



OFFICE OF  
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-12-001)

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.

In assessing the Department's most serious challenges, we are mindful of the budget environment being faced by Treasury and the entire federal government as the Administration and the Congress looks for ways to address the country's budget deficit. Cuts to programs and operations are likely although the extent of any cuts and the specific nature of the cuts are unknown as of this writing. With that as a backdrop, the Treasury Department has in recent years been given a number of new responsibilities that are critical to this country's sustained economic strength. More often than not, the Department has been faced with needing to start up and administer these new responsibilities with very thin staffing and resources. 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 how Treasury's programs and operations are impacted and we look forward to working with the Department leadership in this regard. We also cannot emphasize enough to the Department's stakeholders the critical importance that Treasury is resourced sufficiently to maintain an appropriate control infrastructure.

We continue to report the four challenges from last year.

- Transformation of Financial Regulation
- Management of Treasury's Authorities Intended to Support and Improve the Economy
- Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act Enforcement
- Management of Capital Investments

We are not reporting any new challenges this year. However, in addition to the above challenges, we are reporting an elevated concern about one matter, information security, and the need for constant and effective surveillance over Treasury's security posture.

## **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.

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. As required, FSOC issued its first annual report in July 2011. The report contained recommendations to (1) heighten risk management and supervisory attention in specific areas, (2) further reforms to address structural vulnerabilities in key markets, (3) take steps to address reform of the housing finance market, and (4) ensure interagency coordination on financial regulatory reform. This is an important early step, but FSOC still has work ahead to meet all of its responsibilities. For example, Dodd-Frank calls for the consolidated supervision and heightened prudential standards for large, interconnected nonbank financial companies. FSOC also has the authority to designate nonbank financial companies for consolidated supervision and to recommend heightened standards for these firms and large bank holding companies. In this regard, the Board of Governors of the Federal Reserve System would be responsible for supervising these firms and adopting specific prudential rules. As of this writing, FSOC is still in the process of establishing the framework for identifying systemically significant nonbank financial institutions. To that end, on October 11, 2011, FSOC issued a notice of proposed rulemaking that among other things, set forth a three-stage process in non-emergency situations to determine whether to subject a nonbank financial company to Board of Governors supervision and prudential standards. Each stage of the process would involve an analysis based on an increasing amount of information. FSOC did finalize the rules for implementing its authority under Dodd-Frank for designating financial market utilities<sup>1</sup> as systemically important in July of this year. Financial market utilities so designated 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.

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 will be an important source of independent, unbiased analysis to FSOC. As required, CIGFO met on a quarterly basis and issued its first annual report in July 2011. That report discussed current and pending joint projects of CIGFO members and CIGFO's conclusion that FSOC had either met or is on target to

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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 the person. However, the term does not include entities such as national securities exchanges, national securities associations, and many others.



meet all requirements to date. CIGFO has approved guidelines for the establishment and procedures of working groups. In the future, CIGFO anticipates establishing a working group to oversee the process of designating systemically important nonbank financial institutions for heightened prudential supervision by the Board of Governors.

Additionally, Dodd-Frank established two new offices within Treasury: the Office of Financial Research (OFR) and the Federal Insurance Office (FIO). The OFR is to be a data collection, research and analysis arm of FSOC. The OFR will operate under a Presidentially-appointed, Senate-confirmed Director. As of this writing, a nominee to serve as the OFR Director has not been announced. Among other things, 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 July 21, 2012. 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 of this year, is to advise FSOC on insurance matters. We are currently reviewing the Department's progress in standing up OFR and our future work plans include a review of FIO.

Intended to streamline the supervision of depository institutions and holding companies, Dodd-Frank transferred 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) effective July 21, 2011. As required by Dodd-Frank, we and the Offices of Inspector General of FDIC and the Board of Governors completed two reviews on the transfer during 2011. The first review reported on the planning for the transfer and the second review reported on the status of the transfer 6 months later. The reviews found that the planning was generally adequate and that transfer activities occurred as planned. However, we also reported on items that were still "works-in-progress." We will continue to monitor those items as part of our future reviews.

The other regulatory challenges that we discussed last year still remain. Specifically, since September 2007, 113 Treasury-regulated financial institutions have failed, with estimated losses to the Deposit Insurance Fund of approximately \$36.3 billion. This is an increase of 23 financial institutions and \$1.8 billion in losses since my last challenges letter. With more than 800 banks on FDIC's troubled bank list, we anticipate bank failures to continue into the foreseeable future.

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 failed institutions under their respective supervision. The irresponsible lending practices of many institutions are now well-recognized. At the same time, they also engaged in other high-risk activities, including high asset concentrations in commercial real estate and overreliance on unpredictable wholesale funding to fund growth. Last year, the unprecedented speed at which servicers were foreclosing on defaulted mortgages revealed flaws in the processing of those foreclosures. In response, the federal banking regulators completed a horizontal 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. While it is too soon to tell whether these servicing deficiencies have been addressed, the foreclosure crisis has certainly impacted an already stressed housing market, with no significant turnaround yet in sight.

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 42 such reviews and are engaged in 13 others. These reviews identify the causes of the failures and assess the supervision exercised. OCC has 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 44 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 continue to take a critical look at its supervisory processes to identify areas for improvement in those processes to better protect the financial health of the banking industry and consumers going forward.

In my last memorandum, I discussed the challenges Treasury faced in standing up the Bureau of Consumer Financial Protection (CFPB). I am pleased to note that since then, Treasury was successful in this effort. CFPB opened for business on July 21, 2011, as planned. Established by Dodd-Frank, the purpose of CFPB 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. CFPB is an independent bureau of the Board of Governors but Treasury has a unique role in its operations. Specifically, until a Director is appointed, you are charged with exercising some, but not all, of the Director's authorities. On July 18, 2011, the President nominated Richard Cordray to be the first Director of CFPB. That nomination is currently pending before the Senate. It should be noted that, while no specific legislation has been proposed, there is much discussion in the Congress on whether the form of governance over CFPB should be changed. The Board of Governors Inspector General is designated by Dodd-Frank to provide oversight of CFPB. However, with Treasury's current statutory role under Dodd-Frank, our office will continue to coordinate with the Board of Governors OIG 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 our economy. In order to accomplish this, Dodd-Frank has placed a great deal of responsibility within Treasury and you, as the Treasury Secretary. The management challenge from our perspective is to maintain 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 generally unpopular.



## **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 remain in managing Treasury's outstanding investments. To a large extent, Treasury's program administration under these Acts has matured. However, investment decisions involving the Small Business Jobs Act programs have only recently been completed. Our discussion of this challenge will begin with the most recent act to improve and support the economy and then discuss 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 of 2010 created a \$30 billion Small Business Lending Fund (SBLF) within Treasury and provided \$1.5 billion to be allocated by Treasury to 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 businesses, and thereby, support job creation. Both programs were slow to disburse funds to intended recipients, with Treasury approving the majority of SBLF and SSBCI applications during the last quarter of fiscal year 2011. This occurred because the majority of applicants waited to apply within weeks of the application deadlines and significant delays were encountered in implementing the SBLF program. As a result, Treasury was rushed in making a significant number of SBLF investment decisions to meet 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 will be to exercise sufficient oversight to ensure that funds are used appropriately by participants, SBLF dividends owed Treasury are paid, and that the programs achieve intended results.

SBLF As of September 27, 2011, Treasury had disbursed more than \$4 billion to 332 financial institutions across the country. Of the institutions funded, 42 percent were institutions that used their SBLF investment to refinance securities issued under the Troubled Asset Relief Program (TARP) Capital Purchase Program. Institutions receiving investments under the SBLF program are expected to pay dividends to Treasury at rates that will decrease as the amount of qualified small business lending the institution does increases. 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 their demonstrated increase in small business lending, which is self-reported by the participating institutions. The dividends are non-cumulative, meaning that institutions are under no obligation to make dividend payments as scheduled or to pay off previously missed payments before exiting the program. That said, there are provisions for increased restrictions as dividends are missed, including a prohibition against paying dividends on common stock and a provision for Treasury to appoint up to two members to the bank's board of directors. The



effectiveness of these measures, however, may be impacted if the institution's regulator has restricted it from making dividend payments.

Treasury will face many challenges in ensuring that the SBLF program meets its intended objective of increasing lending to small businesses and in measuring program performance. Under the terms of the authorizing legislation, SBLF funds are intended to stimulate lending to small businesses, but participating institutions are under no obligation to increase their small business lending activity. Once SBLF funds are disbursed and become commingled with other funds of the participating institutions, it will be difficult to track how the funds are spent. Participants are also not required to report how they use Treasury's investments. Additionally, Treasury is reliant on unverified information reported by participating institutions on their small business lending activity to measure performance and to make dividend rate adjustments.

SSBCI As of September 27, 2011, 53 states, territories, and eligible municipalities (participating states) had applied for \$1.5 billion in SSBCI funding. Of the 53 participating states, 31 had received their first funding allocations of approximately \$0.3 billion. Under SSBCI, participating states may obtain funding 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 guaranties, venture capital funds, and collateral support. If a state does not have an existing small business lending program, it can establish one in order to access SSBCI funding. States must provide Treasury with plans for using their funding allocations for review and approval, and report quarterly and annually on results. Another key feature is that participating states receive their allocations in one-third increments. Treasury may withhold a successive increment to a state pending the results of an audit by our office.

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 are in compliance with program requirements. However, Treasury will face challenges in holding states accountable for the proper use of funds as it has not clearly defined the oversight obligations of states or specified minimum standards for determining whether participating states have fulfilled their oversight responsibilities. Treasury has also not required participating states to collect and review compliance assurances made by lenders and borrowers or defined what constitutes a material adverse change in a state's financial or operational condition that must be reported 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 Fund, economic recovery payments to social security beneficiaries and others, and payments to U.S. territories for distribution to their citizens.

Several of these programs 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 approximately \$13 billion under these programs. Payments made to recipients under the specified energy property program alone comprise more than \$9 billion of the funds awarded to date and the number of applicants is expected to grow with the program's application deadline now extended through fiscal year 2012. We previously reported that Treasury dedicated only a small number of staff to award and monitor these funds. It did, however, implement a process for the specified energy property program whereby the Department of Energy's National Renewable Energy Laboratory performs a technical review of payment applications and advises Treasury on award decisions. For larger dollar payments, Treasury also requires the applicant to obtain a review of project costs by an independent public accounting firm. We conducted 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 and have found some questionable claims involving several million dollars in total. We plan to continue our audits of recipients in fiscal year 2012 and will report any major instances of program abuse as necessary.

#### 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 as necessary, and as of June 30, 2011, invested \$164 billion in the two entities. Treasury also purchased \$225 billion of mortgage-backed securities (MBS) issued by the two entities under a temporary purchase program that expired in December 2009. In March 2011, Treasury began to wind down its MBS portfolio and has steadily reduced the portfolio by about \$10 billion a month. As of September 2011, Treasury received proceeds of \$64 billion through sales of its MBS and \$118 billion in principal repayments. So far, over the life of its investment, Treasury has earned \$20 billion in interest. The remaining principal outstanding is approximately \$60 billion. 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, the future of both entities is still in question and prolonged assistance may be required. On a positive note, Freddie Mac did report positive net worth in the second quarter of 2011, the first positive quarter since 2009. Accordingly, there was no increase to Treasury's senior preferred stock investment in Freddie Mac.

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. The legislative process for housing finance reform is in an early stage and it is difficult to predict what lies ahead for winding down the Fannie Mae and Freddie Mac conservatorships and reforming housing finance in the long run.

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. Treasury's challenge in this area has changed from standing-up and running TARP programs to winding them down and recovering its investment. That means Treasury's focus is on managing and exiting from its current TARP investments. To date, Treasury has reported positive returns from the sale of its investments in the banking industry and has begun reducing its investment in American International Group (AIG). EESA also established a special inspector general for TARP and imposed oversight and periodic reporting requirements on both the special inspector general and Government Accountability Office.

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.

#### 2012 Pending Initiatives

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, the Community Development Financial Institutions Fund is tasked with setting regulations and implementing the program by September 27, 2012. Our office plans to assess the progress of the program's implementation in 2012.

Included in the President's legislative proposal, "The American Jobs Act of 2011," is a provision establishing the American Infrastructure Financing Authority (AIFA), as a wholly owned Government Corporation, that would provide direct loans and loan guarantees to facilitate infrastructure projects that are both economically viable and of regional or national significance. The proposed aggregate amount of direct loans and loan guarantees made by AIFA in any single fiscal year may not exceed (1) \$10 billion during the first 2 years of operations; (2) \$20 billion during years 3 through 9 of operations; or (3) \$50 billion during any year thereafter. Although not a Treasury program, the legislation calls for Treasury to assist in implementing AIFA and in carrying out its purpose. Under the proposal, our office would provide oversight of AIFA for the first 5 years and thereafter the oversight would be provided by a Presidentially-appointed, Senate-confirmed special inspector general. Given the potential implications to our office, we will monitor the Congress's consideration of the proposal and respond appropriately.

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

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. Following the terrorist attacks of 2001, Treasury established the Office of Terrorism and Financial Intelligence (TFI). 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. The Financial Crimes Enforcement Network (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, the Internal Revenue Service (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, Treasury has entered into memoranda of understanding with many federal and state regulators in an attempt to build a consistent and effective process. As of last year, FinCEN had signed memoranda of understanding with 7 federal and 51 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 15 million BSA reports, including over 1.3 million suspicious activity reports. While the number of suspicious activity reports has been increasing since 2001, the numbers alone do not necessarily indicate everything is going well. Audits we have done 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. 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 still 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.

BSA data is currently maintained by IRS and access to the database is generally handled through an IRS system known as WebCBRS. FinCEN's BSA Information Technology (IT) Modernization program, begun in 2008, is being built to ensure efficient management, safeguarding, and use of BSA information. BSA IT Modernization 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. This program, which we believe is needed, has yet to reach a point of broad-based integration testing and is highly dependent on continued funding, a challenge for many programs today. The BSA IT Modernization project is also discussed in challenge 4.

FinCEN is mandating the use of its BSA E-Filing network starting in June 2012. 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 and IRS will need to continue to monitor data quality. Last year we noted that FinCEN has a particularly difficult challenge in dealing with MSBs. FinCEN has taken steps to improve MSB examination coverage and compliance. In the past year, FinCEN has 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 and IRS 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 suspicious activity reports 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. This past summer, FinCEN issued a final rule applying customer identification, recordkeeping, and reporting obligations to providers and sellers of prepaid access. Ensuring compliance with these rules 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, will be another significant challenge for FinCEN. It should be noted that this system cannot be fully implemented until FinCEN completes its work on its BSA IT Modernization project, 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. Mandatory work, particularly material loss reviews of failed banks, prevented us from starting any new audits in this area in fiscal years 2009 and 2010. In fiscal year 2011, we initiated audits of the MSB compliance program, the BSA IT Modernization project, and OFAC licensing (a program that allows exceptions to sanction programs upon OFAC's legal review and approval), which we plan to complete in fiscal year 2012.



#### **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. As a new development, after several years of attempting to centrally manage large infrastructure investments at the Department level, Treasury has announced that it will de-consolidate all infrastructure investments to the bureaus. This move is intended to improve efficiency and transparency, cost savings and avoidance, and overall governance.

In prior years, we reported on a number of capital investment projects that either failed or had serious problems. This year, we continue to identify challenges with ongoing IT investments.

Replacement telecommunications platform Treasury plans to spend \$3.7 billion on 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. While TNet has become operational across Treasury, it is not yet fully compliant with Federal security requirements, and issues with change requests, incident response, and contractor billings need to be addressed.

Common identity management system The Treasury Enterprise Identity, Credential and Access Management (TEICAM) is a \$147 million effort to implement Homeland Security Presidential Directive 12 requirements for a common identity standard. As of August 2011, Treasury reported that the system was \$40 million over planned costs.

Data center consolidation OMB initiated the Federal Data Center Consolidation Initiative to reduce the number of federal data centers. In this regard, Treasury had over 60 data centers around the country. During fiscal year 2011, Treasury closed 3 data centers. This was accomplished in part by the Financial Management Service and the Bureau of the Public Debt consolidating their infrastructure and data center operations. Treasury plans to close another 12 data centers by 2015. Its ability to successfully consolidate data centers and achieve budget savings is contingent on adapting shared infrastructure services.

FinCEN 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 and is expected to be completed in 2014. The project has yet to undergo broad-based integration testing, is complicated, and will require continued coordination between FinCEN and IRS. 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. However, early indications from our audit work are that project management is much improved for this project.



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. Moreover, it remains to be seen whether Treasury's decision to de-consolidate all infrastructure investments will improve efficiency and transparency, cost savings and avoidance, and overall governance as intended. We plan to assess the results of this change in managing Treasury's infrastructure investments going forward.

**Matter of Concern**

Although we are not reporting this as a management and performance challenge, we want to highlight an area of increasing concern -- information security.

We reported information security as a serious management and performance challenge at Treasury for a number of years but removed the challenge in 2009. We did so because Treasury had made significant strides in improving and institutionalizing its information security controls, as was evident from our annual Federal Information Security Management audits and evaluations. We believe that remains the case today. However, notwithstanding Treasury's strong security stance, cyber attacks against federal government systems by foreign governments and the hacker community are unrelenting and increasing. Treasury's information systems are critical to the Nation, and thus potential targets of those wishing to do grave harm. Accordingly, this is a very troubling situation that requires the highest level of continual attention to ensure, as we said when we removed the challenge, that information security 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