



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

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OFFICE OF
INSPECTOR GENERAL

INFORMATION MEMORANDUM FOR SECRETARY LEW

FROM:

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Inspector General

SUBJECT:

Management and Performance Challenges Facing the
Department of the Treasury (OIG-CA-14-004)

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 two factors affecting Treasury. The first, which we reported last year, is the sluggish economic recovery despite the efforts of the Administration and Congress. The second is the Nation's budget deficit. In my memoranda for each of the last 2 years, we acknowledged that in looking for ways to address the deficit, cuts to programs and operations were likely although the extent and specific nature of any cuts were unknown. This situation remains the same today. The results of the last national election brought little clarity to the direction the Federal Government will take in addressing these matters, as evidenced by the recent government shutdown and the uncertainties surrounding the future debt ceiling debate. While a significant number of issues related to the future of programs like Social Security and Medicare have once again been put off, problems would be exacerbated if the Government were to default on its obligations. The polarized political environment in which the Federal Government has been operating since 2010, with the repeated cycle of budget and debt ceiling stopgaps, has resulted in more waste and inefficiency. At the same time, more incidents of imprudent use of funds, such as certain conference spending by the General Services Administration, Internal Revenue Service, and the Department of Veterans Affairs, were brought to light. While the Department has implemented strong controls over spending for things like conferences, it is imperative that senior leaders and front-line managers remain ever vigilant when spending the funds that have been entrusted to them.

As I have also noted previously, Treasury has, in recent years, had to administer additional responsibilities intended to support and improve the country's economy. To do so, in nearly every case, the Department had to start up and administer these new responsibilities with thin staffing and resources. That situation remains the case. 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, which are repeated from last year.

- Continued Implementation of Dodd-Frank (in our prior year memorandum, we referred to this challenge as “Transformation of Financial Regulation” but have renamed it as many aspects of Dodd-Frank Wall Street Reform and Consumer Protection Act have been implemented and are maturing)
- Management of Treasury’s Authorities Intended to Support and Improve the Economy
- Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act Enforcement
- Gulf Coast Restoration Trust Fund Administration

In addition to the above challenges, we are continuing to report our elevated concerns about three matters – cybersecurity, currency and coin production, and the need to document key activities and decisions. We close our memorandum this year with observations about the Bureau of the Fiscal Service (Fiscal Service) and its Do Not Pay Initiative.

2013 Management and Performance Challenges

Challenge 1: Continued Implementation of Dodd-Frank

In response to the need for financial reform, Congress passed Dodd-Frank in July 2010. Among other things, 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 and its Federal agency members must continue to work in order to meet all of FSOC’s responsibilities. That said, FSOC accomplished much over the last year. For example:

Annual reporting – As required, FSOC issued its third annual report in July 2013. The report contained recommendations to (1) further reforms to address structural vulnerabilities in key markets, (2) take steps to address reform of the housing finance market, (3) identify alternative interest rate benchmarks, (4) heighten risk management and supervisory attention in specific areas, (5) monitor the impact of the low interest rate environment, (6) ensure enhanced capital planning and robust capital for financial institutions, and (7) ensure implementation and coordination on financial regulatory reform.

Designation of nonbank financial institutions for consolidated supervision – FSOC designated two companies for additional supervision by the Board of Governors of the Federal Reserve System (FRB) in July 2013. After considering an appeal, FSOC designated one additional company in September 2013. FSOC continues to review other nonbank financial institutions for potential designation.

Money Market Reform – In November 2012, FSOC issued for public comment proposed recommendations to the Securities and Exchange Commission (SEC) to address the structural susceptibility of money market funds to investor runs. FSOC’s proposed recommendations state that if SEC moves forward with meaningful structural reforms of

money market funds before FSOC finalizes its recommendation, FSOC expects not to issue a final recommendation. In this regard, SEC posted a money market fund reform proposal in the Federal Register on June 19, 2013, with comments due by September 17, 2013.

Risk Monitoring and Regulatory Coordination – FSOC has considered issues such as sovereign fiscal developments in Europe and the U.S., the multi-billion dollar trading losses by JPMorgan Chase, the state of mortgage foreclosures in the U.S., the failure of MF Global, the impact of Superstorm Sandy on financial markets, weaknesses in the setting process of the London Interbank Offered Rate (LIBOR),¹ and risks to financial stability arising from cybersecurity vulnerabilities. To facilitate this risk monitoring process, FSOC established the Systemic Risk Committee which serves as a forum for member agency staff to identify and analyze potential risks that may extend beyond the jurisdiction of any one agency.

The Council of Inspectors General on Financial Oversight (CIGFO), also established by Dodd-Frank and which I chair, 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 third annual report in July 2013. CIGFO also established its second Working Group in January 2013. The Working Group assessed the rules, procedures, and practices established by FSOC and its members to determine which financial market utilities (FMU)² should be designated as systemically important. The Working Group determined that FSOC carried out the designation activities as established by Dodd-Frank and the FSOC FMU Committee carried out its activities in the designation process as intended by FSOC. However, the Working Group noted that the FMU Committee did not have a designated chairperson and did not keep records of its meetings. Also, the Working Group found that FSOC continues to evaluate whether to consider for designation foreign-based FMUs: retail FMUs; or payment, clearing, and settlement activities conducted by financial institutions, but had not made any such designations at the time of the review. In addition, the Working Group found FSOC relied on the respective regulators of the designated FMUs to monitor their activities and report updates to FSOC. However, there was no agreement or process established in writing by FSOC that defined the nature, frequency, and communication of such updates. The Working Group's July 2013 report made five recommendations to FSOC to address these matters. Going forward, CIGFO will continue to review FSOC operations and its efforts to oversee the U.S. financial system.

¹ LIBOR is the interest rate at which banks can borrow unsecured funds from other banks in London wholesale money markets, as measured by daily surveys of the British Bankers' Association. LIBOR is used to set rates on mortgages, student loans, car loans, credit cards, and some complex financial derivatives.

² FMUs are systems that provide the essential infrastructure for transferring, clearing, and settling payments, securities, and other financial transactions among financial institutions or between financial institutions and the system. FSOC may designate an FMU as systemically important under Title VIII of Dodd-Frank if a failure or a disruption to the functioning of the FMU could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the U.S. financial system.

Dodd-Frank also established two offices within Treasury: the Office of Financial Research (OFR) and the Federal Insurance Office (FIO).³ OFR is the data collection, research and analysis arm of FSOC. Last year, we reviewed the stand-up of OFR. In our report on that review, we noted among other things that OFR had not yet developed performance measures for the office. We are currently conducting a review to assess the design and implementation of performance measures by OFR. 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. We are currently reviewing the stand-up of FIO. We do note, however, that FIO has not completed or submitted two reports required by Dodd-Frank.

1. A report on how to modernize and improve the system of insurance regulation in the U.S. – Due 18 months after enactment (January 27, 2012), now late by nearly 22 months
2. A report describing the breadth and scope of the global reinsurance market and the critical role such a market plays in supporting insurance in the U.S. – Due September 30, 2012, now late by nearly 14 months

The other regulatory challenges that we discussed last year still remain. Specifically, since September 2007, 130 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 \$36.1 billion. While we expect that bank failures will continue, we note the number of failures has dramatically decreased since 2010. Unless there is an unanticipated significant disruption to the financial markets, the rate of bank failures should remain low. Although many factors contributed to the economic crisis, 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 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 and, as a result, the federal banking regulators issued formal enforcement actions against 14 mortgage servicers and 2 third-party providers subject to the review. Among other things, the enforcement actions required the servicers to implement an independent foreclosure review (IFR) process using independent consultants to determine financial injury to affected borrowers. We reviewed OCC's oversight of the servicers' efforts to comply with the enforcement actions. We found that OCC had developed a framework to monitor the servicers' efforts and oversee the foreclosure review process. However, we found areas where OCC oversight needed strengthening. Specifically, OCC had not performed comprehensive direct testing of individual independent foreclosure reviews to assess whether independent consultants were performing the reviews objectively, consistently, and in compliance with OCC guidance. In addition, improvements were needed in the

³ Dodd-Frank also established two other offices within Treasury – the Offices of Minority and Women Inclusion (OMWI) at Departmental Offices and at the Office of the Comptroller of the Currency. We are currently conducting a review of OMWI at Departmental Offices.

documentation of various aspects of OCC oversight.⁴ Subsequent to our review, OCC negotiated a change to the terms of the enforcement actions with 11 of the 12 servicers under OCC supervision because the foreclosure reviews were taking longer than anticipated and delaying compensation to affected borrowers. We are currently reviewing OCC's oversight of the servicers' compliance with the amended enforcement actions.

As we have stated 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 with Treasury and with the Secretary. This management challenge from our perspective is to maintain an effective FSOC process supported by OFR and FIO within Treasury and to build a streamlined banking regulatory structure that timely identifies and appropriately responds to emerging risks. This is especially important in times of economic growth and financial institution profitability, when such government action is generally unpopular. As the regulatory framework prescribed by Dodd-Frank is institutionalized and matures, we will reassess our reporting of it as a management challenge in future years..

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

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. As we stated last year, to a large extent Treasury's program administration under these acts has matured, but challenges remain in managing Treasury's programs and its outstanding investments. Additionally, the long-term impact on small business lending resulting from investment decisions under Small Business Jobs Act programs is 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 within Treasury a \$30 billion Small Business Lending Fund (SBLF) to assist financial institutions 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 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 is to exercise sufficient oversight to ensure that

⁴ Office of Inspector General (OIG), *Safety and Soundness: Improvement Needed in OCC's Oversight of Foreclosure Related Consent Orders* (OIG-13-049; Sep. 9, 2013)

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, approximately 41 percent used SBLF funds to refinance securities issued under the Troubled Asset Relief Program's 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 already 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. Further, although participating institutions must report their small business lending activity, there is no way to isolate the impact of SBLF from other factors that could affect lending to determine program impact. Once participating institutions commingle SBLF disbursements with other funds, it is difficult to track how the funds are used. Additionally, Treasury does not verify that small business lending reported by participating institutions meet SBLF requirements and should be included when measuring performance and making dividend rate adjustments.

SSBCI – As of September 30, 2013, Treasury had disbursed approximately \$912 million of the \$1.4 billion in SSBCI funding awarded to 56 participating states, territories, and municipalities. Treasury disburses the funds in thirds, with each successive third transferred after a state certifies that it has used 80 percent of its last transfer. States have been slow to use their SSBCI funding as many either had to establish small business lending programs to be able to use their funds and/or redirect funds transferred midstream to better performing programs than those originally designated.

Primary oversight of the use of SSBCI funds is the responsibility of each participating state. The states 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 must report quarterly and annually on their use of funds and certify quarterly 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 what is prohibited and has frequently changed program guidelines, making it difficult for states to ensure the proper use of funds. Treasury also has not appropriately addressed how self-reported, non-compliant transactions will be remedied. Current program guidance suggests that if a state self-reports a misuse of funds, the funds are not subject to an OIG audit or recoupment. As a result, Treasury will have difficulty finding states to be in default of program requirements and holding them accountable.

Management of Recovery Act Programs

Since the Recovery Act was enacted in 2009, Treasury has been responsible for overseeing an estimated \$150 billion of funding and tax relief for programs that provided payments for specified energy property in lieu of tax credits and 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. While funding for non-Internal Revenue Service (IRS) programs is coming to a close, Treasury must continue to oversee approximately \$25 billion 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. That is, management must continue to ensure award compliance of approximately 93,000 recipients over an extended period of time (5 years from the date of award for the specified energy properties and 15 years from the date of award for low-income housing projects). Additionally, our Office of Investigations had several open matters involving claims for low-income housing projects and specified energy properties.

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 supported the financial solvency of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), which continue to operate 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 purchased senior preferred stock, and as of September 30, 2013, invested \$187 billion in the two GSEs. Although the GSEs did not require Treasury's support in fiscal year 2013, their futures are still uncertain and further assistance may be required. If such support is needed, the current funding capacity available to Fannie Mae is \$117.6 billion and available to Freddie Mac is \$140.5 billion.

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 as of September 30, 2013, holds an investment of approximately \$9.3 billion. Additionally, several state and local housing agencies opted out of the Temporary Credit and Liquidity Program reducing Treasury's commitment to about \$2.0 billion. Treasury must continue to monitor the underlying assets of its investment in the Housing Finance Agency Initiative to ensure the accuracy of mortgage principal, interest, and fees collected.

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 the Congress in February 2011.⁵ Regarding the long-term structure of housing finance, the report provided three options for increased privatization without recommending a specific option. Since this report, other legislation has been proposed in the Congress to address housing finance reform, but a legislative solution that all can agree on is still in a formative stage. Accordingly, it is difficult to predict what lies ahead for winding down the Fannie Mae and Freddie Mac conservatorships and reforming housing finance.

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 establishing regulations and implementing the program by September 27, 2012. CDFI Fund experienced challenges in standing up the program and missed the program's statutory implementation date. The program, along with regulations, was eventually established in June 2013. Treasury received guarantee authority of \$500 million in fiscal year 2013, and as of September 30, 2013, guaranteed \$325 million of bonds to be issued in fiscal year 2014. The guarantee program is authorized through fiscal year 2014. As with any new program, successful implementation will depend on a strong internal control structure and senior management involvement and support at the front end. Our office plans to assess the CDFI Fund's administration of this program in 2014.

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. 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

⁵ Department of the Treasury and the Department of Housing and Urban Development, *Reforming America's Housing Finance Market - A Report To Congress* (Feb. 2011)

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 the USA Patriot Act. The Financial Crimes Enforcement Network (FinCEN) is the Treasury bureau responsible for administering BSA.

Over the past decade, TFI has made progress 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 to ensure 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 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).

Neither FinCEN nor OFAC have the resources or capability to maintain compliance with their programs without significant help from these other organizations. Accordingly, to be effective, Treasury must establish and maintain working relationships with these entities. To this end, FinCEN signed memoranda of understanding with 73 federal and 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.

In light of these challenges, in November 2012, the Department established a new anti-money laundering (AML) task force composed of federal policymakers, regulators, and law enforcement agencies to examine and strengthen the U.S. AML framework. The objective of the task force was to develop recommendations to address any gaps, redundancies, and inefficiencies in the legal and regulatory foundation, examination function, and enforcement efforts of the AML framework. During 2013, the AML task force was in the early stages of data gathering and analysis.

Last year, financial institutions filed approximately 18.7 million BSA reports, including nearly 1.8 million suspicious activity reports (SAR). While the number of SARs has been increasing since 2001, that alone does not necessarily indicate everything that 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.

More recently, vulnerabilities in certain very large institutions' monitoring of transactions for money laundering and terrorist financing were revealed. For example, in 2013, OCC filed a consent cease and desist order against JP Morgan Chase and Company for critical deficiencies found in its BSA program with respect to submitting SARs, monitoring transactions, conducting customer due diligence and risk assessment, and implementing adequate systems of internal controls and independent testing. Also, as a result of a critical congressional report on OCC's oversight of HSBC's BSA program in July 2012, the Comptroller of the Currency has taken

actions to enhance its supervision of BSA compliance. These include issuing a supervisory memorandum instructing examiners to consider BSA/AML examination findings in a safety and soundness context when assigning the “management” component of a bank’s CAMELS rating.⁶ OCC also plans to issue guidance for examiners to cite violations when a bank fails to meet any one of the statutory minimum requirements for a BSA/AML program.⁷ In addition, OCC created a large bank review team, a Major Matters Supervision Review Committee, and an internal bank supervision appeals program for its examiners. OCC took these actions in an effort to ensure that OCC takes timely actions for financial institutions with multiple Matters Requiring Attention⁸ or BSA/AML program violations.

FinCEN needs to continue its efforts with regulators and examining agencies to ensure that financial institutions establish effective BSA compliance programs and file accurate and complete BSA reports. 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, and real estate closing and settlement services, as well as financial services intermediaries, such as investment advisors.

FinCEN also faces the continuing challenge to enhance financial transparency to strengthen efforts to combat financial crime. One area that has FinCEN’s attention is clarifying and strengthening customer due diligence requirements and associated supervisory expectations. This includes a possible requirement that institutions 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’s BSA Information Technology (IT) Modernization Program, which began in 2008 and is scheduled for completion in 2014, is being built to ensure efficient management, safeguarding, and use of BSA information. On a positive note, we completed four audits of the program pursuant to a Congressional directive in which we concluded that FinCEN is generally meeting schedule and cost milestones, and had an appropriate oversight structure in place. As a result of a 2013 reorganization, FinCEN did redefine some requirements and priorities. As the program moves closer to completion, FinCEN plans to engage users to address their concerns and suggested enhancements. FinCEN also plans to ensure that users are adequately trained to use the new system.

⁶ Federal banking agencies use the CAMELS rating system to evaluate the soundness of financial institutions on a uniform basis and to identify institutions requiring special supervisory attention or concern. A financial institution is assigned a composite rating based on 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.

⁷ At a minimum, a BSA program must reasonably provide (1) a system of internal controls, (2) independent testing, (3) the designation of individual(s) responsible for managing the BSA program, and (4) the training of appropriate personnel.

⁸ Matters Requiring Attention are practices that (1) deviate from sound governance, internal control, and risk management principles, which may adversely impact the bank’s earnings or capital, risk profile, or reputation, if not addressed; or (2) result in substantive noncompliance with laws and regulations, internal policies or processes, OCC supervisory guidance, or conditions imposed in writing in connection with the approval of any application or other request by a bank.

We note that FinCEN continues to have a 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 an ongoing challenge. Furthermore, while IRS serves as the examining agency for MSBs, it has limited resources to inspect MSBs or 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 means (cards or other devices) or non-physical means (codes, electronic serial numbers, mobile identification numbers, or personal identification numbers). 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 continuing 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 Modernization Program.

Other matters of concern are on the horizon. One 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 make sure that providers of these services ensure transactions conform to BSA requirements. Monitoring the transactions of tomorrow may prove to be increasingly difficult for Treasury. In this regard, in March 2013, FinCEN issued guidance

on virtual currencies⁹ and regulatory responsibilities to provide clarity for businesses and individuals engaged in this expanding field of financial activity. FinCEN's rules defined certain businesses or individuals which use convertible virtual currencies or make a business of exchanging, accepting, and transmitting them as MSBs. MSBs have registration requirements and a range of anti-money laundering, recordkeeping, and reporting responsibilities under FinCEN's regulations.

Given the criticality of this 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 programs for MSB compliance and for information sharing under section 314 of the USA Patriot Act, FinCEN's and OFAC's use of Reports of Blocked Transactions as SARs, and OCC's BSA and USA Patriot Act examinations and enforcement actions. We are also reviewing OFAC's 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 2014.

Challenge 4: Gulf Coast Restoration Trust Fund Administration

In response to the *Deepwater Horizon* oil spill, Congress enacted 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. The funds are to be distributed for environmental and economic restoration activities affecting the Gulf Coast states (Alabama, Florida, Louisiana, Mississippi, and Texas). While the total amount that will eventually be deposited into the Trust Fund is unknown at this time, estimates range from \$5 billion to \$21 billion. The Trust Fund has already received a deposit of approximately \$323 million, part of a \$1 billion settlement with the Transocean defendants. Litigation is ongoing with other defendants.

Under the RESTORE Act, money from the Trust Fund is allocated as five components:

- Direct Component (35 percent) – administered by Treasury for allocation in equal shares to the Gulf Coast states for ecological and economic restoration of the Gulf Coast region
- Council-selected Restoration Component (30 percent) – administered by the Gulf Coast Ecosystem Restoration Council¹⁰ for allocation to Gulf Coast states and federal agencies, pursuant to a comprehensive plan approved by the council, to undertake projects and

⁹ Bitcoins are an example of a virtual currency. These consist of a series of numbers created automatically on a set schedule and traded anonymously between digital addresses or "wallets." Certain exchange firms buy or sell Bitcoins for legal tender at a rate that fluctuates with the market. Congress and regulators continue their efforts to determine the legality, legitimacy, and regulatory framework for virtual currencies such as Bitcoins.

¹⁰ The Gulf Coast Ecosystem 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.

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, and coastal wetlands

- Spill Impact Component (30 percent) – administered by the Gulf Coast Ecosystem Restoration Council for allocation to the Gulf Coast states for eligible oil spill restoration activities, pursuant to the council's approval of the states' plans to improve the ecosystems or economy of the Gulf Coast region, using a regulatory formula
- National Oceanic and Atmospheric Administration (NOAA) Science Program Component (2.5 percent) – administered by NOAA for its Gulf Coast Ecosystem Restoration Science, Observation, Monitoring, and Technology Program. This program is 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
- Centers of Excellence Research Grants Program Component (2.5 percent) – administered by Treasury for allocation in equal shares to the Gulf Coast states 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 funds will be distributed and gives the Secretary of the Treasury the authority to withhold funds if certain conditions in the Act are not met, including the following of procurement rules and regulations.

The RESTORE Act gives Treasury many responsibilities. The act also 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. What makes the administration of the RESTORE Act so challenging is that (1) regulations and associated policies and procedures need to be established and put into place before the receipts of the Trust Fund can be used; (2) the numerous entities and councils that are to receive and further allocate funding are still establishing their own policies and procedures; and (3) the need for cooperation and coordination by these entities and councils to ensure funds are spent in an appropriate manner.

Treasury was required, in consultation with the Departments of the Interior and Commerce, to develop policies and procedures to administer the Trust Fund by January 2, 2013. Treasury's Office of the Fiscal Assistant Secretary published the draft procedures, in the form of regulations, in the Federal Register for comment on September 6, 2013; over 8 months after the procedures were to be finalized. We have been meeting with the Fiscal Assistant Secretary's staff and providing our perspectives on controls as the procedures to administer the Trust Fund are being developed. We are also actively engaged in coordinating with affected federal, state, and local government entities to ensure effective oversight of programs established by the act.

Matters of Concern

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

Cybersecurity

Treasury's systems are interconnected and critical to the core functions of government and the Nation's financial infrastructure. Cybersecurity remains a constant area of concern and potential vulnerability for Treasury's internal systems. Our audits in this area have found deficiencies across Treasury in the areas of vulnerability and patch management, password management, system security configurations, and users' susceptibility to social engineering attacks. In addition, cyberthreats continue to grow and are increasingly more sophisticated, posing an ongoing challenge to the confidentiality, integrity, and availability of systems. Accordingly, Treasury management must continuously monitor Treasury's systems for vulnerabilities and ensure all employees and others connected to those systems maintain a heightened awareness of their roles in protecting these critical assets.

The cyber attacks facing banking institutions continue to evolve at an accelerated rate, ranging from distributed denial of service attacks on bank websites to phishing attacks to fraudulent wire payments. Organized hacking groups leverage known and new vulnerabilities and use different methods to make attacks hard to detect and even harder to prevent. Criminal groups and nation-states are constantly seeking to steal information, commit fraud, disrupt, degrade, or deny access to information systems that can strain bank resources and cause financial, operational, or reputational harm. A successful, widespread attack on the banking industry would shake confidence in the banking system.

As a result, an economic and national security challenge for which Treasury must be prepared is providing leadership to financial institutions in particular, and the financial sector in general, to strengthen awareness and preparedness against cyberthreats. Given the evolving environment, Treasury will need to continue to strengthen partnerships and coordination among law enforcement, financial institutions, regulators, and private entities in the financial sector, to address these threats.

Currency and Coin Production

On October 8, 2013, after a 1½ year delay, FRB began supplying financial institutions with the redesigned, NexGen \$100 Note that incorporates new security features to deter counterfeiters and help businesses and consumers tell whether a note is genuine. The original scheduled introduction of this new note, in February 2011, was missed after creasing was detected in some of the finished notes. In January 2012, we reported on deficiencies with the Bureau of Engraving and Printing (BEP) 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 printed in 2010 but not accepted by

FRB. The notes now being supplied to banks were produced after the production problems with the 1.4 billion notes were identified and sufficiently resolved; BEP and FRB still need to decide on a course of action for the 1.4 billion finished notes, which are currently held in BEP vaults.

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, several methods were discussed that Treasury plans to use to provide such access. Among them, the inclusion of raised tactile features and high-contrast numerals that would help distinguish denominations of U.S. currency notes. The lessons learned with the NexGen \$100 Note production process underscore the need for sound and comprehensive project management as BEP undertakes this redesign effort.

Challenges continue to exist with coin production. For example, the cost of producing penny and nickel coins were double their face value because metal prices have resulted in higher production costs for the past 7 years. To meet the demands of managing a retail business, the U.S. Mint has also identified the need to replace its 12-year old Integrated Retail Information System with a new e-commerce system which fully integrates order management.

In the 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. Accordingly, it is 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

In last year’s letter I cited two audits by my office that 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 mortgage backed securities. The other audit involved Treasury’s consultative role with the Department of Energy’s Solyndra loan guarantee. More recently, as mentioned in Challenge 1, we found that documentation of OCC’s oversight of foreclosure-related consent orders was lacking.¹¹ Maintaining proper documentation is a fundamental tenet of government accountability and transparency. Maintaining proper documentation is also in the best long-term interest of Treasury and its component offices and bureaus if actions are later questioned, as they have been. 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. Also adding to the documentation challenge is the fact that federal retirements along with the associated institutional knowledge in this last year are markedly higher. Accordingly, it becomes even more important that actions and their context are documented for reference. We do note that Treasury has issued policy that addresses documentation requirements, such

¹¹ OIG, *Safety and Soundness: Improvement Needed in OCC’s Oversight of Foreclosure Related Consent Orders* (OIG-13-049; issued Sep. 9, 2013)

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.

In my memorandum last year, we reported on risks associated with the consolidation of the former Financial Management Service and the former Bureau of the Public Debt into Fiscal Service, noting that comprehensive planning and the involvement of senior management were key. Fiscal Service has now been stood up for over a year although certain planned restructuring of functions and employee relocations are delayed (along with the anticipated cost savings) in response to Congressional concerns about the impact to Treasury's Maryland operations. I want to close this year with a comment about the Fiscal Service Do Not Pay Initiative. In light of the continuing and unacceptable problem of improper payments (estimated at \$108 billion for fiscal year 2012 alone) and the extreme pressures on the federal budget, the Federal Government has intensified efforts to reduce improper payments in major federal programs. The Do Not Pay Initiative is a chief component of these efforts. In August 2013, pursuant to the Improper Payments Elimination and Recovery Improvement Act of 2012, the Office of Management and Budget (OMB) issued guidance, "Protecting Privacy while Reducing Improper Payments with the Do Not Pay Initiative." The OMB guidance details Treasury's responsibilities, which include hosting a working system for the Do Not Pay Initiative that allows agencies to perform pre-award eligibility, prepayment, and post-payment reviews. Other Treasury responsibilities include entering into computer matching agreements, developing memoranda of understanding with agencies, ensuring records are complete, accurate, and current, complying with the Privacy Act, and periodically reporting to OMB. This will be a major and important undertaking by Fiscal Service and Treasury. We have audit work under way in this area and look forward to working with the Department in our oversight role to ensure the success of Do Not Pay.

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. Coloretti
Assistant Secretary for Management