




DEPARTMENT OF THE TREASURY  
WASHINGTON

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INSPECTOR GENERAL

**INFORMATION MEMORANDUM FOR SECRETARY GEITHNER**

**FROM:** Eric M. Thorson   
Inspector General

**SUBJECT:** Management and Performance Challenges Facing  
the Department of the Treasury (OIG-CA-11-001)

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 have combined three challenges reported last year into two, renamed those two and expanded them to reflect significant economic events and new responsibilities given to Treasury. Specifically, we have:

- renamed the challenge previously reported as “Regulation of National Banks and Thrifts” to “Transformation of Financial Regulation.” We have also expanded this challenge to incorporate significant events and changes that have taken place since last year, most notably those related to Treasury’s new responsibilities under the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act.
- renamed the challenge previously reported as “Management of Treasury’s New Authorities Related to Distressed Financial Markets” to “Management of Treasury’s Authorities Intended to Support and Improve the Economy.” This challenge encompasses the previously reported challenge entitled “Management of Recovery Act Programs” and has been expanded to recognize Treasury’s new responsibilities and authorities related to the recently enacted Small Business Jobs Act of 2010.

We also continue to report two challenges from last year.

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

**Challenge 1: Transformation of Financial Regulation**

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.

A critical challenge in the near term is Treasury’s role in standing up the Bureau of Consumer Financial Protection (BCFP). Established by Dodd-Frank, the purpose of BCFP is to implement and, where applicable, enforce federal consumer financial law consistently to ensure that all

consumers have access to markets for consumer financial products and services and that those markets are fair, transparent, and competitive. Eventually, BCFP will be an independent bureau of the Board of Governors of the Federal Reserve System (the Board of Governors). However, the Treasury Secretary is charged with supporting the creation and management of BCFP until a Director is confirmed. On September 17, 2010, the President appointed Elizabeth Warren to serve as Assistant to the President and Special Advisor to the Secretary of the Treasury on BCFP. At this time, it is uncertain when a BCFP Director will be confirmed. In the mean time, much needs to be done to set up the BCFP. While BCFP remains in Treasury, it will be under the audit and investigative oversight of my office. We are, however, coordinating those oversight efforts with the Office of Inspector General of the Board of Governors.

Dodd-Frank also established the Financial Stability Oversight Council (FSOC), which is chaired by the Treasury Secretary. FSOC held its inaugural meeting on October 1, 2010. 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. The Council of Inspectors General on Financial Oversight (CIGFO), which I chair, facilitates the sharing of information among 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 will be an important source of independent, unbiased analysis to FSOC. In the future, CIGFO may also vote to convene a working group to evaluate the effectiveness and internal operations of the FSOC. We held our inaugural meeting on October 21, 2010.

Dodd-Frank also established two new offices within Treasury: the Office of Financial Research (OFR) and the Federal Insurance Office (FIO). OFR is to be a data collection, research and analysis arm of FSOC. OFR will operate under a confirmed Director while the Director of FIO will be appointed by the Treasury Secretary. Among other things, the Director of OFR is to report to Congress annually on the office's activities and its assessments of systemic risk. FIO is to monitor 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 Director of FIO will advise FSOC on insurance matters.

Intended to streamline the supervision of depository institutions and holding companies, Dodd-Frank transfers the powers and duties of the Office of Thrift Supervision (OTS) to the Office of the Comptroller of the Currency (OCC), the Board of Governors, and the Federal Deposit Insurance Corporation (FDIC) no later than July 21, 2011. Dodd-Frank requires OCC, OTS, the Board of Governors, and FDIC to jointly submit a plan within 180 days of the enactment of Dodd-Frank to their respective Inspectors General and Congress detailing the steps they will take to implement the transfer. The respective Inspectors General will evaluate that plan and jointly provide a written report to OCC, OTS, the Board of Governors, and FDIC, with a copy to Congress, on whether it conforms to the provisions of Dodd-Frank. Our joint report will be issued within 60 days of receiving the plan. In addition, we will jointly report on the status of the implementation of the plan every 6 months thereafter until all aspects of the plan are implemented.

Clearly, the intention of Dodd-Frank is most notably to prevent, or at least minimize, the impact of a future financial sector crisis on our economy. In order to accomplish this, Dodd-Frank has placed a great deal of responsibility within Treasury and on the Treasury Secretary. The management challenge from our perspective is to implement an effective FSOC process supported by the newly created offices within Treasury and the 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 likely to be unpopular. Our future work plans will include reviews to look at how well Treasury establishes the new offices and undertakes its other critical roles.

The other regulatory challenges that we discussed last year still remain. Specifically, since September 2007, 90 Treasury-regulated financial institutions have failed, with estimated losses to the Deposit Insurance Fund of approximately \$36 billion. This is an increase of 51 financial institutions and \$9 billion in losses since my last challenges letter. More financial institutions are expected to fail over the next 2 years.

Although many factors contributed to the turmoil in the financial markets, our work found that OCC and OTS did not identify early or force timely correction of unsafe and unsound practices by numerous institutions under their respective 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. Recently, the unprecedented speed at which servicers were foreclosing on defaulted mortgages has revealed flaws in the processing of those foreclosures. A number of the largest banks with servicing functions have voluntarily placed moratoriums on foreclosures either in certain states or nationwide until these matters are resolved. While the depth and extent of these problems are not fully known at the time of this writing, this is yet another troubling development in the manner in which financial institutions have been operating. I am also concerned about the impact this could have on an already stressed housing market. Addressing this issue could be the first major challenge for the FSOC.

The banking industry will continue to be stressed over the next several years. In the 2010 interagency Shared National Credits (SNC) review, OCC, OTS, and the other federal banking regulators found that credit quality improved from 2009 but remained weak with respect to the \$2.5 trillion in large (\$20 million or more) loans and loan commitments held by domestic bank organizations, foreign bank organizations, and nonbank entities such as securitization pools, hedge funds, insurance companies, and pension funds. The review, which covered \$1 trillion of the \$2.5 trillion SNC portfolio, identified total losses of \$15 billion, down from total losses of \$53 billion in 2009. Criticized assets declined to \$448 billion from \$642 billion and represented nearly 18 percent of the SNC portfolio, compared with 22 percent in 2009. The volume of poorly underwritten credits originated in 2006 and 2007 continued to adversely affect the overall credit quality of the portfolio. Refinancing risk within the portfolio is also significant, with nearly 67 percent of criticized assets maturing between 2012 and 2014.

Our office is mandated to review the failures of Treasury-regulated financial institutions that result in material losses to the Deposit Insurance Fund. Since 2007, we have completed 21 such reviews and are engaged in 31 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. Dodd-Frank now mandates that our office also review failures that result in non-material losses to the Deposit Insurance Fund. To that end, we have completed 28 such reviews. However, neither the material nor non-material reviews 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.

Since implementation of Dodd-Frank is in its early stages, Treasury and its two federal bank regulators, 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 and requirements.

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

Congress provided Treasury with broad authorities to address the 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 still remain in managing Treasury's outstanding investments. To an extent, Treasury's program administration under these two Acts has matured. In contrast, program administration for the Recovery Act is still evolving, and the Small Business Jobs Act programs must be stood up. Our discussion of this challenge will begin with the most recent Act passed to support and improve the economy and then discuss the other new programs Treasury is responsible for.

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

In late September 2010, Congress enacted the Small Business Jobs Act of 2010 creating within Treasury a \$30 billion Small Business Lending Fund (SBLF) and providing \$1.5 billion to be allocated by Treasury to approved states for eligible state programs through the State Small Business Credit Initiative (SSBCI). The Act represents a key initiative of the Administration to increase lending to small business and thereby support job creation. The challenge for Treasury will be to get these two programs up and running quickly while maintaining proper control to ensure transparency, equitable treatment of all participants, and program results. Our office is specifically directed in the Act to exercise vigorous oversight. To that end, I am establishing an Office of Small Business Lending Fund Oversight to be headed by a Special Deputy Inspector General.

SBLF Under SBLF, Treasury will make capital investments in eligible financial institutions (e.g., banks with total assets of \$10 billion or less and not on FDIC's problem bank list) after consultation with the institution's regulator. Eligible institutions are permitted to refinance securities issued to Treasury under the Troubled Asset Relief Program (TARP) Capital Purchase Program (CPP) as long as they are current on their CPP obligations. Treasury's capital investment may be up to 5 percent of the institution's risk-weighted assets depending on the institution's size. During the first 4½ years of Treasury's investment, participating institutions initially pay dividends to Treasury of 5 percent but that rate may be reduced to as low as 1 percent based on their demonstrated increase in small business lending (after 4 ½ years, the dividend rate increases to 9 percent and Treasury's investment is expected to be repaid within 10 years although there are provisions for extending repayment beyond that time).

As of this writing, Treasury has not published specific policies and guidance for program administration. It is critically important that a strong control structure along with commensurate staffing be established on the front-end of this effort. It is also critical in setting up this program that Treasury build on its experience with CPP. For example, in a recent (October 2010) report on TARP, GAO observed that applicants that withdrew from consideration for CPP in response to a request from their regulator received no review by Treasury or other regulators. GAO recommended that if Treasury administers programs containing elements similar to those of CPP, such as SBLF, that Treasury should implement a process for monitoring all applicants that regulators recommend for withdrawal to ensure that similar applicants are treated equitably. Treasury agreed to consider the GAO recommendation, and we believe that this should be a component of the control structure that Treasury establishes for SBLF. Another key provision of the Act is that banking regulators publish guidance by the end of November 2010 regarding prudent underwriting standards that must be used for loans made by participating institutions; these standards will need to be in place so that participating institutions have a clear understanding on how the funds are to be used. Furthermore, it is important that Treasury and regulators coordinate to ensure that participating institutions comply with the terms and conditions of the investments, to include validation of increased small business lending in return for reduced dividend rates on Treasury investments.

SSBCI On October 8, 2010, Treasury announced individual SSBCI funding allocations totaling \$1.46 billion for the 50 States, the District of Columbia, and the U.S. territories, intended to support new small business lending through local programs. Under the SSBCI, states may apply for federal funds for programs that partner with private lenders to extend greater credit to small businesses. SSBCI allows states to build upon existing state-level small business lending programs. If a State does not have an existing small business lending program, the state can establish one in order to access SSBCI funding. States must provide plans for utilizing their funding allocations to Treasury for review and approval and report quarterly and annually on results. Another key feature is that participating states receive their allocations in 1/3 increments. Treasury may withhold a successive increment to a State pending the results of an audit by our office.

The Act also details specific expectations of Treasury for program administration to include consulting with the Small Business Administration and federal banking agencies; establishing minimum national standards for approved State programs; providing technical assistance and disseminating best practices; managing, administering, and performing necessary program integrity functions; and ensuring adequate oversight of approved State programs, including oversight of the cash flows, performance, and compliance of each approved State program. As with SBLF, Treasury will be challenged to stand this program up quickly with an adequate control structure and commensurate staffing to meet these expectations and make the federal funds available to the states.

A common theme we have seen in recent years, most notably with TARP and Recovery Act programs, is that Treasury first attempts to administer new and complex programs with minimal staffing only to find that more resources need to be devoted to program administration after problems start to surface. We cannot stress enough that a similar approach be avoided with SBLF and SSBCI.

#### 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 were new to Treasury in 2009 and involve very large dollar amounts. It is estimated that Treasury's Recovery Act payments in lieu of tax credit programs—for specified energy property and to states for low-income housing projects—will cost more than \$20 billion over their lives. To date, Treasury has already awarded more than \$6 billion under these programs and has yet to implement comprehensive monitoring procedures. In 2009, we reported that Treasury had dedicated only a small number of staff to award and monitor these funds. That has not changed and we continue to have concerns that the current staffing level is not commensurate with the size of these programs. Payments made to recipients under the specified energy property program alone comprise more than \$5 billion of the funds awarded to date and the number of applicants continues to grow. We initiated and plan a number of audits of recipients of payments under the specified energy property program to ensure funds were properly awarded to eligible applicants for eligible properties. Our audits of these recipients, however, should not be viewed as a substitute for appropriate and comprehensive management oversight and monitoring of the program.

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 continues to address the distressed financial condition of Fannie Mae and Freddie Mac which are under the conservatorship of the Federal Housing Finance Agency. In order to cover the continuing losses of the two entities and their ability to maintain a positive net worth, Treasury agreed to purchase senior preferred stock, and as of June 30, 2010, had purchased \$145 billion. Treasury also purchased and is still holding \$184 billion of mortgage-backed securities issued by two entities under a temporary purchase program that expired in December 2009. Through the Housing Finance Agency Initiative supporting state and local finance agencies, Treasury purchased securities in Fannie Mae and Freddie Mac backed by state and local Housing Finance Agency bonds (New Issue Bond Program) and a participation interest in the obligations of Fannie Mae and Freddie Mac (Temporary Credit and Liquidity Program). Prior to expiring in December 2009, Treasury purchased \$15.3 billion of securities under the New Issue Bond Program and provided \$8.3 billion under the Temporary Credit and Liquidity Program. Even with this assistance, both entities remain in a weakened financial condition and may require prolonged assistance. Dodd-Frank requires the Secretary of the Treasury to conduct a study on ending the conservatorship of Fannie Mae and Freddie Mac and minimizing the cost to taxpayers. The report on this study is to be presented to Congress no later than January 31, 2011.

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 large financial institutions and other businesses, as well as guaranteed other troubled mortgage-related and financial assets. On October 3, 2010, the authority to make new investments under the TARP program expired. Treasury will, however, continue making payments for programs which have existing contracts and commitments. TARP is expected to be less costly than first thought. Treasury has recently estimated that the total cost of TARP will be about \$50 billion. As the life-cycle of TARP is maturing, Treasury's challenge in this area is morphing from standing-up and running TARP programs to winding them down. That means Treasury must now focus on managing and exiting from its current TARP investments. These investments include, but are not limited to, AIG and General Motors. In this regard, at the time of this writing, it has been reported that AIG announced a restructuring plan that will accelerate the timeline for repaying the government, and General Motors is planning an initial public offering for later this year.

EESA also established a special inspector general for TARP and imposed oversight and periodic reporting requirements on both the special inspector general and GAO.

As conditions improve, Treasury will need to continue 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 3: 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 must coordinate the efforts of these multiple entities. To this end, 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. In 2009, FinCEN had memoranda of understanding with 43 percent of federal and state regulators. While important to promote coordination and cooperation, it should be noted that 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 2009, financial institutions filed approximately 15 million BSA reports. The number is lower than 2008, which Treasury has attributed primarily due to a change in law that increased currency transaction report exemptions. FinCEN needs to work with regulators to ensure that financial institutions establish effective BSA compliance programs and file BSA reports, as required.

Adding to this risk in the current environment is that financial institutions and their regulators may have decreased their attention to BSA and OFAC program compliance as they address safety and soundness concerns during the current economic crisis. FinCEN's analysis of suspicious activity report data also found non-bank lenders and originators initiated many of the mortgages associated with suspicious activity reports filed for possible mortgage fraud. Furthermore, evidence suggests a link between mortgage fraud and money laundering. In that regard, FinCEN is considering applying anti-money laundering and suspicious activity report regulations to these non-bank institutions.

FinCEN also has a particularly difficult challenge in dealing with money services businesses (MSB). FinCEN has to balance the needs of certain consumers who depend on access to MSBs (particularly the unbanked), with potentially unfettered access to the financial system that non-transparent MSBs create for those engaged in money laundering and terrorist financing. FinCEN has been working with the IRS to ensure MSBs comply with BSA registration and report filing requirements. IRS serves as the examining agency for MSBs but does not have the resources to annually inspect all MSBs or even identify unregistered MSBs, estimated to be in the tens of



thousands. Within this framework, FinCEN has been concerned with MSBs that use informal value transfer systems and with MSBs that issue, redeem, or sell prepaid (or stored value) cards. MSBs using informal transfers have been identified in several attempts to launder proceeds of criminal activity or finance terrorism. Similarly, prepaid cards 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 suspicious activity reports on MSBs that may be inappropriately using informal transfers, when they use financial institutions to store currency, clear checks, remit and receive funds, and obtain other financial services. Also this year, FinCEN proposed revising definitions and other regulations pertaining to prepaid access to close regulatory gaps.

In September 2010, to add transparency to possible illicit wire transfer use of the financial system, FinCEN proposed a regulatory requirement for certain depository institutions and MSBs to report cross-border electronic transmittals of funds (CBETF). 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. If implemented, ensuring financial institutions, particularly MSBs, comply with the CBETF reporting requirements, as well as managing this new database, will be a significant challenge for FinCEN.

To ensure efficient management, safeguarding, and use of BSA information, FinCEN also plans to modernize BSA information management. BSA data is currently maintained by IRS and access to the database is generally handled through an IRS system known as WebCBRS. FinCEN believes modernization will provide increased data integrity and analytical tools, and maximize value for state and federal partners. BSA Information Technology (IT) Modernization is also discussed in challenge 4.

Given the criticality of this management challenge to the Department's mission, we continue to consider anti-money laundering and combating terrorist financing programs as inherently high-risk. 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 in 2010 we were limited to completing audits started years earlier. With legislated changes to the financial loss threshold for performing material loss reviews, we expect to be able to increase audit coverage of anti-money laundering and terrorist financing programs in Fiscal Year 2011.

#### **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 reported on a number of capital investment projects that either failed or had serious problems. This year, we identified challenges in 4 on-going investments, 2 of which were identified by the Office of Management and Budget (OMB) as high-risk projects.

Replacement telecommunications platform The Information Technology Infrastructure Telecommunications investment with an overall value of \$3.7 billion was rated as poorly

performing by the Acting Chief Information Officer (CIO) and a high-risk project by OMB. This investment includes the Treasury's replacement telecommunications platform, TNet, as a major component. Treasury was originally to have begun implementation of TNet in November 2007 but was delayed until August 2009 and is still in transition. Additionally, TNet does not currently incorporate all OMB security requirements, and many Treasury components have reported performance concerns with the network.

Treasury implementation of a common identity management system OMB also recognized Treasury's Consolidated Enterprise Identity Management system as a high-risk project. This system is a \$147 million effort to implement the requirements of the Homeland Security Presidential Directive 12. This directive requires deployment of a common identity standard. This initiative was identified as being more than \$40 million over budget and significantly behind schedule.

Data Center Consolidation OMB initiated the Federal Data Center Consolidation Initiative to consolidate the number of federal data centers. Treasury has over 60 data centers around the country. Treasury is currently in the planning phase of a significant effort to reduce the number of data centers by 2015. This effort would require restructuring of Treasury's IT infrastructure over a relatively short time. Relocating and consolidating data centers is a major investment that requires careful planning to address security concerns, disaster recovery, and infrastructure support.

FinCEN's BSA IT Modernization As discussed in Challenge 3, Treasury, through FinCEN, is undertaking a major project known as BSA IT Modernization. Already underway, the project is expected to cost about \$120 million. This project requires coordination between FinCEN and IRS, which has historically maintained the BSA database, and effective oversight by the Treasury Office of the CIO. A prior attempt, from 2004 to 2006, to develop a new BSA system ended in failure with over \$17 million wasted because of shortcomings in project planning, management, and oversight.

Treasury's decentralized management of IT investments presents a significant hurdle to the successful implementation of major department-wide and government-wide initiatives. Large initiatives are often tasked to individual bureaus for overall management with some direction provided by the Treasury Office of the CIO. Coordination issues between bureaus can delay and disrupt implementation of department-wide policies and systems or prevent necessary changes from proceeding. Accordingly, Treasury should exercise continuous vigilance in managing the investments described above and others due to previously reported problems with large capital investments, and billions of procurement dollars at risk.

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

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