



OFFICE OF  
INSPECTOR GENERAL

DEPARTMENT OF THE TREASURY

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INFORMATION MEMORANDUM FOR SECRETARY GEITHNER

FROM:

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Inspector General

SUBJECT:

Management and Performance Challenges Facing the  
Department of the Treasury (OIG-CA-13-002)

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.

In assessing the Department's most serious challenges, we are mindful of the fragile state of the economy. Despite the efforts of the Administration and the Congress, the economic recovery in the United States has been slow, in part, because of economic conditions in other parts of the world such as the European Union and China. Last year, we acknowledged that, in looking for ways to address this country's budget deficit, cuts to programs and operations were likely although the extent of and the specific nature of any cuts were unknown. That situation remains the same today. Very soon, the Administration and the Congress will need to address the "fiscal cliff" as it relates to the expiration of the Bush-era tax cuts, the payroll tax "holiday," and the automatic spending cuts from the sequestration agreement reached as part of the debt ceiling compromise last year. While the results of the upcoming national election may bring some clarity as to the direction the federal government will take to address these matters, that direction is expected to require significant sacrifices.

With that as a backdrop, Treasury has, in recent years, had to administer additional responsibilities intended to support and improve the country's economy. In order to do so, in nearly every case, the Department had to start up and administer these new responsibilities with very thin staffing and resources. In July of this year, the Department was given another new responsibility – the Gulf Coast Restoration Trust Fund – with no additional resources to administer it. I know that the Department's senior leadership is fully cognizant of these pressures and the need for strong management. That said, if the Department is faced with reduced funding, my office will monitor and examine the effect on Treasury's programs and operations. Like last year, we cannot emphasize enough to the Department's stakeholders the critical importance that Treasury is resourced sufficiently to maintain a strong control environment.

This year we are reporting four challenges, three of which are repeated from last year.

- Transformation of Financial Regulation (Repeat Challenge)
- Management of Treasury's Authorities Intended to Support and Improve the Economy (Repeat Challenge)
- Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act Enforcement (Repeat Challenge)
- Gulf Coast Restoration Trust Fund Administration (New Challenge)

We removed one challenge from last year – Management of Capital Investments – as the Department demonstrated improved governance in the development of two major investments, Treasury Network (TNet) and the Financial Crimes Enforcement Network (FinCEN) Bank Secrecy Act Information Technology Modernization (BSA IT Mod) program. While the removal of this challenge is a major accomplishment, we caution that going forward, engaged senior management involvement is essential to any successful systems development effort.

In addition to the above challenges, we are reporting elevated concerns about three matters – cyber security, currency and coin production, and documenting key activities and decisions. We also note the actions Treasury is undertaking to consolidate and restructure the Bureau of the Public Debt (BPD) and the Financial Management Service (FMS) into the Bureau of the Fiscal Service (BFS).

## **2012 Management and Performance Challenges**

### **Challenge 1: Transformation of Financial Regulation (Repeat Challenge)**

In response to the need for financial reform, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) in July 2010. Dodd-Frank established new responsibilities for Treasury and created new offices tasked to fulfill those responsibilities.

Dodd-Frank established the Financial Stability Oversight Council (FSOC), which you chair as the Treasury Secretary. FSOC's mission is to identify risks to financial stability that could arise from the activities of large, interconnected financial companies; respond to any emerging threats to the financial system; and promote market discipline. FSOC accomplished a number of things over the last year.

Annual reporting - As required, FSOC issued its second annual report in July 2012. The report contained recommendations to (1) further reforms to address structural vulnerabilities in key markets, (2) heighten risk management and supervisory attention in specific areas, (3) take steps to address reform of the housing finance market, and (4) ensure implementation and coordination on financial regulatory reform.

Designation of systemically significant financial market utilities<sup>1</sup> - In July 2012, FSOC designated eight financial market utilities as systemically important. The financial market utilities are subject to (1) risk management standards governing the operations related to the payment, clearing, and settlement activities and (2) additional examinations and reporting requirements, as well as potential enforcement actions.

Ruling for designating nonbank financial institutions for consolidated supervision - Dodd-Frank calls for consolidated supervision and heightened prudential standards for large, interconnected nonbank financial companies. In this regard, the Board of Governors of the Federal Reserve System (FRB) is responsible for supervising these firms and adopting specific prudential rules. In April 2012, FSOC adopted a final rule and interpretative guidance related to designating nonbank financial companies for consolidated supervision.

FSOC still has quite a bit of work ahead to meet all of its responsibilities. For example, it is still in the process of designating the first group of nonbank financial institutions for consolidated supervision. That said, FSOC continues its work monitoring the stability of U.S. and European markets. Additionally, we note that you as the Secretary of the Treasury recently released a letter on the urgent need for money market fund reform to be completed either by the Securities and Exchange Commission or FSOC.

The Council of Inspectors General on Financial Oversight (CIGFO), which I chair, was also established by Dodd-Frank. It facilitates the sharing of information among member inspectors general with a focus on reporting our concerns that may apply to the broader financial sector and ways to improve financial oversight. Accordingly, CIGFO is an important source of independent analysis to FSOC. As required, CIGFO met quarterly and issued its second annual report in July 2012. CIGFO also established its first working group in December 2011. This working group evaluated FSOC controls over non-public information and the manner in which FSOC, as a whole, safeguarded information from unauthorized sources. The working group issued its report in June 2012 which highlighted several areas for FSOC's consideration as it moves forward. In the future, CIGFO will continue reviewing FSOC's compliance with Dodd-Frank to ensure continued rigorous oversight of the U.S. financial system.

Dodd-Frank also established two new offices within Treasury: the Office of Financial Research (OFR) and the Federal Insurance Office (FIO).<sup>2</sup> OFR is the data collection, research and analysis arm of FSOC. In December 2011, the President nominated Mr. Richard Berner to serve as Director. The Director position currently remains vacant while Mr. Berner's confirmation is under consideration in the Senate. Among other duties, the OFR Director is to report to Congress annually on the office's activities and its assessments of systemic risk, with the first report due in

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<sup>1</sup> The term "financial market utility" means any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and that person. However, the term does not include entities such as national securities exchanges, national securities associations, and many others.

<sup>2</sup> It should be noted that Dodd-Frank also established two other new offices within Treasury – the Offices of Minority and Women Inclusion at Departmental Offices and at the Office of the Comptroller of the Currency. Our future work plan includes reviews of these new offices.

July 2012. Despite not having a confirmed Director, OFR issued its annual report. Furthermore, in June 2012, we completed a review of the stand-up of OFR and reported that in the 21 months since OFR was created, efforts to establish the office were still in progress. The officials responsible for establishing OFR initially engaged in high-level strategic and organizational planning and sought to hire key personnel. They also focused their attention on developing and facilitating the global acceptance of a universal Legal Entity Identifier (LEI).<sup>3</sup> In the summer of 2011, after key operational personnel were brought on board, we noted that progress toward establishing a comprehensive implementation planning and project management process accelerated. This culminated in the approval of a methodology in January 2012, a strategic framework in March 2012, and a strategic “roadmap” in April 2012. While well over a year had passed since OFR was established, we concluded that these documents and methodology, taken together, finally provide OFR with a comprehensive implementation plan. This plan lays out the expected evolution of OFR’s capabilities, reaching a mature state by fiscal year 2016. Concurrent with the development of its comprehensive implementation plan, OFR also began to develop its analytic and data support for FSOC, and its Research and Analysis Center has sponsored seminars and published two working papers on risk assessment topics.

The FIO is charged with monitoring the insurance industry, including identifying gaps or issues in the regulation of insurance that could contribute to a systemic crisis in the insurance industry or financial system. The FIO Director, whom you appointed in March 2011, is to advise FSOC on insurance matters. We are currently reviewing the stand-up of FIO.

The other regulatory challenges that we discussed last year still remain. Specifically, since September 2007, 126 financial institutions supervised by the Office of the Comptroller of the Currency (OCC) or the former Office of Thrift Supervision (OTS) have failed, with estimated losses to the Deposit Insurance Fund of approximately \$35.3 billion. This is an increase of 13 financial institutions since my last challenges memorandum. With more than 450 banks on the Federal Deposit Insurance Corporation’s troubled bank list, we anticipate bank failures to continue into the foreseeable future but at a lower rate than in recent years.

Although many factors contributed to the turmoil in the financial markets, our failed bank reviews generally found that OCC and the former OTS did not identify early or force timely correction of unsafe and unsound practices by numerous failed institutions under their respective supervision. Furthermore, in 2010, the unprecedented speed at which servicers foreclosed on defaulted mortgages revealed flaws in the processing of those foreclosures. In response, the federal banking regulators completed a review of foreclosure practices at major mortgage servicers. The review found deficiencies in the servicers’ foreclosure processes including weak management oversight, foreclosure document deficiencies, poor oversight of third parties involved in the foreclosure process, and inadequate risk control systems. As a result, the federal banking regulators issued formal enforcement actions against 14 mortgage servicers and 2 third party providers subject to the review. We are currently reviewing OCC’s oversight of the servicers’ efforts to comply with the enforcement actions. While it is too soon to tell whether

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<sup>3</sup> LEI is being developed as the universal standard for identifying all parties to financial contracts. It is a key element in OFR’s efforts to understand and monitor risks to financial stability and meet its statutory mandate to develop and promote data standards.

these servicing deficiencies have been addressed, at the time, the foreclosure crisis did not help an already stressed housing market.

In my last memorandum, I noted that Treasury was successful in standing up the Bureau of Consumer Financial Protection (CFPB). CFPB is an independent bureau of FRB but Treasury has a unique role in its operations. Specifically, until a Director is confirmed by the Senate, you are charged with exercising some, but not all, of the Director's authorities. In January 2012, the President made a recess appointment of Mr. Richard Cordray as Director. However, recess appointments expire at the end of the Senate's next session – accordingly Mr. Cordray's appointment will end in late 2013, or when formally confirmed by the Senate, or when another individual is nominated, confirmed, and permanently appointed to the position. Legislation has also been proposed to change the form of governance over CFPB. The FRB Inspector General is designated by Dodd-Frank to provide oversight of CFPB. However, given Treasury's statutory role, our office will coordinate with the FRB Office of Inspector General when necessary on CFPB oversight matters.

Clearly, as we have said in the past, the intention of Dodd-Frank is most notably to prevent, or at least minimize, the impact of a future financial sector crisis on the U.S. economy. To accomplish this, Dodd-Frank has placed great responsibility within Treasury and with the Treasury Secretary. This management challenge from our perspective is to maintain an effective FSOC process supported by OFR and FIO within Treasury and build a streamlined banking regulatory structure that timely identifies and strongly responds to emerging risks. This is especially important in times of economic growth and financial institution profitability, when such government action is generally unpopular.

### **Challenge 2: Management of Treasury's Authorities Intended to Support and Improve the Economy (Repeat Challenge)**

Congress provided Treasury with broad authorities to address the recent financial crisis under the Housing and Economic Recovery Act (HERA) and the Emergency Economic Stabilization Act (EESA) enacted in 2008, the American Recovery and Reinvestment Act of 2009 (Recovery Act), and the Small Business Jobs Act of 2010. Certain authorities in HERA and EESA have now expired but challenges remain in managing Treasury's outstanding investments. To a large extent, Treasury's program administration under these acts has matured. However, the long-term impact on small business lending resulting from investment decisions under the Small Business Jobs Act programs are still not clear. Our discussion of this challenge will begin with this act and then address the others for which Treasury is responsible.

#### Management of the Small Business Lending Fund and State Small Business Credit Initiative

Enacted in September 2010, the Small Business Jobs Act created a \$30 billion Small Business Lending Fund (SBLF) within Treasury and provided \$1.5 billion to Treasury to allocate to eligible state programs through the State Small Business Credit Initiative (SSBCI). These represent key initiatives of the Administration to increase lending to small businesses, and thereby support job creation. Both programs were slow to disburse funds, with Treasury

approving the majority of SBLF and SSBCI applications during the last quarter of fiscal year 2011. Because the majority of applicants waited until near the application deadlines to apply, Treasury encountered significant delays in implementing the two programs. As a result, Treasury was rushed in making a number of SBLF investment decisions in order to meet the funding deadlines, and disbursed the initial installment of SSBCI funds without establishing clear oversight obligations of participating states. Now that Treasury has completed the approval process for these two programs, the challenge for Treasury is to exercise sufficient oversight to ensure that funds are used appropriately, SBLF dividends owed Treasury are paid, and programs achieve intended results.

SBLF – As of September 2011, Treasury had disbursed more than \$4 billion to 332 financial institutions across the country. Of the institutions funded, 41.3 percent used SBLF funds to refinance securities issued under the Troubled Asset Relief Program (TARP) Capital Purchase Program. Institutions receiving investments under the SBLF program pay dividends to Treasury at rates that decrease as the institutions increase their qualified small business lending activity. During the first 4½ years of Treasury’s investment, participating institutions initially pay dividends to Treasury of up to 5 percent, but that rate may be reduced to as low as 1 percent based on institutions’ self-reported increases in small business lending. Institutions are under no obligation to make dividend payments as scheduled or to pay off previously missed payments before exiting the program. There are provisions for increased restrictions as dividends are missed, including a prohibition against an institution paying dividends on common stock and a provision for Treasury to appoint one or two members to the bank’s board of directors. The effectiveness of these measures, however, can be affected if the institution’s regulator has restricted it from making dividend payments.

Treasury faces challenges in measuring program performance and ensuring that the SBLF program meets its intended objective of increasing lending to small businesses. The intent of the authorizing legislation was to stimulate lending to small businesses, but participating institutions are not required to report how they use Treasury’s investments and are under no obligation to increase their small business lending. Once participating institutions commingle SBLF disbursements with other funds, it is difficult to track how the funds are used. Additionally, Treasury relies on unverified information on small business lending reported by participating institutions to measure performance and to make dividend rate adjustments.

SSBCI – As of September 2012, 56 states, territories, and eligible municipalities (participating states) had been awarded \$1.4 billion in SSBCI funding. Funds awarded are disbursed in one-third increments. To date, Treasury disbursed \$533 million of the \$1.4 billion awarded. States participating in SSBCI may use funds awarded for programs that partner with private lenders to extend credit to small businesses. Such programs may include those that finance loan loss reserves; and provide loan insurance, loan guarantees, venture capital funds, and collateral support. States were required to provide Treasury with plans for using their funding allocations and report quarterly and annually on their use of funds. We conduct audits of participating states to determine whether SSBCI funds are being used as intended. In this regard, the Small Business Jobs Act requires Treasury to recoup funds we

identify as having been recklessly or intentionally misused, and Treasury may withhold disbursements from a state based on the audit results.

Primary oversight of the use of SSBCI funds is the responsibility of each participating state. The states are required to provide Treasury with quarterly assurances that their programs approved for SSBCI funding comply with program requirements. However, Treasury will face challenges in holding states accountable for the proper use of funds as it has not clearly communicated the prohibited uses of funds and has changed program guidelines frequently, making it difficult for states to ensure the proper use of funds. Treasury has also not defined what constitutes a material adverse change in a state's financial or operational condition that the state must report to Treasury. As a result, Treasury will have difficulty finding states to be in default of program requirements and holding states accountable should our office find that a state has intentionally or recklessly misused funds.

#### 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 programs that provide payments for specified energy property in lieu of tax credits, payments to states for low-income housing projects in lieu of tax credits, grants and tax credits through the Community Development Financial Institutions (CDFI) Fund, economic recovery payments to social security beneficiaries and others, and payments to U.S. territories for distribution to their citizens. Approximately \$20 billion of the \$22 billion provided for non-Internal Revenue Service (IRS) programs has been disbursed to recipients under Treasury's payments in lieu of tax credit programs – to persons for specified energy properties and to states for low-income housing projects. To date, all funds have been disbursed under the low-income housing program and the specified energy property program is beginning to wind down. In the past, we expressed concern about the small number of Treasury staff dedicated to these programs. However, we noted there was a process for the Department of Energy's National Renewable Energy Laboratory to perform a technical review of payment applications and advise Treasury on award decisions. Also, for larger dollar payments, Treasury requires the applicant to obtain a review of project costs by an independent public accounting firm. Nevertheless, Treasury must continue to ensure recipient compliance with award agreements for an extended period of time. Additionally, our Office of Investigations had several open matters involving claims for specified energy property projects.

#### Management of the Housing and Economic Recovery Act and the Emergency Economic Stabilization Act

Through several HERA and EESA programs, Treasury injected much needed capital into financial institutions and businesses.

Under HERA, Treasury continued to support the financial solvency of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) which are under the conservatorship of the Federal Housing Finance Agency. To cover the losses of the two government sponsored enterprises (GSE) and maintain a positive net worth,

Treasury agreed to purchase senior preferred stock as necessary. As of June 30, 2012, Treasury invested a total of \$187 billion in the two GSEs. The maximum amount available to each GSE under its agreement with Treasury is based on a formulaic cap which will set on December 31, 2012, at no less than \$200 billion per enterprise. For the first time since being placed under conservatorship, Fannie Mae and Freddie Mac reported a positive net worth in the first and second quarters of 2012. The future of both GSEs is still in question and prolonged assistance may be required. However, as noted above, the funding cap will set on December 31, 2012.

Prior to the expiration of its purchase authority in December 2009, Treasury acquired \$225 billion of mortgage-backed securities (MBS) issued by the two GSEs under a temporary purchase program. In light of improved market conditions, Treasury started to sell its MBS in March 2011. In March 2012, Treasury completed its sale of remaining MBS and reported that overall, cash returns of \$250 billion were received from the MBS portfolio through sales, principal, and interest.

Through the Housing Finance Agency Initiative supporting state and local finance agencies, Treasury purchased \$15.3 billion of securities issued by Fannie Mae and Freddie Mac backed by state and local Housing Finance Agency bonds (New Issue Bond Program) and committed \$8.2 billion for a participation interest in the obligations of Fannie Mae and Freddie Mac (Temporary Credit and Liquidity Program). Treasury received payments of principal and interest on its securities and currently holds an investment of approximately \$14 billion. Additionally, several state and local housing agencies opted out of the Temporary Credit and Liquidity Program reducing Treasury's commitment to about \$5 billion. Treasury continues to monitor its investment in the Housing Finance Agency Initiative.

As required by Dodd-Frank, Treasury and the Department of Housing and Urban Development conducted a study on ending the conservatorship of Fannie Mae and Freddie Mac and minimizing the cost to taxpayers. The report on this study was presented to Congress in February 2011. Regarding the long-term structure of housing finance, the report provided three options for consideration without recommending a specific option. The three options are (1) a privatized system of housing finance with the government insurance role limited to the Federal Housing Administration (FHA), the U.S. Department of Agriculture (USDA), and the Department of Veterans Affairs (VA) with assistance for narrowly targeted groups of borrowers; (2) a privatized system of housing finance with assistance from FHA, USDA, and VA for narrowly targeted groups of borrowers and a guarantee mechanism to scale up during times of crisis; and (3) a privatized system of housing finance with FHA, USDA, and VA assistance for low- and moderate-income borrowers and catastrophic reinsurance behind significant private capital. Although specific legislation has been proposed in the Congress, the legislative process for housing finance reform is still in a formative stage and it is difficult to predict what lies ahead for winding down the Fannie Mae and Freddie Mac conservatorships and reforming housing finance.

TARP, established under EESA, gave Treasury the authorities necessary to bolster credit availability and address other serious problems in the domestic and world financial markets. Treasury's Office of Financial Stability administers TARP, and through several of its programs, made purchases of direct loans and equity investments in many financial institutions and other

businesses, as well as guaranteed other troubled mortgage-related and financial assets. Authority to make new investments under the TARP program expired on October 3, 2010. Treasury, however, is continuing to make payments for programs which have existing contracts and commitments. One Treasury challenge in this area is managing and winding down its various investment programs. To date, Treasury has reported positive returns from the sale of its investments in the banking industry and the American International Group (AIG), and reduced its investments in the auto industry. Treasury is also still managing various housing programs to provide mortgage relief to homeowners and prevent avoidable foreclosures. Unless current conditions change and while we acknowledge the continuing difficulties facing Treasury with the housing programs, in recognition of the substantial progress the Department has made in exiting its investments we do not plan to report on TARP in future management and performance challenges memoranda. We also note EESA established a special inspector general for TARP and imposed oversight and periodic reporting requirements on both the special inspector general and Government Accountability Office.

#### Unmet Mandate

In addition to SBLF and SSBCI, the Small Business Jobs Act of 2010 provided Treasury with authority to guarantee the full amounts of bonds and notes issued for community and economic development activities not to exceed 30 years. Under this authority, Treasury may issue up to 10 guarantees of no less than \$100 million each, but may not exceed \$1 billion in total aggregate guarantees in any fiscal year. As the program administrator, CDFI Fund was tasked with setting regulations and implementing the program by September 27, 2012. CDFI Fund is experiencing challenges in standing up the program and has missed the program's statutory implementation date. Our office plans to assess the progress of the program's implementation in 2013.

#### **Challenge 3: Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act Enforcement (Repeat Challenge)**

As we have reported in the past, ensuring criminals and terrorists do not use our financial networks to sustain their operations and/or launch attacks against the U.S. continues to be a challenge. Treasury's Office of Terrorism and Financial Intelligence (TFI) is dedicated to disrupting the ability of terrorist organizations to fund their operations. TFI brings together intelligence gathering and analysis, economic sanctions, international cooperation, and private-sector cooperation to identify donors, financiers, and facilitators supporting terrorist organizations, and disrupt their ability to fund them. Enhancing the transparency of the financial system is one of the cornerstones of this effort. Treasury carries out its responsibilities to enhance financial transparency through the Bank Secrecy Act (BSA) and USA Patriot Act. FinCEN is the Treasury bureau responsible for administering BSA.

Over the past decade, TFI has made good progress in closing the vulnerabilities that allowed money launderers and terrorists to use the financial system to support their activities. Nonetheless, significant challenges remain. One challenge is ensuring the continued cooperation and coordination of all the organizations involved in its anti-money laundering and combating terrorist financing efforts. A large number of federal and state entities participate with FinCEN to

ensure compliance with BSA, including the four federal banking agencies, IRS, the Securities and Exchange Commission, the Department of Justice, and all the 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).

To be effective, Treasury must establish and maintain working relationships with these numerous entities. Neither FinCEN nor OFAC have the resources or capability to maintain compliance with their programs without significant help from these other organizations. To this end, FinCEN had signed memoranda of understanding with 7 federal and 52 state regulators to ensure that information is exchanged between FinCEN and the entities charged with examining for BSA compliance. While important to promote the cooperation and coordination needed, it should be noted that these instruments are nonbinding and carry no penalties for violations, and their overall effectiveness has not been independently assessed.

Last year, financial institutions filed approximately 17 million BSA reports, including over 1.5 million suspicious activity reports (SAR). While the number of SARs has been increasing since 2001, that alone does not necessarily indicate everything is going well. Our audits have found problems with the quality of the data reported. Other audits have also identified gaps in the regulatory examination programs of the bank regulators and examining agencies.

Recently the vulnerability in large institutions' monitoring of transactions for money laundering and terrorist financing was revealed. In 2012, OCC filed a consent cease and desist order against Citigroup for failure to adopt and implement a compliance program that adequately covers the required BSA/anti-money laundering program elements due to its inadequate system of internal controls and ineffective independent testing. The bank did not develop adequate due diligence on foreign correspondent bank customers and failed to file SARs related to its remote deposit capture/international cash letter instrument activity in a timely manner. OCC also found weaknesses with other large banks' BSA programs. In July 2012 testimony related to a critical congressional report on OCC's oversight of HSBC's BSA program, the Comptroller of the Currency mentioned several actions that OCC was planning to take going forward. One such action was to assure BSA deficiencies are fully considered in a safety and soundness context and taken into account as part of the "management" component of a bank's CAMELS rating.<sup>4</sup>

FinCEN needs to continue its efforts to work with regulators and examining agencies to ensure that financial institutions establish effective BSA compliance programs and file accurate and complete BSA reports, as required. Furthermore, FinCEN needs to complete work to issue anti-money laundering regulations, as it determines appropriate, for some non-bank financial institutions, such as vehicle dealers; pawnbrokers; travel agents; finance companies; real estate closing and settlement services; and financial services intermediaries, such as investment advisors.

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<sup>4</sup> CAMELS is a system used by federal banking agencies for evaluating the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special supervisory attention or concern. A financial institution is assigned a composite rating and ratings on six components: Capital adequacy, quality of Assets, the capability of the board of directors and Management, the quality and level of Earnings, the adequacy of Liquidity, and Sensitivity to market risk.

FinCEN faces the continuing challenge to enhance financial transparency in order to strengthen efforts to combat financial crime. So far, in this effort, FinCEN's attention has been on clarifying and strengthening customer due diligence (e.g., know your customer) regulatory requirements and supervisory expectations. This includes requiring institutions to identify beneficial ownership of their accountholders so that the true identities of their customers are not hidden. FinCEN issued an advance notice of proposed rulemaking in March 2012 to address this.

FinCEN became the authoritative source for BSA data when it transitioned the collection, processing, and storage of all BSA data from IRS in January 2012. FinCEN's BSA IT Mod program, begun in 2008, is being built to ensure efficient management, safeguarding, and use of BSA information. BSA IT Mod will reengineer BSA data architecture, update the infrastructure, implement more innovative web services and enhanced electronic filing, and provide increased analytical tools. FinCEN believes modernization will provide increased data integrity, and maximize value for its state and federal partners. We completed two audits of the program in which we concluded that FinCEN is generally meeting schedule and cost milestones, and had an appropriate oversight structure in place. As the modernization effort moves toward completion, FinCEN needs to continue to maintain heightened oversight of this program.

FinCEN mandated the use of its BSA E-Filing network effective July 2012, and for all BSA reports, March 2013. BSA E-Filing allows financial institutions to file reports with FinCEN electronically. We anticipate that this will improve data quality in that data will be more quickly entered into the database and that some of the errors or omissions that previously occurred through paper filings should be reduced if not eliminated. However, until this can be verified, FinCEN will need to continue to monitor data quality. We noted that FinCEN has a particularly difficult challenge in dealing with money service businesses (MSB). To that end, FinCEN has taken steps to improve MSB examination coverage and compliance. For example, in past years, FinCEN finalized new rules and increased enforcement designed to ensure MSBs comply with BSA requirements, including registration and report filing requirements. However, ensuring MSBs register with FinCEN has been a continuing challenge. Furthermore, IRS serves as the examining agency for MSBs, but has limited resources to inspect MSBs or even identify unregistered MSBs. FinCEN engaged the states to participate in joint MSB examinations with IRS, and for outreach programs aimed at these nonbank institutions. FinCEN, IRS, and the states need to work together to ensure that MSBs operating in this country are identified, properly registered, and in compliance with all applicable laws and regulations.

FinCEN has also been concerned with MSBs that use informal value transfer systems and with MSBs that issue, redeem, or sell prepaid access, through physical (cards or other devices) or non-physical (e.g., code, electronic serial number, mobile identification number, and/or personal identification number) means. MSBs using informal value transfers have been identified in a number of attempts to launder proceeds of criminal activity or finance terrorism. Similarly, prepaid access can make it easier for some to engage in money laundering or terrorist financing. In September 2010, FinCEN notified financial institutions to be vigilant and file SARs on MSBs that may be inappropriately using informal value transfers when they use financial institutions to store currency, clear checks, remit and receive funds, and obtain other financial services. In 2011, FinCEN issued a final rule applying customer identification, recordkeeping, and reporting

obligations to providers and sellers of prepaid access, and continues to issue clarifying guidance for institutions to implement the requirements. Ensuring institutions properly implement these rules and maintain compliance will be a major challenge.

To detect possible illicit wire transfer use of the financial system, FinCEN also proposed a regulatory requirement for certain depository institutions and MSBs to report cross-border electronic transmittals of funds. FinCEN determined that establishing a centralized database will greatly assist law enforcement in detecting and ferreting out transnational organized crime, multinational drug cartels, terrorist financing, and international tax evasion. Ensuring financial institutions, particularly MSBs, comply with the cross-border electronic transaction reporting requirements, as well as managing this new database, is another significant challenge for FinCEN. It should be noted that this system cannot be fully implemented until FinCEN completes work on its BSA IT Mod program, scheduled for 2014.

Other matters of concern are beginning to appear or are on the horizon. One concern we reported before is that the focus on safety and soundness resulting from the recent financial crisis may have reduced the attention financial institutions have given to BSA and OFAC compliance. Another concern is the increasing use of mobile devices for banking, internet banking, internet gaming, and peer-to-peer transactions. FinCEN, OFAC, and other regulatory agencies will need to ensure that providers of these services ensure transactions are transparent and conform to BSA requirements. Monitoring the transactions of tomorrow may prove to be increasingly difficult for Treasury.

Given the criticality of this management challenge to the Department's mission, we continue to consider anti-money laundering and combating terrorist financing as inherently high-risk. In this regard, we have on-going BSA-related audits of FinCEN's MSB compliance program and OCC's BSA and USA Patriot Act examinations and enforcement actions. With respect to OFAC, we are reviewing its licensing program (where OFAC may grant exceptions to a sanction program as allowed under law) and performing a case study review of its Libyan sanctions program. We plan to complete these audits in fiscal year 2013.

#### **Challenge 4: Gulf Coast Restoration Trust Fund Administration**

In response to the Deepwater Horizon oil spill, Congress enacted as part of P.L. 112-141, the Resources and Ecosystems Sustainability, Tourist Opportunities, and Revived Economies of the Gulf Coast States Act of 2012 (Restore Act). This law established within Treasury the Gulf Coast Restoration Trust Fund and requires Treasury to deposit in the Trust Fund, 80 percent of administrative and civil penalties paid by responsible parties for the Deepwater Horizon oil spill. It is estimated that the Trust Fund could receive tens of billions of dollars from these penalties to be distributed for eligible activities affecting the Gulf Coast states (Alabama, Florida, Louisiana, Mississippi, and Texas). Treasury, in consultation with the Departments of the Interior and Commerce, is required to develop policies and procedures to administer the Trust Fund by January 2, 2013. The procedures are to include (1) procedures to assess whether programs and activities comply with applicable requirements, (2) auditing requirements to ensure that amounts in the Trust Fund are expended as intended, and (3) procedures for identification and allocation

of funds available to Treasury under other provisions of law that may be necessary to pay administrative expenses directly attributable to the management of the Trust Fund. The Restore Act authorizes our office to conduct, supervise, and coordinate audits and investigations of projects, programs and activities funded under this legislation. Neither Treasury nor our office was provided specific funding in the act for carrying out our respective responsibilities.

The Restore Act established the allocation of available amounts in the Trust Fund during any fiscal year.

- 35 percent to the Gulf Coast states, in equal shares, for expenditure for ecological and economic restoration of the Gulf Coast region
- 30 percent to the Gulf Coast Ecosystem Restoration Council (Gulf Restoration Council)<sup>5</sup> pursuant to the council's approval of its comprehensive plan to undertake projects and programs using the best available science that would restore and protect the Gulf Coast region's natural resources, ecosystems, fisheries, marine and wildlife habitats, beaches, coastal wetlands, and economy
- 30 percent to the Gulf Restoration Council for allocation to the Gulf Coast states for eligible oil spill restoration activities, pursuant to the council's approval of the state's plan to improve the ecosystems or economy of the Gulf Coast region, using a regulatory formula
- 2.5 percent to the National Oceanic and Atmospheric Administration for its Gulf Coast Ecosystem Restoration Science, Observation, Monitoring, and Technology Program. This program is to be established by January 2013 to carry out research, observation, and monitoring to support the long-term sustainability of the ecosystem, fish stocks, fish habitat, and the recreational, commercial, and charter fishing industry in the Gulf of Mexico
- 2.5 percent to the Gulf Coast states, in equal shares, for competitive grant awards to nongovernmental entities and consortia in the Gulf Coast region, including public and private institutions of higher education, to establish centers for excellence to conduct Gulf Coast region research

The Restore Act prescribes how each distribution of funds will be further distributed and the conditions that must be met to receive funds. These conditions include that the amounts distributed be used in accordance with the legislation, that procurement rules and regulations be followed, and that the Secretary of the Treasury has the authority to withhold funding if the conditions are not met.

Treasury's Office of the Fiscal Assistant Secretary (OFAS) is currently developing regulations for the new program. We have been meeting with OFAS staff and providing our perspectives on controls as the regulations are being developed. What makes the administration of the act so challenging is that (1) regulations and associated policies and procedures need to be established

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<sup>5</sup> The Gulf Restoration Council consists of the following members, or designees: (1) at the federal level, the Secretaries of the Interior, Army, Commerce, Agriculture, the head of the department in which the Coast Guard is operating (currently the Secretary of Homeland Security), and the Administrator of the Environmental Protection Agency; and (2) at the state level, the Governors of Alabama, Florida, Louisiana, Mississippi, and Texas.

and put into place quickly; (2) many of the entities/councils that are to receive and further allocate funding were not created before the enactment of the legislation and need to establish their own policies and procedures; and (3) there are many entities/councils that must cooperate for the funds to be distributed and spent in an appropriate manner. Treasury is also challenged by the fact that it must use existing resources to administer its responsibilities for the Trust Fund, and it is not a member of the entity, the Gulf Restoration Council, that will directly control how over half of the available amounts are spent.

## **Challenge Removed**

### **Management of Capital Investments**

As we have reported in past years, managing large capital investments, particularly information technology investments, is a difficult challenge for any organization, whether public or private. In the past, we have also reported on a number of capital investment projects that either failed or had serious problems. However, we believe Treasury's implementation activities for two capital investments, TNet and FinCEN's BSA IT Mod, while not perfect, demonstrated that the Department has made sufficient, sustainable improvement in managing and mitigating investment risk to warrant removal of this area from our list of the most serious management and performance challenges.

TNet - Treasury plans to spend \$3.7 billion during the life cycle of its Information Technology Infrastructure Telecommunications Systems and Services investment. Treasury was originally to have begun implementation of TNet, a major component, in November 2007 but the project was delayed until August 2009. In September 2011, we reported serious problems with the initial contracting and project management of TNet that contributed to the delay and the unnecessary expenditure of \$33 million to maintain the prior telecommunications system in the interim. TNet is now operational across Treasury. While it is not yet fully compliant with all Federal security requirements, Treasury has committed to correcting the weaknesses in a timely manner and has taken other steps to strengthen security.

FinCEN BSA IT Mod - As discussed in Challenge 3, Treasury, through FinCEN, is undertaking the BSA IT Mod program and achieved a major milestone when it successfully transitioned BSA data from IRS in January 2012. The project is expected to cost about \$120 million and is on track to be completed in 2014. Pursuant to a Congressional directive, we completed two in a series of audits of BSA IT Mod. The first audit reported that FinCEN had developed a sound business case for the program and the Department and FinCEN had implemented a strong governance system. The audit did identify one issue dealing with the mapping of BSA data from the new system to legacy IRS systems, which was addressed. The second audit found that the program was on schedule and within budgeted cost. We did note a concern with changes in program oversight, which we concluded had not adversely impacted the program so far but would be an area of follow-up in our work going forward.

We do note that we have started or planned audits of two on-going and costly capital investments to determine whether sound project management and effective governance are in place.

BEP Enterprise - BEP Enterprise, or BEN, is intended to integrate the Bureau of Engraving and Printing's (BEP) manufacturing and administrative components in a unified platform to simplify and standardize procedures, increase efficiency, and eliminate unnecessary processes. The goals are to increase quality, reduce spoilage, and improve accountability. The cost for BEN is estimated at \$123 million for initial implementation and \$400 million over the 10-year life of the project. We initiated an audit of BEN in 2012 which we anticipate completing in fiscal year 2013.

Common identity management system - The Treasury Enterprise Identity, Credential and Access Management (TEICAM) is an effort to implement Homeland Security Presidential Directive 12 requirements for a common identity standard. Started in 2007, the investment's targeted life cycle is through 2018. The estimated TEICAM cost is \$178 million as of this writing, which has increased \$31 million since the estimate in my last challenges memorandum. Although recently Treasury reported the investment is on schedule, within cost, and operating as planned, the investment has incurred significant schedule variances. As of August 2012, the Treasury Chief Information Officer assessed the investment as medium risk. We plan to begin an audit of TEICAM in fiscal year 2013.

While removed as a challenge, because of the billions of dollars at risk both in terms of procurement and mission effectiveness, Treasury should continue to exercise vigilance in managing the capital investments described above and others it has underway and may undertake in the future.

## **Matters of Concern**

Although we are not yet reporting these as management and performance challenges, we want to highlight areas of concern – cyber security, currency and coin production, and documenting key activities and decisions.

### Cyber Security

Not surprisingly, Treasury's systems are interconnected and critical to the core functions of government and the Nation's financial infrastructure. Information security remains a constant area of concern and potential vulnerability for Treasury's systems.

As a result, an economic and national security challenge for which Treasury must be prepared, is to provide leadership to defend against the full spectrum of threats against financial institutions in particular, and the financial sector in general. Many U.S. banks face cyber threats to their infrastructure on a continuous basis. Recent examples include denial of service attacks against a number of large U.S. banks. Organized hacking groups leverage known and new vulnerabilities and use different methods to make attacks hard to detect and even harder to prevent. Given the evolving cyber-threat environment, Treasury will need to

build on existing partnerships among financial institutions, regulators, and private entities in the financial sector, in order to be well-positioned to identify and respond to emerging cyber threats against financial institutions and the broader financial sector.

### Currency and Coin Production

We have issued two reports related to the delayed introduction of the NexGen \$100 notes caused by creasing in some of the finished notes. Our first report, issued in May 2011, discussed deficiencies related to the physical security over notes and sheets in the production facilities; we noted that BEP promptly addressed those matters. Our second report, issued in January 2012, reported on deficiencies with BEP's NexGen \$100 note production process, project management, and the need to complete a comprehensive cost-benefit analysis for the disposition of the 1.4 billion finished NexGen \$100 notes already printed but not accepted by FRB. Originally planned to be issued in February 2011, a decision still needs to be made regarding the introduction of the NexGen \$100 note into circulation although production has resumed. In this regard, FRB, as the issuing authority, will make that determination. Another matter related to currency redesign that should be kept in mind is meaningful access to U.S. currency for blind and visually impaired individuals. In response to a court ruling on that matter, you discussed several methods that Treasury plans to use to provide such access. Among them, you described the inclusion of raised tactile features and high-contrast numerals that would help them distinguish denominations of U.S. currency notes. The lessons learned with NexGen \$100 note underscore the need for sound and comprehensive project management as BEP undertakes this redesign effort.

Challenges also exist with coin production. In recent years, the Mint reported that the cost of producing penny and nickel coins were double their face value and that metal prices have caused the production costs to be higher than the coins' face value for the past 6 years. Treasury also suspended production of the dollar coins to save money in production and storage costs due to excess supplies on-hand and low demand for the coins. Even though the demand is not there, the fiscal year 2011 production costs of the dollar coin were approximately a fifth of the coin's face value.

In the medium- to long-term future, the impact of alternative payment systems and other technological advances – such as stored value cards, the Internet, and smartphones – to BEP's and the Mint's respective business models and practices must be considered. This is especially the case in light of the profound effect that such technology had on the U.S. Postal Service's business model. Accordingly, it will become more and more imperative that BEP and the Mint factor this into their business model and future planning and interactions with their customer, FRB.

### Documenting Key Activities and Decisions

Two recently completed audits by my office highlighted lapses by the Department in maintaining a complete and concurrent record of key activities and decisions.

One audit involved the selection of financial agents for Treasury's investment in Fannie Mae and Freddie Mac MBS. The other audit involved Treasury's consultative role with the Department of Energy's Solyndra loan guarantee. In both cases, while some documentation was available, we were only able to piece together what had happened through extensive interviews with personnel and email reviews. It was only then that we could conclude that in the case of the selection of financial agents, that Treasury followed a reasonable approach, and in the case of the Solyndra loan guarantee, that a consultation by Treasury did occur, albeit rushed.<sup>6</sup> On-going work by my office shows that these are not isolated instances. We are often told that the exigencies at the time precluded the preparation of more complete documentation. While we appreciate the pressures that are involved, especially during times of economic crisis, maintaining proper documentation is a fundamental tenet of government accountability and transparency. Maintaining proper documentation is also in the best long-term interest of the Department, should, at a later date, it want to repeat its actions or they be called into question. In this regard, appropriate documentation can be as simple as contemporaneous notes providing a record of why decisions were made, the way they were made, and how the government satisfied itself that the decisions were the best course. We do note that Treasury has issued policy that addresses documentation requirements, such as Treasury Directive Publication 80-05, *Records and Information Management Program*. In our view, this is a matter of Treasury management personnel needing to remain aware and vigilant, especially during times of economic crisis.

We have a final observation and this regards the Department's October 2012 consolidation and restructuring of BPD and FMS into BFS. Expected to save money in the long run, the initiative is laudable. Furthermore, early indications from our on-going review of the consolidation, is that planning for the consolidation, as well as communication with affected personnel, has been extensive. That said, such consolidations do entail risk as separate processes, systems, and workplace cultures are meshed together. Comprehensive planning and the involvement of senior leadership has been key to other recent and successful restructurings of government operations, such as with CFPB and the transfer of the functions of the former OTS. At this stage, we encourage Treasury's senior leadership to at least maintain its current level of effort in this important undertaking.

We would be pleased to discuss our views on the management and performance challenges and the other matters in this memorandum in more detail.

cc: Nani A. Coloretto  
Acting Assistant Secretary for Management

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<sup>6</sup> *Treasury's Financial Agent Selection Process for the Agency Mortgage Backed Securities Purchase Program Was Not Fully Documented* (OIG-12-061; issued July 31, 2012); *Consultation on Solyndra Loan Guarantee Was Rushed* (OIG-12-048; issued April 3, 2012)