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INSPECTOR GENERAL

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

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INFORMATION MEMORANDUM FOR SECRETARY GEITHNER

FROM: Eric M. Thorson 
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SUBJECT: Management and Performance Challenges Facing
the Department of the Treasury (OIG-CA-10-001)

In accordance with the Reports Consolidation Act of 2000, we are providing you with our perspective on the most serious management and performance challenges facing the Department of the Treasury.

This year, we are reporting one new challenge:

- Management of Recovery Act Programs

This challenge relates to the significant additional responsibilities and funding received by Treasury through the American Recovery and Reinvestment Act of 2009 (Recovery Act) for a variety of programs.

We also continue to report four challenges from last year:

- Management of Treasury's New Authorities Related to Distressed Financial Markets
- Regulation of National Banks and Thrifts
- Management of Capital Investments
- Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act Enforcement

We removed two previously reported challenges:

- Corporate Management
- Information Security

Challenge 1: Management of Treasury's New Authorities Related to Distressed Financial Markets

As we reported last year, Treasury, along with the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the Federal Housing Finance Agency, has taken unprecedented actions to address the current financial crisis. To assist in those efforts, Congress passed the Housing and Economic Recovery Act in July 2008, which gave Treasury broad new authorities to address the distressed financial condition of Fannie Mae and Freddie Mac. Less than 6 weeks later, the Federal Housing Finance Agency put both entities into conservatorship.

Treasury agreed to purchase senior preferred stock in Fannie Mae and Freddie Mac, established a new secured line of credit available to them, and initiated a temporary program to purchase new mortgage-backed securities issued by them. According to Treasury data, as of June 30, 2009, Treasury had purchased \$86.5 billion in preferred stock of the two entities to cover their continuing losses and maintain a positive net worth. Treasury also purchased \$154.2 billion of mortgage-backed securities issued by Fannie Mae and Freddie Mac. Even with this assistance, both entities remain in a weakened financial condition and may require more assistance.

As the turmoil in the financial markets increased, Treasury and the Federal Reserve took additional actions to deal with the situation, including rescuing Bear Stearns and American International Group. Treasury also sought and obtained additional authorities through passage of the Emergency Economic Stabilization Act (EESA) in October 2008. EESA, commonly known as the Troubled Assets Relief Program (TARP), gave the Treasury Secretary \$700 billion 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 were intended to bolster credit availability and address other serious problems in U.S. and world financial markets.

After EESA was enacted, the Department aggressively moved forward to loosen the credit market by purchasing senior preferred stock in nine of the nation's largest financial institutions. Since then, hundreds of other financial institutions have also participated in the Capital Purchase Program (CPP). To date, some CPP participants have repurchased preferred shares and warrants totaling more than \$70 billion. However, a small but growing number of CPP recipients are failing to make their 5 percent dividend payments due to Treasury.

The Department implemented a number of other mechanisms to carry out its other authorities and responsibilities under TARP, including the Public-Private Investment Program and the Home Affordable Modification Program. To administer TARP, Treasury established the Office of Financial Stability.

EESA established a special inspector general for TARP and imposed oversight and periodic reporting requirements on both the special inspector general and the Government Accountability Office (GAO). Under EESA, GAO is also responsible for performing the annual financial statement audit of TARP. Recently, GAO reported that at the 1-year mark, TARP in general and CPP in particular, along with other efforts by the Federal Reserve and FDIC, had made important contributions to help stabilize credit markets. However, GAO also reported that many challenges and uncertainties remain—for example, whether Treasury will fully recoup TARP assistance to the automobile industry and AIG, among others. GAO further noted that other programs, such as the Public-Private Investment Program and the Home Affordable Modification Program, still face implementation or operational challenges. GAO recommended that as Treasury considers further action under TARP, including whether to extend the program beyond December 31, 2009, the Department should evaluate the program in the broader context of efforts by the Federal Reserve and FDIC to stabilize the financial system.

At the time of this writing, it should also be noted that the Department is working through several significant accounting issues involving some very complex TARP transactions. As a result, the Department, in consultation with our office and GAO, has requested an extension from the Office of Management and Budget for its fiscal year 2009 annual financial reporting submission.

As conditions improve, Treasury will need to work with its partners to disassemble the structure established to support recovery efforts and ensure that federal funds no longer needed for those efforts are returned in an orderly manner to the Treasury general fund.

Challenge 2: Regulation of National Banks and Thrifts

Since September 2007, 39 Treasury-regulated financial institutions have failed, with estimated losses to the deposit insurance fund exceeding \$27 billion. Even more financial institutions are expected to fail over the next 2 years.

Although many factors have contributed to the turmoil in the financial markets, Treasury's Office of the Comptroller of the Currency (OCC) and Office of Thrift Supervision (OTS) did not identify early or force timely correction of unsafe and unsound practices by institutions under their supervision. The irresponsible lending practices of many institutions are now well-recognized—including reliance on risky products, such as option adjustable rate mortgages, and degradation of underwriting standards. At the same time, financial institutions engaged in other high-risk activities, including high asset concentrations in commercial real estate and overreliance on unpredictable brokered deposits to fund rapid growth. There have also been instances of certain ailing thrifts backdating capital contributions.

The banking industry will continue to be stressed over the next several years. In their 2009 interagency Shared National Credits (SNC) review, OCC, OTS, and the other federal banking regulators found that credit quality had deteriorated to record levels with respect to the \$2.9 trillion in large (\$20 million or more) loans and loan commitments held by U.S. bank organizations, foreign bank organizations, and nonbank entities such as securitization pools, hedge funds, insurance companies, and pension funds. The review, which covered \$1.2 trillion of the \$2.9 trillion SNC portfolio, identified total losses of \$53 billion. That amount exceeded the combined losses reported in the previous eight SNC reviews and was nearly triple the amount of the previous high, identified in 2002. The next substantial stresses to financial markets may result from troubled credit card debt and further deterioration in commercial real estate loans and could significantly affect financial institutions that had limited exposure to the housing crisis.

Our office is mandated to review failures of Treasury-regulated financial institutions that result in material losses to the deposit insurance fund. Since 2007, we have completed 12 such reviews and are engaged in 19 others. These reviews identify the causes of the failures and assess supervision exercised over failed institutions. Both OCC and OTS have been responsive to our recommendations for improving supervision. For example, OTS has issued guidance addressing concentration issues and the appropriate accounting treatment for capital contributions. However,

these reviews do not address the broader supervisory effectiveness of the federal banking regulators as a whole or the effectiveness of the supervisory structure. It is therefore essential that OCC and OTS continue to take a critical look at their supervisory processes to identify why those processes did not prevent or mitigate the practices that led to the current crisis and what can be done to better protect the financial health of the banking industry and consumers going forward.

Recognizing that the focus of EESA and the Recovery Act is on the current crisis, another consideration is the need to identify, monitor, and manage emerging domestic and global systemic economic risks. Moreover, these emerging risks may go beyond the current U.S. regulatory structure. As we reported last year, Treasury and its regulatory partners must continue to diligently monitor both regulated and unregulated products and markets for new systemic risks that may require action.

Finally, in response to the current crisis, both the administration and Congress are considering proposals for regulatory reform, ranging from the creation of a single financial regulator to a more limited approach calling for oversight councils composed of the existing regulators and consolidating OTS and OCC. (Consolidating OTS and OCC is a common feature of the proposals and has been advocated by the Department.) Also under consideration is transferring responsibility for consumer financial protection functions to a new regulatory agency. Although it is too soon to know which direction regulatory reform will take, Treasury, OCC, and OTS will need to work in concert with the other affected federal bank regulators to ensure a smooth and effective transition to the new regulatory structure that emerges.

Challenge 3: Management of Recovery Act Programs

Treasury is responsible for overseeing an estimated \$150 billion of Recovery Act funding and tax relief. Treasury's oversight responsibilities include grants for specified energy property in lieu of tax credits, grants to states for low-income housing projects in lieu of tax credits, increased Community Development Financial Institutions Fund grants and tax credits, economic recovery payments to social security beneficiaries and others, and payments to U.S. territories for distribution to their citizens. Many of these programs are new to Treasury and involve very large dollar amounts. As a result, Treasury faces immense challenges in ensuring that the programs achieve their intended purposes, provide for accountability and transparency, and are free from fraud and abuse.

It is estimated that Treasury's Recovery Act grants in lieu of tax credit programs—for specified energy property and to states for low-income housing projects—will cost almost \$20 billion over their lives. Treasury has dedicated only a small number of staff to award and monitor these funds. We have concerns that the current staffing level is not commensurate with the size of these programs.

To date, we have issued two audit reports on Treasury's Recovery Act programs. The first, issued in August 2009, discussed progress made and additional steps necessary to operate the

specified energy property program more effectively. The second, issued in October 2009, discussed our concerns with a survey the Department completed for the Recovery Accountability and Transparency Board on Recovery Act staffing levels, qualifications, and training. We concluded that the information provided in the survey response was unreliable. Although these two early audits identified problems, the Deputy Secretary and the Senior Accountability Officer (the Assistant Secretary for Management, Chief Financial Officer, and Chief Performance Officer) have shown a strong commitment to implementing an effective control structure over Recovery Act activities and strong support for our oversight effort. We will work with the Department and the Treasury Inspector General for Tax Administration to help ensure that appropriate controls are in place.

Challenge 4: Management of Capital Investments

Managing large capital investments, particularly information technology investments, is a difficult challenge for any organization, whether public or private. In prior years, we have reported on a number of capital investment projects that either failed or had serious problems. Treasury is now making the transition to a new, mission-critical telecommunications system, TNet. The overall value of the TNet contract is estimated at \$270 million. Treasury was originally to have begun the transition in February 2008. It is now expected to begin in December 2009, nearly 2 years late. In light of this delay, previously reported problems with large capital investments, and hundreds of millions of procurement dollars at risk, Treasury must exercise continuous vigilance in managing such investments.

Challenge 5: Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act Enforcement

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. The Financial Crimes Enforcement Network (FinCEN) is the Treasury bureau responsible for administering BSA. However, a large number of other federal and state entities participate in efforts to ensure compliance with BSA, including the five federal banking regulators, the Internal Revenue Service, 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).

Treasury faces significant challenges in coordinating the efforts of these multiple entities, many external to Treasury. FinCEN and OFAC have entered into memoranda of understanding with many federal and state regulators in an attempt to build a consistent and effective process. However, these instruments are nonbinding and carry no penalties for violations, and their overall effectiveness has not been independently assessed. Furthermore, the USA Patriot Act has increased the types of financial institutions required to file BSA reports. In fiscal year 2008, financial institutions filed approximately 18 million BSA reports.

Although BSA reports are critical to law enforcement, past audits have shown that many contain incomplete or erroneous data and that examination coverage by financial institution regulators of BSA compliance has been limited. In a response to our 2008 management challenges letter, Secretary Paulson said that FinCEN had published interpretive guidance in fiscal year 2008 to address many issues, including common errors noted in suspicious activity reports. The response also stated that FinCEN, OCC, OTS, and other federal banking regulators had studied and made adjustments to the risk-based examination process. We have not had the opportunity to assess these or other recent changes.

Given the criticality of this management challenge to the Department's mission, we continue to consider BSA and OFAC programs as inherently high-risk. Adding to this risk in the current environment is the risk that financial institutions and their regulators may decrease their attention to BSA and OFAC program compliance as they address safety and soundness concerns. As the administration and Congress consider what could be sweeping changes to the financial regulatory structure, those changes must ensure that BSA and OFAC compliance examination coverage is sufficient. Mandatory work, particularly material loss reviews of failed banks and thrifts, prevented us from performing any audits in this area in fiscal year 2009 and we do not expect to provide significant audit coverage in this area in fiscal year 2010.

Challenges Removed

We removed corporate management as an overarching management challenge, first identified as a challenge in 2004, because the Department has made significant progress in building up a sustainable corporate control structure. This progress was evident in the relatively smooth transition that occurred with the change in administrations this year. Treasury nevertheless remains a highly decentralized organization, and recent economic events have increased the number and complexity of its missions. Possible regulatory reforms could subject the Department's missions and structure to further change. In addition, Treasury has yet to fill many key leadership positions. Given these matters, senior leadership will need to ensure that the Department's corporate control structure remains strong and in place.

We removed information security as a management and performance challenge because Treasury has made significant strides in improving and institutionalizing its information security controls. We noted this progress in our two most recent annual Federal Information Security Management Act independent evaluations. Information security requires continued and strong management attention, however, so that policies remain current and practices do not deteriorate.

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

cc: Daniel Tangherlini, Assistant Secretary for Management, Chief Financial Officer, and
Chief Performance Officer