

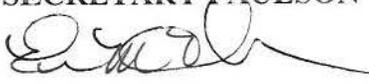


DEPARTMENT OF THE TREASURY
WASHINGTON

October 30, 2008

INSPECTOR GENERAL

INFORMATION MEMORANDUM FOR SECRETARY PAULSON

FROM: Eric M. Thorson 
Inspector General

SUBJECT: Management and Performance Challenges Facing the
Department of the Treasury (OIG-CA-09-001)

The Reports Consolidation Act of 2000 requires that we provide you with our perspective on the most serious management and performance challenges facing the Department of the Treasury, for inclusion in the Department's annual performance and accountability report.

This year, we are reporting two new challenges:

- Management of Treasury's New Authorities Related to Distressed Financial Markets
- Regulation of National Banks and Thrifts

Both of these challenges relate to the crises that began in the subprime mortgage market and spread more broadly into the U.S. and global financial markets.

We also continue to report four challenges from last year:

- Corporate Management
- Management of Capital Investments
- Information Security
- Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act Enforcement

We removed one previously reported challenge, Linking Resources to Results, based on the progress the Department has made in implementing managerial cost accounting in its operations.

Furthermore, as we have pointed out in the past, management and performance challenges do not always represent a deficiency in management or performance. Instead, they can represent inherent risks associated with Treasury's mission, organizational structure, or the environment in which it operates. In this regard, the Department can and should take steps to mitigate these challenges but may not be able to entirely eliminate them. As such, they require ongoing management attention.

Challenge 1 – Management of Treasury’s New Authorities Related to Distressed Financial Markets

Last year we reported as a matter of increasing concern the deterioration of the real estate market and its impact on the credit markets. With worsening conditions over the past year and the impact the subprime mortgage situation has had on the broader financial markets, we have elevated this concern to the most serious management and performance challenge facing the Department.

Treasury, along with the Federal Reserve and the Federal Housing Finance Agency (FHFA), has been dealing with multiple financial crises requiring unprecedented actions through the latter half of Fiscal Year 2008. In July 2008, Congress passed the Housing and Economic Recovery Act which gave Treasury broad new authorities to address the distressed financial condition of Fannie Mae and Freddie Mac. While the hope at the time was that Treasury would not need to exercise those authorities, less than 6 weeks later, FHFA put the two mortgage giants into conservatorship and Treasury agreed to purchase senior preferred stock in the companies, established a new secured line of credit available to the companies, and initiated a temporary program to purchase new mortgage-backed securities issued by the companies.

As the turmoil in the financial markets increased, Treasury and the Federal Reserve took a number of additional unprecedented actions including the rescue of Bear Stearns and American International Group (AIG). It became evident that a more systemic, comprehensive plan was needed to stabilize the financial markets. Treasury sought and obtained additional authorities through passage of the Emergency Economic Stabilization Act (EESA), which gave the Treasury Secretary \$700 billion in authority to, among other things: (1) purchase capital in qualifying U.S. controlled financial institutions; and (2) buy, maintain, and sell toxic mortgage-related assets from financial institutions. These authorities are intended to bolster credit availability and address other serious problems in the U.S. and world financial markets.

As of this writing, the Department has aggressively moved forward to make capital infusions through the purchase of senior preferred stock in nine large banks in an effort to loosen up the credit market. A number of other have subsequently sought to participate in the Capital Purchase Program. The Department is also implementing the mechanisms to carry out its other authorities and responsibilities for the Troubled Assets Relief Program (TARP). It plans to rely extensively on the private sector, initially with a small cadre of Treasury staff to exercise managerial control over TARP. With the hundreds of billions of dollars involved, the need to move quickly, and with so much of the program to be managed by financial agents and contractors, the risk is high that Treasury objectives will not be achieved or taxpayer dollars will be wasted. Accordingly, Treasury needs to ensure strong controls are in place and that its managerial oversight is effective.

Additionally, the Act provides for the appointment of a Special Inspector General to provide oversight of this program. It also directs the U.S. Government Accountability Office (GAO) to conduct ongoing monitoring and report on the program every 60 days. Having said that, it is important to keep in mind that the presence of a Special Inspector General and the work by GAO are not a substitute for sound internal controls and appropriate management stewardship of this critical program.

Also, while the structure and execution of the EESA is still unfolding, it appears that Treasury will be relying to some extent on the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) to both evaluate their supervised institutions for participation in TARP and to monitor their compliance with the requirements for participation and the use of the capital that Treasury provides, including requirements related to limits on executive compensation. If this is to be effective, there will need to be close coordination between the Treasury team managing implementation of EESA, OCC, and OTS (as well as the other Federal Banking Agencies).

Going forward sound administration of the significant taxpayer dollars committed to this rescue effort will clearly be Treasury's most significant management challenge. Furthermore, given the rapidly changing conditions in the financial markets and the coming change in administrations, the importance of establishing a sustainable leadership team as quickly as possible to manage this program cannot be overstated.

Challenge 2 – Regulation of National Banks and Thrifts

Since September 2007, nine Treasury-regulated financial institutions failed with estimated losses to the deposit insurance fund exceeding \$10 billion. Predictions are that many more will fail before the economy improves. This is in sharp contrast to the relatively few and much smaller Treasury-regulated financial institutions that failed during the previous 5 years.

While there are many factors that have contributed to the current turmoil in the financial markets, Treasury's regulators, OCC and OTS, did not identify early or force timely correction of the unsafe and unsound practices by institutions under their supervision. The irresponsible lending practices by many institutions that contributed to the current crisis are now well recognized—including, degradation of underwriting standards, loan decisions based on factors other than the borrowers' ability to repay, and with the ready availability of investor financing, a mentality of "originate to sell" instead of the more prudent "originate to hold" permeated the industry. At the same time, financial institutions engaged in other high risk activities including high asset concentrations in areas such as commercial real estate, and over-reliance on unpredictable brokered deposits to fund rapid growth.

The banking industry will continue to be under pressure over the next several years. For example, OCC, OTS, and the other federal banking regulators recently reported that 2007 data for Shared National Credits (loan commitments of \$20 million or more that are shared by three or more federally supervised institutions) showed a large increase in volume during

the year, with shared credits now totaling \$2.8 trillion (a 22.6 percent increase over 2006). The regulators also reported a significant deterioration in quality of these credits. It has also been reported that the next substantial stress to financial markets will come from troubled credit card debt and auto loans, and this may significantly impact those financial institutions that previously had limited exposure to the subprime mortgage crises

Our office is mandated to look into Treasury-regulated bank failures that result in material losses to the deposit insurance fund. In this regard, during the last 6 months, we completed one review of the NetBank failure and are currently engaged in five. These reviews are useful in identifying the causes for failures and assessing the supervision exercised over a particular failed institution. It should be noted that OCC and OTS have been responsive to our recommendations for improving supervision. However, these reviews do not address supervisory effectiveness overall. It is therefore essential that OCC and OTS take a critical look at their respective (and collective) supervisory processes to identify why those processes did not prevent or better mitigate the unsafe and unsound practices that led to the current crisis and what can be done to better protect the financial health of the banking industry going forward.

Recognizing that the focus of EESA is on the current crisis, another consideration is the need for Treasury to identify, monitor, and manage *emerging* domestic and global systemic economic risks. It should be noted that these emerging risks may go beyond the current U.S. regulatory structure. Treasury, in concert with its regulatory partners, needs to diligently monitor regulated as well as unregulated products and markets for new systemic risks that may require action.

Challenge 3 – Corporate Management

Starting in 2004, we identified corporate management as an overarching management challenge. In short, Treasury needs to provide effective corporate leadership in order to improve performance as a whole. Inherent in this is the need for clear lines of accountability between corporate, bureau, and program office management; enterprise solutions for core business activities; and effective oversight of capital investments and information security. With nine bureaus and a number of program offices, Treasury is a highly decentralized organization. As we reported last year, the Department has made progress in building up a sustainable corporate control structure. The challenge continues to be maintaining emphasis on corporate governance, particularly as the Department develops the infrastructure to carry out its vastly expanded role in addressing the current economic crisis and as key management officials turnover with the change of administration.

Challenge 4 – Management of Capital Investments

Managing large capital investments, particularly information technology (IT) investments, is a difficult challenge facing any organization whether in the public or private sector. In prior years we have reported on a number of capital investment projects that either failed or had

serious problems. In light of this, with hundreds of millions of procurement dollars at risk, Treasury needs to exercise continuous vigilance in this area as it proceeds with its:

- (1) transition to a new telecommunications contract (TNet) under the General Services Administration's Networx program, a transition that has already experienced delays;
- (2) implementation of enhanced information security requirements;
- (3) the anticipated renovation of the Treasury Annex; and
- (4) other large capital investments.

During the last year, the Department reinstated a governance board consisting of senior management officials to provide executive decision-making on, and oversight of, IT investment planning and management and to ensure compliance with the related statutory and regulatory requirements.

Challenge 5 – Information Security

While improvements have been made, by its very nature information security will continue to be a management challenge to the Department. Our Fiscal Year 2008 audit addressing the objectives of the Federal Information Security Management Act of 2002 (FISMA) and Office of Management and Budget (OMB) requirements found that Treasury's non-IRS bureaus made progress in improving information security controls and practices.

Notably, during the past year Treasury strengthened its inventory reporting and Plan of Action and Milestones (POA&M) processes for tracking and correcting security weaknesses. However, our audit found that (1) minimum security control baselines were not sufficiently documented, tested, and/or implemented as required; (2) computer security incidents were not consistently reported timely or correctly categorized; (3) common security configuration baselines were not fully compliant; and (4) federal desktop core configurations were not fully implemented. Treasury management has indicated its commitment to address these issues. It should be noted, however, that the annual FISMA review is not designed to detect all information security vulnerabilities.

Challenge 6 – Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act Enforcement

As reported in previous years, Treasury faces unique challenges in carrying out its responsibilities under the Bank Secrecy Act (BSA) and USA Patriot Act to prevent and detect money laundering and terrorist financing. While the Financial Crimes Enforcement Network (FinCEN) is the Treasury bureau responsible for administering BSA, a large number of federal and State entities participate in efforts to ensure compliance with BSA. These entities include the five federal banking regulators, the Internal Revenue Service (IRS), the Securities and Exchange Commission, the Department of Justice, and State regulators. Many of these entities also participate in efforts to ensure compliance with U.S. foreign sanction programs administered by Treasury's Office of Foreign Assets Control (OFAC).

The dynamics and challenges for Treasury of coordinating the efforts of multiple entities, many external to Treasury, are difficult. In this regard, FinCEN and OFAC entered into memoranda of understanding (MOU) with many federal and State regulators in an attempt to build a consistent and effective process. However, these MOUs are non-binding (and without penalty) and their overall effectiveness have not been independently assessed.

Furthermore, the Patriot Act has increased the types of financial institutions required to file BSA reports. In Fiscal Year 2007, nearly 18 million BSA reports were filed. Although these reports are critical to law enforcement, past audits have shown that many contain incomplete or erroneous data. Additionally, past audits have also shown that examination coverage by regulators of financial institution compliance with BSA has been limited.

Given the criticality of this management challenge to the Department's mission, we continue to consider BSA and OFAC programs as inherently high-risk. Further adding to this risk in the current environment is the risk that financial regulators and examiners may lessen their attention on BSA compliance as they address safety and soundness concerns. It should also be understood that due to resource constraints and mandatory requirements, particularly with respect to failed banks, we do not anticipate providing significant audit coverage to this challenge area during Fiscal Year 2009.

As mentioned above, we removed the previously reported management and performance challenge "Linking Resources to Results" because of the progress the Department has made in this area. For example, among other things, it updated its Managerial Cost Accounting Policy to provide additional guidance to its bureaus and offices for accumulating, measuring, analyzing, interpreting and reporting cost information.

We would be pleased to discuss our views on these management and performance challenges in more detail.

cc: Peter B. McCarthy, Assistant Secretary for Management and Chief Financial Officer