhead costs.

During our audit we requested certain information regarding staffing needs; however, the information provided by the Division was not sufficient to reach a conclusion on staffing requirements. Although the Division indicated that additional examiners may not be necessary to accommodate its current licensee base, a thorough analysis should be performed and a staffing plan developed that adapts to changing market conditions.

### **Serious Violations and Disputes Not Resolved Timely**

The Division did not resolve cases or conduct hearings in a timely manner. Based on division records, at least five administrative orders issued in 2006 were unresolved at the end of 2007. Further, only one hearing was conducted in calendar year 2007. When enforcement actions are not timely, there is minimal deterrent to licensees that commit violations. In addition, inequitable regulation occurs when entities commit serious violations and avoid timely enforcement.

We asked for a list of all hearings requested and hearings conducted from January 2006 through June 2008. The Division initially responded that it could not provide a list of all hearings requested and conducted during that period, but it did provide other lists. After additional research, it subsequently provided a list of hearings conducted. Our review of these lists identified 8 of 17 cases took 9 months or more to resolve. This includes one case that took 2½ years from when the order was issued until it was settled.

Problems with the enforcement process also allowed companies and individuals who committed serious violations to avoid or postpone paying fines. For example, we found one instance when an administrative fine of \$10,000 and an order to cease and desist was issued in May 2006. The respondent promptly requested a hearing. However, no hearing was conducted and the Division dismissed the case 2 years later. The Division stated the order was withdrawn in May 2008 upon the recommendation of its counsel. According to management, the division's prior legal counsel determined the order was incomplete and needed to include additional allegations. The matter is still unresolved and the Division has requested its current legal counsel review the file so it may proceed with action. Further, until this case is resolved, a related case against another company cannot go to a hearing. This case also involves a fine of \$10,000 issued in 2006.

When examinations or investigations reveal serious violations, an administrative order is issued. For example, this can be an order to cease and desist, an order imposing a fine, or both. In addition, the respondent has the right to request a hearing if the order is disputed. Therefore, the Division must have an enforcement process which



takes appropriate, consistent, and timely enforcement actions that address the violations cited, including collecting any fines levied.

The Division stated there were many problems with the prior hearings process. In November 2007, the Division entered into a contract with the Department of Administration's Hearings Division to conduct administrative hearings. Management indicated the new contract with the Hearings Division has been beneficial in moving cases to resolution. Although the Division made improvements to the hearings process during our audit, it is still working to resolve certain cases that date back to 2006.

#### **Licensee Financial Information Not Adequately Monitored**

The Division did not ensure licensees submitted all required financial statements, including audited financial statements from high-risk licensees. Mortgage brokers and bankers are required by state law to submit annual financial statements to the Division. If the licensee maintains certain trust accounts, audited statements for the company and the trust accounts must be submitted. Overall, 16 of 55 (29%) licensees we tested did not submit all required statements. Further, about one-half of the companies that submitted financial statements were late and about one-third of these statements were not reviewed timely. When financial statements are not submitted by the due date and reviewed timely, there is an increased risk financial concerns will not be identified and corrected timely.

In addition, the Division has not established procedures for approving extensions. The Commissioner is allowed to grant an extension for the submission of a financial statement if the request is submitted prior to the date on which the financial statement is due. Our combined testing of 55 companies identified 13 requested extensions. For all 13 companies, the date of request and proper approval were not documented. Therefore, we could not determine if extensions were requested timely and properly approved.

#### **Audited Statements From High-Risk Licensees Not Received**

The Division did not monitor licensees with trust accounts to ensure various requirements for audited financial statements were met. We selected 25 companies with trust accounts and found 12 (48%) did not meet the filing requirements. When companies hold money in trust, especially if they are financially unstable, there is an

increased risk managers and employees may engage in dishonest business practices. Because of this risk, companies with trust accounts are subject to more stringent financial reporting requirements than those without trust accounts.

Licensees may not be in compliance because they are unaware of the applicable audit requirement. For example, 2 of 25 companies submitted financial statements that were not audited. Further, for 10 of the 19 companies required to have audits of both the company and the trust accounts, audited statements for the trust accounts were not submitted. The Division has not provided guidance to licensees regarding the audit requirements.

The audit requirements for mortgage brokers, mortgage bankers, and escrow agencies are slightly different. The various audit requirements are:

Mortgage Brokers – NRS 645B.085(3) requires a broker who maintains trust accounts for private investor funds to submit audited financial statements for the company. Further, if the broker maintains trust accounts for loan servicing, those trust accounts are also to be audited.

Mortgage Bankers – NRS 645E.360(3) requires a banker with impound trust accounts<sup>3</sup> to submit audited financial statements for the company. There is no additional audit requirement for trust accounts.

Escrow Agencies – NAC 645A.040(3) requires escrow agencies with trust accounts for money deposited in escrow to submit either a review or audited financial statements for the company, depending on the trust account's average monthly balance. There is no additional audit requirement for trust accounts.

In addition, controls were not in place to ensure statements were submitted and reviewed timely for companies with trust accounts. For example, 11 of 25 companies did not submit statements by the statutory due date, ranging from 16 to 263 days late. We also found statements submitted by 10 companies were not reviewed timely. This ranged from 35 days to 201 days after receipt of the statements. When financial statements are not submitted and reviewed timely, problems may not be identified in time for corrective action.

#### Company Financial Statements Not Always Submitted

Licensees without trust accounts did not always submit a financial statement when required. We found 6 of 30 (20%) companies did not submit a required financial

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<sup>3</sup> An impound trust account is for money paid to a mortgage banker for payment of taxes or insurance premiums on real property.

statement to the Division in 2007. Mortgage brokers and mortgage bankers without trust accounts are required by law to submit annual financial statements. However, these statements are not required to be audited. Our testing of 30 companies also identified:

- Poor Follow-Up Efforts – For four of the six companies that did not submit financial statements, there was no documentation of follow-up efforts to obtain the required financial information.
- Untimely Submittals – For 13 of 24 companies that submitted financial statements, the statements were not submitted timely. Six financial statements were more than 200 days late, including one that was 303 days late.
- Untimely Review – For 8 of 24 companies that submitted financial statements, the statements were not reviewed timely. This ranged from 32 days to 194 days after receipt of the statements.
- Unresolved Concerns – The Division's review of financial statements identified concerns at two companies. Although a letter was sent to each licensee, no response was received and the Division did not perform additional follow up.

These problems occurred because the Division does not have policies and procedures to ensure financial statements are submitted and reviewed timely, and companies are adequately monitored.

#### Monthly Loan Activity Reports Not Submitted

Licensed companies did not always submit required monthly loan activity reports. We tested 40 companies over a 1-year period and found 78 of 472 (17%) required reports were not submitted. Monthly activity reports provide useful information to assist the Division in scheduling examinations and performing sample selection. For example, the Division normally does not schedule examinations for licensees who report little or no activity.

NRS 645B.080 and 645E.350 require brokers and bankers, respectively, to submit a monthly loan activity report by the 15th of each month for the previous month. This report is required even if no loans were arranged in the month. The Division does not have an efficient process to monitor these submittals, including reports for high-risk licensees. For example:

- High-Risk Licensees – 20 brokers who arrange loans funded by private investors did not provide 33 of 240 (14%) required monthly loan activity reports.
- Random Sample of Licensees – 20 licensees did not provide 45 of 232 (19%) required monthly loan activity reports.

The Division indicated it would be a large undertaking to establish a tracking system for monitoring the submission of these reports and performing follow-up contacts. However, the Division has options for establishing an efficient process, with emphasis on certain licensees. This includes using a risk-based approach, and monitoring different licensees on a monthly or quarterly basis. Although the division's examination process includes testing for monthly activity reports, the infrequency of examinations prevents it from being an effective method for monitoring this requirement.

### **Complaint Process Needs Some Improvement**

The Division did not always take timely action to resolve complaints once requested documents were provided. Our review of 25 open complaint files found 5 did not have timely follow up by the Division after the respondent had submitted the requested information. The number of days to resolve these complaints ranged from 105 to 244 days after the documents were provided to the Division.

When a complaint is filed, division procedures require staff to send a letter to the company that was named in the complaint. The letter will include a request for necessary documents. However, the division's procedures do not establish timeframes for resolving the complaint once the requested documents have been provided. As a result, complainants may wait too long to receive reimbursement of funds to which they are entitled or for the impropriety to be rectified.

Further, the complaint database did not always contain accurate and up-to-date information. For 12 of 25 complaints, there were inconsistencies or omissions in the database. This included seven instances when the complaint had been closed, but it was listed as open in the database. In two cases, the complaint had been closed for 1 year or more.

## **Recommendations**

1. Develop policies and procedures for scheduling examinations and monitoring compliance with annual examination requirements.
2. Develop policies and procedures to implement the biennial examination process, including a tracking system to ensure compliance with statutory requirements and for determining which licensees rated “2” or better are subject to an annual examination.
3. Prepare a staffing plan to determine the number of examination staff needed to meet statutory requirements, and periodically update the plan as changes take place in the mortgage industry.
4. Develop policies, procedures, and a tracking system to help ensure disputed administrative orders are resolved timely.
5. Develop policies and procedures to help ensure financial statements are submitted and reviewed timely; extensions are properly approved and documented; and financial related issues are resolved timely.
6. Provide guidance to licensees regarding the requirements for audited financial statements.
7. Establish an efficient process to help ensure monthly loan activity reports are submitted, especially for high-risk licensees.
8. Revise procedures for complaints to include timeframes for performing critical steps in the complaint process and to ensure the database has complete, accurate, and up-to-date information.

## **Revenue Collection Process Needs Improvement**

The Division needs to improve its processes for collecting accounts receivable. Our testing identified weak collection efforts for about \$1.5 million in unpaid assessments, fees, and fines. In many instances, no collection efforts took place. In addition, we identified inefficiencies in the division's practices for documenting and processing payments received. For example, the division's process to photocopy and return thousands of checks is inefficient. Improvements to these processes would increase revenues, improve efficiency, and strengthen controls over payments received.

### **Controls Over Accounts Receivable Not Adequate**

Our testing identified little or no collection efforts for about \$490,000 in assessments, \$50,000 in fees, and \$975,000 in unpaid fines. Because the Division did not take timely collection actions, most of these receivables may be uncollectable. Many receivables are now several years past due, and the high number of licensees that have closed in recent years increases the risk that amounts will not be paid.

Because the Division has regulatory authority over entities that owe it money, it should take timely enforcement action to compel its licensees to pay. Several laws and regulations give the Commissioner authority to take action when a licensee has not paid fees, assessments, or other amounts owed. This includes revocation or suspension of their license and a fine of \$10,000 for each violation. Therefore, when licensees do not pay amounts owed, the Division should take quick action to compel them to pay.

Once a licensee closes its operations, collection efforts become more difficult. Therefore, the Division should follow guidance in the State Controller's Accounting Policies and Procedures Manual. This manual indicates agencies should send a request for payment letter when accounts are 30 days delinquent. A final request for payment letter should be sent when accounts are 60 days delinquent. Accounts greater than 60 days delinquent should be referred to a private debt collector, if above a minimum dollar threshold.

### **Attorney General and CPA Assessments Not Collected**

The Division did not collect about \$490,000 in assessments from its licensees during fiscal years 2007 and 2008. This amount includes \$323,000 in costs for legal services that were not assessed for fiscal year 2007. The Commissioner is authorized

by state laws to collect an assessment from licensed companies to recover the costs of legal services provided by the Attorney General and to cover all the costs related to the employment of a Certified Public Accountant. However, the Division does not have policies and procedures for assessments and has not established guidelines for collection efforts and monitoring. Exhibit 3 shows the results of our testing for assessments.

**Exhibit 3**

**Test Results for Assessments**

<p><b>Attorney General Assessment (NRS 645F.290)</b></p> <ul style="list-style-type: none"> <li>• <u>Fiscal Year 2008</u> – For the assessment billed on October 1, 2007, agency records showed 333 licensees with outstanding balances. We selected 25 companies from this list and found collection letters were not sent until April 21, 2008, which is 203 days after the billing date. No further collection efforts were performed. As of June 12, 2008, there was an unpaid balance of about \$152,000, which is 24% of the total assessment.</li> <li>• <u>Fiscal Year 2007</u> – The Division indicated that for reasons unknown, but believed to be due to a vacancy in its management analyst position, the Division did not assess its licensees for the Attorney General assessment, but instead paid for it out of its reserves. The Attorney General cost allocation not assessed totaled \$323,000.</li> </ul>
<p><b>CPA Assessment (NRS 645F.180)</b></p> <ul style="list-style-type: none"> <li>• <u>Fiscal Year 2008</u> – For the assessment billed on August 30, 2007, agency records showed 250 licensees with outstanding balances. We selected 15 from this list and found collection letters were not sent until December 12, 2007, which is 104 days after the billing date. No further collection efforts were performed. The unpaid balance was \$10,000, which is 13% of the total assessment.</li> <li>• <u>Fiscal Year 2007</u> – For the assessment billed on September 20, 2006, agency records showed 127 licensees with outstanding balances. We selected 20 from this list and found collection letters were sent on November 1, 2006. However, no further collection efforts were performed. The unpaid balance was about \$6,100, which is 10% of the total assessment.</li> </ul>

Source: Auditor review of the division's records.

Staff indicated they collect past due assessments when companies renew their license. However, this practice is ineffective. The renewal date can be as much as 9 months from when assessments are billed. Our testing of the September 2006 CPA assessment included 12 licensees that renewed their license in 2007. For all 12 licensees, the outstanding CPA assessment was not paid at the time of renewal in

2007. In addition, the database was not always updated with accounts receivable information. Therefore, staff did not always know at the time of renewal if there was a past due assessment. For 25 of 57 licensees, the database was not updated to reflect their unpaid balance.

#### Lack of Collection Efforts for Examination Fees

The Division does not have a process to ensure its examination fees are collected. About \$50,000 of fees billed between June 2005 and December 2007 were still outstanding in June 2008. For 24 of 25 unpaid fees tested, there was either no evidence of collection efforts or efforts were not timely. This included:

- Thirteen instances of no documented collection effort.
- Six instances when collection letters were sent late. This ranged from 36 to 474 days after the billing date.
- Five instances when the collection effort was a phone call or email, ranging from 53 to 74 days after the billing date.

The Division did not always receive payment for examinations when a branch office closed, but the company remained active. For example, we asked the Division for documentation of collection efforts for certain companies with past due accounts. One of these companies was billed in September 2006 and another was billed for two examinations in July 2007. The Division stated there were no collection efforts for these two companies because the offices examined have closed. However, we found that both companies were still active, as of August 2008. Although certain branch offices have closed, collection from the company's principal location should be pursued.

#### Better Monitoring Needed for Fines and Settlement Agreements

Better monitoring is needed for the collection of administrative fines and settlement agreements. Our review of 37 fines and settlement agreements found untimely collection efforts and incomplete accounts receivable records. This included 18 unpaid fines and agreements with a total due of about \$975,000.

- Untimely Collection Efforts – Our testing identified 16 past due fines totaling about \$545,000. For 12 of these fines, there was no evidence of collection efforts. This includes one fine for \$199,000 issued in September 2004 and another fine for \$140,000 issued in July 2006. For four other fines, efforts were not timely. This included three instances when collection letters were sent about 250 days after the due date.



- Incomplete Accounts Receivable Records – Our testing also identified two unpaid fines totaling \$430,000 that did not appear on the division's accounts receivable list. One fine for \$420,000 was issued in September 2006 and another fine for \$10,000 issued in January 2006. The Division could not provide evidence of collection efforts. Management indicated the individual owing \$420,000 is in jail in California.

The Division has a procedure requiring staff to notify the Commissioner if delinquent settlement agreements are not paid within 30 days. However, this procedure was not followed by staff. Therefore, management was not always notified of unpaid fines.

### **Inefficient Practices for Documenting and Processing Payments Received**

The division's process to photocopy all checks received and return checks to those who submit incomplete applications is inefficient. We estimate the staff received, copied, and filed about 20,000 checks during 2007. Of these, about 4,000 checks were returned to applicants. After the check was returned, most applicants resubmitted the same check with their revised applications. By eliminating unnecessary work, more time would be available for staff to improve billing and collection practices.

The time spent copying and filing 20,000 checks is unnecessary work. This work is unnecessary because the Division also enters the payment information into an automated check register. The check register includes the payer's name, check number, date, and amount. Therefore, a copy of the check is not needed. In addition, the process of filing each check copy in the licensee's file is time consuming and increases record storage and disposal costs.

The process of returning 4,000 checks is inefficient and weakens controls over the revenue collection process. For 23 of 25 returned checks we tested, the same check was resubmitted by the applicant. In nine instances the same check was returned at least twice. This included one instance when the applicant submitted the same check five times over a period of 3½ months. Since all 25 applicants were eventually granted a license, the check return process provided no benefit.

The Division has not reviewed its procedures for revenues that were implemented by prior management. These procedures should be reviewed to improve

efficiency and to ensure all checks are restrictively endorsed upon receipt and deposited timely.

### **Recommendations**

9. Develop policies and procedures to help ensure timely collection of all assessments.
10. Establish a process for monitoring the collection of all examination fees, fines, and settlement agreements.
11. Review and revise procedures for revenues to improve efficiency and strengthen controls over cash.

### **Management Information Is Needed to Monitor Activities**

The Division needs better management information to monitor its activities. Better use of management information would allow the Division to improve its regulatory, financial, and administrative practices. For example, management did not use reports which would provide critical information on scheduling examinations, receiving licensee financial statements, and collecting past due receivables. In addition, performance measures were not reliable, and better monitoring of state personnel requirements is needed.

#### **Information Lacking to Monitor Regulatory Activities**

The Division operates without the information it needs to effectively manage its regulatory activities. Critical information was not always received by management in a time frame that allows them to take action to prevent problems or correct deficiencies timely. Although data was often captured and recorded by staff, the information was not always used or reported to management. The lack of reliable and timely information contributed to many problems identified throughout this report. Management information weaknesses noted during our audit included the following areas:

- Examinations – Reports were not used to help identify which high-risk licensees should be scheduled for an examination. This includes licensees with a poor rating, brokers who arrange loans funded by private investors, and those licensed more than 1 year that have not had an initial examination.
- Biennial Examination Process – Although management indicated the Division implemented a biennial examination process, information was not available to

monitor compliance with statutory requirements to qualify for a biennial examination.

- Financial Statements – Reports were not used to track licensees that had not submitted required financial statements. In addition, management did not know if staff reviewed financial statements timely, or if timely follow up occurred when problems were identified.
- Accounts Receivable – Reports were not used by management to monitor past due: (1) assessments, (2) examination fees, and (3) fines and settlement agreements.
- Complaints – Data on complaints was not always entered into the division's database by staff. Therefore, management reports used to monitor the process were not accurate.
- Hearings – Reports were not used to track all requested, conducted, and pending hearings. During our audit, management had to contact other entities to provide information on hearings conducted during 2007.

Management information is a critical element of an entity's system of internal control. In order for an entity to run and control its operations, it must have reliable and timely information. Management and others need information in a form and time frame that enables them to carry out their internal control and other responsibilities. This information is needed to monitor operations, measure performance, and ensure efficient and effective use of resources.

#### **Performance Measures Not Reliable**

The Division did not retain records used for computing and reporting its performance measures for fiscal years 2006 and 2007. Therefore, we could not verify the reliability of the performance information reported in the Executive Budget. When performance measures are not reliable, managers and oversight bodies may have used unreliable information for evaluating programs and making decisions.

The State Administrative Manual states the performance measurement data in the Executive Budget must be reliable. Agencies are required to retain records used in computing performance measures for 3 fiscal years and develop written procedures on how the measures are computed. However, the Division did not have written policies and procedures for how the performance measures are computed.

#### **Tracking System Needed to Monitor Personnel Requirements**

The Division did not have an adequate internal tracking system for employee evaluations. For 13 of 20 employees tested, evaluations were either not performed or

not performed timely. Of the 13 employees with exceptions, there were 4 instances when the annual evaluation was not timely and 10 instances when probationary evaluations were either not timely or not done. This includes:

- One employee went more than 2 years without an evaluation.
- Five employees did not have an 11-month evaluation until after the 1-year probationary period had expired.

NRS 284.340 requires annual evaluations for employees in the classified service that have achieved permanent status. For those employees with a 12-month probationary period, an evaluation is required by the end of the 3<sup>rd</sup>, 7<sup>th</sup>, and 11<sup>th</sup> months of employment. When evaluations are not performed, deficiencies in performance may not be corrected timely. In addition, when 11-month evaluations are performed after the 1-year probationary period expires, an employee with substandard performance could automatically attain permanent status.

### **Recommendations**

12. Evaluate the division's information and reporting needs to ensure management receives reliable and timely information to monitor and control agency operations.
13. Implement controls over employee evaluations to help ensure compliance with NRS 284.340, including the development of an internal tracking system.

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# Appendices

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## Appendix A Audit Methodology

To gain an understanding of the Division of Mortgage Lending, we interviewed agency staff and reviewed statutes, regulations, and policies and procedures significant to the division's operations. In addition, we reviewed the agency's financial information, budgets, minutes of various legislative committees, and other information describing the activities of the Division. We documented and assessed internal controls over accounts receivable, fixed assets, revenues, expenditures, personnel, information systems, licensing, examinations, required financial information, and complaints.

To evaluate the division's regulatory practices for licensing, we obtained a list of all companies and mortgage agents that were issued a license in calendar year 2007. From the list, we randomly selected 25 companies and 25 mortgage agents. For each selection, we verified all required documents were provided and a background check was performed. We also contacted 10 states and compared their practices to those of the Division.

To evaluate the division's regulatory practices for examinations, we obtained a list of all companies that were licensed on December 31, 2007, and had been licensed for at least 1 year. From this list, we randomly selected 30 companies and identified which companies had an examination in 2007. To determine if examinations were performed for high-risk licensees, we obtained a list of all companies with a rating of 4 or 5 on their most recent examination and randomly selected 25 companies. For each company selected, we identified which companies remained open for 1 year or more after the examination and reviewed agency records to verify if a follow-up examination was performed. Further, we obtained a list of all companies with trust accounts, and judgmentally selected 25 companies. Our judgment included selecting at least 15 brokers who arrange loans funded by private investors and have trust accounts. For each company selected, we reviewed agency records to identify whether there was an examination in 2007.

To determine if initial examinations were performed timely, we tested all companies previously selected. For each company, we documented the original license date and initial examination date. We also performed analytical review to determine if a risk-based approach was consistently utilized for scheduling examinations. Further, we requested the division's policies and procedures for implementing biennial examinations and reviewed information regarding staffing needs. The division's examination fee of \$60 per hour was compared to staff salaries to ensure it was adequate to cover the cost of examinations.

To determine if loans with an adjustable rate mortgage (ARM) were properly disclosed, we selected 25 ARM's and reviewed the loan files. Selection was based on the first 25 ARM loans identified in examination reports. For each selection, we verified the examiner reviewed the ARM disclosure, the terms and conditions of the ARM were adequately disclosed, and the borrower signed the agreement.

To evaluate the process for monitoring required financial information, we randomly selected 30 companies from a list of all companies that were licensed on December 31, 2007, and had been licensed for at least 1 year. We also randomly selected 25 companies from a list of all licensees with trust accounts. For each company selected, we verified whether financial statements due in 2007 were submitted and reviewed timely, met all requirements, and extensions were properly approved. Next, we selected 40 companies for submittal of monthly loan activity reports. This included 20 companies randomly selected and 20 judgmentally selected. Judgmental selection was based on companies that arrange loans funded by private investors. For each company selected, we reviewed the division's database and verified reports were submitted timely for all 12 months in calendar year 2007.

To evaluate the division's regulatory practices for complaints, we randomly selected 25 complaints from a list of all open complaints. For each complaint, we verified there was timely correspondence with the complainant and company, accurate database recording, and timely resolution.

To determine if activities related to collections were carried out in accordance with applicable state laws, regulations, and policies, we accessed the division's database and randomly selected 30 payments during 2007. For each payment

selected, we verified the payment amount was correct, and it was properly deposited and recorded. Next, we randomly selected 25 checks that were returned during 2007. For each returned check selected, we reviewed the file and determined if the applicant submitted payment a second time, or withdrew their application. We also randomly selected 12 weeks in 2007 and calculated the number of checks received and returned for each week selected. From these totals, we estimated the total number of checks received and returned during 2007.

To determine if activities related to accounts receivable were carried out in accordance with applicable state laws, regulations, and policies, we obtained multiple lists for assessments, examination fees, and fines. First, we randomly selected 60 companies with past due assessments. For each company selected, we reviewed the database and file for collection efforts and documented the licensee status. If the license was active, we also determined if payment was made at the time of license renewal. Next, we randomly selected 25 companies for payment of examination fees. For each company selected, we verified the billing was accurate and timely. We also verified the payment was timely and properly recorded. For untimely payments, we reviewed the file and identified if collection efforts were timely. We also selected 25 companies with past due fees and reviewed collection efforts. Further, we reviewed lists of fines that had been issued and selected 37 fines. Selection was based on identifying fines that were not disputed. For each fine selected, we verified payment was made. If payment was not made, we reviewed the division's collection efforts.

To determine if the division's performance measures were reliable, as reported in the 2007 – 2009 Executive Budget, we requested supporting documentation to determine if the measures were mathematically accurate and underlying records were competent.

To evaluate activities related to personnel administration, we randomly selected 20 employees from a list of the Division's classified employees during 2007. For each employee, we reviewed personnel files to determine if all required employee evaluations were performed timely.

Our audit work was conducted from November 2007 through September 2008. We conducted this performance audit in accordance with generally accepted

government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

In accordance with NRS 218.821, we furnished a copy of our preliminary report to the Commissioner of the Division of Mortgage Lending. On November 14, 2008, we met with agency officials to discuss the results of our audit and requested a written response to the preliminary report. That response is contained in Appendix C which begins on page 42.

Contributors to this report included:

Dennis Klenczar, CPA  
Deputy Legislative Auditor

Rocky Cooper, CPA  
Audit Supervisor

Richard Phillips, CPA  
Deputy Legislative Auditor

Stephen M. Wood, CPA  
Chief Deputy Legislative Auditor



## Appendix B

### Nevada Revised Statutes for Examinations

#### Escrow Agencies:

##### **NRS 645A.050 Duties of Commissioner.**

1. Subject to the administrative control of the Director of the Department of Business and Industry, the Commissioner shall exercise general supervision and control over escrow agents and agencies doing business in the State of Nevada.

2. In addition to the other duties imposed upon him by law, the Commissioner shall:

(a) Adopt such regulations as may be necessary for making this chapter effective.

(b) Conduct or cause to be conducted each year an examination of each escrow agency licensed pursuant to this chapter.

(c) Conduct such investigations as may be necessary to determine whether any person has violated any provision of this chapter.

(d) Conduct such examinations, investigations and hearings, in addition to those specifically provided for by law, as may be necessary and proper for the efficient administration of the laws of this State relating to escrow.

(e) Classify as confidential the financial statements of an escrow agency and those records and information obtained by the Division which:

(1) Are obtained from a governmental agency upon the express condition that they remain confidential.

(2) Except as otherwise provided in NRS 645A.082, consist of information compiled by the Division in the investigation of possible violations of this chapter.

↳ This paragraph does not limit examination by the Legislative Auditor or any other person pursuant to a court order.

3. An escrow agency may engage a certified public accountant to perform such an examination in lieu of the Division. In such a case, the examination must be equivalent to the type of examination made by the Division and the expense must be borne by the escrow agency being examined.

4. The Commissioner shall determine whether an examination performed by an accountant pursuant to subsection 3 is equivalent to an examination conducted by the Division. The Commissioner may examine any area of the operation of an escrow agency if the Commissioner determines that the examination of that area is not equivalent to an examination conducted by the Division.

(Added to NRS by 1973, 1308; A 1985, 1812; 1991, 1850; 1993, 1892; 2003, 3466)

#### Mortgage Brokers:

##### **NRS 645B.060 Duties of Commissioner: Regulations; investigations; annual examinations; periodic and special audits; hearings; related fees; biennial examinations.**

1. Subject to the administrative control of the Director of the Department of Business and Industry, the Commissioner shall exercise general supervision and control over mortgage brokers and mortgage agents doing business in this State.

2. In addition to the other duties imposed upon him by law, the Commissioner shall:

(a) Adopt regulations:

(1) Setting forth the requirements for an investor to acquire ownership of or a beneficial interest in a loan secured by a lien on real property. The regulations must include, without limitation, the minimum financial conditions that the investor must comply with before becoming an investor.

(2) Establishing reasonable limitations and guidelines on loans made by a mortgage broker to a director, officer, mortgage agent or employee of the mortgage broker.

(b) Adopt any other regulations that are necessary to carry out the provisions of this chapter, except as to loan brokerage fees.

(c) Conduct such investigations as may be necessary to determine whether any person has violated any provision of this chapter, a regulation adopted pursuant to this chapter or an order of the Commissioner.

**Appendix B**  
**Nevada Revised Statutes for Examinations**  
(continued)

(d) Except as otherwise provided in subsection 4, conduct an annual examination of each mortgage broker doing business in this State. The annual examination must include, without limitation, a formal exit review with the mortgage broker. The Commissioner shall adopt regulations prescribing:

(1) Standards for determining the rating of each mortgage broker based upon the results of the annual examination; and

(2) Procedures for resolving any objections made by the mortgage broker to the results of the annual examination. The results of the annual examination may not be opened to public inspection pursuant to NRS 645B.090 until any objections made by the mortgage broker have been decided by the Commissioner.

(e) Conduct such other examinations, periodic or special audits, investigations and hearings as may be necessary for the efficient administration of the laws of this State regarding mortgage brokers and mortgage agents. The Commissioner shall adopt regulations specifying the general guidelines that will be followed when a periodic or special audit of a mortgage broker is conducted pursuant to this chapter.

(f) Classify as confidential certain records and information obtained by the Division when those matters are obtained from a governmental agency upon the express condition that they remain confidential. This paragraph does not limit examination by:

(1) The Legislative Auditor; or

(2) The Department of Taxation if necessary to carry out the provisions of chapter 363A of NRS.

(g) Conduct such examinations and investigations as are necessary to ensure that mortgage brokers and mortgage agents meet the requirements of this chapter for obtaining a license, both at the time of the application for a license and thereafter on a continuing basis.

3. For each special audit, investigation or examination, a mortgage broker or mortgage agent shall pay a fee based on the rate established pursuant to NRS 645F.280.

4. The Commissioner may conduct biennial examinations of a mortgage broker instead of annual examinations, as described in paragraph (d) of subsection 2, if the mortgage broker:

(a) Received a rating in the last annual examination that meets a threshold determined by the Commissioner;

(b) Has not had any adverse change in financial condition since the last annual examination, as shown by financial statements of the mortgage broker;

(c) Has not had any complaints received by the Division that resulted in any administrative action by the Division; and

(d) Does not maintain any trust accounts pursuant to NRS 645B.170 or 645B.175 or arrange loans funded by private investors.

(Added to NRS by 1973, 1538; A 1973, 1669; 1981, 1789; 1983, 1380, 1703; 1987, 1878, 2224; 1993, 497, 1893; 1995, 526; 1999, 3784; 2001, 2467; 2003, 3552; 2003, 20th Special Session, 220; 2007, 955)

**Mortgage Bankers:**

**NRS 645E.300 Duties of Commissioner: Regulations; investigations; annual examinations; periodic and special audits; hearings; related fees; biennial examinations.**

1. Subject to the administrative control of the Director of the Department of Business and Industry, the Commissioner shall exercise general supervision and control over mortgage bankers doing business in this State.

2. In addition to the other duties imposed upon him by law, the Commissioner shall:

(a) Adopt regulations establishing reasonable limitations and guidelines on loans made by a mortgage banker to a director, officer or employee of the mortgage banker.

(b) Adopt any other regulations that are necessary to carry out the provisions of this chapter, except as to loan fees.

**Appendix B**  
**Nevada Revised Statutes for Examinations**  
(continued)

(c) Conduct such investigations as may be necessary to determine whether any person has violated any provision of this chapter, a regulation adopted pursuant to this chapter or an order of the Commissioner.

(d) Except as otherwise provided in subsection 4, conduct an annual examination of each mortgage banker doing business in this State.

(e) Conduct such other examinations, periodic or special audits, investigations and hearings as may be necessary for the efficient administration of the laws of this State regarding mortgage bankers.

(f) Classify as confidential certain records and information obtained by the Division when those matters are obtained from a governmental agency upon the express condition that they remain confidential. This paragraph does not limit examination by:

(1) The Legislative Auditor; or

(2) The Department of Taxation if necessary to carry out the provisions of chapter 363A of NRS.

(g) Conduct such examinations and investigations as are necessary to ensure that mortgage bankers meet the requirements of this chapter for obtaining a license, both at the time of the application for a license and thereafter on a continuing basis.

3. For each special audit, investigation or examination, a mortgage banker shall pay a fee based on the rate established pursuant to NRS 645F.280.

4. The Commissioner may conduct biennial examinations of a mortgage banker instead of annual examinations, as described in paragraph (d) of subsection 2, if the mortgage banker:

(a) Received a rating in the last annual examination that meets a threshold determined by the Commissioner;

(b) Has not had any adverse change in financial condition since the last annual examination, as shown by financial statements of the mortgage banker; and

(c) Has not had any complaints received by the Division that resulted in any administrative action by the Division.

(Added to NRS by 1999, 3751; A 2003, 3564; 2003, 20th Special Session, 223; 2007, 962)

# Appendix C

## Response From the Division of Mortgage Lending



STATE OF NEVADA  
DEPARTMENT OF BUSINESS AND INDUSTRY  
**DIVISION OF MORTGAGE LENDING**

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JIM GIBBONS  
*Governor*

DIANNE CORNWALL  
*Director*

JOSEPH L. WALTUCH  
*Commissioner*

November 21, 2008

Paul V. Townsend, CPA  
Legislative Auditor  
State of Nevada  
Legislative Counsel Bureau  
Legislative Building  
401 S. Carson Street  
Carson City, NV 89701-4747

Re: Audit of Division of Mortgage Lending

Dear Mr. Townsend:

Thank you for your letter of November 3, 2008 in the above matter along with the copy of your audit report of the Division of Mortgage Lending ("Division") for calendar year 2007. We have reviewed the report and find it to be well written and insightful. We also agree with all of your general conclusions and recommendations.

The purpose of this letter is to respond in detail regarding the findings and recommendations that commence at the bottom of page 12 of the report. Part I of this letter will address each of your findings in the order in which they are set forth. Each response may include additional background information, or an explanation, of which you may not be aware, and the lack of which may have contributed to your findings. Part II will address your recommendations and the actions taken by the Division in response thereto, along with what remains to be done.

We understand that your audit report is a snapshot in time for the calendar year 2007. As a reminder, however, a new Commissioner was appointed in September 2007 and inherited all of the issues discussed herein. We have also had to rely on historical information provided by staff, much of it verbal, in order to properly respond to your report. We have included events in 2008 where necessary to further provide relevant information.

After you read this response we hope you will acknowledge that the Division has made great strides in addressing your concerns.

### PART I---FINDINGS

#### I. Examinations not performed when required

The Division acknowledges that it has not been able to meet its statutory mandate for annual examinations. The reason for this has been inadequate staffing and other external factors described below.

The following explanation not only applies to this particular topic heading but to many of the others. It should be viewed a prefatory explanation as to each. It is not meant to excuse the fact that in 2007 the Division did not meet many of its mandates. It is also not necessary for us to address each of the percentage figures you cite in the various

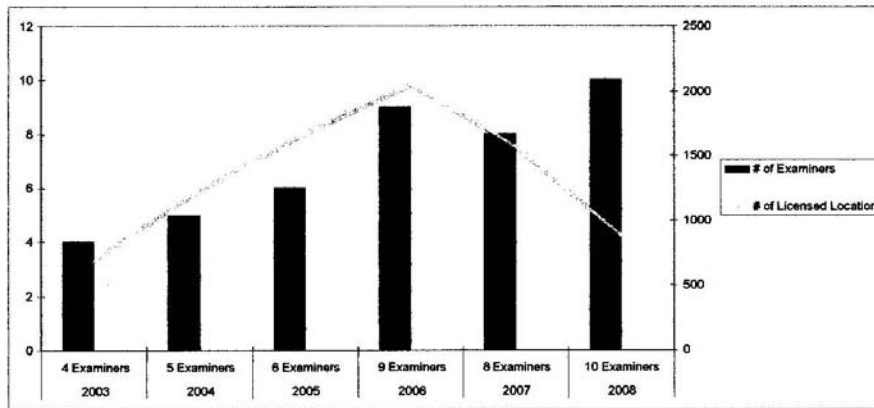
sections of your report, given the numbers speak for themselves and the conclusions reached from them are generally accurate.

By way of background, the Division was created in 2003 by Assembly Bill 490. At the time of its creation there were approximately 700 offices that became licensees under the Division's supervision. The bill sponsor recognized that initial staffing levels would not be adequate. He directed the Division to submit a request to IFC for an increase in staff, which was done, but IFC informed the Division that it first had to demonstrate the need for additional staffing before it would approve such a request. Consequently, initial staffing levels were not then increased.

Initial staffing of the Division included one (1) examiner for all of Northern Nevada (who also was charged with managing the Division's licensing function) and three (3) for Southern Nevada. In addition to their duties as examiners (and the one examiner as licensing manager), examiners were also tasked with assisting the Division's one (1) investigator, increased to four (4) in 2007, in conducting investigations of written complaints. It was not until June 2007 that the investigation function was removed from the examiners duties, although examiners may still be called upon to perform this function on an as needed basis. [Pursuant to NRS 645B.610, the Division is required to investigate all written complaints that fall within its jurisdiction. In 2006, there were 846 such complaints filed with the Division, and in the first half of 2007, until the investigation function was removed from the examiners, there were 430.] The backlog of required examinations grew significantly as examiner resources were diverted to time sensitive investigations.

By early 2007 there were well over 2,000 licensed locations needing examination. The number of actual licensees more than doubled in that same time period, thereby also decreasing the ability of the examiner/licensing manager in Northern Nevada to conduct examinations. To meet this increase in growth, the Division hired additional examiners, and at year end 2007 had eight (8) on staff. Since the appointment of the new Commissioner, we have brought the total to ten (10).

The growth patterns to date of licensed locations versus examiners can be seen from the following chart:



As easily observable, although not to scale, the number of examiners did not keep pace with the growing number of licensed locations needing examinations. Towards the end of the third quarter in 2007, the money committees of the Legislature recognized this fact and authorized 17 new positions, including 11 examiner positions. They also expressed concerns about how these new positions would impact the Division's reserve levels, and suggested to the Division that it evaluate its fee and associated revenue structure over the interim in order to maintain adequate reserve levels and to develop a proper staffing plan to meet the annual branch examination requirements.

The Division reviewed its revenue and reserve structure shortly after the appointment of the new Commissioner, and given the severe downturn in the mortgage lending industry, and accompanying loss in our licensee base and

revenue stream, the Division determined to take a cautious approach in filling the 17 new positions. If the Division had hired all 11 examiners, the number of examiners would have soon far outpaced the need for their services, leading to layoffs. Our cautious approach was borne out by the fact that the Legislature at its last special session re-categorized \$3.5 million (approximately one-half) of the Division's reserve funds into general fund moneys and used it to help balance the then budget deficit. And, as you know, the deficit has widened and the implications of this to the Division in the immediate future cannot be underestimated.

Inadequate staffing was also occasioned by turnover and lack of very experienced candidates to fill the positions.

In the relevant time periods, the Division lost four examiners due to resignations, promoted two into supervisory capacities and one became an investigator. Coupling this with massive boom in the mortgage lending industry in 2006 and leading into early 2007, the ability to recruit experienced examiners was greatly diminished since these individuals could earn more money in the private sector. Additionally, the Division has found that it takes on average 4-6 months of on the job experience for an examiner to be able to handle an examination on his own. Proficiency in conducting examinations of licensees that arrange private investor loans or maintain trust accounts, as well as follow-ups on adversely rated licensees, can take much longer. Consequently, for that initial 4-6 month period and on private investor loan exams, an experienced examiner accompanies a lesser experienced one on his examinations, thus decreasing the availability of the experienced examiner from conducting other examinations.

Not only does inadequate staffing contribute to the lack of examinations conducted, but so, too, do events.

We stated above that examiners sometimes perform investigatory functions, and we repeat it here because of a comment in your letter on page 16, in the first paragraph. Although you were referencing risk factors regarding broker trust accounts, you cited an example of the Division taking action in July 2008 against a broker who maintained such accounts.

Due to the nature of the complaints received against this particular Northern Nevada broker beginning in mid-June 2008, the Commissioner instructed the supervisory examiner in Carson City to conduct an investigation. It was determined that the broker was conducting business in an unsafe and injurious manner. The Division issued an order taking possession of the assets and business of the broker on July 3, 2008, approximately 3 weeks from receipt of the first complaint. By law, once we took possession, the Division had to compile an inventory of all the assets of the broker and file that inventory with the district court within a very short timeframe. See NRS 645B.630.

We discuss this example for two reasons. First, normal examination schedules can be upset by emergency situations, thus influencing the percentage of untimely examinations. Second, the transfer of employees from a scheduled task to an unscheduled task also influences the percentage of untimely examinations. In this particular case, the Division had to utilize all three of its examiners from the Carson City office, 2 administrative staff and its education officer on a full time basis for at least 5 full workdays in order to do what was necessary to protect the private investors and the public in this matter and to meet our statutory requirements. This matter is still not concluded.

## 2. Examinations were not performed for most companies in 2007

The Division did not conduct examinations on many companies in 2007, although it did conduct 261 examinations in that year. The Division is working to correct that issue, and in the first 10 months of 2008 it conducted 374 examinations. On average, the number of examinations conducted on a monthly basis has increased from approximately 22 per month in 2007 to approximately 37 per month in 2008, with the average for the last three months being 49.

## 3. Untimely examinations of licensees with a poor rating

In 2007 the Division did not perform timely follow up examinations for many companies that received a poor rating (i.e. a 4 or a 5) on a prior examination. We believe the Division has cured that problem in 2008. Of all the companies that received a "4" rating, only one remains to be examined, and that examination is in process at this writing. No "5" companies remain to be examined.

We now address the one company with a "5" rating that you discussed on page 14 of your report. It is true that this company received a "5" rating in November 2002, long before the Division was created. This company was also headquartered in Chicago, Illinois, and at the time of the Division's creation, and until into 2006, the Division was not budgeted with out of state travel funds. Irrespective of this fact, however, this licensee was the target of multi-state litigation brought by the Attorneys General in numerous states including Nevada, and in a national settlement paid moneys to affected consumers and initiated company wide corrective measures, correcting those issues raised in the 2002 examination. In this settlement over 4 million dollars was returned to Nevada consumers. This company was also acquired by a large international banking organization, such that federal regulators continue to closely monitor the company through oversight of its ultimate parent.

Since the date of the multi-state settlement agreement in 2005, the Division has only received one complaint against this company. In light of the settlement, corrective actions taken, federal oversight and lack of complaints, a follow-up examination was not viewed as a priority by prior Division management. The Division did, however, complete an examination of the licensee in Chicago in May 2008. It was rated a "2".

#### 4. Untimely examinations of licensees with certain trust accounts and brokers that arrange privately funded loans

The Division acknowledges that in 2007 it did not timely exam many of these licensees. It also acknowledges that licensees who maintain certain types of trust accounts pose a greater risk than those licensees who do not maintain these type accounts.

The Division draws a distinction, however, between those licensees who hold private investor moneys and those licensees who hold borrower moneys impounded for the payment of taxes and insurance as required by their mortgage loan contracts. The risk factor is higher as to the former and lower as to the latter, since impound accounts are subject to the Real Estate Settlement Procedures Act and are highly regulated by HUD. Multi-state mortgage bankers, not Nevada based mortgage brokers, generally maintain these type accounts, and Nevada activity cannot be easily extracted. Additionally, out of state companies that service mortgage loans and impound accounts are not licensed by the Division, and any complaints received by the Division are forwarded to the appropriate federal or out of state agency.

Upon appointment of the new Commissioner, we instructed staff to place those companies maintaining private investor trust accounts, and escrow company licensees maintaining escrowed moneys, at the top of the examination list. Since it requires staff experienced in trust accounting, which reduces the number of examiners available to conduct these examinations, and since these type exams include additional steps in the examination process, as you noted on page 15 of your report, they take a much longer amount of time to complete as compared to non-trust account exams. Nonetheless, most of these licensees have been examined in 2008. All but two will either be examined by the end of this year or an examination initiated, and as to another, the Division is currently negotiating with the licensee for an independent outside CPA audit of its numerous trust accounts, paid for by the licensee. This audit may take upwards of 120-180 days to complete.

#### 5. Licensees without timely initial examination

The Division also did not perform timely initial examinations in 2007. Again, this was due to limited resources. Priority was also given to other identified areas of concern, such as if a serious complaint was received against a licensee by the Division and an investigation confirmed the allegations of the complaint, an examination was scheduled of the licensee at the expense of a newer licensee's initial exam. Additionally, in an attempt not to prohibit commerce, the Division has at times taken out of turn and examined a licensee that wished to open a branch office, but was not otherwise scheduled for an examination, also at the expense of conducting an initial exam of a newer licensee.

#### 6. Risk based approach for scheduling examinations not consistently used

The Division agrees that it did not consistently use a risk-based approach for scheduling examinations. As noted immediately above, however, certain trust account and escrow account activity creates the greatest risk to the public, and these examinations have been placed at the top of the list for examinations.

The Division has drafted an examination manual (see Part II, below) which includes procedures for risk based assignments of examinations.

7. Better planning needed for biennial examinations and determining staffing requirement

The Division acknowledges that in 2007 it did not have adequate policies and procedures in place to implement biennial examinations. See Part II for a further discussion of this matter.

8. Staffing plan is needed

As stated at the beginning of this letter, inadequate staffing levels during the 2006/2007 period of highest licensee growth attributed to the issues raised in your report. A staffing plan to maintain appropriate staffing levels is being created. See Part II for a further discussion of this matter, although we would like to note one item under this subject heading from your report.

On page 21 you state that “[b]ecause the Division charges an examination fee of \$60 per hour examiners can generate sufficient revenue to recover examination costs.” We infer from this comment that you believe that examiners pay for themselves.

Unfortunately, this is not the case. Although examiners can *bill* at \$60 per hour, there is no guaranty that the Division can *collect* \$60 per hour. In fact, they don’t. This issue will be addressed later in this letter when we respond to your comments regarding revenue collection.

9. Serious violations and disputes not resolved timely

The Division agrees that it did not resolve cases or conduct hearings in a timely manner. It is axiomatic to say that justice delayed is justice denied, and as you noted on page 22 of the report, when enforcement actions are not timely, there is minimal deterrence to future violations.

There are two major reasons that contributed to the Division’s inability to timely resolve such matters.

The Division is required by statute to utilize as its counsel the services of the Office of Attorney General. These services include the preparation of administrative orders, such as cease and desist orders, license revocation orders and the like, along with the preparation for and prosecution of the administrative actions themselves. In this regard, the Division did not have a full time Deputy Attorney General assigned to it. Rather, work was assigned between two deputies. Because of this arrangement, the Division’s workload ‘backed up’ at the Attorney General’s office, and orders were not timely prepared or cases timely heard. In August 2008 a full time deputy was assigned to the Division, along with an experienced part time deputy in Carson City. They and the Division are currently working to erase the backlog of orders and at the same time remain current as to new matters.

During this time the Division also conducted its own hearings, and this has proven to be inefficient. In November 2007 the Division entered into a contract with the Department of Administration’s Hearings Division whereby that office agreed to conduct all disciplinary hearings on behalf of the Division. Unfortunately, however, the Division has no control over a hearing officer’s calendar, and although the Division may bring an action in a timely manner, it may not be set for hearing in as timely a manner as preferred. This calendaring is outside the control of the Division and may continue to lead to untimely resolution of some cases.

Additionally, in many cases after an initial order is served on a licensee the licensee demands a hearing but thereafter the Division and the licensee enter into settlement negotiations to resolve their dispute. Sometimes, just like with any lawsuit in the courts, these negotiations drag on beyond what one might consider reasonable. There are many reasons why this might occur, such as counsel for either party not promptly responding to correspondence, counsel being involved in other trials that necessitate a continuance of an administrative matter, the inability of counsel to timely communicate with his client, and the like. Many of these situations are also outside the control of the Division such that the Division must rely upon its counsel to properly monitor and resolve these type situations.



10. Licensee financial information not adequately monitored  
Audited statements from high-risk licensees not received  
Company financial statements not always submitted

We have grouped all of these headings together since they all relate to the overall issue of our weakness in the monitoring of, and timely response to, financial information required to be submitted by the Division's licensees. See Part II for a further discussion of these items.

11. Monthly loan activity reports not submitted

The Division acknowledges that not all monthly activity reports are submitted, or submitted on time.

When the Division's database system was first developed it permitted the capability of querying for the receipt of monthly activity reports, which could then be used by supervisory examiners to monitor deficient submissions and schedule examinations. At some point in the past, and for an unknown reason, that querying capability simply failed and was no longer available. To our knowledge, DoIT did not, and still does not, have anyone on its staff that can perform routine and required maintenance on the Division's Sequel database. Recognizing the problem, in mid-2007 we created a manual spreadsheet to track report submissions for high risk licensees.

The Division is pursuing a "patch" to our current database by the use of an outside vendor. It is anticipated, however, that the planned VERSA system (a new database system for several Business and Industry agencies) will contain the capability for tracking the submission of monthly activity reports, and thus eliminate the problems cited.

12. Complaint process needs some improvement

This matter is discussed further in Part II, below. Three items are worth noting:

a. The Division has recently hired a Chief Compliance Audit Investigator who will be responsible for supervising and monitoring all investigative activities.

b. The Division does have a complaint procedure in place for the taking of complaints, assignment to an investigator and initial contact with the person upon whom the complaint is lodged. Your report is not criticizing these procedures but rather is only concerned with improving the process once the person upon whom the complaint was made has initially responded to the Division.

c. The nature of the particular complaint or investigation may preclude establishing a standard timeframe within which to close it. Many times an investigation of an apparently simple issue leads to other issues, making the complaint much more complex and time consuming.

13. Revenue collection process needs improvement  
Controls over accounts receivable not adequate  
Attorney General and CPA assessments not collected  
Lack of collection efforts for examination fees  
Better monitoring needed for fines and settlement agreements  
Inefficient practices for documenting and processing payments received

We have grouped all of these headings together since they all relate to the overall issue that the Division's collection processes need improvement. Corrections to the weaknesses in the Division's collection efforts will be discussed in more detail in Part II.

Upon the appointment of the new Commissioner, and pending the preparation and adoption of appropriate policies, we instructed staff to not renew any license unless fees were paid current. As you noted in your report, this is an inefficient process, but these instructions were an immediate attempt to reduce the problem of insufficient collections.

Insufficient collections are also attributable to the severe down turn in the mortgage lending industry. Numerous licensees have simply walked away from their businesses, many times without paying their outstanding examination fees or assessments owed. Some file bankruptcy and discharge these unpaid debts while some simply vanish without leaving an address where they can be found.

As discussed, infra, the Division has implemented, and continues to improve upon, its collection policies and procedures. However, the collection of all licensing and renewal fees may significantly change should the State join the national mortgage licensing system authorized by the S.A.F.E. Mortgage Licensing Act of 2008, a federal law that went into effect on July 30, 2008.

14. Management information is needed to monitor activities  
Information needed to monitor regulatory activities

The Division recognizes that deficiencies exist with the level of information available to management necessary to effectively manage its regulatory activities. Improved procedures are being drafted that will put into practice monthly and quarterly reporting by key personnel of essential information pertaining to examinations, financial statement review, accounts receivable, complaints and hearings. See Part II, below.

15. Performance measures not reliable

The Division not maintaining records used for computing and reporting its performance measures for fiscal years 2006 and 2007 is directly attributable to the turnover of its Management Analyst position. Recognizing the deficiency, corrective actions were implemented in mid-2007 and performance measures have been efficiently monitored and records maintained since the beginning of fiscal year 2008. The 2008 Performance Measures Questionnaire was prepared and submitted to the Budget and Planning Division as required.

16. Tracking system needed to monitor personnel requirements

Procedures are in place to efficiently monitor employee valuations. They are attached as a tabbed section in the material accompanying this letter.

PART II--RECOMMENDATIONS AND ACTIONS TAKEN

The recommendations set forth in the audit report are repeated here, immediately followed by the Division's response thereto. Approximately 80% of the recommendations are already completed or the policies and procedures in regards thereto are in the process of being improved in response to your report.

1. Develop policies and procedures for scheduling examinations and monitoring compliance with annual examination requirements.

An examination manual for mortgage brokers has been developed and will be expanded to include mortgage bankers and escrow companies. The manual includes procedures for scheduling examinations. Procedures are being developed to report to management, on a monthly basis, the number of examinations performed, the number of outstanding examinations by risk category, licensees receiving a poor rating on an examination and the number of outstanding examinations by category. A copy of the current manual is included in the tabbed material included with this letter.

2. Develop policies and procedures to implement the biennial examination process, including a tracking system to ensure compliance with statutory requirements and for determining which licensees rated "2" or better are subject to an annual examination.

In the development of its procedures for conducting examinations the Division is assuming all licensees will be examined on an annual basis. In today's mortgage lending climate, it is doubtful any licensee has not experienced an adverse change in its financial condition since the last annual examination. Given your report stating that the Division's rating system may not always be the best indicator of those entities which should receive a biennial examination, the Division has determined it is currently in the best interests of the

public that it conducts annual examinations of all licensees. As the mortgage lending industry improves the Division will revisit the issue of biennial examinations.

3. Prepare a staffing plan to determine the number of examination staff needed to meet statutory requirements, and periodically update the plan as changes take place in the mortgage industry.

A staffing plan will be developed within the next 120 days.

4. Develop policies, procedures, and a tracking system to help ensure disputed administrative orders are resolved timely.

The Division has existing policies and written procedures in this regard. However, they are being improved to enhance existing spreadsheets to ensure disputed administrative orders are resolved in a timely manner. The procedures will include a process of review by the Commissioner on a monthly basis. A copy of the current policies and procedures is included in the tabbed material included with this letter.

5. Develop policies and procedures to help ensure financial statements are submitted and reviewed timely; extensions are properly approved and documented; and financial related issues are resolved timely.

The Division has existing policies and written procedures in this regards. However, they are being improved to ensure financial statements are submitted as required and reviewed timely. The procedures will include a process of review by the Commissioner and Deputy Commissioner on a regular basis. A copy of the current policies and procedures is included in the tabbed material included with this letter.

6. Provide guidance to licensees regarding the requirements for audited financial statements.

The financial statement policies and written procedures being improved, above, will include requirements to send a letter to all licensees on an annual basis that explains the annual financial statement filing requirements. The letter will also be e-mailed and will be posted to the Division's website.

7. Establish an efficient process to help ensure monthly loan activity reports are submitted, especially for high-risk licensees.

Procedures have been in place since mid-2007 to monitor monthly activity reports for high-risk licensees. The written procedures are being improved to ensure compliance, identify deficiencies and to include a reporting element to the Commissioner and Deputy Commissioner on a monthly basis. A copy of the current procedure is included in the tabbed material included with this letter.

8. Revise procedures for complaints to include timeframes for performing critical steps in the complaint process and to ensure the database has complete, accurate, and up-to-date information.

As noted in Part I, it is not the front end of the complaint resolution process that needs improvement, but only the back end.

In that regards, the Division is currently in the process of drafting procedures that address the issues referenced in your report. These procedures will include:

- Development a "no response" letter advising licensees that failure to cooperate is a violation of NAC 645B.320 and licensees may be subject to an order and fine for failure to comply. A sample 'form' order will be prepared that can be completed by the investigator if such an action is warranted.
- Establishment of a policy that each investigator must maintain a simple Excel spreadsheet that provides an at-a-glance snapshot of his caseload on any given day. This spreadsheet would be emailed to the supervisor at a specified interval.

- A requirement that investigators use the complaint activity log in the database in lieu of handwritten notes in the case file to record contacts, document receipt, or any changes in direction or focus of the investigation which extends the time the case may remain open.
- Establishment of a procedure that requires the investigator to review a licensee's response within 5 working days of receipt and to note such a review in the complaint activity log.
- A policy whereby the Supervisor will meet individually with each investigator on a monthly basis to review the status of the investigator's case assignments and to assist with any problems.
- An investigator manual that will be developed which will provide a ready reference for the investigators on the Division's complaint handling policies and procedures. Each investigator will be provided with a copy of this manual as part of his training.

It should be noted here that when the Division's new VERSA data system is developed it is intended that it have a case management aspect that will track cases. Investigators will use the system to log all information related to the investigation. This system will replace the need for Excel spreadsheets since all reports will be handled through one integrated data management source.

9. Develop policies and procedures to help ensure timely collection of all assessments.

The Division has implemented policies and procedures relating to the collection of past due exam fees, assessments and fines, a copy of them being attached as part of the tabbed material. These policies and procedures also address returned mail (i.e. bills being returned for non-delivery) and procedures for sending an unpaid fee, assessment or fine to the state Controller's office for collection. Sample delinquency and collection letters are attached. These policies and procedures will help ensure timely collection of all assessments.

10. Establish a process for monitoring the collection of all examination fees, fines, and settlement agreements.

The policies and procedures referenced in number 9, above, provide for the monitoring of the collection of examination fees, fines, and settlement agreements.

Additionally, in an effort to maximize collections as well as reduce the time and cost associated therewith, the Division has instructed its counsel to research the legality of utilizing a confession of judgment in cases where the licensee has agreed to settlement of \$10,000 or more. A confession of judgment is a mechanism whereby a debtor, in this case a person against whom the Division has taken an action, agrees that the Division can obtain a judgment in a certain sum without the necessity of having to file suit and go to trial to obtain the award. (The \$10,000 number is arbitrary at this point in time. Assuming a favorable legal opinion, the dollar amount will be adjusted to reflect what is deemed to be the most cost efficient amount for which to utilize this procedure.) This confession of judgment can be made a part of the settlement agreement and will assist in reducing the costs associated with litigation and in enhancing revenue collection by permitting immediate execution upon the bank accounts or other assets of the debtor. It will also have a psychological effect upon the debtor to not violate the terms of the settlement agreement.

11. Review and revise procedures for revenues to improve efficiency and strengthen controls over cash.

The Division has not yet drafted policies and procedures for revenues, as recommended. It is anticipated that they will be drafted and in place within 120 days from the date of this letter.

There are two items of note in this regard:

- a. Your report details check returns and photocopying. When the Division was first created, all checks were deposited whether or not the application was complete. A cost analysis was subsequently conducted (We are advised it was conducted by the Division, with assistance from the Attorney General and Controller, but no written record exists) and the result was that it was cost *ineffective* to monitor and

follow up on incomplete applications, when they could simply be returned along with the application fee checks. There was (i) an added expense in processing refunds if the application process could not be completed, and (ii) it was also determined that the interest earned was minimal because of the dollar amounts involved and the relatively short time these moneys were retained by the state.

The Division receives checks for fees that range anywhere from \$10 to \$1,500. The actual cost of processing a refund may in any case be prohibitive as it involves the staff's time spent in preparing the initial request, accounting time in processing the refund in the state accounting system, check distribution in handling the payment and even the cost of the actual check stock.

The process of returning checks that are submitted with incomplete applications (and that assumes the Division is legally entitled to keep the funds submitted with incomplete applications) is the procedure that has been in place since the cost analysis was conducted in mid-2004. As an aside, we are advised that your office has in the past cited at least one other agency for not photocopying checks, yet we are being cited for photocopying them. Regardless, we concur with you that this procedure is inefficient.

Our statutes do not specify whether fees received with incomplete applications are non-refundable. Accordingly, we have requested our counsel to provide an opinion as to whether or not an incomplete application is legally deemed an application for purposes of payment of those fees. If a favorable advisement is rendered, all checks will be deposited and no photocopies will be made. Until then, we do not believe we can change our current procedure.

b. As noted in Part I, above, a new federal law was adopted effective July 30, 2008. This is the S.A.F.E. Mortgage Licensing Act of 2008. This act, in part, establishes a national licensing and registration system for state licensed mortgage loan originators. At present, the system is up and running, it being voluntary to join. It is anticipated that if a state does not join, HUD will impose upon the state a HUD licensing system that must at a minimum contain the same elements as the current voluntary system. The Legislature will hopefully address this issue in the next session.

Should the Division join in the national licensing system, voluntarily or not, all application, licensing and renewal fees will be paid directly by the applicant/licensee to the national system. The national system will deduct its administrative costs (the amount is unknown at this time) and electronically remit the remainder to the Division. This process will, as to the above fees, eliminate the issue regarding checks and photocopying noted in the report. It will also reduce the Division's revenue stream.

12. Evaluate the division's information and reporting needs to ensure management receives reliable and timely information to monitor and control agency operations.

Each policy and/or procedure that is being developed or enhanced will include an element of monthly or quarterly reporting to management. Reports will be reviewed by both the Commissioner and Deputy Commissioner to ensure deficiencies are addressed in a prompt and responsive manner.

13. Implement controls over employee evaluations to help ensure compliance with NRS 284.340, including the development of an internal tracking system.

Procedures are in place and are included in the tabbed material.

Should you have any questions regarding this response, please do not hesitate to contact me.

Sincerely,



Joseph L. Waltuch  
Commissioner

## Division of Mortgage Lending Response to Audit Recommendations

<u>Recommendation Number</u>		<u>Accepted</u>	<u>Rejected</u>
1	Develop policies and procedures for scheduling examinations and monitoring compliance with annual examination requirements.....	<u>  X  </u>	<u>      </u>
2	Develop policies and procedures to implement the biennial examination process, including a tracking system to ensure compliance with statutory requirements and for determining which licensees rated "2" or better are subject to an annual examination.....	<u>  X  </u>	<u>      </u>
3	Prepare a staffing plan to determine the number of examination staff needed to meet statutory requirements, and periodically update the plan as changes take place in the mortgage industry .....	<u>  X  </u>	<u>      </u>
4	Develop policies, procedures, and a tracking system to help ensure disputed administrative orders are resolved timely .....	<u>  X  </u>	<u>      </u>
5	Develop policies and procedures to help ensure financial statements are submitted and reviewed timely; extensions are properly approved and documented; and financial related issues are resolved timely .....	<u>  X  </u>	<u>      </u>
6	Provide guidance to licensees regarding the requirements for audited financial statements .....	<u>  X  </u>	<u>      </u>
7	Establish an efficient process to help ensure monthly loan activity reports are submitted, especially for high-risk licensees.....	<u>  X  </u>	<u>      </u>
8	Revise procedures for complaints to include timeframes for performing critical steps in the complaint process and to ensure the database has complete, accurate, and up-to-date information .....	<u>  X  </u>	<u>      </u>
9	Develop policies and procedures to help ensure timely collection of all assessments.....	<u>  X  </u>	<u>      </u>
10	Establish a process for monitoring the collection of all examination fees, fines, and settlement agreements...	<u>  X  </u>	<u>      </u>
11	Review and revise procedures for revenues to improve efficiency and strengthen controls over cash.....	<u>  X  </u>	<u>      </u>

**Division of Mortgage Lending  
Response to Audit Recommendations  
(continued)**

<u>Recommendation Number</u>		<u>Accepted</u>	<u>Rejected</u>
12	Evaluate the division's information and reporting needs to ensure management receives reliable and timely information to monitor and control agency operations.	<u>  X  </u>	<u>      </u>
13	Implement controls over employee evaluations to help ensure compliance with NRS 284.340, including the development of an internal tracking system.....	<u>  X  </u>	<u>      </u>
	<b>TOTALS</b>	<u>    13    </u>	<u>      0      </u>