Annual Report of the Council of Inspectors General on Financial Oversight

July 2013

Message from the Chair

Three years after the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Financial Stability Oversight Council (FSOC) continues to implement the law to ensure U.S. financial system stability. At the same time, the Council of Inspectors General on Financial Oversight (CIGFO) continues to monitor FSOC activities, share information on financial oversight at each CIGFO member agency, and conduct audits of FSOC operations. This year, CIGFO completed a review of the FSOC's designation of financial market utilities (FMU).

During the last year CIGFO worked with experts outside of the inspector general community to gain additional perspectives on the impact that regulatory reform is having on the stability of financial institutions and markets. For example, the Honorable Sheila Bair, former Federal Deposit Insurance Corporation Chair shared her thoughts with CIGFO members on the implementation of financial reform and how the government can enhance the safety and soundness of the financial system.

In July 2012, FSOC, under its Dodd-Frank Act authority, designated eight FMUs as systemically important. The law authorizes the FSOC to designate an FMU as systemically important if it determines that the failure or a disruption to the functioning of the FMU could create or increase risk throughout the financial system. FMUs designated as systemically important are then subject to enhanced risk management requirements and enhanced supervision.

Once the FSOC completed its work, CIGFO established a Working Group to audit the methods the FSOC used to make decisions on which FMUs to designate. The Working Group found that the processes and procedures used to designate the eight FMUs complied with Title VIII of the Dodd-Frank Act. That said, among the things the Working Group reported was that during the designation process, the FSOC identified certain foreign-based FMUs as potential candidates for designation but decided not to pursue possible designation at the time pending further deliberations. Furthermore, the Working Group made the observation that the FSOC has not defined the nature, frequency, and communication of updates on designated FMUs by the FMU regulators, or established a timeline for periodic reviews of non-designated FMUs that may be systemically important. In a written reply to the report, the FSOC identified commitments and planned actions that were responsive to the Working Group's five recommendations.

In the coming year CIGFO will continue to monitor the processes by which the FSOC member agencies and the Office of Financial Research collect and use information to determine financial system vulnerabilities and protect institutions and markets from serious disruption.

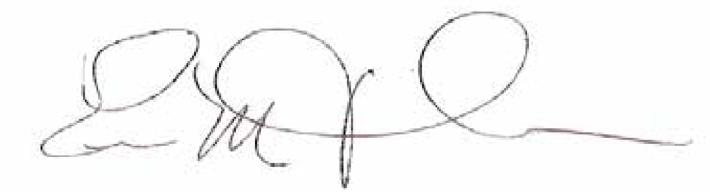

Table of Contents

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The Council of Inspectors General on Financial Oversight

The Council of Inspectors General on Financial Oversight (CIGFO) was established by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), and meets on a quarterly basis to facilitate the sharing of information among Inspectors General. The CIGFO members discuss the ongoing work of each Inspector General who is a member of the Council, with a focus on concerns that may apply to the broader financial sector and talk about ways to improve financial oversight. The CIGFO publishes an annual report that includes separate sections within the exclusive editorial control of each Inspector General. Those sections describe the concerns and recommendations of each Inspector General and a discussion of ongoing and completed work, with an emphasis on issues that may apply to the broader financial sector.

During the course of the year, CIGFO continued to monitor coordination efforts among and between Financial Stability Oversight Council members. Specifically, the CIGFO members discussed the FSOC member agency disaster recovery efforts, protection of non-public information, and use of the Dodd-Frank Act's section 120 authority to recommend Money Market Mutual Fund reforms. In addition, CIGFO discussed coordination efforts among and between the FSOC and the Office of Financial Research, the Office of Financial Research development of financial system metrics for use by the FSOC, and the institutionalization of the FSOC Secretariat operations, including staffing and budget. Also, meetings were held with Treasury officials to determine the processes and procedures used to monitor gaps in financial stability.

The general belief of each Inspector General is that the FSOC's implementation of the Dodd-Frank Act continues to progress. However, the Inspectors General believe that more should be done to institutionalize the FSOC processes and procedures in order to ensure the law is applied in a fair and consistent manner.

Office of Inspector General Board of Governors of Federal Reserve System and Consumer Financial Protection Bureau

The Office of Inspector General provides independent oversight by conducting audits, investigations, and other reviews of the programs and operations of the Federal Reserve Board of Governors and the Consumer Financial Protection Bureau and demonstrates leadership by making recommendations to improve economy, efficiency, and effectiveness, and preventing and detecting fraud, waste, and abuse.

Background

Congress established the Office of Inspector General (OIG) as an independent oversight authority for the Board of Governors of the Federal Reserve System (Board), the government agency component of the broader Federal Reserve System, and the Consumer Financial Protection Bureau (CFPB).

Under the authority of the Inspector General Act of 1978, as amended (IG Act), the OIG conducts independent and objective audits, inspections, evaluations, investigations, and other reviews related to the programs and operations of the Board and the CFPB. Through its work, the OIG promotes integrity, economy, efficiency, and effectiveness; helps prevent and detect fraud, waste, and abuse; and strengthens the agencies' accountability to Congress and the public.

Through its independent oversight, the OIG supports

- the Board in fostering the stability, integrity, and efficiency of the nation's monetary, financial, and payment systems to promote optimal macroeconomic performance
- the CFPB in implementing and enforcing federal consumer financial law to ensure that consumers have access to fair, transparent, and competitive financial markets, products, and services

In addition to the duties set forth in the IG Act, Congress has mandated additional responsibilities for the OIG. Section 38(k) of the Federal Deposit Insurance Act (FDI Act) requires that the OIG review failed financial institutions supervised by the Board that result in a material loss to the Deposit Insurance Fund (DIF) and produce a report within six months. The Dodd-Frank Act amended section 38(k) of the FDI Act by raising the materiality threshold and requiring the OIG to report on the results of any nonmaterial losses to the DIF that exhibit unusual circumstances warranting an in-depth review.

Additionally, section 211(f) of the Dodd-Frank Act also requires that the OIG review the Board's supervision of any covered financial company that is placed into receivership. In such cases, the OIG will produce a report that evaluates the effectiveness of the Board's supervision, identifies any acts or omissions by the Board that contributed to or could have prevented the company's receivership status, and recommends appropriate administrative or legislation action.

OIG Reports and Other Products Related to the Broader Financial Sector

In accordance with section 989E(A)(2)(B) of the Dodd-Frank Act, the following highlights the completed and ongoing work of our office, with a focus on issues that may apply to the broader financial sector.

Completed Work

Review of the Failure of Bank of Whitman

On August 5, 2011, the Washington State Department of Financial Institutions closed Bank of Whitman and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. The FDIC estimated that Bank of Whitman's failure would result in a $134.8 million loss to the DIF, which did not exceed the $200 million materiality threshold that applied at the time of notification by the FDIC OIG. While the loss to the DIF was below the materiality threshold, we conducted an in-depth review after determining that Bank of Whitman's failure presented unusual circumstances because of various questionable transactions and business practices involving senior management.

Bank of Whitman failed because of the convergence of several factors. The bank altered its traditional agricultural lending strategy and expanded into new market areas, which resulted in rapid growth and high commercial real estate concentrations as well as credit concentrations to individual borrowers. Bank of Whitman's corporate governance weaknesses allowed the bank's senior management to dominate the institution's affairs and undermine the effectiveness of key control functions. Bank of Whitman's credit concentrations and poor credit risk management practices, along with a decline in the local real estate market, resulted in asset quality deterioration, significant losses, and eroded capital. At that point, management engaged in a series of practices to mask the bank's true condition. The escalating losses depleted earnings and left the bank in a critically undercapitalized condition, which prompted the Washington State Department of Financial Institutions to close the bank and appoint the FDIC as receiver.

Bank of Whitman became a state member bank in 2004, and the Federal Reserve Bank of San Francisco (FRB San Francisco) complied with premembership supervisory requirements. FRB San Francisco also complied with examination frequency guidelines for the time frame we reviewed, 2005 through 2011, and conducted regular offsite monitoring. However, our analysis of FRB San Francisco's supervision of Bank of Whitman revealed that FRB San Francisco identified the bank's fundamental weaknesses during its first examination in 2005 but did not take decisive action to resolve those weaknesses until September 2009. In our opinion, FRB San Francisco had multiple opportunities from 2005 to 2009 to take stronger supervisory action to address the bank's persistent deficiencies.

We recommended that the Director of the Division of Banking Supervision and Regulation (BS&R) review the supervisory approach for premembership examinations and determine whether enhancements to the current approach outlined in Supervision and Regulation Letter 11-2, Examinations of Insured

Depository Institutions Prior to Membership or Mergers into State Member Banks, are appropriate. BS&R staff acknowledged the conclusion and lessons learned in the report and we will follow up on the report's recommendation.

Audit of the Board's Actions to Analyze Mortgage Foreclosure Processing Risks

In fall 2010, issues surfaced regarding documentation deficiencies and irregularities in foreclosure processing. In response, the Board, the Office of the Comptroller of the Currency, the FDIC, and the Office of Thrift Supervision initiated an interagency review of the foreclosure policies and practices of selected federally regulated mortgage servicers. Personnel from several Board divisions were engaged in this review, including the Division of Consumer and Community Affairs (DCCA) and BS&R. Our audit objective was to assess the Board's activities in response to potential risks related to mortgage foreclosures.

Overall, we found that the Board was able to develop approaches and perform activities to assess the foreclosure processing risks. The Board did, however, experience challenges in executing the interagency foreclosure review. DCCA and BS&R faced challenges with managing the review's resource demands and timeline, which delayed other scheduled supervisory activities. The examiners who participated on the interagency foreclosure review were challenged to quickly develop an understanding of the complex legal issues related to foreclosures and to examine a third-party service provider's foreclosure processing activities, with which examiners lacked prior experience. DCCA and BS&R were challenged with identifying staff who had the necessary expertise to perform the interagency foreclosure review.

Our report contained two recommendations focused on improving the Board's processes for responding to future risks. We recommended that BS&R and DCCA conduct a lessons-learned exercise to evaluate insights gained from the interagency foreclosure review. We also recommended that BS&R assess whether the current processes and tools used to identify staff with specialized skills and competencies are adequate and define a frequency for the periodic review of skill and competency categories.

In comments on a draft of our report, the Directors of BS&R and DCCA stated that staff have conducted an informal assessment of the interagency foreclosure review initiative, which can be leveraged to satisfy the intent of our first recommendation. Regarding our second recommendation, the Directors stated that they agree that an opportunity exists to assess whether the processes used to identify skills and competencies beyond those needed for basic supervision can be enhanced.

Audit of the Board's Small Community Bank Examination Process

On February 10, 2012, the Chairman of the Senate Committee on Banking, Housing, and Urban Affairs requested that the Inspectors General of the FDIC, the Department of the Treasury, the Board, and the National Credit Union Administration conduct audits of their respective agencies' examination processes for small community banks and credit unions. We reviewed matters relating to examination timeliness, the Board's approach to ensuring consistency in the administration of examinations throughout the Federal Reserve System, the ability of Board-regulated institutions to question examination results through the Federal Reserve System's Ombudsman program or other appeals processes, and the frequency and results of examination appeals.

We found that the Board's examination oversight includes Federal Reserve System–wide supervision and communication, detailed examiner guidance, training, and quality assurance. This structure is designed to ensure consistency of state member bank examinations throughout the Federal Reserve System. We found that, generally, Federal Reserve Banks issued examination reports within the time frame required by the Board's Commercial Bank Examination Manual. We also found that all 12 Federal Reserve Banks have established appeals policies that follow Board guidance.

Our report contained one recommendation designed to improve the reliability of the data in the Board's National Examination Data System database. We recommended that the Director of BS&R improve controls for verifying the accuracy of the data entered into the National Examination Data System. The Director of BS&R agreed with the summary conclusions in the report and stated that BS&R had initiated a Federal Reserve System–wide effort to strengthen the examination database management reviews.

No Changes Recommended to Freedom of Information Act Exemption Included in the Amended Federal Reserve Act

Section 1103 of the Dodd-Frank Act amends section 11 of the Federal Reserve Act (FRA) to establish mandatory disclosure dates for information concerning the borrowers and counterparties participating in emergency credit facilities, discount window lending programs, and open market operations that are authorized by the Board. Prior to these mandatory release dates, the Dodd-Frank Act exempts this information from disclosure under the Freedom of Information Act (FOIA). As required by the Dodd-Frank Act, we conducted a study of the impact that this FOIA exemption has had on the public's ability to access information about the Board's administration of emergency credit facilities, discount window lending operations, and open market operations. Further, we were required by the FRA to submit a report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services on the findings of our study, as well as make any recommendations on whether the exemption in section 11(s) should remain in effect.

During our evaluation, we did not find evidence that the FOIA exemption included in section 11(s) of the amended FRA has impacted the public's ability to access information concerning the Board's administration of emergency credit facilities, discount window lending programs, or open market operations. We determined that neither the Board nor the Federal Open Market Committee had utilized the FOIA exemption in section 11(s) of the FRA to withhold information regarding any FOIA requests received from July 21, 2010, the date the exemption became effective, through October 31, 2012, the end of our FOIA review period. We also found that the Federal Reserve System provides a significant amount of publicly available information about the administration of these facilities, programs, and operations that includes statutorily mandated disclosures. Published information also includes broad-based reporting, program administrative terms and conditions, and aggregate data, such as weekly statistical reports and balance sheet information. In addition, we noted that if the FOIA exemption in section 11(s) of the FRA were eliminated, the earlier release of transaction-level information could have adverse impacts on individual financial institutions and the broader financial markets, as well as on the effectiveness of the emergency credit facilities, discount window lending programs, and open market operations as tools to effect monetary policy and respond to financial crises.

Given our determination that the FOIA exemption in section 11(s) of the FRA has not impacted the public's ability to access information about the Board's administration of emergency credit facilities, discount window lending programs, or open market operations and that there is the potential for adverse impacts with earlier releases of information, we did not recommend any change to the FOIA exemption that Congress provided in section 11(s) of the amended FRA. The Board indicated that it agreed with our conclusion.

Ongoing Work

Review of the Federal Reserve's Supervisory Activities Related to the Multibillion-dollar Loss at JPMorgan Chase & Co.'s Chief Investment Office

In May 2012, we initiated a scoping review of the Federal Reserve's supervisory activities related to the multibillion-dollar loss at JPMC's Chief Investment Office. We completed our scoping review and subsequently initiated evaluation work in July 2012. Our objectives for this evaluation are to (1) assess the effectiveness of the Board's and the Federal Reserve Bank of New York's consolidated and other supervisory activities regarding JPMC's Chief Investment Office and (2) identify lessons learned for enhancing future supervisory activities.

Evaluation of the CFPB's Integration of Enforcement Attorneys into Examinations

We initiated an evaluation of the CFPB's integration of enforcement attorneys into its examinations of banking and nonbanking institutions' compliance with applicable consumer protection laws and regulations. Our objectives for this evaluation are to assess (1) the potential risks associated with this approach to conducting examinations and (2) the effectiveness of any safeguards that the CFPB has adopted to mitigate the potential risks associated with this examination approach.

Evaluation of the CFPB's Supervision Program

We initiated an evaluation of the CFPB's supervision program for large depository institutions and nondepository consumer financial service companies. Based on the authority granted by the Dodd-Frank Act, the CFPB began examinations of large depository institutions on July 21, 2011, and of nondepository consumer financial service companies on January 5, 2012. The objectives of our evaluation are to (1) review key program elements, including policies and procedures, examination guidance, and controls to promote consistent and timely reporting; (2) assess the approach for staffing examinations; and (3) assess the training program for examination staff.

In-depth Review of the Failure of Waccamaw Bank

On June 8, 2012, the North Carolina Office of the Commissioner of Banks closed Waccamaw Bank and appointed the FDIC as receiver. According to the FDIC's press release, as of March 31, 2012, Waccamaw Bank had approximately $533.1 million in total assets and $472.7 million in total deposits. On June 8, 2012, the FDIC estimated that the cost of Waccamaw Bank's closure to the DIF would be $51.1 million, which did not meet the materiality threshold as defined under section 38(k) of the FDI Act. Based on the results of our failed bank review, we determined that the failure of Waccamaw Bank was due to circumstances that have been covered in past OIG reports. However, our failed bank review also identified three unusual circumstances that warrant an in-depth review of Waccamaw Bank: (1) Waccamaw Bank appears to have misinformed regulators about key aspects of an asset swap transaction that significantly changed its risk profile and financial condition; (2) Waccamaw Bank initiated a series of appeals related to the bank examiners' recommended accounting treatment of a transaction, which ultimately reached the highest level of appellate review by a Board Governor; and (3) there were unique circumstances surrounding the retirement of Waccamaw Bank's former president and chief executive officer. As a result, we initiated an in-depth review that focuses on these three unusual circumstances.

Audit of the Board's Monitoring of Mortgage Servicers

We began an audit of the Board's efforts to monitor and ensure compliance with (1) enforcement orders against mortgage servicers issued in April 2011 and amended in February 2013 and (2) enforcement orders against bank holding companies issued in April 2011, September 2011, and April 2012, and amended in February 2013. Our audit will focus on evaluating the Board's oversight to ensure that the institutions for which it has regulatory responsibility implement the terms and conditions of the enforcement orders. Under the amended orders, the Board, along with the Office of the Comptroller of the Currency, required the mortgage servicers to establish a fund to provide borrowers, who were in foreclosure in 2009 and 2010, $3.6 billion in compensation, ranging from a few hundred dollars up to $125,000 depending on the possible servicer error. Additionally, the servicers are required to provide $5.7 billion in other foreclosure prevention assistance, such as loan modifications.

Office of Inspector General
U. S. Commodity Futures Trading Commission

The CFTC OIG acts as an independent Office within the CFTC that conducts audits, investigations, reviews, inspections, and other activities designed to identify fraud, waste, and abuse in connection with CFTC programs and operations, and makes recommendations and referrals as appropriate.

Background

The U.S. CFTC OIG was created in 1989 in accordance with the 1988 amendments to the Inspector General Act of 1978 (P.L. 95-452). OIG was established as an independent unit to:

- promote economy, efficiency and effectiveness in the administration of CFTC programs and operations and detect and prevent fraud, waste and abuse in such programs and operations;
- conduct and supervise audits and, where necessary, investigations relating to the administration of CFTC programs and operations;
- review existing and proposed legislation, regulations and exchange rules and make recommendations concerning their impact on the economy and efficiency of CFTC programs and operations or the prevention and detection of fraud and abuse;
- recommend policies for, and conduct, supervise, or coordinate other activities carried out or financed by such establishment for the purpose of promoting economy and efficiency in the administration of, or preventing and detecting fraud and abuse in, its programs and operations;
- and keep the Commission and Congress fully informed about any problems or deficiencies in the administration of CFTC programs and operations and provide recommendations for correction of these problems or deficiencies.

CFTC OIG operates independently of the Agency and has not experienced any interference from the CFTC Chairman in connection with the conduct of any investigation, inspection, evaluation, review, or audit, and our investigations have been pursued regardless of the rank or party affiliation of the target.[1] The CFTC OIG consists of the Inspector General, the Acting Assistant Inspector General for Auditing, a Senior Auditor, one Attorney, and one support staff. The CFTC OIG obtains additional audit and administrative assistance through contracts.

1 The Inspector General Act of 1978, as amended, states: "Neither the head of the establishment nor the officer next in rank below such head shall prevent or prohibit the Inspector General from initiating, carrying out, or completing any audit or investigation…." 5 U.S.C. App. 3 sec. 3(a).

Role in Financial Oversight

The CFTC OIG has no direct statutory duties related to oversight of the futures, swaps and derivatives markets; rather, the CFTC OIG acts as an independent Office within the CFTC that conducts audits, investigations, reviews, inspections, and other activities designed to identify fraud, waste, and abuse in connection with CFTC programs and operations, and makes recommendations and referrals as appropriate. The CFTC's yearly financial statement and Customer Protection Fund audits are conducted by an independent public accounting firm, with OIG oversight.

Recent, Current or Ongoing Work in Financial Oversight

In addition to our work on CIGFO projects described elsewhere in this report, CFTC OIG worked on the following projects during the past year:

1. Audit of CFTC Customer Protection Fund

The CFTC OIG obtained the services of an independent public accounting (IPA) firm to conduct an audit of the CFTC's Customer Protection Fund. The IPA reported that the Customer Protection Fund financial statements as of September 30, 2012, were presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles.

2. Study Mandated by Dodd-Frank: Performance Audit Report on the Impact of the Freedom of Information Act (FOIA) Exemption Related to Protecting the Identity of Whistleblowers in Fiscal Year 2011 and 2012

The CFTC OIG obtained the services of an IPA, to conduct a performance audit of the CFTC's processes relating to the FOIA exemption established under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) pertaining to the protection of the identities of whistleblowers, and also audited the impact of the exemption on the public's ability to access information about the Commission's regulation of commodity futures and options markets.

Section 748 of the Dodd-Frank Act added to the Commodity Exchange Act new section 23, 7 U.S.C. 26, establishing commodity whistleblower incentives and protection. Section 23(h)(2) provided for the confidentiality of whistleblowers, specifically exempting their identities from disclosure under the FOIA pursuant to Exemption 3 of the FOIA, 5 USC 552(b)(3). New subsection 23(h)(2)(C)(iii)(l) required the Inspector General of the Commission to conduct a study on the impact of FOIA exemption on Commodity Futures Trading Commission.

The audit resulted in findings that the protection afforded by section 26(h)(2) "appear to positively aid whistleblowers in disclosing information to the CFTC," and that "there is strong evidence to support the Commission's continued usage" of section 23(h)(2) in conjunction with FOIA Exemption 3, and related findings. The audit resulted in two recommendations -- that CFTC establish written policies and procedures to include a protocol to ensure that the confidentiality of whistleblowers remains intact, and that CFTC enhance related whistleblower information on the Commission's website. The Commission agreed to implement both recommendations.

3. Review of the CFTC's Oversight and Regulation of MF Global, Inc.

On November 30, 2011, Senator Richard C. Shelby, then Ranking Member on the Banking, Housing, and Urban Affairs Committee, requested "a report on the CFTC's oversight and regulation of MF Global Inc." (MF Global or MFGI). Senator Shelby made this request in response to the collapse of MF Global.

One month earlier, MF Global Holdings Ltd. and MF Global Finance USA Inc. filed for bankruptcy protection in the Southern District of New York under Chapter 11 of the Bankruptcy Code. On the same day, October 31, 2011, the United States District Court for the Southern District of New York entered an order granting the application of the Securities Investor Protection Corporation ("SIPC") for issuance of a Protective Decree adjudicating that the customers of MFGI were in need of protection afforded by Securities Investor Protection Act, and appointing a Trustee to oversee the liquidation. The Trustee eventually reported that MFGI suffered a shortfall in segregated property available to return to customers ("customer segregated funds") totaling "approximately $900 million in domestic accounts (both commodities and securities), plus an additional approximately $700 million related to trading by customers on foreign exchanges."[2]

In light of these events, Senator Shelby requested:

1. A detailed account of the CFTC's role in overseeing and regulating MFGI, including an assessment of whether its oversight and regulation of MFGI differed in any material way from its oversight and regulation of other futures commission merchants (FCMs);

2. A detailed account of how the CFTC coordinated with the Chicago Mercantile Exchange ("CME"), the designated self-regulatory organization for MFGI, in overseeing MFGI's customer segregated funds;

3. A summary of relevant examination manuals or other guidance for staff involved in overseeing and regulating MFGI or monitoring the CME's oversight of MFGI;

4. An analysis of whether and how the CFTC's oversight of MFGI changed after the CFTC's enforcement actions against MFGI in December 2007 and December 2009;

5. An analysis of the CFTC's role in the determination that caused MFGI to increase its net capital in August 2011;

6. An analysis of the CFTC's activities with respect to MFGI in the week prior to the liquidation;

7. An analysis of whether CFTC Chairman Gary Gensler's decision to recuse himself from matters relating to the MFGI investigation is consistent with the CFTC's official recusal policy; and

8. An analysis of whether and how a decision by CFTC Chairman Gary Gensler to recuse himself from previous matters relating to MFGI would have been consistent with the CFTC's official recusal policy.

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2 Report of Trustee's Investigation and Recommendations ("Trustee's Report"), page 2, filed June 4, 2012, In re *MF Global, Inc.*, Case No. 11-2790 (MG) SIPA, US Bankruptcy Court, Southern District of New York. A link to the Trustee's Report is available here: *http://dm.epiq11.com/MFG/Project*. All internet addresses cited in this report were last visited on May 15 or May 16, 2013.

Our responses to the questions are summarized below.

CFTC's monitoring of MFGI differed from other FCMs in that CFTC enhanced surveillance of MF Global three years before the events leading to the MF Global bankruptcy. These enhancements consisted of daily (rather than monthly) review of MF Global's limited financial information (known as the "cap, seg, and secured" statement),[3] along with a limited review performed after 2009 that did not involve a detailed examination of MFGI's treatment of customer funds. CFTC also required MF Global to undergo a review by an independent consulting firm in 2009, as part of a settlement following a CFTC Enforcement proceeding. CFTC staff charged with responsibility for monitoring MFGI reviewed those findings and was briefed on MFGI's compliance with the settlement provisions.

CFTC staff did not formally coordinate with CME concerning oversight of MFGI. Staff told us that they would communicate with CME occasionally pertaining to MFGI, essentially to address specific issues as deemed necessary, but nothing formal was in place to coordinate regulatory efforts with regard to MFGI (or any other FCM). CFTC staff encountered CME staff at MFGI offices during the final week of MFGI's existence, but these encounters were not coordinated. Instead, CFTC separately determined to go to MFGI's offices to obtain information and assurances, and found CME staff arriving on site within a short period. CME and CFTC communicated during the final week of MFGI's existence on a consistent basis.

CFTC had no examination manuals or other guidance for staff involved in overseeing and regulating MFGI or any other FCM, or for monitoring CME's oversight of MFGI or any other FCM. Instead, prior to MFGI's collapse, CFTC relied on materials provided by the Joint Audit Committee,[4] its own guides for registrants regarding FCM statements, and CFTC published interpretations. Since the collapse of MFGI, CFTC has created a guide to reviewing the monthly financial statements it receives for all FCMs under its oversight.

The CFTC Division of Enforcement ("Enforcement") charged MFGI in two Enforcement proceedings in the four years leading to the eventual SIPC filing; however, neither Enforcement proceeding involved misconduct pertaining to treatment of customer segregated funds. CFTC did not alter its oversight of MFGI after the first Enforcement proceeding in 2007, but it did enhance its oversight of MFGI following the second CFTC Enforcement proceeding in 2009. The 2009 Enforcement proceeding arose from a rogue trader event that took place in February 2008; unauthorized trading resulted in overnight losses to MFGI in excess of

3 In accordance with CME's Audit Information Bulletin #12-04, dated April 2, 2012, and NFA Financial Requirements Section 8, CME and NFA require FCMs to submit daily segregated, secured 30.7 and sequestered statements, as applicable, through WinJammer™ by 12:00 noon on the following business day. ***http://www.cmegroup.com/tools-information/lookups/advisories/clearing/Daily_Segregatedx_Secured_30.7_and_Sequestered_Statements.html.*** NFA has published detailed information on current daily reporting requirements here: ***http://www.nfa.futures.org/NFA-compliance/NFA-futures-commission-merchants/fcm-reporting.pdf***.

The Trustee's Report refers to this statement as the Segregated and Secured Statement. See, e.g., Trustee's Report at 92 (discussing CFTC and CME's request for cap, seg, and secured statements for October 26, 2011). We use "cap, seg, and secured" because it was the term used by CFTC staff during our interviews.

4 The Joint Audit Committee is a representative committee of US futures exchanges and regulatory organizations. Information about the Committee (including documents) is available here: ***http://www.wjammer.com/jac/***.

$141 million, which immediately impacted MFGI's net capital.[5] Daily review of MFGI's financial information would permit CFTC staff to know quickly if a similar large overnight decrease in firm capital took place in the future, indicating a similar rogue trader situation, and CFTC staff required MFGI to submit their financial information to CFTC on a daily basis. CFTC staff charged with day-to-day oversight responsibilities for MFGI also remained informed on MFGI's compliance with undertakings that were part of the 2009 settlement agreement, which pertained to branch office training of managers and establishment of supervisory controls pertaining to the monitoring and supervision of traders.

CFTC had no official role in the determination that caused MFGI to increase its net capital in August 2011. Staff charged with responsibility for day-to-day oversight of MFGI were aware of the situation at the time, and were in communication with FINRA and CME.

In the week prior to the SIPC filing, CFTC staff charged with responsibility for day-to-day oversight were on site at MFGI in Chicago and New York on Thursday and Friday. On Thursday, CFTC staff were briefed on MFGI's financial status; CFTC staff asked for supporting documentation for the cap, seg, and secured statement for that day (which would reveal status as of close of business on Wednesday October 26), but they left without the documentation. Staff returned on Friday and received the documents on disc. CFTC staff did not go to MFGI on Saturday, but did remain in contact with FINRA, CME, and other regulators. The Chairman became an active participant on Saturday, speaking directly not only with regulators but also with an outside attorney for MFGI, asking that MFGI comply with document requests made by staff, and that staff be updated on bankruptcy contingency plans. This level of participation was not unusual for the Chairman; when necessary or requested by staff, the Chairman has directly called registrants and other related professionals in connection with official business.

CFTC staff deployed to MFGI offices in Chicago and New York on Sunday. Staff demanded customer fund status as of close of business Friday and were put off by MFGI until approximately 5 pm CST.[6] At 5 pm CST, MFGI staff let CFTC know that initial calculations of segregated customer funds showed a $900 million shortfall, but claimed that it was an error caused by the amount and type of entries at the end of the week, and promised the deficit would be cured once the error was found. CFTC staff in Washington worked on technical matters necessary to facilitate any sale of MFGI and accompanying transfer of customer funds.

At 2:30 am EST,[7] MFGI admitted the segregated funds deficiency was not an error, but was real. The anticipated sale fell through, as the potential buyer withdrew from negotiations. By 5:30 am it was decided that MFGI would be subject to a SIPC filing. At noon, the Commission held a closed emergency meeting led by Chairman Gensler. Chairman Gensler described the events of the prior week and weekend, and with staff

5 On December 12, 2012, the trader admitted guilt in a federal criminal proceeding, and faced a maximum prison sentence of 10 years and a $1 million fine; the trader was sentenced to five years in prison. *Former MF Global Trader Pleads Guilty in $141 mln Trading Loss*, Ann Saphir, Thomson Reuters News & Insight, December 11, 2012. ***http://newsandinsight.thomsonreuters.com/Legal/News/2012/12_-_December/Former_MF_Global_trader_pleads_guilty_in_$141_mln_trading_loss/***; *Ex-MF Global Broker Sentenced to 5 Years for Rogue Trades*, Andrew Harris, Bloomberg, April 17, 2013. ***http://www.bloomberg.com/news/2013-04-16/ex-mf-global-broker-sentenced-to-5-years-for-trades-correct-.html***.

6 Central Standard Time. All times represent our best estimate based on our ability to reconstruct the events using the available documents that have been reviewed, and also on individuals' best recollections.

7 Eastern Standard Time. Central Standard Time is one hour behind Eastern Standard Time. On October 31, 2011, both time zones were on Daylight Saving Time.

briefed the Commissioners on the procedures to be followed in the SIPC proceeding. Before the meeting ended, the Commissioners voted an Order of Investigation of MFGI to the Division of Enforcement; the Chairman made the motion and voted "aye."

The Chairman exclusively used his personal email account over the weekend while dealing with MFGI matters from his home. In fact, it appears he used his personal email consistently from his arrival at CFTC in 2009 until the collapse of MFGI. He used his personal email so much that he carried two smartphones, one issued by CFTC with his work email, and another for his personal email. He used his personal email to schedule meetings and for substantive conversations; he used it to contact CFTC staff at their official CFTC email addresses as well as their personal email accounts; he used it because he did not know how to access his official email at home. In reviewing hundreds of email messages using the Chairman's personal email address, we found nothing that appeared corrupt, and he has since ceased this practice. Nevertheless, our examination of the Chairman's email was limited to email pertaining to MFGI.

On November 2, the Commission participated in a hearing in the SIPC proceeding to permit the first bulk transfer of customer accounts; the Chairman was fully briefed following the hearing. The Commission held a second closed meeting to discuss MFGI; the Chairman led the meeting, and he did not discuss the possibility of recusal nor did he express any concern for appearances caused by his continued participation.

On November 3, the Chairman sought the advice of the General Counsel and Designated Agency Ethics Official, asking whether he should recuse himself at this point. The Commission does not have an official recusal policy, but the General Counsel and Designated Agency Ethics Officer does give advice on recusals when requested and follows Office of Government Ethics (OGE) regulations and policy in giving advice. The General Counsel and Designated Agency Ethics Officer instructed that there was no need to recuse given the fact that there was neither a financial conflict nor an appearance problem under OGE regulations. The Chairman nevertheless decided to recuse himself; the General Counsel and Designated Agency Ethics Officer advised it would be more consistent with OGE regulatory language to state that he would no longer participate. The Chairman decided not to participate in matters involving MFGI.

On November 8, the Chairman signed a Statement of Non-Participation. On the same day, the Commission received a memo and sign-off to appoint Commissioner Sommers to oversee matters involving MFGI; the appointment was completed on November 9.

On December 13, the General Counsel and Designated Agency Ethics Official issued a memorandum describing the Chairman's involvement in matters leading up to the collapse of MFGI in detail, and concluded that the Chairman's initial involvement was consistent with OGE standards and was not improper.

The Chairman's level of involvement in MFGI was not inconsistent with CFTC's interpretation of OGE recusal policy leading up to the collapse of MFGI; his decision to issue a non-participation statement ran counter to specific advice on the matter offered by the General Counsel and Designated Agency Ethics Official.

In the aftermath of MFGI, a number of regulatory and industry initiatives now address the safety of customer funds, including increased reporting requirements, notification requirements for large transfers of customer funds out of protected accounts, changes to permissible investments that may be made with customer segregated funds, and a prohibition against internal transactions among affiliates with customer funds.[8] We were not asked to formulate recommendations in this regard.

We did express a number of concerns based on our fieldwork.

We were concerned with the FCM oversight processes in place in October 2011 by the Examinations Branch. There were no manuals. The reports created by the Examinations Branch did not conform to audit standards, and it does not appear that the Examinations Branches were subject to peer reviews or other detailed internal examination. This does not *ipso facto* mean that the Examinations Branch performed poorly; we did not formally audit or review the Examinations Branch's overall operations in the course of our fieldwork. We understand that process improvement in the Examinations Branch is ongoing.

We were concerned that CFTC staff was not able to obtain same day access to all documentation for MFGI's cap, seg, and secured statement on Thursday, October 27, 2011. With CFTC's higher ranking supervisory auditor in Chicago teleworking on both Thursday and Friday of MFGI's final week, we wonder if the request was not taken as seriously as it might have been had she been on site with staff (especially on Friday after failing to obtain the requested documents on Thursday), both by virtue of her position and because she took a leadership role in the MFGI Chicago Office on Sunday. For a matter of this importance, we believe the attendance of the higher ranked supervisory auditor would have conveyed a stronger message to MFGI.

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8 The regulatory response to MFGI includes:

Jan 18, 2012 -- Futures industry self-regulatory organizations (CME Group, National Futures Association (NFA), InterContinental Exchange (ICE), the Kansas City Board of Trade (KCBOT) and the Minneapolis Grain Exchange (MGEX)) formed a joint committee to address customer segregation issues. *http://www.nfa.futures.org/news/newsRel.asp?ArticleID=3944*.

February 17, 2012 -- The Commission proposed to amend Commission Rule 1.25 in December 2011 to, among other things, prohibit the investment of customer segregated funds in foreign sovereign debt, and transactions with affiliates. The new rule, which also included other investment prohibitions and other provisions, became effective February 17, 2012. 76 Fed. Reg. 78,776 (Dec. 19, 2011). *http://www.gpo.gov/fdsys/pkg/FR-2011-12-19/pdf/2011-31689.pdf*.

May 1, 2012 -- Enhanced reporting implemented. CME Group Advisory Notice: Enhanced Customer Protections (April 2, 2012), *http://www.cmegroup.com/tools-information/lookups/advisories/clearing/AIB12-04.html*.

May 24, 2012 -- FCMs are now required to file daily cap, seg, and secured statements. See CME Group Advisory Notice: Daily Segregated, Secured 30.7 and Sequestered Statements (May 24, 2012), *http://www.cmegroup.com/tools-information/lookups/advisories/clearing/Daily_Segregatedx_Secured_30.7_and_Sequestered_Statements.html*.

July 13, 2012 – CFTC approved new financial rules submitted by the NFA to strengthen the protection of customer funds held by FCMs. This includes restrictions on removing funds from customer accounts. The CFTC's press release is available here: *http://www.cftc.gov/PressRoom/PressReleases/pr6303-12*. NFA's rule submission is available here: *http://www.nfa.futures.org/news/PDF/CFTC/FR_Sec_16_ProtectionCustomerFunds_IntNotc_0517.pdf*. Further information is available here: *http://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4116*.

August 16, 2012 – NFA approved a new requirement for FCMs to provide its DSRO with view-only access via the Internet to account information for each of the FCM's customer segregated fund accounts maintained and held at a bank or trust company. NFA's press release is available here: *http://www.nfa.futures.org/news/newsRel.asp?ArticleID=4092*. NFA's notice to CFTC is available here: *http://www.nfa.futures.org/news/.%5CPDF%5CCFTC%5CFR_Sec_4_OnLineAccessToFCMCustomerBankInfo_082012.pdf*.

October 23, 2012 -- CFTC proposed to adopt new regulations and amend existing regulations to require enhanced customer protections, risk management programs, internal monitoring and controls, capital and liquidity standards, customer disclosures, and auditing and examination programs for futures commission merchants ("FCMs"). 77 FR 67866 (Nov. 14, 2012) (available here: *http://www.cftc.gov/LawRegulation/FederalRegister/ProposedRules/2012-26435*). The comment period closed on February 15, 2013. 78 FR 4093 (Jan. 18, 2013) (available here: *http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-00820a.pdf*).

We were also concerned at the lack of procedure (formal or informal) in place to guide the process of requesting documentation of a cap, seg, and secured statement, and to address delays in production and, therefore, we were concerned that the staff document request was not an effective mechanism to assure the Commission that customer funds were protected.

We were concerned that CFTC staff and management did not learn that MFGI was experiencing a run on the bank until after the fact.

We were concerned with the lack of coordinated effort by multiple regulators on site at MFGI during its final days, and concerned with the lack of communication between CFTC and CME, and between CFTC and SIPC.

We were concerned with the Chairman's use of personal email to conduct official business relating to MFGI, and noted that our review was limited to email pertaining to the collapse of MFGI.

Finally, we were concerned with the Chairman's determination to withdraw from participation. Seeking ethics advice only when the matter became a public sensation – after both leading the Agency's response to the ongoing crisis and voting to authorize the Enforcement investigation – was not the most desirable course. While seeking guidance at the outset would have been preferable, the OGE regulations did not require it. It is the extent of participation prior to requesting advice that is troubling.

Moreover, after requesting guidance from the General Counsel and Designated Agency Ethics Official, the Chairman's actions ran counter to the legal advice he received. Determining to withdraw from participation on November 3 potentially disadvantaged the Commissioner who now had to take on this work at a late stage.

Office of Inspector General
Federal Deposit Insurance Corporation

Background

The FDIC was created by the Congress in 1933 as an independent agency to maintain stability and public confidence in the nation's banking system by insuring deposits and independently regulating state-chartered, non-member banks. Federal deposit insurance protects depositors from losses due to failures of insured commercial banks and thrifts. According to most recent data, the FDIC insured approximately $7.0 trillion in deposits at 7,083 banks and savings associations, and promoted the safety and soundness of these institutions by identifying, monitoring, and addressing risks to which they are exposed. The FDIC was the primary federal regulator for 4,460 of the insured institutions. An equally important role for the FDIC, especially in light of the recent financial crisis, is as receiver for failed institutions—that is, upon closure of an institution by its chartering authority—the state for state-chartered institutions, and the Office of the Comptroller of the Currency for national banks and federal savings associations—the FDIC is responsible for resolving the institution and managing and disposing of its remaining assets.

The FDIC OIG is an independent and objective unit established under the Inspector General (IG) Act of 1978, as amended. The FDIC OIG mission is to promote the economy, efficiency, and effectiveness of FDIC programs and operations, and protect against fraud, waste, and abuse. In doing so, we can assist and augment the FDIC's contribution to stability and public confidence in the nation's financial system. We have continued to undertake a comprehensive body of work during the past year to carry out that mission.

A major undertaking for our office during the past year involved a comprehensive study called for by Public Law 112-88, in which we examined the impact of the failure of insured depository institutions. Also of interest to readers of this CIGFO report, we reviewed a structured asset sale transaction, one of the FDIC's key mechanisms for managing and disposing of assets in its role as receiver. With respect to failed bank work, we conducted material loss reviews in cases where losses to the Deposit Insurance Fund met the threshold outlined in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), and we performed failed bank reviews of all failures of FDIC-supervised institutions, as required by the Act. In other assignments, we gained insights into characteristics of institutions that were able to weather high concentrations in acquisition, development, and construction loans during the recent financial crisis, and we reviewed certain aspects of the FDIC's examination process for community banks at the request of the Chairman of the Senate Banking Committee. We continued ongoing coordination with our financial IG counterparts on issues of mutual interest. We sustained strong investigative efforts to combat financial institution fraud at both open and closed institutions. Further discussion of these efforts follows.

Comprehensive Study on the Impact of the Failure of Insured Depository Institutions

As we previewed in CIGFO's last annual report in July 2012, our most recent priority has been work conducted in connection with Public Law 112-88, or H.R. 2056. On January 3, 2012, President Obama signed H.R. 2056, as amended. This legislation required that the FDIC IG conduct a comprehensive study on the impact of the failure of insured depository institutions and submit a report to the Congress not later than 1 year after the date of enactment. The report was to contain the results of the study and any recommendations. The legislation further required that the FDIC IG and the Comptroller General appear before the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives after publication of the study to discuss the results. The scope of the study, as defined in the legislation, was to include institutions regulated by the FDIC, the Board of Governors of the Federal Reserve System (FRB), and the Office of the Comptroller of the Currency (OCC).

In response to the legislation, our office initiated a series of assignments to address the issues outlined in H.R. 2056. In doing so, we addressed over 30 topics that fell under one of the following eight matters:

- Shared-loss agreements (SLA),
- Significance of losses at institutions that failed,
- Examiner implementation of appraisal guidelines,
- Examiner assessment of capital adequacy and private capital investment in failing institutions,
- Examiner implementation of loan workout guidance,
- Application and impact of formal enforcement orders,
- Impact of FDIC policies on investments in institutions, and
- The FDIC's handling of private equity company investments in institutions.

We issued a 200+ page report in January 2013, and the IG subsequently testified, as called for in the law, before the Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit, U.S. House of Representatives, on March 20, 2013, and before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, on June 13, 2013.

By way of context for the observations and recommendations that we made, our report noted that the financial crisis had devastating impacts on the banking industry, businesses, communities, and consumers. At the time of our review, over 400 institutions had failed and several of the country's largest institutions had required government intervention to remain solvent. Commercial real estate (CRE) collateral values had fallen by more than 42 percent. Construction starts remained partially complete and continued to detract from the quality of neighborhoods and home values. Trillions of dollars of household wealth had vanished, and almost 18 million loans had faced foreclosure since 2007. Unemployment peaked at 10 percent in October 2009 and remained stubbornly high at the time of our study.

We reported that events leading to the financial crisis and subsequent efforts to resolve it involved the dynamic interplay of laws passed by the Congress, regulatory rules, agency-specific policies and practices, and the real estate and financial markets in ways that are continuing to play out. In that regard, our study indicated the following:

- The markets drove behaviors that were not always prudent. Banks expanded lending to keep pace with rapid growth in construction and real estate development, rising mortgage demands, and increased competition. Many of the banks that failed did so because management relaxed underwriting standards and did not implement adequate oversight and controls. For their part, many borrowers who engaged in commercial or residential lending arrangements did not always have the capacity to repay loans and pursued many construction projects without properly considering the risks involved. Ultimately, these loans created significant losses for the institutions involved and often left the FDIC with the challenge of managing and disposing of troubled assets.
- In response to unprecedented circumstances, the regulators generally fulfilled their supervisory and resolution responsibilities as defined by statutes, regulations, accounting standards, and interagency guidance in place at the time. In addition, the regulators reacted to a rapidly changing economic and financial landscape by establishing and revising supervisory policies and procedures to address key risks facing the industry. While not a focus of this study, our report does acknowledge, however, material loss review findings that showed the FRB, OCC, and FDIC could have provided earlier and greater supervisory attention to troubled institutions that failed. For its part, among other initiatives associated with resolutions, the FDIC reinstituted the use of SLAs with acquiring institutions and took steps to promote private capital investments in failing institutions.

We provided a detailed presentation of our findings and conclusions for each of the topics under the law's eight matters. In addressing these matters, we also made the following observations:

- The FDIC's resolution methods—including the SLAs that we studied—were market-driven. Often, failing banks with little or no franchise value and poor asset quality did not attract sufficient interest from viable bidders to enable the FDIC to sell the banks without a loss-share guarantee. The FDIC used SLAs to keep failed bank assets in the banking sector, support failed bank asset values, and preserve the solvency of the Deposit Insurance Fund (DIF). The FDIC has established controls over its SLA monitoring program, which help protect the FDIC's interests, promote loan modifications, and require equal treatment of SLA and legacy loans. We did find, however, that the FDIC should place additional emphasis on monitoring commercial loan extension decisions to ensure that acquiring institutions do not inappropriately reject loan modification requests as SLAs approach termination. In addition, we concluded that the FDIC needed to formulate a better strategy for mitigating the impact of impending portfolio sales and SLA terminations on the DIF so that the FDIC will be prepared to address the potentially significant volume of asset sale requests.
- The majority of community banks failed as a result of aggressive growth, asset concentrations, poor underwriting, and deficient credit administration coupled with declining real estate values. These factors led to write-downs and charge-offs on delinquent and non-performing real estate loans as opposed to examiner-required write-downs or fair value accounting losses.

- The regulators have longstanding policies for classifying problem assets, monitoring appraisal programs, assessing capital adequacy, evaluating CRE loan workouts, and administering enforcement actions, when warranted. The regulators also have processes and controls, training programs, and job aids to help ensure examiner compliance and consistency. We found that examiners generally followed relevant policies and implemented them appropriately. For example, examiners usually did not classify as loss loans that the institution claimed were paying as agreed without justification, nor did they question or reduce the appraised values of assets securing such loans. However, examiners did not always document the procedures and steps that they performed to assess institutions' appraisal and workout programs. We also noted that the regulators had different approaches to enforcement actions, particularly related to non-problem banks.
- The FDIC has investment-related policies in place to protect the DIF and to ensure the character and fitness of potential investors. These policies are largely based in statute. By their nature, such policies are going to have an impact on investments in institutions. The FDIC approved most change-in-control and merger applications, although approval rates were lower for states such as California, Florida, and Nevada that were heavily impacted by the financial crisis. The FDIC has policies and procedures for certain aspects of the review of private capital investors, and the FDIC generally followed those policies. Purchases of failed institutions by private capital investors accounted for 10 percent of total failed bank assets acquired. Finally, we identified instances where the FDIC did not accept proposed open bank investments and instead closed an institution. However, in each case, we found that the FDIC identified concerns with the proposed investment related to safety and soundness issues, proposed management, or proposed business plans, or determined that the proposed transaction would not present the least loss option to the DIF.

While the regulators generally implemented their policies appropriately, our study identified certain areas for improvement and issues warranting management attention. In the interest of strengthening the effectiveness of certain supervisory activities and helping ensure the success of the FDIC's ongoing resolution efforts, we made seven recommendations. Five were addressed specifically to the FDIC and two were directed to the three regulators. These recommendations involved the following areas:

- **SLA Program.** We made recommendations related to developing additional controls for monitoring acquiring institutions' commercial loan modification efforts and developing a more formal strategy for mitigating the impact of impending portfolio sales and SLA terminations on the DIF.
- **Appraisals and Workouts.** We made several recommendations related to clarifying how examiners should review institutions' appraisal programs and strengthening examiner documentation requirements to more clearly define examination methodologies and procedures performed to assess institutions' appraisal and workout programs. These recommendations should help to assure agency management that examiners are consistently applying relevant guidance.
- **Enforcement Orders.** We recommended that the regulators study differences between the types of enforcement actions that are used by the regulators and the timing of such actions to determine whether there are certain approaches that have proven to be more effective in mitigating risk and correcting deficiencies that should be implemented by all three regulators.

The regulators concurred with our recommendations and proposed actions that adequately address the intent of our recommendations.

Resolution and Receivership Work Examines Structured Asset Sale Transaction

Also as noted last year, a significant body of our work relates to the FDIC's role as receiver for failed institutions' assets and liabilities. In that regard, for example, in addition to resolution and receivership issues that we covered in our H.R. 2056 work, we have focused specific attention over the past few years on two different types of risk-sharing agreements that the FDIC employs--shared loss agreements and structured asset sale transactions. We issued the results of one such audit of the FDIC's structured sale transaction with an LLC during the past year.

Structured asset sale transactions involve pools of assets from one or more FDIC receiverships. The FDIC sells or contributes assets to a limited liability company (LLC) formed by the FDIC as receiver. These transactions are competitively bid to prequalified purchasers. The receiver then sells an interest in the LLC to a private third-party, which manages the LLC. The receiver retains either an equity interest in the LLC or a participation interest in the net cash collected through the servicing and liquidation of the LLC's assets. Once ownership of the assets is conveyed to the LLC, control over the LLC is passed to the private third-party. The FDIC, acting as receiver for failed banks, reported that it has consummated 34 structured sale transactions involving 42,900 assets with a total unpaid principal balance of approximately $26.0 billion, as of May 28, 2013.

During the past year, we completed an audit of the FDIC's structured transactions with an LLC in response to a request from FDIC management. With respect to the bidding and selection processes, we determined that the FDIC: marketed the assets that comprised the portfolios and approved (i.e., qualified) prospective investors to bid consistent with its then-existing policies, procedures, and guidance; and properly determined that the LLC's bids represented the best value offered for the assets and awarded an equity interest in the portfolios to the LLC. We did note, however, that the FDIC should develop guidance that defines an approach for informing the public about structured transactions as the Corporation enters into such partnerships.

Based on our assessment of the terms and conditions of the LLC sales agreements, we determined that they were generally consistent with customary and usual business practices in the financial services industry. We also reviewed asset files and other information pertaining to a sample of 120 assets and concluded that the LLC was in compliance with the provisions of the structured transaction agreements that we tested. Notably, in this case, our review did not identify any questioned costs or violations of the prohibitions in the structured transaction agreements regarding asset sales to affiliates. However, our report notes that the FDIC was working with the LLC to address a number of ongoing concerns. We indicated that the FDIC should confirm that the LLC appropriately documented and effectively implemented procedures to address all of these matters.

As for the FDIC's monitoring and oversight, we found that the FDIC had limited controls in place when the structured transactions with the LLC were consummated. Since that time, the FDIC's monitoring controls had improved considerably. Still, we identified several areas where the Corporation could improve its monitoring and oversight, and we made seven recommendations to strengthen controls pertaining to the structured transactions with the LLC, with which FDIC management concurred.

Failed Bank and FDIC Supervision-Related Work

To a far lesser extent than during the height of the financial crisis, we continued to conduct our mandatory reviews of failed FDIC-supervised institutions causing material losses to the DIF, as defined by the Dodd-Frank Act, and we issued two material loss review reports since last July. We also issued 18 failure reviews of institutions whose failures caused losses under the thresholds outlined in the Act. Such efforts provide insights into why banks fail and help us better understand the FDIC's supervisory processes. Generally speaking, these most recent reviews confirmed the causes of failure and supervisory practices that we have reported in our previous material loss reviews.

In a related vein, we conducted an evaluation of acquisition, development, and construction (ADC) loan concentrations—oftentimes a major contributing cause of institution failures—to identify factors that may have helped certain banks mitigate the risks historically associated with these types of concentrations during periods of economic stress. We also completed a congressionally requested assignment related to the FDIC's examination process for small community banks and issued the results of that work, offering an analysis of FDIC examination timelines and consistency, and the appeals mechanisms available to the community banks. These assignments are summarized below.

Acquisition, Development, and Construction Loan Concentrations Study

Prior to the recent financial crisis, competition among financial institutions for growth, profitability, and community influence often resulted in the compromise of sound credit principles and acquisition of unsound loans. Ultimately, that type of compromise resulted in a spate of bank failures not seen since the 1980s—a period that, in broad terms, was not that long ago. Much was written following the banking crisis of the 1980s and early 1990s, and there were ample discussions of lessons learned. In addition, far reaching legislative and regulatory actions were taken and extensive guidance was issued by regulators on key risks, including repeated warnings and references to best practices related to ADC lending because it is a highly specialized field with inherent risks that must be managed and controlled. Nevertheless, Boards and management at many institutions pursued profits through growth and higher-earning, risky assets, in an era of easy credit, while lacking robust risk management practices—a story that appears very similar to the one told just over 20 years ago.

We conducted a study to examine what practices institutions with ADC concentrations undertook that allowed them to weather the recent financial crisis without experiencing a corresponding decline in their overall financial condition. We determined that the factors contributing to their survival validated the point that regulators have emphasized and reiterated for years – a well-informed and active Board, strong management, sound credit administration and underwriting practices, and adequate capital are important in managing ADC concentrations in a safe and sound manner. In addition, the banks in our study did not rely on brokered deposits to fund growth, and geographic location factored into the degree of ADC loan losses. Ultimately, the strategic decisions and disciplined, values-based practices and actions taken by the Boards and management helped to mitigate and control the institutions' overall ADC loan risk exposure and allowed them to react to a changing economic environment. Unlike many failed banks that saw their capital evaporate rapidly because of the losses associated with their ADC portfolios, the banks in our study—that is, those that weathered the storm—experienced comparatively fewer losses and were able to maintain stable capital positions.

The FDIC's Examination Process for Small Community Banks

One of the FDIC Chairman's stated priorities is the future of community banks. The FDIC is the primary federal regulator for the majority of these institutions, and based on a recent FDIC study, the FDIC believes that the community bank model is viable and that there will be a strong community banking sector in the U.S. financial system for the foreseeable future. One of our Congressionally requested assignments over the past year speaks to the FDIC's examination process for small community banks.

On February 10, 2012, the Chairman of the Senate Committee on Banking, Housing, and Urban Affairs requested that the Inspectors General of the FDIC, the Department of the Treasury, the Board of Governors of the Federal Reserve System, and the National Credit Union Administration conduct audits of their respective agencies' examination processes for small community banks and credit unions. The Chairman's request was prompted by concerns from community banks and credit unions that examinations were being conducted without clear standards or consistent application of agency policies and procedures, which could discourage business growth and responsible lending. The request indicated that the results of the audits would help the Committee to better understand the supervisory processes at the agencies and facilitate the Committee's efforts to address concerns raised by community banks and credit unions.

In response to this request, we reported that the FDIC has established and implemented a nationwide program for planning, conducting, reporting, and evaluating the effectiveness of its examinations of FDIC-supervised community institutions. With respect to examination timelines, in broad terms, the cycle time for conducting risk management examinations increased significantly as the supervisory ratings for, and condition of, the institution deteriorated. We also noted that overall cycle time for well-rated institutions increased to a limited degree during the period covered by our review, which the FDIC attributed to policy changes that increased baseline procedures and allowed for more examiner discretion in expanding the scope of their examinations, based on identified risks.

As it relates to the time it takes the FDIC to issue an examination report following onsite work, that phase of the examination process generally ranged from 2 to 4 weeks for well-rated institutions and 6 to 9 weeks for institutions rated less favorably. The difference in report processing timeframes can generally be attributed to the additional complexity and volume of deficiencies associated with troubled institutions, the level of review required to ensure the reports fully support lower ratings and appropriate supervisory actions, and examiners working with bank management and other regulatory agencies to reach agreement on the examination findings and supervisory actions before the final report is issued.

We also collected examination timeline statistics for compliance examinations—that is examinations to assess compliance with consumer protection laws and regulations and Community Reinvestment Act requirements. Generally, we identified a trend similar to what we found with risk management examinations—longer overall cycle times for lower-rated institutions. However, unlike risk management examinations, elapsed days between onsite examination work and the issuance of the final report did not vary much, averaging about 1 month.

Regarding how consistently the FDIC administers examinations in its various regions, the FDIC has established a number of controls and practices intended to promote a consistent examination process, including policy and guidance, training, multiple levels of review for examination reports, quality control reviews of key regional and field office examination activities, and coordination with other federal and state regulatory agencies on matters of mutual interest.

Concerning the ability of FDIC-supervised institutions to question examination results, the FDIC encourages examiners and bankers to make a good-faith attempt to resolve disputes through informal dialogue during the examination. Other opportunities for such a dialogue include exit meetings with bank management, discussions during the reporting process to clarify issues, and meetings with an institution's board of directors at which the examination results are presented. The FDIC also asks each institution, at the end of a risk management examination, to complete a Post-Examination Survey to help the FDIC in improving the efficiency and quality of its examinations.

When agreement on key issues such as examination ratings, loan loss reserve provisions, or classifications of significant loans cannot be reached informally, institutions may request a formal review by FDIC Division Directors, as appropriate. Institutions that dispute the results of the directors' reviews may appeal to the Supervision Appeals Review Committee, which is outside of the examination and supervision process.

Bankers may also question examination results in enforcement action cases filed by the FDIC with the Office of Financial Institution Adjudication (OFIA) administrative law judge, who conducts hearings and recommends decisions associated with formal enforcement actions. They may also contact the FDIC's Ombudsman's Office, which can be used to discuss and resolve concerns associated with any aspect of the examination process in a confidential forum.

We believe the results of these two reviews provide the Congress, FDIC, bankers, and public helpful information on practices that helped banks survive the recent crisis and a fuller understanding of the examination process for the community banking sector.

Collaboration with OIG Colleagues and Ongoing Efforts

Collaboration with colleagues is an effective means of leveraging FDIC OIG resources. During the past year, we partnered with the Department of the Treasury and Federal Reserve OIGs on reviews to ensure the efficient and effective transfer of Office of Thrift Supervision functions to the FDIC, OCC, and FRB, as required under the Dodd-Frank Act.

Importantly, on an on-going basis, we are monitoring the FDIC's activities as they relate to implementing provisions of the Dodd-Frank Act, particularly given the FDIC's new responsibilities under the Act to resolve certain large, complex, and interconnected financial institutions when they run into problems. Several assignments are underway in this area. First, we are assessing the risks associated with the FDIC's efforts to implement its new authorities under the Dodd-Frank Act for the orderly liquidation of financial companies. Additionally, we are conducting an audit to identify potential security control enhancements to mitigate the risk of unauthorized disclosure of sensitive information pertaining to systemically important financial institutions. We will report the results of these efforts in upcoming reports.

OIG Investigations Target Financial Institution Fraud

FDIC OIG investigative work at both open and closed banks over the past year continued to complement our audit and evaluation work. Our criminal investigations provide additional insights into the control weaknesses that allowed perpetrators of fraud to commit illegal acts. We are particularly concerned when individuals inside the bank—officers, directors, and others—conspire to circumvent controls and commit crimes that harm their banks and cause losses to the DIF, thus undermining the integrity of the banking system as a whole.

Our office is committed to partnerships with other OIGs, the Department of Justice, the Federal Bureau of Investigation, and other state and local law enforcement agencies in pursuing criminal acts in open and closed banks and helping to deter fraud, waste, and abuse. The OIG also actively participates on numerous mortgage fraud and other financial fraud working groups nationwide to keep current with new threats and fraudulent schemes that can undermine the integrity of the FDIC's operations and the financial services industry as a whole. These include the Bank Fraud Working Group, Mortgage Fraud Working Group, and Federal Financial Enforcement Task Force, all spearheaded by the Department of Justice.

Our current caseload includes 281 active investigations. Of these, 118 relate to open bank matters and 113 to closed bank matters. These cases involve fraud and other misconduct on the part of senior bank officials, and include mortgage and commercial loan fraud exposed by turmoil in the housing, commercial real estate, and lending industries. The perpetrators of such crimes can be those very individuals entrusted with governance responsibilities at the institutions—directors and bank officers. Currently about 60 percent of our open cases involve such individuals. In other cases, parties providing professional services to the banks and customers, others working inside the bank, and customers themselves are principals in fraudulent schemes. Other investigations include cases involving misrepresentations of FDIC insurance or affiliation, concealment of assets, and computer crimes. We are coordinating closely with the FDIC to ensure the continued safety and soundness of the nation's banks and to preserve public confidence in the banking system.

FDIC OIG investigative results over the past year include the following: 117 indictments; 40 arrests; 131 convictions; potential monetary recoveries (fines, restitution, and asset forfeitures) of $412.8 million; and 88 referrals to the Department of Justice.

Office of Inspector General Federal Housing Finance Agency

The Federal Housing Finance Agency's Office of Inspector General (FHFA-OIG) conducts, supervises, and coordinates audits, evaluations, investigations, and other activities relating to the programs and operations of the Federal Housing Finance Agency (FHFA or the Agency), which regulates and supervises the housing-related government-sponsored enterprises (GSEs): the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Banks (FHLBanks). Since September 2008, FHFA has also served as conservator for Fannie Mae and Freddie Mac (collectively, the enterprises).

Over the past year, FHFA-OIG has recorded significant accomplishments relating to financial oversight, many of which are discussed below. These and other accomplishments are discussed further in FHFA-OIG's Fourth and Fifth Semiannual Reports to the Congress, which are available at ***www.fhfaoig.gov***.

Selected Examples of FHFA-OIG's Recent Financial Oversight Work

Reports

Report No. WPR-2012-02: *Fannie Mae and Freddie Mac: Where the Taxpayers' Money Went* (May 24, 2012)

> U.S. taxpayers have invested nearly $187.5 billion in the enterprises since September 2008, prompting questions about why they required such intervention, how they have used it, and who benefited from it. FHFA-OIG found that when housing prices began declining rapidly in 2006-2007, the enterprises owned or guaranteed mortgages worth over $5 trillion, but lacked adequate capital reserves to continue operating in the face of their portfolios' growing losses. The enterprises used Treasury's investments to cover: (1) losses from single-family mortgage loans acquired from 2004 through 2008; (2) dividend payments owed to Treasury; (3) losses from investments and other expenses; and (4) payments to creditors who had purchased the enterprises' bonds and mortgage-backed securities (MBS). Further, without Treasury's assistance, the enterprises likely would have been unable to finance new mortgages or create new MBS.

Report No. WPR-2012-03: *Overview of the Risks and Challenges the Enterprises Face in Managing Their Inventories of Foreclosed Properties* (June 14, 2012)

> When a borrower defaults on a mortgage owned or guaranteed by an enterprise, the associated property may be foreclosed upon, repossessed, and then sold to recoup some or all of the enterprise's loss. The process of securing, maintaining, repairing, and selling foreclosed properties is known as REO

management. Since 2007-2008, the enterprises have experienced surging foreclosure rates, rising REO inventories, and associated costs. By the end of 2011, their REO inventories had more than tripled to nearly 180,000 units and their related expenses totaled $8.5 billion. Further, given the financial distress many homeowners still experience, the enterprises may face elevated REO inventories and costs for years to come. For these reasons, this report discussed: (1) the enterprises' foreclosure and REO management processes; (2) the critical role that contractor oversight plays in REO management; (3) key enterprise REO management challenges; (4) FHFA's oversight of the enterprises' REO management; and (5) FHFA's and Fannie Mae's development of a REO pilot program under which investors can purchase, in bulk, foreclosed properties with rental commitments. The report also identified FHFA-OIG's strategy for assessing FHFA's oversight of the enterprises' REO management efforts.

Report No. EVL-2012-005: *FHFA's Oversight of the Federal Home Loan Banks' Unsecured Credit Risk Management Practices* (June 28, 2012)

The FHLBanks may extend unsecured credit (i.e., loans not backed by collateral) to financial institutions. FHFA-OIG evaluated FHFA's oversight of the FHLBanks' unsecured credit risk management practices, and found that unsecured credit extensions to European financial institutions increased substantially in 2010-2011 even as associated risks intensified. Although FHFA was aware of such risks, its examinations did not prioritize unsecured credit extensions until 2011. FHFA initiatives contributed to a significant decline in the amount of unsecured credit the FHLBanks were extending by the end of that year, but FHFA-OIG recommended that FHFA further strengthen its oversight by investigating potential violations of its regulations on unsecured credit extensions, and that it consider revising those regulations as necessary.

Report No. EVL-2012-007: *Follow-up on Freddie Mac's Loan Repurchase Process* (September 13, 2012)

In a prior evaluation report, Evaluation of the Federal Housing Finance Agency's Oversight of Freddie Mac's Repurchase Settlement with Bank of America (EVL-2011-006, September 27, 2011), FHFA-OIG raised concerns about the methodology that Freddie Mac used to determine the number of defective loans purchased from Bank of America that were eligible for repurchase. FHFA-OIG concluded that Freddie Mac's methodology underestimated the number of defective loans that should have been covered by a settlement with Bank of America because it tended to exclude from its review defective loans that were originated more than two years prior to default. In the follow-up report, FHFA-OIG found that FHFA and Freddie Mac had acted on the concerns raised in the initial report by adopting a more expansive loan review process. Specifically, Freddie Mac changed its policy to review for potential repurchase claims significantly larger numbers of loans that defaulted more than two years after origination. FHFA-OIG determined that, as a result of its new loan review process, Freddie Mac will realize between $2.2 billion and $3.4 billion in additional recoveries.

Report No. EVL-2012-008: *Evaluation of FHFA's Oversight of Fannie Mae's Transfer of Mortgage Servicing Rights from Bank of America to High Touch Servicers* (September 18, 2012)

In July 2011, Fannie Mae transferred mortgage servicing rights (MSR) for 384,000 mortgage loans and paid Bank of America a $421 million transfer fee. The deal received media attention, and members of Congress asked FHFA-OIG to investigate the transaction. FHFA-OIG concluded the transaction was only the latest in a series of transactions under the High Touch Servicing Program, the concept behind which FHFA-OIG deemed to be sound, calling it "a fundamentally promising initiative with the potential to reduce Fannie Mae's—and, by extension, the taxpayers'—losses on mortgage guarantees." However, FHFA-OIG found that FHFA could improve its oversight of the program and recommended that the agency consider revising its delegation of authorities to require its preapproval of "unusual, high-cost, new initiatives, like the High Touch Servicing Program."

Report No. EVL-2012-009: *FHFA's Oversight of Freddie Mac's Investment in Inverse Floaters* (September 26, 2012)

Freddie Mac structures and markets bonds known as collateralized mortgage obligations (CMOs) that can be tailored to investors' preferences. As investor appetite for floating-rate bonds increased, Freddie Mac began to issue CMOs by carving them out of securitized mortgages. It retained for itself the by-product variable-rate bonds known as inverse floaters, which can be adversely affected by large-scale refinancings of the underlying mortgages. An FHFA-OIG evaluation found no evidence that Freddie Mac deliberately limited loan refinancings to protect the value of their inverse floaters. However, FHFA-OIG found that some of FHFA's public statements about inverse floaters could have been clearer, and made several recommendations to FHFA, including that it monitor Freddie Mac's investment models.

Report No. EVL-2013-003: *Freddie Mac's Unsecured Lending to Lehman Brothers Prior to Lehman Brothers' Bankruptcy* (March 14, 2013)

FHFA-OIG evaluated two unsecured loans totaling $1.2 billion that Freddie Mac made to Lehman Brothers Holdings Inc. (Lehman), on which Lehman subsequently defaulted by declaring bankruptcy. FHFA-OIG found that Freddie Mac determined that its corporate culture allowed management to override counterparty risk management policies, which would have altered the loans' terms and thereby reduced the enterprise's risk. FHFA and Freddie Mac have worked to improve the enterprise's corporate governance environment and to correct its risk management failures, and FHFA is actively engaged in recovering the loss from the bankruptcy estate. FHFA-OIG recommended that FHFA develop an examination program encompassing enterprise-wide risk exposure to all of Freddie Mac's counterparties. This case study demonstrates that risk management controls are essential, that corporate culture cannot be allowed to override or marginalize them, and that effective oversight is essential to reinforce them.

Report No. AUD-2012-004: *FHFA's Supervisory Framework for Federal Home Loan Banks' Advances and Collateral Risk Management* (June 1, 2012)

FHFA-OIG audited FHFA's supervision of the FHLBanks' advances and collateral risk management practices. FHFA-OIG found that although FHFA has acted to mitigate risk at the FHLBanks related to advances and collateral, it can strengthen its supervisory framework. FHFA-OIG also found that FHFA does not have access to data that could enable it to better assess the risk of losses on advances and other risks posed to the FHLBanks. FHFA-OIG recommended that FHFA implement its pending review recommendations, strengthen its supervisory framework, coordinate with other federal banking agencies, and improve its oversight of problem member institutions.

Report No. AUD-2012-005: *FHFA's Supervisory Risk Assessment for Single-Family Real Estate Owned* (July 19, 2012)

FHFA-OIG audited FHFA's oversight of the enterprises' REO inventories. FHFA-OIG found that FHFA's 2012 examinations of certain REO risk areas (such as REO contractor management) were positive supervisory steps that could be applied to other REO risk areas, such as the enterprises' handling of properties in or near foreclosure (the "shadow inventory"). FHFA-OIG also found that FHFA might benefit from using a more comprehensive REO risk assessment and from using this assessment to enhance its planning of supervisory activities. FHFA-OIG recommended that FHFA implement such an assessment and link the results to supervisory plans that address those risks through specific supervisory activities.

Report No. AUD-2012-007: *FHFA's Oversight of the Enterprises' Management of High-Risk Seller/Servicers* (September 18, 2012)

FHFA-OIG audited FHFA's oversight of the enterprises' controls over "high-risk" counterparties – i.e., entities with which an enterprise does business, whose circumstances may present a financial threat to the enterprises. Although the enterprises estimated that they incurred losses of up to $6.1 billion since 2008 from just four counterparties' failures, and that remaining risk exposure to high-risk seller/servicers was approximately $7.2 billion, FHFA-OIG found that FHFA had not directed the enterprises to implement contingency plans for deteriorating or failing counterparties. FHFA-OIG recommended that FHFA issue standards for the enterprises to develop comprehensive contingency plans for high-risk and high-volume seller/servicers and that the Agency finalize its examination guidance regarding contingency planning.

Report No. AUD-2012-008: *FHFA's Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions* (September 27, 2012)

In November 2008, FHFA delegated to the enterprises most of its conservatorship authority over their operations on the condition that they obtain FHFA's approval for certain business decisions, such as those involving legal settlements over $50 million and counterparty risk limit increases. However, an FHFA-OIG audit found that FHFA did not mandate conservatorship approval for various major enterprise business decisions, and that the enterprises did not always request such approval. FHFA-OIG also determined that FHFA had not established criteria or policies to ensure rigorous review of enterprise business decisions, nor a formal process to verify that the enterprises abided by conservatorship decisions. FHFA-OIG recommended that the Agency: (1) ensure that the enterprises seek the Agency's approval for significant business decisions; (2) guide the enterprises to establish processes to ensure that approval is sought when necessary; (3) properly analyze, document, and support conservator decisions; and (4) confirm the enterprises' compliance with conservator decisions.

Report No. AUD-2013-001: *FHFA's Oversight of the Enterprises' Efforts to Recover Losses from Foreclosure Sales* (October 17, 2012)

FHFA-OIG audited FHFA's oversight of the enterprises' efforts to recover deficiencies owed on foreclosed mortgages (i.e., amounts owed after a property is sold at auction for less than what was owed on the mortgage). FHFA-OIG found that FHFA did not oversee the enterprises' deficiency management practices, nor monitor those practices' scope or effectiveness. FHFA-OIG recommended that FHFA obtain information sufficient to analyze how the enterprises manage deficiencies, issue appropriate guidance, and incorporate deficiency management into its enterprise oversight.

Report No. AUD-2013-007: *Enhanced FHFA Oversight Is Needed to Improve Mortgage Servicer Compliance with Consumer Complaint Requirements* (March 21, 2013)

Freddie Mac's servicers interact with borrowers associated with the residential mortgages Freddie Mac owns or guarantees. Such interaction may include handling complaints, including more significant complaints – known as escalated cases. FHFA-OIG audited FHFA's oversight of Freddie Mac's controls over servicers' handling of escalated cases. FHFA-OIG found that, although FHFA and Freddie Mac require servicers to report within 30 days on escalated cases they receive, most did not do so and an FHFA examination missed the problem. FHFA also missed Freddie Mac's failures to implement both compliance testing procedures and penalties for non-compliance, possibly due to insufficient guidance for FHFA examination teams. FHFA-OIG recommended that FHFA: (1) ensure that Freddie Mac requires its servicers to report, timely resolve, and accurately categorize escalated cases; (2) ensure that Freddie Mac enhances servicer oversight by testing performance and fining noncompliance; and (3) improve its oversight of Freddie Mac by issuing examination guidance on testing the implementation of directives.

Report No. AUD-2013-008: *FHFA Should Develop and Implement a Risk-Based Plan to Monitor the Enterprises' Oversight of Their Counterparties' Compliance with Contractual Requirements Including Consumer Protection Laws* (March 26, 2013)

FHFA-OIG assessed FHFA's oversight of the enterprises' monitoring of their loan sellers' compliance with their contractual agreements, with an emphasis on their compliance with federal consumer protection laws. FHFA-OIG found that FHFA does not thoroughly oversee how the enterprises monitor counterparties' contractual compliance. Specifically, FHFA does not examine how the enterprises monitor compliance with consumer protection laws, and, indeed, OIG determined that the enterprises do not ensure that their counterparties' business practices follow all federal and state laws and regulations designed to protect consumers from unlawful activities such as discrimination. FHFA-OIG recommended that FHFA develop and implement a risk-based plan to assess the enterprises' oversight of their counterparties' compliance with their contractual obligations.

Investigations

Investigation of Homefirst Realty Group Inc.

On October 18, 2012, Juan Carlos Sanchez pled guilty to conspiracy and on January 3, 2013, he was sentenced to 15 years' incarceration followed by 3 years' supervised release. Sanchez led a large-scale mortgage fraud conspiracy involving mortgage brokers, real estate agents, and settlement agents whose work related to selling condo-conversion properties in Ft. Lauderdale, Orlando, and Tampa, Florida, many of which have subsequently defaulted. Freddie Mac's exposure is 36 units totaling $8.5 million. Fannie Mae has reported losses over $4.1 million.

Investigation of Audrey Yeboah

On October 25, 2012, Audrey Yeboah, an accountant and tax preparer, pled guilty to wire fraud in the U.S. District Court for the Southern District of California. From May 2007 through September 2008, Yeboah and others induced mortgage lenders to pay for inflated loans for straw buyers based on false loan applications. Yeboah admitted creating fraudulent employment and income records for the straw buyers, which allowed her co-conspirators to collect at least $14 million in kickbacks from approximately $100 million in fraudulently obtained mortgage loans. Fannie Mae bought five of these mortgages and suffered losses. This was a joint investigation with the Federal Bureau of Investigation (FBI).

Investigation of Raymond Morris

On November 5, 2012, Raymond Morris, a businessman, was sentenced in the U.S. District Court for the Southern District of West Virginia to nearly 5 years' incarceration and 5 years' probation with restitution for wire and bank fraud. From 2006 to 2007, Morris conspired to inflate 30 homes' values, with excess funds used to make down payments and initial mortgage payments. This scheme cost lenders approximately $7 million. Fannie Mae bought nine of those loans and has lost over $921,000 to date. This was a joint investigation with the FBI.

Investigation of Larry Reisman

On November 8, 2012, Larry Reisman, owner of LR Development, pled guilty to conspiracy to commit money laundering in the U.S. District Court for the Eastern District of Texas. From January 2006 to October 2008, Reisman inflated the sales price of 53 homes he built and kicked back a portion of the proceeds to recruiters and buyers. The enterprises bought or guaranteed mortgages on four of the homes, and lost over $500,000. This was a joint investigation with the Department of Housing and Urban Development's Office of Inspector General (HUD-OIG), the Internal Revenue Service-Criminal Investigation (IRS-CI), the FBI, the Secret Service, and U.S. Postal Inspection Service (USPIS).

Investigation of Burchell Builder Bailout

On January 4, 2013, Aref Abaji, Maher Obagi, Jacqueline Burchell, Mohamed Salah, Mohamed El Tahir, and Wajieh Tbakhi were indicted for conspiracy to commit wire and bank fraud in the U.S. District Court for the Central District of California. The indictment alleges that from 2007 through 2009, the defendants negotiated with housing developers in several states to sell condominiums in exchange for large undisclosed commissions. The defendants allegedly recruited straw buyers and prepared loan applications with false information in order to sell more than 100 units. The enterprises purchased many of the mortgages secured by the units, and to date they have lost approximately $2.4 million because of related delinquencies, defaults, and foreclosures. This was a joint investigation with the FBI and IRS-CI.

Investigation of Jerrick Hawkins

On January 9, 2013, real estate investor Jerrick Hawkins pled guilty in the U.S. District Court in the Eastern District of Missouri to one count of bank fraud and two counts of false statements. From 2007 until September 2011, Hawkins supported loan applications with fraudulent documents. Most of the loans went into default. The scheme involved over 14 enterprise loans and 21 FHA loans. Total losses are still being determined, but are estimated at $1.5 million. This was a joint investigation with HUD-OIG and USPIS.

Investigation of Jose Luis Salguero et al.

On January 23, 2013, Jose Luis Salguero Bedoya, an investor, and his girlfriend Yazmin Soto-Cruz; Carmine Fusco, an unlicensed title agent or attorney; Kenneth Sweetman, an unlicensed title agent or attorney; Delio Coutinho, a loan officer; Joseph DiValli, a loan officer; Paul Chemidlin Jr., an unlicensed appraiser; Christopher Ju, a short sale negotiator; and Jose Martins Jr., a bank employee, were charged with conspiracy to commit wire fraud in the U.S. District Court for the District of New Jersey. From March 2008 to July 2012, the defendants allegedly defrauded financial institutions by submitting fraudulent appraisals, sales contracts, and other documents in connection with mortgage loans. Fannie Mae allegedly purchased numerous loans involved in the scheme. The charges relate to 15 properties that allegedly caused losses of approximately $10 million. This was a joint investigation with the FBI, HUD-OIG, the Special Inspector General for the Troubled Asset Relief Program ("SIGTARP"), USPIS, IRS-CI, and the Hudson County, New Jersey, prosecutor's office.

Investigation of Sky Investments

On January 31, 2013, Yakov Alfasi and Rafael Rubinez pled guilty to wire fraud conspiracy in the U.S. District Court for the Southern District of Florida. Alfasi and Rubinez owned Sky Investments, an independent mortgage banker, which sold loans to and serviced them for Fannie Mae. From September 2009 through August 2010, Alfasi and Rubinez stole $2.6 million from an account Fannie Mae established to pay taxes and insurance on its properties. Alfasi and Rubinez also submitted false and misleading documents to Fannie Mae to conceal their theft and to misrepresent their company's financial health. This was a joint investigation with the FBI.

Investigation of West Ohio St Condos

On January 31, 2013, Matthew Okusanya and Alex Ogoke were indicted for wire fraud in the U.S. District Court for the Northern District of Illinois. On February 21, 2013, James Vani and Olabode Rotibi were also indicted in that court for wire fraud. From 2007 to 2008, defendants allegedly developed a corporation to buy a Chicago apartment building, convert the units to condominiums, and recruit straw buyers to buy them. Through the straw buyers and misleading loan applications, they allegedly led lenders to approve loans they would not normally have approved. The scheme exposed the enterprises to $3 million in potential losses with over $400,000 in actual losses as of the indictment. This was a joint investigation with the FBI.

Investigation of AMFS

On February 20, 2013, Dean Counce was sentenced in the U.S. District Court for the Middle District of Florida to over 8 years' incarceration and 3 years' supervised release, and ordered to make over $12.7 million in restitution for conspiring to commit wire fraud. From 2009 to March 2012, Counce, as President of American Mortgage Field Services (AMFS), conspired to submit fraudulent reports to Bank of America for property inspections for which AMFS was paid but had not conducted. The enterprises reimbursed Bank of America, as their servicer, for the fake inspections. This was a joint investigation with HUD-OIG and the Secret Service.

Residential Mortgage-Backed Securities Civil Cases

The New York State Attorney General instituted civil proceedings against JP Morgan Chase and Credit Suisse alleging violations of the New York State Martin Act in connection with the sale of residential mortgage-backed securities to, among others, the enterprises. FHFA-OIG made significant contributions—including assisting with the interviews of witnesses and the review of documents—in connection with both cases.

Countrywide Hustle Civil Case

On October 24, 2012, U.S. Attorney for the Southern District of New York filed a civil mortgage fraud lawsuit against Bank of America and its predecessors, Countrywide Financial Corporation and Countrywide Home Loans Inc., for engaging in a scheme to defraud the enterprises. The complaint seeks damages and civil penalties under the False Claims Act and the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. Specifically, the complaint alleges that from 2007 through 2009, the defendants implemented a loan origination process known as the "Hustle." The Hustle was designed to process loans at high speeds and without quality control checkpoints. According to the complaint, the Hustle generated thousands of fraudulent and otherwise defective residential mortgage loans that were later sold to the enterprises and caused over $1 billion in losses and countless foreclosures. The government amended its complaint on January 11, 2013, among other things, to add a claim against a former Countrywide and current Bank of America executive, who was responsible for implementing the Hustle. This case is the result of a joint-action between the U.S. Attorney's Office for the Southern District of New York, SIGTARP, and OIG.

FHFA-OIG's Planned Financial Oversight Work and Related Activities

Audit and Evaluation Plan

FHFA-OIG has developed an Audit and Evaluation Plan that focuses on the areas of FHFA's operations posing the greatest risks to the agency and to the GSEs. The plan responds to current events and feedback from FHFA officials, members of Congress, and others. The plan is available for inspection at FHFA-OIG's website, www.fhfaoig.gov.

Investigations Strategy

FHFA-OIG has developed and intends to further develop close working relationships with other law enforcement agencies, including DOJ and the U.S. Attorneys' Offices; state attorneys general; mortgage fraud working groups; the Secret Service; the FBI; HUD-OIG; the FDIC-OIG; the IRS-CI; SIGTARP; FinCEN; and other federal, state, and local agencies.

During this reporting period, OI has continued to work closely with FinCEN to review allegations of mortgage fraud for follow-up investigations and to determine where FHFA-OIG can best assign special agents to investigate fraud against the GSEs. FHFA-OIG also pursues innovative approaches to ensure its investigations are prosecuted timely. For example, FHFA-OIG has provided dedicated investigative counsels with substantial criminal prosecution experience to U.S. Attorneys' Offices to help prosecute FHFA-OIG's investigations. In addition, FHFA-OIG has partnered with a number of state attorneys general to pursue shared law enforcement goals.

Hotline

FHFA-OIG's Hotline allows concerned parties to confidentially report information regarding possible fraud, waste, or abuse related to FHFA or the GSEs. FHFA-OIG honors all applicable whistleblower protections.

FHFA-OIG promotes the Hotline through its website, posters, emails targeted to FHFA and GSE employees, and its Semiannual Reports to the Congress.

Regulatory Review

Consistent with the Inspector General Act, FHFA-OIG considers whether proposed legislation and regulations related to FHFA are efficient, economical, legal, and susceptible to fraud and abuse. FHFA-OIG makes recommendations to FHFA as necessary and monitors its compliance with recommended courses of action.

Coordinating with Other Oversight Organizations

FHFA-OIG actively participates in the Financial Fraud Enforcement Task Force ("FFETF"), a broad coalition of state and federal law enforcement agencies, prosecutors, and other entities. FHFA-OIG is a member of several FFETF task forces and working groups, including: (1) the Mortgage Fraud Working Group; (2) the Securities and Commodities Fraud Working Group; (3) the Residential Mortgage Backed Securities Working Group; and (4) the Recovery Act, Procurement, and Grant Fraud Working Group.

FHFA-OIG continues to participate in the Federal Housing Inspectors General working group, which includes the Offices of Inspector General for federal agencies with responsibility for housing, including FHFA, HUD, the Department of Veterans Affairs, and the Department of Agriculture. The Federal Housing Inspectors General collaborate on multiple joint initiatives.

FHFA-OIG actively participates in the Council of the Inspectors General on Integrity and Efficiency ("CIGIE"). The Inspector General serves on CIGIE's Inspection and Evaluation Committee, which supports and promotes evaluation and inspection practice in the OIG community. The Inspector General also serves as co-chair of CIGIE's Suspension and Debarment Working Group, which is charged with improving the effectiveness of federal suspension and debarment practices.

FHFA-OIG has also partnered with FinCEN, SIGTARP, HUD-OIG, the FBI, and the Secret Service to share data, analyze internal complaints, and identify trends. Doing so allows the partnering entities to leverage their combined investigative resources towards identifying, investigating, and prosecuting those involved in fraud and other illegal activities related to their respective statutory authorities.

Office of Inspector General
U.S. Department of Housing and Urban Development

The HUD Office of Inspector General (OIG) strives to make a difference in HUD's performance and accountability and has a strong commitment to its statutory mission of detecting and preventing fraud, waste, and abuse and promoting the effectiveness and efficiency of government operations.

Background

The U.S. Department of Housing and Urban Development (HUD) Inspector General is one of the original 12 Inspectors General authorized under the Inspector General Act of 1978. The HUD Office of Inspector General (OIG) strives to make a difference in HUD's performance and accountability. HUD OIG has a strong commitment to its statutory mission of detecting and preventing fraud, waste, and abuse and promoting the effectiveness and efficiency of government operations.

While organizationally located within HUD, HUD OIG operates independently with separate budget authority. Its independence allows for clear and objective reporting to HUD's Secretary and Congress. HUD's primary mission is to improve housing and expand opportunities for families seeking to improve their quality of life. HUD does this through a variety of housing and community development programs aimed at helping Americans nationwide obtain affordable housing. These programs are funded through a $45 billion annual congressional budget.

Also, within HUD are the Federal Housing Administration (FHA) and Government National Mortgage Association (Ginnie Mae). FHA provides mortgage insurance for single-family and multifamily properties, nursing homes, and hospitals. FHA receives limited congressional funding because it is self-funded through mortgage insurance premiums. FHA generated almost a trillion dollars in insured loans last year.

Ginnie Mae guarantees the timely payment of principal and interest payments on mortgage-backed securities (MBS) to institutional investors worldwide. These securities, or "pools" of mortgage loans, are used as collateral for the issuance of securities on Wall Street. MBS are commonly referred to as "pass-through" certificates because the principal and interest of the underlying loans is passed through to investors. Ginnie Mae guarantees only securities backed by mortgage loans insured by government agencies, including FHA, the U.S. Department of Veterans Affairs, HUD's Office of Public and Indian Housing, and the U.S. Department of Agriculture's Rural Development.

While there are other programs at HUD that are used in a significant way to help stimulate the economy (for example, billions of dollars in new funding for Community Development Block Grants, increased public housing assistance, etc.), which are also vulnerable to fraudulent and abusive activities, our focus has remained on the FHA program due to the mortgage crisis and an increased reliance on HUD to resolve foreclosure matters at this critical juncture.

The degree of FHA predominance in the market is unparalleled. To put the FHA issues into perspective, we recently stated in testimony to Congress that, through the magnitude of our work in auditing and investigating many facets of the FHA programs over the course of many years, OIG has had and continues to have concerns regarding the ability of FHA's systems and infrastructure to adequately perform its requirements and services. These concerns were expressed by OIG to FHA through audits and reports regarding a wide spectrum of areas before the program's influx of loans and before considering the many proposals that expanded its reach. OIG remains concerned regarding FHA's ability and capacity to oversee the newly generated business. Some of these are long-standing concerns that go back to unresolved issues highlighted in our work products from as far back as the early to mid-1990s.

The FHA Mutual Mortgage Insurance (MMI) fund has not met the statutory 2 percent requirement for the last 4 years. In addition, for the first time ever, HUD's fiscal year 2013 budget included an appropriations request for $688 million to cover a possible shortfall in the MMI fund.

At the end of fiscal year 2012, the MMI fund fell below zero (-1.44 percent). As a result, we estimate that HUD's fiscal year 2014 budget may include an appropriations request for $14 to $16 billion to cover a possible shortfall in the MMI fund.

OIG continues to have a concern that increases in demand to the FHA program will have collateral implications for the integrity of the Ginnie Mae MBS program, including the potential for increases in fraud in that program. Ginnie Mae securities are the only MBS to carry the full faith and credit guaranty of the United States. If an issuer fails to make the required pass-through payment of principal and interest to MBS investors, Ginnie Mae is required to assume responsibility for it. Typically, Ginnie Mae defaults the issuers and assumes control of the issuers' MBS pools. Like FHA, Ginnie Mae has seen an increase in its market share. From a different vantage point, the industry has noted that Ginnie Mae's struggle to keep pace with FHA could also reduce liquidity in the housing market at a critical moment.

A significant problem facing FHA and the lenders it works with is the fallout from decreasing home values. This condition increases the risk of default, abandonment, and foreclosure and makes it difficult for FHA to resell the properties. A major cause for concern is that even as FHA endorsement levels meet or exceed previous peaks in its program history, FHA defaults have already exceeded those of previous years. This issue reinforces the importance for FHA-approved lenders to maintain solid underwriting standards and quality control processes to withstand severe adverse economic conditions.

Last year, we reported that HUD OIG had enlisted the assistance of the U.S. Department of Justice's (DOJ) Civil Division to facilitate any possible litigation under the False Claims Act or other statute against mortgage loan servicers for their actions related to foreclosure requirements. On February 9, 2012, DOJ and 49 State attorneys general announced a proposed settlement of $26 billion with the five servicers for their reported violations of foreclosure requirements.

Over the years, HUD OIG has continued to report on the mediocre underwriting standards and quality control processes of FHA's approved lenders. Therefore, based on the results of the foreclosure initiative, HUD OIG again enlisted the assistance of DOJ's Civil Division to facilitate any possible litigation under the False Claims Act or other statute against FHA-approved lenders. Our reviews focus on FHA's largest mortgage lenders, their compliance with FHA's underwriting requirements, and their quality control processes. HUD OIG staff will complete these reviews in fiscal year 2013.

Many "traditional" fraud schemes continue to affect FHA and are described below.

Loan Origination Fraud:

This fraud includes fraudulent and substantially inaccurate income, assets, and employment information; false loan applications, false credit letters, and reports; false gift letters; seller-funded down payments; concealed cash transactions; straw buyers; flipping; kickbacks; cash-out schemes; fraud rings; and inadequate or fraudulent underwriting activities. While these types of mortgage fraud schemes continue to operate, changing market conditions have generated new or variant schemes.

Home Builder-Seller Pleads Guilty in FHA Mortgage Fraud Case

A manufactured home and modular home dealer pled guilty to charges of conspiracy and wire fraud, false statements to HUD, and aiding and abetting. From 2004 to 2008, the defendant and others conspired and created or provided false information and fraudulent documents to qualify borrowers for FHA-insured manufactured and modular home mortgages. HUD has realized losses in excess of $5.4 million on 81 claims. HUD OIG, the North Carolina Bureau of Investigation, the North Carolina Office of the Commissioner of Banks, and the North Carolina Attorney General's Office conducted this investigation.

Former Loan Officer and Lender Branch Manager Sentenced

A former loan officer and branch manager was sentenced to 48 months incarceration, followed by five years supervised release, for her earlier guilty plea to criminal information charging her with conspiracy to commit mail fraud and wire fraud. The defendant conspired with at least four other individuals to obtain mortgages for unqualified borrowers, using fraudulent pay stubs, Internal Revenue Service forms W-2, income tax returns, verifications of employment, and seller-provided down payments to make the borrowers appear to be qualified for at least 19 FHA-insured and 13 conventional mortgages. Fifteen of the FHA-insured mortgages are in default or foreclosure status. The defendant was ordered to pay restitution totaling more than $1.9 million, with $962,283 directed to HUD. HUD OIG and the Federal Bureau of Investigation (FBI) conducted this investigation.

Two Former Mortgage Company Principals Plead Guilty in a Mortgage Fraud Scheme That Included Junior Mortgages

Two former principals of a HUD-approved mortgage company pled guilty to one count of racketeering following their original indictment in June 2011. The defendants were involved in a complex scheme to defraud FHA through a series of false statements on at least 65 FHA loans totaling in excess of $10 million. The fraudulent acts included the use of straw purchasers, phony employers, bogus bank statements and pay stubs, forged college transcripts, counterfeit court documents, and phony down payment gifts. Additionally, the defendants profited from the scheme by recording junior mortgages that were payable to business entities or associates from the loan proceeds. This case was worked jointly with the State of Minnesota and the U.S. Department of Commerce OIG.

Former State Department Employee Sentenced in Mortgage Fraud Scheme

A former U.S. Department of State employee and FHA-insured borrower was sentenced to 8 months home detention and 3 years probation and ordered to pay restitution to FHA. The defendant previously pled guilty to wire fraud in connection with a scheme to defraud a large bank by securing an FHA-insured mortgage loan using false documents and falsely inflating her income and assets. She further defrauded FHA and the bank by submitting false documents and information to secure a loan modification of the original FHA-insured mortgage. This case was worked jointly with the Department of State OIG.

Former Loan Processor Sentenced

A former loan processor for an FHA-approved lender was sentenced to 49 days in jail and 3 years supervised probation with the additional condition of not possessing the personally identifiable information of others. The defendant forged rental agreements claiming that borrowers were receiving rental income and submitted them in FHA loan files without the borrowers' knowledge. Five FHA loans totaling $1.1 million were identified as containing forged rental agreements, and it was determined that the loans would not have been approved without the added income provided by the fraudulent rental agreements. Two of the FHA loans have gone to claim with a total loss to HUD of $307,198. In several instances, the buyers walked away from existing conventional loans once the FHA-insured loan was fraudulently obtained.

Former Loan Officer Sentenced in Mortgage Fraud Case after Guilty Plea

A former mortgage company loan officer was sentenced to 54 months incarceration and 3 years supervised release. He was further ordered to pay more than $9.2 million in restitution to FHA. The defendant previously pled guilty to conspiracy to commit wire fraud. He conspired with others to create and submit false and fraudulent FHA mortgage loan applications and accompanying documents to a lender on behalf of unqualified borrowers. The defendant created false pay stubs, Federal tax forms, verification of employment forms, explanation letters, and other documents to ensure that otherwise unqualified borrowers could obtain FHA-insured loans. He enticed borrowers to obtain an FHA mortgage by paying them an incentive of up to $20,000 per loan. The loss to FHA is estimated at $6.5 million.

Appraisal Fraud:

This fraud is typically central to every loan origination fraud and includes deliberately fraudulent appraisals (substantially misrepresented properties, fictitious properties, bogus comparable), inflated appraisals (designed to "hit the numbers"), or both; appraiser kickbacks; and appraiser coercion.

Appraiser Debarred After Guilty Plea in FHA Mortgage Fraud Case

An FHA-approved appraiser was debarred from procurement and nonprocurement transactions throughout the Executive Branch of the Federal Government for an indefinite period. On March 21, 2011, the appraiser pled guilty to one count of making a false statement in an FHA-insured mortgage transaction. The appraiser had been charged with creating fraudulently inflated appraisals by "photoshopping" pictures of appraised properties in exchange for payments, often in cash, of thousands of dollars per home. The payments were well beyond the basic appraisal fee of about $375 that was disclosed in appraisals and on Federal mortgage documents. The Government alleged that this mortgage fraud scheme involved approximately

35 properties and loans obtained in the amount of approximately $10 million. Losses from the scheme are estimated to be at least $4.7 million. Twelve of the properties involved in this scheme involve FHA-insured mortgages totaling approximately $2.8 million. FHA has realized approximately $300,000 in losses. This case was investigated by HUD OIG and the FBI.

Home Equity Conversion Mortgage (Reverse Mortgage) Fraud:

FHA reverse mortgages are a new and potentially vulnerable area for fraud perpetrators. We are aware that the larger loan limits can be attractive to exploiters of the elderly, whether third parties or family members, who seek to strip equity from senior homeowners.

Six Sentenced in Reverse Mortgage Fraud Case

Six defendants were sentenced for their roles in a large-scale home equity conversion mortgage and short sale fraud scheme. One of the purported "ring leaders" of the group was sentenced to 151 months incarceration, and supervised probation for a period of 5 years after pleading guilty to charges of bank fraud and conspiracy to commit bank fraud. The defendant was ordered to pay restitution of more than $1 million to HUD, $119,095 to Old Republic, $9,000 to Georgia Multiple Listing Service (GA MLS), and more than $1.8 million to GE Capital. Another defendant and purported co-"ring leader," who pled guilty to aggravated identity theft and conspiracy to commit bank fraud, was sentenced to 63 months and 24 months incarceration, to run concurrently, and 5 years supervised probation. The defendant also was ordered to pay $271,522 in restitution to HUD and $9,000 to GA MLS. Four other defendants, including an attorney and loan officer, were sentenced to prison terms, ranging from time served to 37 months, and ordered to pay restitution totaling more than $6.2 million to HUD, seven banks and lenders, and others.

Rescue or Foreclosure Fraud

Recent trends show that certain individuals in the industry are preying on desperate and vulnerable homeowners who face foreclosure. Some improper activities include equity skimming (whereby the homeowner is approached and offered an opportunity to get out of financial trouble by the promise to pay off the mortgage or to receive a sum of money when the property is sold; the property is then deeded to the unscrupulous individual, who may charge the homeowner rent and then fail to make the mortgage payment, thereby causing the property to go into foreclosure) and lease or buy-back plans (wherein the homeowner is deceived into signing over title with the belief that he or she may remain in the house as a renter and eventually buy back the property; however, the terms are so unrealistic that buy-back is impossible, and the homeowner loses possession, with the new title holder walking away with most or all of the equity).

Complex Mortgage Fraud Scheme Results in a Number of Arrests and Indictments

Twenty Federal indictments were filed against real estate agents and property investors, a loan officer, straw buyers, and several coconspirators who were involved in a scheme with several mortgage companies. The indictments resulted in 19 arrests. Two of the defendants acted as real property investors, home improvement contractors, or real estate agents, while acting as the recruiters for straw buyers. The defendants identified properties in the process of foreclosure or properties of owners who were deceased.

The defendants offered to buy the properties or find buyers for them. Once owners agreed, the defendants produced either false mortgage notes or home improvement contracts so they could justify collecting part of the sales proceeds directly from the lenders or from the sellers. Straw buyers were recruited, who applied and obtained approval for FHA-insured loans for the purchase of the properties. The defendants helped the straw buyers obtain false income verification documents, such as pay stubs, Federal tax forms, tax returns, and verifications of employment. The former loan officer assisted with the approval of the loans. This was a joint investigation with the Internal Revenue Service-Criminal Investigation Division, the FBI, Immigration and Customs Enforcement, the United States Secret Service, and the Puerto Rico Office of the Commissioner of Financial Institutions.

The tasks before HUD OIG continue to be daunting addressing the elements of fraud that were involved in the collapse of the mortgage market; monitoring the rollout of new FHA loan products to reduce exploitation of program vulnerabilities; and combating perpetrators of fraud, including those who have migrated from the subprime markets, who would exploit FHA loan programs.

The consequences of the mortgage crisis, its worldwide economic implications, and the resulting pressures placed on HUD and OIG came at a time when HUD has had significant new leadership responsibilities. Over the last seven years HUD has also been focused on rebuilding communities devastated by disasters (for example, lower Manhattan post-September 11; the Gulf Coast region after hurricanes Katrina, Rita, and Wilma; the Galveston area after recent hurricanes; California fires; and Midwest flooding) that have added tens of billions of dollars in new program funds that require quick distribution and keen oversight. Recently, Congress appropriated $16 billion to assist States and people affected by Superstorm Sandy. HUD OIG continues to work closely with the Department as it implements the funding for Superstorm Sandy.

Office of Inspector General National Credit Union Administration

The NCUA OIG promotes the economy, efficiency, and effectiveness of NCUA programs and operations, and detects and deters fraud, waste and abuse, thereby supporting the NCUA's mission of providing, through regulation and supervision, a safe and sound credit union system which promotes confidence in the national system of cooperative credit.

Agency Overview

The National Credit Union Administration (NCUA) is responsible for chartering, insuring, and supervising Federal credit unions and administering the National Credit Union Share Insurance Fund (NCUSIF). The NCUA also manages the Operating Fund (OF), the Temporary Corporate Credit Union Stabilization Fund (TCCUSF), the Community Development Revolving Loan Fund (CDRLF), and the Central Liquidity Facility (CLF).

Credit unions are member-owned, not-for-profit cooperative financial institutions formed to permit members to save, borrow, and obtain related financial services. NCUA charters and supervises federal credit unions, and insures accounts in federal and most state-chartered credit unions across the country through the NCUSIF, a federal fund backed by the full faith and credit of the United States government.

The NCUA's mission is to provide, through regulation and supervision, a safe and sound credit union system that promotes confidence in the national system of cooperative credit. The agency also has a vision to protect consumer rights and member deposits. Finally, the NCUA is further dedicated to upholding the integrity, objectivity, and independence of credit union oversight. NCUA continually implements initiatives designed to continue meeting these goals.

Major NCUA Programs

Supervision

NCUA's supervision program ensures the safety and soundness of the credit union system.

Identifying and resolving risk concerns such as credit risk, concentration risk, and strategic risk continue to be the primary focus of the agency's supervision program. NCUA supervises natural person credit unions through annual examinations, regulatory enforcement, providing guidance in regulations and Letters to Credit Unions, and taking administrative actions as necessary to manage credit union risk.

On January 1, 2013, the NCUA established the Office of National Examinations and Supervision (ONES) to oversee the unique examination and supervision issues related to consumer credit unions with assets greater than $10 billion and to all corporate credit unions. Large consumer credit unions pose unique challenges in light of their size in comparison to the NCUSIF. Corporate credit unions touch the operations of thousands of consumer credit unions through the critical services they provide. ONES staff includes examiners, lending specialists, capital markets specialists, information systems specialists, and payment systems specialists to focus on key areas of potential risk. ONES is positioned to adapt its examination and supervision process and procedures to keep pace with a changing financial and operational environment.

Insurance

The NCUA administers the NCUSIF, which provides insurance for deposits held at federally-insured natural person and corporate credit unions nationwide. The fund is capitalized by credit unions. NCUA manages the fund to ensure members' deposits are insured. In 2010, Congress permanently increased the insurance limit from $100,000 to $250,000 per depositor.

Small Credit Union Initiatives

The NCUA fosters credit union development, particularly the expansion of services provided by small credit unions to eligible consumers. NCUA fulfills this goal through training, partnerships and assistance. A major source of assistance is the CDRLF, which provides loans and grants to credit unions which serve low-income customers. CDRLF assistance enables these credit unions to provide basic financial services and stimulate economic activities in their communities. NCUA's Office of Small Credit Union Initiatives (OSCUI) is also responsible for assisting the agency's risk mitigation program.

Consumer Protection

NCUA protects credit union members through effective enforcement of consumer protection regulations and requirements. NCUA's Office of Consumer Protection (OCP), created in 2010, is responsible for consumer protection in the areas of fair lending examinations, member complaints, and financial literacy. OCP consults closely with the Consumer Financial Protection Bureau (CFPB). CFPB has direct supervisory authority over credit unions with assets of $10 billion or more, but can request to accompany NCUA on examinations of other credit unions. In addition to consolidating consumer protection examination functions within NCUA, OCP responds to inquiries from credit unions, their members, and consumers involving consumer protection and share insurance matters. Additionally, OCP processes member complaints filed against federal credit unions.

Asset Management

The NCUA's Asset Management and Assistance Center (AMAC) conducts credit union liquidations and performs management and recovery of assets. AMAC assists NCUA regional offices with the review of large, complex loan portfolios and actual or potential bond claims. AMAC also participates extensively in the operational phases of conservatorships and records reconstruction. AMAC's purpose is to minimize costs to the NCUSIF and to credit union members.

Office of Minority and Women Inclusion

NCUA formed the Office of Minority and Women Inclusion (OMWI) in response to the "Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010" (the Dodd-Frank Act). OMWI has the responsibility for ensuring compliance with the Dodd-Frank Act in the areas of diversity, civil rights and the promotion of minority and women hiring and contracting practices throughout the credit union industry.

The NCUA Office of Inspector General

The 1988 amendments to the Inspector General Act of 1978 (IG Act), 5 U.S.C. App. 3, established IGs in 33 designated Federal entities (DFEs), including the NCUA. The NCUA Office of Inspector General (OIG) was established in 1989. The NCUA IG is appointed by, reports to, and is under the general supervision of, a three-member presidentially-appointed Board. The OIG staff consists of nine FTEs: the IG, the Deputy IG, the Counsel to the IG/Assistant IG for Investigations, the Director of Investigations, four senior auditors, and an office manager. The OIG promotes the economy, efficiency, and effectiveness of NCUA programs and operations, and detects and deters fraud, waste and abuse, thereby supporting the NCUA's mission of facilitating the availability of credit union services to all eligible consumers through a regulatory environment that fosters a safe and sound credit union system. The OIG supports this mission by conducting independent audits, investigations, and other activities, and by keeping the NCUA Board and the Congress fully and currently informed of its work.

The OIG Role in Financial Oversight

In 2012-2013, the NCUA continued to focus on completing the many credit union reforms required by the Dodd-Frank Act. In particular, the NCUA highlighted two recommendations of the Financial Stability Oversight Council (FSOC) that are of particular interest to credit unions: the need for improved emergency liquidity planning and how changes in interest rates can affect risk profiles. Consequently, in the past year the OIG has had ample opportunity to monitor the agency's recent, ongoing, and projected implementation efforts.

In accordance with section 989(a)(2)(B) of the Dodd-Frank Act, the following highlights the completed and ongoing work of our office, with a focus on issues particular to NCUA as well as those that may apply to the broader financial sector.

OIG Capping Report on Material Loss Reviews

While the volume of the OIG's Material Loss Review (MLR) work has lessened considerably in the past year, given fewer credit union failures and ensuing material losses to the NCUSIF, we continue to monitor the NCUA's implementation of recommendations set forth in previous and more recent MLRs. A number of our MLR findings and recommendations correspond to the 2012 FSOC Annual Report highlights and recommendations applicable to the larger financial sector—in particular the need for heightened management of and supervisory attention to current and emerging risks in federally insured credit unions. The OIG initially summarized its findings and recommendations in the "OIG Capping Report on Material Loss Reviews," (Capping Report) issued on November 23, 2010. In the past year the OIG continued its oversight of the agency's efforts to implement the remaining open Capping Report recommendations.

At the time of its issuance, the Capping Report summarized significant findings from MLRs the OIG had conducted to date and made 11 recommendations to NCUA management for corrective action. The majority of the Capping Report's findings and recommendations addressed what the OIG determined were recurring issues. Specifically, these findings and recommendations related to the examination and supervision procedures for overseeing credit unions and included issues involving documentation, monitoring, ratings, call reports, third party relationships, due diligence, exam procedures, quality control reviews, and regulatory guidance.

Currently, there are two open and unimplemented recommendations which we consider long-term, high priority items:

1. Determine whether to propose and/or change regulatory guidance to establish limits or other controls for concentrations that pose an unacceptable safety and soundness risk and determine an appropriate range of examiner response to high risk concentrations.

2. Develop a more specific process such as trigger reports or standards so examiners can better identify, analyze, and monitor loan concentrations during exams, as well as between exams.

With regard to the first recommendation, the agency agreed with the OIG and has provided training to examiners and issued a Supervisory Letter to credit unions advising them how to evaluate and manage concentration risk. NCUA further anticipates issuing--later in 2013--a proposed revision to update the risk-based net worth component of its current Prompt Corrective Action (PCA) regulation. The revised regulation will place additional emphasis on the various concentrations of credit on a balance sheet including, inter alia, real estate, member business lending (MBL), and loan participations. Thereafter, the minimum net worth level will be based more on the level of concentrations in the financial position of each credit union than previously. We are continuing to monitor the agency's efforts to address this recommendation.

With regard to our second recommendation, the agency has enhanced quarterly regional risk reports to better detect excessive growth of various loan investment products; updated the national risk reports to identify concentration risk, including excess levels in products such as real estate and MBL; and issued credit union and supervisory guidance addressing concentration risk and how to mitigate it. Finally, the NCUA has current and future plans to update its Automated Integrated Regulatory Examination Software (AIRES) to better guide examiners to the review of concentration risk. As with the first open recommendation, we are continuing to monitor the agency's implementation efforts in this area as we plan and conduct current and future audits and MLRs.

Maintaining Access to Emergency Liquidity

As mentioned above, in the numerous MLRs the OIG conducted and reported on since 2008, we focused on those factors that contributed to the credit union's failure and/or a material loss to the NCUSIF. A significant area of concern identified in several previous MLRs (as well as MLRs we conducted in the past year) was the importance of liquidity risk planning, in particular credit union access to reliable emergency liquidity. As a result, the NCUA proposed a new emergency liquidity rule requiring larger credit unions, in the event of another credit union systemic crisis, to have demonstrated access to a dependable source of government-backed emergency liquidity. As of the time of this reporting, that rule is near finalization and has the following features.

The NCUA's CLF in its role as an emergency liquidity provider for most credit unions is currently undergoing change. Prior to October 29, 2012, most credit unions had access to emergency liquidity by belonging to a corporate credit union that was a member of U.S. Central Bridge. U.S. Central Bridge held CLF stock on behalf of member corporate unions and their members. However, completing three years of efforts to stabilize the corporate credit union sector, the NCUA closed U.S. Central Bridge on October 29, 2012.

As part of the closure, U.S. Central Bridge redeemed its CLF stock and is now no longer providing CLF coverage for member natural person credit unions. As a result, credit unions and their corporates no longer have the CLF as a source of backup liquidity, unless they join the CLF directly. In July 2012, NCUA's Board issued for 60-day comment a targeted proposed rule (new Section 741.12) to require credit unions to plan for emergency liquidity. The proposed rule incorporates a three-tiered approach based on the size of the federally insured credit union:

- Credit unions with under $10 million in assets would have to maintain a written liquidity policy approved by their board. The policy would provide a basic framework for managing liquidity and have a list of contingent liquidity sources for use in emergency situations.
- Credit unions with more than $10 million in assets would have to establish a formal contingency funding plan that clearly sets out strategies for liquidity shortfalls in emergency situations.
- Credit unions with more than $100 million in assets would have to demonstrate access to at least one of the following three options for a backup federal liquidity source:
    - becoming a direct member of the CLF;
    - becoming an indirect CLF member through a CLF agent; or
    - establishing direct borrowing access to the Federal Reserve's Discount Window.

The OIG is continuing to monitor NCUA examiner diligence in understanding liquidity risk and, as the issue arises in the course of future MLRs and audits, the agency's monitoring of larger credit unions' implementation of the new rule.

Interest Rate Risk Rule

In recommending that agencies heighten risk management and supervisory attention, the FSOC advised agencies to bolster resilience to unexpected interest rate shifts. Several of the MLRs the OIG conducted over the past several years as well as in the current reporting period noted that credit unions without an appropriate interest rate risk (IRR) policy, and a program to effectively implement that policy as part of their asset liability management responsibilities, caused losses to the NCUSIF and/or contributed to the credit union's failure. The MLR reports we issued further identified where improvements could be made in NCUA's monitoring of IRR.

In January, 2012, the NCUA Board adopted a final amendment to the agency's insurance rules requiring certain federally-insured credit unions to have a written policy to address IRR management as well as an effective IRR program for successful asset liability management. Credit unions had until September 30, 2012, to comply with the new rule. To assist credit unions, the final rule included an appendix setting forth guidance on developing an IRR policy, and effectively implementing a program based on generally recognized best practices for safe and sound interest rate risk management. NCUA tailored the final IRR rule to apply to credit unions most at risk for interest rate shocks. As a result, the final rule does not apply to credit unions with less than $10 million in assets. Federally-insured credit unions with assets between $10 million and $50 million must have a written policy if first mortgage loans plus total investments longer than five years is equal to or greater than 100 percent of net worth. Federally-insured credit unions with assets more than $50 million must comply with the new IRR rule.

The OIG is continuing its oversight of the NCUA's implementation of the new IRR management policy and program, with particular emphasis on the agency's monitoring of how potential changes in interest rates could adversely affect the risk profiles of credit unions.

Audit of NCUA's Small Credit Union Supervision Program and Credit Union Examination Appeal Process

Over the past year, the Dodd-Frank Act implementation within the credit union system included introducing stronger supervision and risk management as well as implementing measures to enhance consumer protections. By letter dated February 10, 2012, Senator Tim Johnson, Chairman of the Senate Banking Committee, requested--under the aegis of the Dodd-Frank Act and its mandate that federal agencies improve oversight of the financial systems they regulate--that the NCUA OIG conduct an audit of NCUA's small credit union supervision program, including examination timelines and how NCUA ensures consistency in the administration of examinations nation-wide. Chairman Johnson requested further that NCUA report on the ability of federally-regulated credit unions to question examination results, such as through an Ombudsman, an appeals process, or informal channels, and the frequency of such appeals. Chairman Johnson's request came at a time when two proposed bills, S. 2160 and H.R. 3461, both entitled the "Financial Institutions Examination Fairness and Reform Act," would codify financial institution examination standards and move the appeals process outside the respective agencies.

Our Office of Audit issued its Review of NCUA's Examination and Complaint Processes for Small Credit Unions on August 31, 2012. The OIG's review considered: (1) the NCUA's examination process for small credit unions; and (2) the ability of insured credit unions to question examination results. Consistent with the request, we emphasized examination policies and procedures, and examination timeliness to determine how NCUA ensures consistency on a national basis in the administration of examinations, including the tools to accomplish the process. Our review also concentrated on complaints related to safety and soundness issues to ensure credit unions can seek informal review of disputed issues at the examiner/regional level, as well as through a formal appeals process.

Overall, we determined NCUA's examination process had clear standards and policies to conduct examinations. However, we noted inconsistencies in the manner in which NCUA carried out the procedures to implement those policies. We also determined there were operational and organizational deficiencies related to compliance monitoring, the regional determination process, the Supervisory Review Committee, and the Ombudsman position, respectively, which we believe NCUA management could improve.

As a result, we made four recommendations to correct identified deficiencies. We consulted extensively with the NCUA as it initiated and then fully implemented our recommendations regarding the Ombudsman position. We are continuing our oversight of the other three areas where the agency needs to address deficiencies.

Review of NCUA's Controls over Sensitive and Proprietary Information

The Dodd-Frank Act created the CIGFO in part, to evaluate the effectiveness and internal operations of the FSOC. On December 8, 2011, CIGFO members approved a proposal to convene a working group to review FSOC's control of sensitive and proprietary information. The NCUA OIG conducted a review--concurrently with reviews by the other CIGFO members--in support of the CIGFO's "Audit of the Financial Stability Oversight Council's Controls over Non-public Information." The results from the OIG's report were incorporated into the 2012 CIGFO Annual Report.

The objective of our audit was to review NCUA's policies, procedures, and practices for ensuring that FSOC-related information which the agency collects, shares, or deliberates is adequately protected from unauthorized disclosure. We found that NCUA's existing policies and procedures were not sufficiently comprehensive to assist the agency in protecting confidential, non-public FSOC information, which it collects, shares, or deliberates, from unauthorized disclosure. Specifically, the OIG found that NCUA needed to improve its policies and procedures to address:

- Protecting oral communication of confidential non-public FSOC information;
- Inventorying or tracking FSOC information requests/responses;
- Controlling access to and authorizing release of confidential non-public information to FSOC, FSOC member agencies or other external parties (e.g., Congress);
- Marking FSOC information;
- Designating a central person/group to coordinate all FSOC communications;
- Selecting, identifying, maintaining, and communicating to FSOC and its member agencies who the NCUA representatives are and their respective responsibilities;
- Identifying, controlling, and monitoring who within NCUA will have access to an who has accessed specific FSOC information and systems;
- Handling, controlling, and protecting FSOC information during teleconferences and telework sessions; and
- Stating consequences for the breach/unauthorized disclosure of FSOC information.

We suggested that NCUA coordinate with FSOC and FSOC member agencies to supplement or improve its policies, procedures, and practices.

The OIG issued its final audit report to NCUA management on June 27, 2012.

Actions Taken in Response to the GAO's Report on the NCUA

On June 2012, the FSOC released a report to Congress on actions NCUA took in response to recommendations made by the Government Accountability Office (GAO) in its January 2012 report, National Credit Union Administration: Earlier Actions Are Needed to Better Address Troubled Credit Unions (GAO-12-247). The report analyzed NCUA's supervision of corporate credit unions and implementation of PCA, as required by the National Credit Union Authority Clarification Act. The report indicated that, in response to one of GAO's recommendations, NCUA verified estimates of projected losses for the legacy assets of corporate credit unions. In particular, GAO recommended that the NCUA provide the OIG with the necessary supporting documentation to enable our office to verify the total losses incurred from January 1, 2008, to June 30, 2011. The NCUA provided the OIG the supporting documentation on the loss estimates set forth in the NCUA 2010 Financial Statement Audit for Temporary Credit Union Stabilization Fund, which was released after GAO completed its review and was therefore not available for its analysis. Based on the documentation provided, the OIG concluded the loss estimates were reasonable. The OIG met with NCUA and GAO officials on May 7, 2012, to discuss the documentation that NCUA provided to us. GAO also reviewed a sample of the supporting documentation, and agreed with the OIG that the methodology (including key assumptions) used to calculate the estimates were appropriately documented. GAO also found that the estimates were adequately supported in the documentation provided.

To improve the effectiveness of NCUA's PCA framework, GAO also recommended that the NCUA Chairman consider additional triggers that would require early and forceful regulatory actions, including the indicators identified in the GAO's report. The GAO stated that in considering these actions, the Chairman should make recommendations to Congress on how to modify PCA for credit unions and, if appropriate, for corporates.

The PCA framework for credit unions was established by the Credit Union Membership Access Act in 1998 and is described in Part 702 of NCUA's Rules and Regulations. The NCUA's PCA framework establishes five net worth ratios categories with associated mandatory supervisory actions. As described in the GAO report, the PCA framework provides more stringent mandatory and discretionary actions to be taken by the NCUA in addressing the problems of a credit union as it falls into lower PCA categories.

The GAO study of PCA in the context of credit unions built on a previous study of PCA in the context of banks. Both studies concluded that the main weakness of the PCA framework is the reliance on measures of capital adequacy. The GAO report noted that "capital based indicators have weaknesses, notably that they can lag behind other indicators of financial distress." The GAO Report noted further that other financial indicators could help identify troubled credit unions earlier than capital. Some of the indicators identified by GAO in the report include asset quality (such as loans as a percentage of total assets; payment-option, adjustable rate mortgage, and interest-only mortgage loans as a percentage of total assets; participation loans as a percentage of total assets; and member business loans as a percentage of total assets), management (such as operating expenses as a percentage of average total assets), and earnings (such as net income as a percentage of assets).

NCUA agreed with GAO's recommendation and supports research into indicators that may be able to better assist in identifying troubled institutions earlier and with more precision. As NCUA continues its commitment to review its PCA regulations, in particular the risk-based net-worth component (as discussed above in the section on "OIG Capping Report on Material Loss Reviews," supra), the OIG is likewise committed to its ongoing oversight of that review process and any ensuing measures the agency takes towards early identification of troubled credit unions.

Office of Inspector General
U. S. Securities and Exchange Commission

The SEC OIG promotes the integrity, efficiency, and effectiveness of the critical programs and operations of the SEC and operates independently of the Commission to help prevent and detect fraud, waste, and abuse through audits, evaluations, and investigations.

Background

The mission of the U. S. Securities and Exchange Commission (SEC or Commission) is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. SEC strives to promote a market environment that is worthy of the public's trust and characterized by transparency and integrity. SEC's goals are to foster and enforce compliance with the federal securities laws; establish an effective regulatory environment; facilitate access to the information investors need to make informed investment decisions; and enhance the Commission's performance by effectively aligning and managing human resources, information, and financial capital.

The SEC staff monitors and regulates a securities industry consisting of more than 35,000 registrants, including over 9,500 public companies, about 11,800 investment advisers, about 4,200 mutual funds, and about 5,400 broker-dealers, as well as national securities exchanges and self-regulatory organizations, 450 transfer agents, 16 national securities exchanges, 8 clearing agencies, and 9 credit rating agencies. Additionally, SEC has oversight responsibility for the Securities Investor Protection Corporation, the Financial Industry Regulatory Authority, the Municipal Securities Rulemaking Board, and the Public Company Accounting Oversight Board.

The SEC Office of Inspector General (OIG) was established in 1989 in accordance with the Inspector General Act of 1978, as amended. OIG's mission is to promote the integrity, efficiency, and effectiveness of the critical programs and operations of the SEC. The SEC OIG is an independent office within the SEC; it helps prevent and detect fraud, waste, and abuse through audits, evaluations, and investigations related to SEC programs and operations.

Examples of SEC OIG Oversight Work

SEC OIG Office of Audits, Report No. 505, SEC's Records Management Practices (September 2012)

On November 28, 2011, a Presidential memorandum was issued on managing government records. This memorandum called proper records management "the backbone of open Government" and emphasized the importance of having a well-managed records management program that includes reducing redundant efforts, minimizing costs, and sharing institutional knowledge within and across organizations. A well-managed records management program is critical to the SEC's ability to effectively and efficiently perform its mission.

The SEC Office of Records Management Services (ORMS) is responsible for coordinating, overseeing, and implementing SEC's records management program through points of contact in most divisions and offices. The Office of Security Services (OSS) has oversight of the SEC's vital records management program.

The SEC OIG audit found that the SEC did not have an active staff assistance program and ORMS or its predecessors did not conduct periodic agency-wide staff assistance visits. Although ORMS provided assistance to divisions and offices to identify their records and had scheduled records for disposition, it had not conducted staff assistance visits of all 36 SEC divisions and offices. In addition, the audit revealed that although ORMS readily answered questions from agency staff about records matters, provided basic records management training during the SEC's new employee orientation, and provided training to staff in the regional offices, ORMS did not provide records management training to all SEC staff.

The SEC OIG recommended that ORMS develop a sound records management program with a new regulation, handbook, and records management points of contact throughout the agency. We also recommended ORMS develop an action plan, including milestones to address the records destruction backlog.

SEC OIG Office of Audits, Report No. 511, Evaluation of SEC's Whistleblower Program (January 2013)

Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), amended the Securities Exchange Act of 1934 (Exchange Act) by adding Section 21F, "Securities Whistleblower Incentives and Protection." Section 21F directs the SEC to make monetary awards to eligible individuals who voluntarily provide original information about a violation of Federal securities laws, leading to a successful Commission enforcement action and resulting in the imposition of monetary sanctions over $1,000,000; the SEC is also authorized to pay an award for certain actions related to those successful enforcement actions.

On May 25, 2011, the Commission adopted final Regulation 21F to implement the provisions of Section 21F of the Exchange Act. Regulation 21F became effective on August 12, 2011. Among other things, Regulation 21F defines terms that are essential to the whistleblower program's operations, establishes procedures for submitting tips and applying for awards and appeals, describes the criteria SEC considers in making award decisions, and implements Dodd-Frank's prohibition against retaliation for whistleblowing.

Section 922 of the Dodd-Frank Act required the SEC's OIG to conduct a review of the whistleblower protections established under the amendments made by Section 21F and to report its findings no later than 30 months after enactment of the Act to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services.

The SEC OIG found that the SEC's whistleblower program is clearly defined and user-friendly for individuals with a basic knowledge of the securities laws, rules, and regulations. For example, the whistleblower program is promoted on SEC's public website. Additionally, the SEC's Office of the Whistleblower has made strong outreach efforts. We also found that SEC was generally prompt in responding to information that whistleblowers provided, in responding to applications for whistleblower awards, and in communicating with interested parties. However, we found that the internal controls for whistleblower program need to be strengthened by adding performance metrics.

The award levels for the SEC's whistleblower program are comparable to the award levels of other Federal government whistleblower programs and range from 10 to 30 percent of the monetary sanctions collected. At the time of our review, we determined that SEC's award levels were reasonable and should not change.

Further, the SEC OIG found that the funding mechanism for the Investor Protection Fund established by Section 922 of the Dodd-Frank Act is adequate. However, we determined that it would be premature to introduce a private right of action into the SEC whistleblower program because it has only been in place since August 2011. A fundamental change in approach would disrupt the system currently in place. Finally, the SEC OIG found that the Freedom of Information Act exemption added by the Dodd-Frank Act encouraged whistleblowers to disclose information to the Commission because the exemption added an additional safeguard for whistleblower confidentiality. We determined that this exemption had no significant impact on the public's ability to access information on SEC's regulation and enforcement of the Federal securities laws and that it should be retained.

The SEC OIG recommended that the SEC Division of Enforcement ensure that (1) the Office of Market Intelligence assesses the manual triage process for whistleblower complaints and establishes key performance metrics that can be used to measure process performance and (2) the Office of the Whistleblower adds the key performance metrics to its internal control plan where appropriate.

SEC OIG Office of Audits, Report No. 509, SEC's Controls Over Sensitive/Non-public Information Collected and Exchanged With the Financial Stability Oversight Council and Office of Financial Research (March 2013)

On December 8, 2011, the Council of Inspectors General on Financial Oversight (CIGFO) established a working group to examine the controls and protocols that the Financial Stability Oversight Council (FSOC) and its member agencies employed to ensure FSOC's nonpublic information, deliberations, and decisions are properly safeguarded from unauthorized disclosure. The working group conducted a joint audit of the major financial entities of the Federal government to determine whether their business practices met industry standards and practices established in the National Institute of Standards and Technology's special publications,. On June 22, 2012, the working group issued a consolidated report entitled Audit of the Financial Stability Oversight Council's Controls over Nonpublic Information, to the FSOC Chairman.

Subsequently, the SEC OIG conducted an audit to follow up on SEC deficiencies identified in the joint audit. Specifically, the SEC OIG examined the controls and protocols SEC employs to ensure that sensitive and nonpublic information collected and exchanged with FSOC, its member agencies, and the Office of Financial Research (OFR) is properly safeguarded from unauthorized disclosure. The audit found that SEC employees and contractors who access SEC's e-mail system using Outlook Web Access (OWA) are not restricted from saving and uploading sensitive or non-public information on non-SEC computers.

Consequently, sensitive or nonpublic information could potentially be disclosed to unauthorized persons.

The audit also found that SEC has not appointed primary information owners to oversee information received and shared with FSOC, its member agencies, or OFR. In addition, the SEC has not fully developed a protocol for inventorying documents and ensuring that they are appropriately marked. As a result, the SEC may be unable to readily identify information owners and ensure that documents are tracked and marked appropriately. Finally, the audit found that new SEC contractors have 30 days from the date that they are approved to work at SEC and have a network user account to take the mandatory online security awareness training on handling sensitive or non-public information.

The SEC OIG recommended that the SEC (1) develop controls to prevent remote users from saving files accessed using Outlook Web Access to public computers; (2) assign points of contact to serve as information owners for sensitive and non-public documents provided to, or received from, FSOC, OFR, or FSOC's member agencies; (3) ensure a system is developed to identify and track all sensitive and non-public information provided to, or received from, FSOC, OFR, or FSOC's member agencies; (4) develop documented procedures to ensure individuals who serve as information owners for sensitive and non-public information provided to, or received from, FSOC, OFR, or FSOC's member agencies properly mark the documents (or files containing documents) according to the sensitivity level; and (5) ensure new contractors are given a copy of the SEC's rules on using information technology resources to read and sign, indicating that they will adhere to those rules before they are given access to agency systems.

SEC OIG Office of Audits, Report No. 516, Implementation of the Current Guidance on Economic Analysis in SEC Rulemakings (June 2013)

In response to a Congressional request, the SEC OIG examined the SEC's implementation and use of its current guidance on economic analysis in rulemakings. The objectives were to determine whether:

(1) the SEC has established and implemented procedures for a methodical economic analysis process in accordance with its current guidance; (2) the SEC developed and uses procedures to improve the economic analysis process such as hiring additional economists and implementing a systematic review process; and (3) the current guidance incorporates the recommendations on economic analysis from the SEC OIG and other commenters.

The SEC OIG recommended that the SEC issue written operating procedures for economic analysis that implement the Current Guidance on Economic Analysis in SEC Rulemakings, issued on March 16, 2012.

SEC OIG Office of Audits, Report No. 518, Use of the Current Guidance on Economic Analysis in SEC Rulemakings (June 2013)

In response to a Congressional request, the SEC OIG procured subject matter experts (economists) to determine whether: (1) the economic analyses in proposed and final Commission rules complied with the principles and policies identified in SEC's current guidance on economic analysis; (2) the SEC had ensured that the Public Company Accounting Oversight Board, the Financial Industry Regulatory Authority, and other self-regulatory organizations under the Commission's jurisdiction had followed the current guidance for economic analyses in their rulemakings; (3) the SEC had effectively implemented the current guidance;

(4) SEC rulemaking divisions and offices used a consistent methodology for economic analyses; and (5) further improvements are needed in SEC's rulemaking processes and procedures.

The SEC OIG recommended that SEC should (1) develop a general outline of economic considerations that discusses the substantive requirements for economic analyses in rule releases and also create a checklist that rulewriting teams can use when drafting rule releases; (2) document the policies and procedures on how the Current Guidance on Economic Analysis in SEC Rulemakings applies to extensions of existing rules; (3) consider developing a management control, such as a guide, to facilitate greater consistency in presentation of economic analyses in proposing and adopting release texts; (4) consider options for including confidential information in the SEC's rules without releasing it to the public; (5) examine the feasibility of presenting costs per example firm and benefits per average beneficiary where feasible for rule releases for which overall costs and benefits cannot be estimated; and (6) consider revising the Current Guidance on Economic Analysis in SEC Rulemakings to apply different levels of analysis for rules having different degrees of impact, remove reference to cost-benefit analysis, and specify procedures to be used for extensions of temporary rules.

SEC OIG Office of Investigations, Memorandum Report No. PI 12-01, Allegation of Leak of Draft Inter-Agency Rule (July 2012)

The Dodd-Frank Act included a prohibition on proprietary trading and certain relationships with hedge funds and private equity funds. SEC and four other financial and bank regulatory agencies were tasked with coordinating and issuing a rule to implement this prohibition, commonly referred to as the "Volcker Rule," and had worked jointly to develop the rule. On October 5, 2011, a banking industry news organization published an online article that outlined the key points of the proposed Volcker Rule and included a link to the draft document. The draft document was confidential, predecisional information that should not have been released to the public.

The SEC OIG did not identify any source within SEC who provided a copy of the draft document to the banking industry news organization or to anyone outside SEC. Further, the SEC OIG did not identify any draft document within the SEC files that it reviewed that corresponded exactly to the draft version that was published.

The SEC OIG Office of Investigations, Report No. OIG-557, Investigation into Misuse of Resources and Violations of Information Technology Security Policies within the Division of Trading and Markets (August 2012)

The SEC Division of Trading and Markets (TM) maintained a computer security lab that is used to support the TM's Automation Review Policy (ARP) program, which inspects self-regulatory organization (SRO), stock exchange, and clearing agency computer networks. The SEC OIG reported significant deficiencies with the operation and management of the computer security lab and, in particular, with the security of laptop computers that the ARP lab staff used to conduct inspections of SROs, stock exchanges, and clearing agencies.

While the ARP lab had spent over $1 million on computer equipment and software since 2006, the SEC OIG found that a significant portion of this equipment and software was not needed or was never used in the program. The SEC OIG also found lab employees took home some of this equipment and used it primarily for personal purposes. Some of this equipment was purchased based on contracting documentation containing misrepresentations made by lab staff.

The SEC OIG found that lab staff used, to do inspections, laptops that were unencrypted and did not have virus protection, in violation of SEC information technology security policies. Although no laptop was reported lost or stolen, the unprotected laptops could have been compromised as they were left unattended in hotel rooms and were connected to public wireless networks. These security violations occurred despite SEC having spent hundreds of thousands of dollars on security and information technology training for lab staff.

Upon discovering the security risks presented by the unprotected laptops, the SEC OIG apprised SEC management of the deficiencies identified. As a consequence, and before the SEC OIG issued its report, SEC management commenced certain actions to address the problems and deficiencies identified, including retaining an outside forensics team to conduct testing and related work on several selected laptops that lab staff had used on inspections. Additionally, the SEC OIG recommended that (1) the SEC Office of Information Technology (OIT) exercise authority over the ARP lab to ensure its computer equipment is properly secured and protected, (2) another SEC office monitor the lab's future equipment purchases, and (3) processes and procedures for training of lab staff be improved.

SEC OIG Office of Investigations, Report No. OIG-577, Follow-up Investigation Relating to Forensic Analysis of Division of Trading and Markets Laptops (March 2013)

On September 26, 2012, the outside firm that the SEC retained to perform forensic analysis of a sample of eight laptops that had been used on SRO and clearing agency inspections reported that it had found no evidence of active malware operating on those laptops. However, the firm confirmed several vulnerabilities that posed a risk to SEC systems and the data of regulated entities and offered no opinion with respect to the Automation Review Policy (ARP) lab's other laptops and computer devices. The firm also reported that one of the laptops examined was reformatted, and a new operating system was installed, near the time when SEC OIT took custody of the laptop.

To ensure that an independent forensic analysis was performed on the laptops that the firm retained by SEC had not examined, the SEC OIG arranged for the Federal Deposit Insurance Corporation Office of Inspector General Economic Crimes Unit (FDIC OIG ECU) to conduct forensic analysis of certain laptops and to independently verify the results of SEC OIT's testing of additional laptops. The forensic analysis performed by FDIC OIG ECU and SEC OIT found no evidence of a breach or compromise on the additional laptops examined.

The SEC OIG found that an ARP lab information technology specialist reformatted two laptop drives before the laptops were collected by OIT. However, the SEC OIG did not find evidence that the drives were reformatted in an effort to interfere with the SEC OIG's ongoing investigation of the ARP lab. The SEC OIG also did not find evidence that lab management had directed, or were aware of, the reformatting.

Planned Work

The SEC OIG has no planned work to report but will continue efforts to promote the integrity, efficiency, and effectiveness of critical SEC programs and operations.

Office of the Special Inspector General for the Troubled Asset Relief Program

The Special Inspector General for the Troubled Asset Relief Program has the duty, among other things, to conduct, supervise, and coordinate audits and investigations of the purchase, management, and sale of assets under the Troubled Asset Relief Program ("TARP") or as deemed appropriate by the Special Inspector General.

Background

The Office of the Special Inspector General for the Troubled Asset Relief Program ("SIGTARP") was established by Section 121 of the Emergency Economic Stabilization Act of 2008 ("EESA"). Under EESA, the Special Inspector General has the duty, among other things, to conduct, supervise, and coordinate audits and investigations of the purchase, management, and sale of assets under the Troubled Asset Relief Program ("TARP") or as deemed appropriate by the Special Inspector General.

Although Treasury cannot make new purchases or guarantees of troubled assets, Treasury is still administering existing TARP investments and continues to expend TARP funds previously obligated. TARP programs supporting the housing market and certain securities markets are scheduled to last as late as 2021. As part of SIGTARP's unwavering commitment to protect taxpayers who funded TARP, SIGTARP has conducted oversight of TARP funds and has promoted transparency related to TARP by issuing 18 quarterly reports to Congress and, as of April 9, 2013, publishing 21 audits and evaluations. As of that date, SIGTARP had issued 121 recommendations designed to improve TARP programs and make them less susceptible to fraud, waste, and abuse.

As part of SIGTARP's oversight of TARP, SIGTARP continues to aggressively investigate and stop fraud related to TARP. As of April 8, 2013, criminal charges[9] have been filed against 136 individuals, including 87 senior officers (CEOs, owners, founders, or senior executives) of their organization. SIGTARP investigations have resulted in criminal convictions of 91 defendants, of whom 43 have been sentenced to prison as of April 8, 2013, with others awaiting sentencing. SIGTARP, under the authorizing provisions of EESA, will remain on watch as long as Treasury holds an investment or guarantee under TARP.

Role in Financial Oversight

SIGTARP continues to protect the American taxpayer through comprehensive and thorough enforcement and oversight of the billions of taxpayer dollars committed as part of TARP, striving to promote transparency

9 Criminal charges are not evidence of guilt. A defendant is presumed innocent until and unless proven guilty.

in TARP programs. SIGTARP fulfills its mission and role by auditing and evaluating TARP-related programs and activities of Treasury and TARP recipients and investigating allegations of fraud, waste, and abuse related to TARP programs, coordinating closely with other oversight and enforcement agencies.

As of April 8, 2013, SIGTARP's investigations have resulted in orders of restitution, forfeiture, and civil judgments of $4.26 billion. While the ultimate recovery remains to be seen, SIGTARP has already assisted in the recovery of $161.8 million. With more than 150 ongoing investigations, SIGTARP is committed to stopping fraud, deterring criminal behavior, and bringing criminals to justice.

Recent, Current, or Ongoing Work in Financial Oversight

January 2013 Evaluation on Executive Compensation

In January 2013, SIGTARP issued a report titled, "Treasury Continues Approving Excessive Pay for Top Executives at Bailed-Out Companies,"[10] in which SIGTARP reviewed the process and decisions of Treasury's Office of the Special Master for TARP Executive Compensation ("OSM") in setting 2012 pay packages at the three then-remaining TARP exceptional assistance companies: American International Group, Inc. ("AIG"), General Motors Corporation ("GM"), and GMAC, Inc., later rebranded as Ally Financial Inc. ("Ally").

SIGTARP had previously addressed this issue, reporting in January 2012 that the Special Master did not effectively rein in excessive executive compensation at companies that received exceptional assistance through TARP from 2009 through 2011, and approved pay packages in the millions,.

SIGTARP previously reported serious problems with OSM's process to set pay for the Top 25 employees[11] at companies that were recipients of exceptional TARP assistance and recommended fixes for those problems. SIGTARP also previously reported that although OSM set guidelines aimed at curbing excessive pay, Treasury lacked robust criteria, policies, and procedures to ensure its guidelines were met, which SIGTARP recommended they develop. OSM guidelines included that cash and total compensation for Top 25 employees would target the 50th percentile for similarly situated employees, and that cash salaries should not exceed $500,000 except for good cause shown.

In its latest report on OSM's process, SIGTARP found that Treasury failed to make any meaningful reform from SIGTARP's prior findings or fully implement SIGTARP's prior recommendations. It is not surprising that without meaningful reform to its process, Treasury continued to approve excessive pay packages in 2012 for the Top 25 employees at AIG, GM, and Ally. Indeed, in 2012, Treasury approved pay packages of $3 million or more for 54% of the 69 Top 25 employees at AIG, GM, and Ally – 23% of these top executives (16 of 69) received Treasury-approved pay packages of $5 million or more, and 30% (21 of 69) received from $3 million to $4.9 million. In fact, in 2012, Treasury approved pay of more than $1 million for all but one Top 25 employee at AIG, GM, and Ally.

The Acting Special Master, Patricia Geoghegan, told SIGTARP that OSM would not normally reopen executive compensation from year to year because it would be disruptive, and it is relatively easy for OSM

10 See http://www.sigtarp.gov/Audit%20Reports/2013_SIGTARP_Bailout_Pay_Report.pdf

11 A "Top 25 employee" includes the 5 senior executive officers and the next 20 most highly compensated employees.

to keep things the way they were. The Acting Special Master largely based her decisions on prior years' pay. Even where there was a negative change, such as Ally subdivision ResCap filing bankruptcy or GM Europe suffering significant losses, OSM did not reduce compensation for the employees in charge of those entities. OSM awarded $6.2 million in pay raises to all 18 top employees requested by these TARP recipients. Treasury approved a $1 million pay raise for the CEO of AIG's Chartis subsidiary; a $200,000 pay raise for a ResCap employee weeks before ResCap filed bankruptcy; and a $100,000 pay raise for an executive at GM's European unit, despite that unit experiencing significant losses.

Treasury failed to implement SIGTARP's recommendation made in January 2012 that OSM develop more robust criteria, policies, procedures, or guidelines. Absent robust policies, procedures, or criteria to implement OSM's guidelines, Treasury approved compensation largely driven by the proposals of AIG, GM, and Ally. With these companies having significant leverage, the Acting Special Master appears to have rolled back OSM's application of guidelines. In 2012, OSM did not follow its own guidelines aimed at curbing excessive pay by having total compensation generally not exceed the 50th percentile for similarly situated employees. Treasury awarded total pay packages exceeding the 50th percentile by approximately $37 million for approximately 63% of the Top 25 employees of AIG, GM, and Ally. OSM set total compensation for all of Ally's Top 25 employees between the 50th and 75th percentile.

Never have there been so many exceptions to the $500,000 cash salary guideline as there were in 2012. Former Special Master Feinberg testified before Congress that "base cash salaries should rarely exceed $500,000, and only then for good cause shown, and should be, in many cases, well under $500,000." In 2012, despite the fact that the number of companies under OSM's jurisdiction dropped from five in 2011 to three in 2012, the Acting Special Master increased the number of employees with cash salaries greater than $500,000 from 22 to 23 in those years. OSM allowed cash salaries of $500,000 or more for 70% (48 of 69) of Top 25 employees at AIG, GM, and Ally. Moreover, OSM approved 2012 cash salaries exceeding $500,000 for one-third of the employees under its jurisdiction (23 of 69 employees at AIG, GM, and Ally). In stark contrast, 2011 median household income of U.S. taxpayers who fund these companies was approximately $50,000.

SIGTARP found that the inadequacies in OSM's oversight, including its failure to establish meaningful criteria to award cash salaries greater than $500,000, risks excessive unsubstantiated cash salaries. Because OSM lacked a robust review process, including criteria to implement its guidelines, and failed to conduct its own independent analysis, OSM put itself in a position of relying heavily on justifications by the companies, companies that have historically pushed back on the Special Master's limitations on compensation, in particular, on cash salaries. OSM's decisions were largely driven by the three companies' own proposals. As the companies' proposals demonstrate, these exceptional TARP recipients still fail to take into account their exceptional situations that resulted in a taxpayer-funded bailout and fail to view themselves through the lenses of companies substantially owned by the Government. However, OSM's "justifications" for good cause for cash salaries to exceed $500,000 largely parrot what each company asserted to OSM.

SIGTARP also found that OSM failed to follow another important guideline needed to effectively keep excessive pay under control, the use of long-term restricted stock. In 2012, OSM significantly decreased the use of long-term restricted stock, replacing it with stock salary as requested by the companies. Approximately 50% of the top 25 employees at AIG, GM, and Ally did not receive long-term restricted stock tied to meeting performance criteria. OSM removed long-term restricted stock for senior executives including the CEOs of AIG, GM, and Ally, despite the fact that Treasury's rule states that the portion of performance-based compensation should be greater for positions that exercise high levels of responsibility. The Acting Special Master removed long-term restricted stock for every top 25 employee of Ally. By removing long-term restricted stock from these employees' pay, OSM removed tying individual executive compensation to long-term company success, a guideline aimed at fixing the material role executive compensation played in causing the financial crisis.

The report included the following four new recommendations to Treasury:

- Each year, Treasury should reevaluate total compensation for those employees at TARP exceptional assistance companies remaining in the Top 25 from the prior year, including determining whether to reduce total compensation.
- To ensure that Treasury effectively applies guidelines aimed at curbing excessive pay and reducing risk taking, Treasury should develop policies, procedures, and criteria for approving pay in excess of Treasury guidelines.
- Treasury should independently analyze whether good cause exists to award a Top 25 employee a pay raise or a cash salary over $500,000. To ensure that the Office of the Special Master has sufficient time to conduct this analysis, Treasury should allow OSM to work on setting Top 25 pay prior to OSM's receiving the company pay proposals, which starts the 60-day timeline[12].
- To be consistent with Treasury's Interim Final Rule that the portion of performance-based compensation compared to total compensation should be greater for positions that exercise higher levels of responsibility, Treasury should return to using long-term restricted stock for employees, particularly senior employees such as CEOs.

Treasury Exit from Banks Remaining in the Capital Purchase Program ("CPP")

SIGTARP noted in October 2012 that as Treasury accelerated its exit from investments in the banks remaining in TARP's Capital Purchase Program Treasury should conduct analysis and document its considerations to ensure it exits these TARP investments in a way that protects taxpayers and promotes financial stability. Treasury began auctioning preferred TARP shares in individual banks—in some instances to the bank itself at a discount—and announced that it will sell shares in multiple banks in pooled auctions.

Treasury officials have told SIGTARP that they approach these auctions as a private investor. Treasury has publicly stated that it has already estimated that the value of the majority of these investments is less than par, and therefore Treasury will sell above a pre-set reserve price. Indeed, at the time of SIGTARP's recommendations, in every auction conducted Treasury has sold the taxpayers' TARP investment in specific banks at a loss. This was a significant change from Treasury's previous approach of waiting for banks to repay in full and only agreeing to transactions that were likely to result in a partial loss when the bank was at risk of failure.

SIGTARP is concerned that TARP banks that may have the ability to repay TARP in full, either on their own or

12 Under Treasury's rule, OSM has 60 days to issue determinations on individual pay packages when the company proposals are received by OSM and considered "substantially complete."

by raising new capital, may try to buy back their own shares in auctions at a significant discount. The result is a loss to the taxpayers who bailed them out.

Treasury has told SIGTARP that it does not consult with Federal banking regulators in determining a bank's ability to repay in full, preferring to act as a private investor. However, taxpayers' TARP investments are unique because they were part of an unprecedented Government bailout of private institutions. Treasury has the responsibility to protect taxpayers and promote financial stability. Throughout the existence of TARP, Treasury and the Federal banking regulators have shared non-public information about specific banks and should develop a similar solution.

Additionally, Treasury's view that it acts like a private investor risks Treasury not considering its greater Governmental responsibility to promote financial stability. Treasury's decisions to make investments in these banks were made with the goals of TARP's Capital Purchase Program in mind — promoting financial stability, maintaining confidence in the financial system, and enabling lenders to meet the nation's credit needs. These goals did not end when banks entered TARP and cannot be viewed in the past tense, but must be met now and in the future to protect taxpayers.

SIGTARP is concerned that Treasury is not analyzing the potential impact of the auctions of its CPP investment on the financial stability of the bank or the industry, at a community, state, or regional level. Based on conversations with Treasury officials, SIGTARP understands that Treasury does not conduct any analysis to determine whether the individual or pooled auctions promote financial stability or preserve the strength of community banks or the banking industry.

A clear and workable TARP exit strategy would need to strike the appropriate balance between maximizing returns to taxpayers and limiting any potential risk to financial stability that may result from Treasury exiting its investments in hundreds of community banks close in time. Without conducting any analysis, Treasury does not know the impact of a swift exit of so many TARP investments, particularly when the remaining banks are weaker than those that already exited TARP, with less capital, missed dividends, and some subject to enforcement orders by their regulators. As these smaller banks remain weak, their lending in their communities may continue to be constrained, which could impact economic recovery in these communities. While an en masse exit of these banks from TARP could provide a partial return for taxpayers, care must be taken in that exit to ensure that these banks and the banking industry remain stable.

Because Treasury is treating its decision like a private investor, it does not consult with the Federal banking regulators on financial stability even though the regulators have important information about these banks and the banking industry. Without analysis or consultation with banking regulators, it is unclear how Treasury can be assured that this exit strategy promotes financial stability or preserves the strength of community banks. This analysis should include, for example, the impact of a pooled auction of the TARP interests in many banks in the same community, state, and region. It should also include whether Treasury's swift exit of its investments in hundreds of banks could have the effect of accelerating an already existing trend towards greater consolidation in the community banking industry, and if so, the impact of such consolidation, particularly in light of the fact that Treasury's shares carry the right to appoint up to two members to the institution's board of directors if six dividend payments are missed. Treasury should not rush to exit these banks from TARP, especially at a loss, without assessing, in consultation with Federal banking regulators, whether the exit meets CPP's goals to promote financial stability, maintain confidence, and enable lending, and that those goals are enduring to protect taxpayers.

Treasury should also improve how it documents its decisions to auction its TARP interests in certain banks to adequately reflect the rationale for its decision-making in detail, which should include the considerations regarding each bank. Clear documentation of decision-making promotes consistency and accountability, and is necessary to permit effective oversight.

In SIGTARP's quarterly report to Congress in October 2012[13], SIGTARP included the following recommendations to Treasury with respect to Treasury's exit from its investments in CPP banks:

- In order to fulfill Treasury's responsibility to wind down its TARP Capital Purchase Program investments in a way that protects taxpayer interests, before allowing a TARP bank to purchase Treasury's TARP shares at a discount to the TARP investment (for example as the successful bidder at auction), Treasury should undertake an analysis, in consultation with Federal banking regulators, to determine that allowing the bank to redeem its TARP shares at a discount to the TARP investment outweighs the risk that the bank will not repay the full TARP investment. Treasury should document that analysis and consultation.
- In order to fulfill Treasury's responsibility to wind down its TARP investments in a way that promotes financial stability and preserves the strength of our nation's community banks, Treasury should undertake an analysis in consultation with Federal banking regulators that ensures that it is exiting its Capital Purchase Program investments in a way that satisfies the goals of CPP, which are to promote financial stability, maintain confidence in the financial system and enable lending. This financial stability analysis of a bank's exit from TARP should determine at a minimum: (1) that the bank will remain healthy and viable in the event of an auction of Treasury's preferred shares; and (2) that the bank's exit from TARP does not have a negative impact on the banking industry at a community, state, regional, and national level. Treasury should document that analysis and consultation.
- Treasury should better document its decision whether or not to auction its preferred shares in a TARP bank to adequately reflect the considerations made for each bank and detailed rationale.

SIGTARP Recommendations on Libor

The London Interbank Offered Rate ("LIBOR"), a global interest rate benchmark used in several TARP programs, has historically been used to reflect the average cost to banks of unsecured borrowing. In June 2012, the LIBOR scandal came to light with enforcement actions by the CFTC, the U.S. Department of Justice, and the United Kingdom's Financial Services Authority ("FSA") against Barclays Bank PLC for manipulating LIBOR in which Barclays paid record fines of $450 million.

LIBOR was used as the interest rate in several TARP programs. SIGTARP noted in August that it continued to be used in two TARP programs, the Public-Private Investment Program ("PPIP") and the Term Asset-Backed Securities Loan Facilities ("TALF"), a TARP loan program by the Federal Reserve where TARP funds are used in the event of loan defaults. Both then-Treasury Secretary Timothy Geithner and Federal Reserve Chairman

13 See SIGTARP's Quarterly Report to Congress, October 25, 2012 http://www.sigtarp.gov/Quarterly%20Reports/October_25_2012_Report_to_Congress.pdf

Ben Bernanke shared their concerns about LIBOR's vulnerability with Congress. Former Secretary Geithner told Congress that Treasury was analyzing whether taxpayers who funded TARP were harmed by LIBOR manipulation. SIGTARP stressed the importance of that study and urged Treasury to publish the results of its analysis.

SIGTARP, concerned that American taxpayers who funded TARP may have been at risk and continue to be at risk from the manipulation of LIBOR, issued, in an August 22, 2012 letter to then Treasury Secretary Geithner and Chairman of the Federal Reserve Bernanke[14], the following recommendations related to LIBOR being used in TARP programs:

> *In order to protect taxpayers who funded TARP against any future threat that might result from LIBOR manipulation, Treasury and the Federal Reserve should immediately change any ongoing TARP programs including, without limitation, PPIP and TALF, to cease reliance on LIBOR.*

Neither the Federal Reserve nor Treasury have agreed to implement SIGTARP's recommendation despite the fact that in response to SIGTARP's recommendation, the Federal Reserve agreed that "recent information regarding the way the LIBOR has been calculated has created some uncertainty about the reliability of the rate," and Treasury stated that they "share [SIGTARP's] concerns about the integrity of LIBOR."

Despite its own concerns over the reliability of LIBOR, the Federal Reserve, which has contracts with TALF borrowers, is unwilling to use its considerable leverage to tell TALF borrowers that in light of the LIBOR scandal and LIBOR's lack of reliability, the Government needs to amend the contract.

Although many TALF loans indexed to LIBOR have been repaid, at the time SIGTARP issued its recommendations, $598.6 million in TALF loans remained outstanding. Those TALF loans had interest rates tied to LIBOR and the program continues until as late as 2015. This is a substantial amount of money owed to taxpayers for a continuing number of years. Given the LIBOR manipulation and the unreliability of LIBOR that has come to light, SIGTARP noted that the Federal Reserve had a solid basis to reach out to TALF borrowers and express its need to amend the TALF contracts. TALF contracts already provided for alternative interest rates, including the prime rate and the Federal funds rate, which presumably the Federal Reserve already determined were appropriate before including them in the contract. Taxpayers are entitled to interest on TALF debt and protection against any manipulation in that interest payment.

Despite sharing SIGTARP's concerns about the lack of integrity of LIBOR, Treasury rejected SIGTARP's recommendation, saying that under PPIP contracts, Treasury would need evidence that LIBOR is currently misstated in order to have the right to change the benchmark. First, given the LIBOR manipulation and its lack of reliability, SIGTARP indicated that Treasury could also use its considerable leverage to reach out to the remaining PPIP managers to express the need to amend the PPIP contracts. In addition, interestingly, Treasury, through a contingency in the PPIP contracts, foresaw the potential need for Treasury unilaterally to change the interest rate away from LIBOR. The PPIP contracts specifically state that Treasury can change the interest rate from LIBOR to the prime rate under one of various scenarios, including if Treasury reasonably determines that LIBOR would not adequately and fairly reflect the true cost of lending. Treasury

14 See SIGTARP's Quarterly report to Congress, October 25, 2012, http://www.sigtarp.gov/Quarterly%20Reports/October_25_2012_Report_to_Congress.pdf

told SIGTARP that it would need evidence that LIBOR is currently misstated to change the rate, and that enforcement agencies had not released findings that the rate was currently misstated.

The PPIP contracts do not require that law enforcement agencies release findings that LIBOR is currently misstated, but only require that Treasury make a "reasonable determination" that LIBOR would not adequately and fairly reflect the true cost of lending – a broad standard that gives Treasury discretion to act. Public findings made by the FSA and the CFTC formed a significant basis for Treasury to arrive at that "reasonable determination." SIGTARP also stated that Treasury should ask these entities to share with it their analysis and information that may not have been publicly released.

SIGTARP stressed that taxpayers, who were still owed $5.685 billion in outstanding PPIP debt indexed to LIBOR at the time of the recommendation, must be protected, particularly because the PPIP program could continue until as late as 2017. Treasury also responded that changing the benchmark may possibly harm rather than benefit taxpayers. Treasury did not suggest that it had any analysis to support its statement that changing the interest rate may harm taxpayers, but instead focused on its belief that it would be difficult to make these changes. Treasury stated that altering the benchmark could have significant adverse consequences on the performance of funds in PPIP, which could reduce returns in the program. The fact that Treasury foresaw that it could change the interest rate and provided for that in PPIP contracts evidences that Treasury has always believed that it is possible to change the interest rate from LIBOR without harm to taxpayers.

Continued use of LIBOR for TARP while it is not reliable and remains potentially subject to manipulation could harm taxpayers and undermines public confidence in financial markets and TARP. For Treasury and the Federal Reserve to cling to the status quo of keeping in TARP a rate that is broken, unreliable, and subject to manipulation, is contrary to TARP's historical goal of using unprecedented solutions to promote confidence in the financial system.

Oversight and Regulation of American International Group ("AIG")

SIGTARP reported in a July 2012 quarterly report to Congress[15], that for more than two years, one of the largest TARP recipients, AIG, had no consolidated banking regulator of its non-insurance financial business. In the report SIGTARP stated that the Federal Reserve could regulate AIG under two scenarios. First, the Federal Reserve could regulate AIG as a savings and loan holding company based on AIG's ownership of a small bank if Treasury decreased its TARP ownership interest under 50%. Second, the Federal Reserve could also regulate AIG if the Financial Stability Oversight Council ("FSOC") designated AIG as a systemically important financial institution. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") recognized that the largest and most interconnected institutions whose financial distress could pose a risk to United States financial stability should be subject to enhanced regulation, presumably the strongest level of regulation available.

On September 10, 2012, Treasury sold some of the AIG TARP stock it then held, dropping its ownership of AIG below 50% and triggering AIG's regulation by the Federal Reserve as a savings and loan holding

15 See SIGTARP's Quarterly Report to Congress, July 25,2012, http://www.sigtarp.gov/Quarterly%20Reports/July_25_2012_Report_to_Congress.pdf

company. However, it appeared that this regulation may be short-lived, as the next day, AIG's CEO Robert Benmosche said in a television interview about AIG Federal Savings Bank that AIG was planning "to probably close it or sell it now." He said this plan was based on AIG's concerns about the application of additional regulation under Dodd-Frank known as the Volcker Rule to this small part of AIG. If AIG sells or closes its bank, it would escape Federal Reserve regulation, unless it is designated by FSOC as systemically important. Even if AIG keeps its bank, it may not be subject to the strongest level of regulation for institutions deemed systemically important.

Therefore, on September 13, 2012, SIGTARP, in a letter to Treasury and the Federal Reserve[16], recommended the following:

> *In order to protect taxpayers who invested TARP funds into AIG to the fullest extent possible, Treasury and the Federal Reserve should recommend to the Financial Stability Oversight Council that AIG be designated as a systemically important financial institution so that it receives the strongest level of Federal regulation.*

Treasury responded to this recommendation by saying that Treasury will consider information provided by SIGTARP as it continues to evaluate nonbank financial companies for potential designation. Treasury also stated that FSOC members are in the process of analyzing an initial set of companies based on certain quantitative thresholds and that the designation determinations must be made based upon the statutory criteria set forth in Dodd-Frank.

AIG, as one of the single largest recipients of TARP funds, must be effectively and stringently regulated to prevent the type of behavior that led to the bailout of AIG. Following SIGTARP's recommendation, on September 28, 2012, FSOC voted to advance certain nonbank financial companies to the final stage of a three-stage review process to designate companies as systemically important. On October 2, 2012, AIG disclosed that it had received notice that it was under consideration by FSOC for a proposed determination that AIG is a systemically important financial institution, which was a positive step towards implementation of SIGTARP's recommendation. The designation of AIG as a systemically important financial institution is necessary to ensure strong Federal regulation of the company so that taxpayer dollars are not put at risk.

16 See SIGTARP's Quarterly report to Congress, October 25, 2012, http://www.sigtarp.gov/Quarterly%20Reports/October_25_2012_Report_to_Congress.pdf

Office of Inspector General
U.S. Department of the Treasury

The Treasury OIG performs independent, objective reviews of specific Treasury programs and operations with oversight responsibility for one federal banking agency--the Office of the Comptroller of the Currency (OCC). OCC is responsible for approximately 1,400 national banks and 575 federal savings associations with total assets of $10 trillion, comprising 71 percent of the U.S. banking system.

Introduction

The Department of the Treasury Office of Inspector General (OIG) was established pursuant to the 1988 amendments to the Inspector General Act of 1978. The Treasury Inspector General is appointed by the President, with the advice and consent of the Senate. Treasury OIG performs independent, objective reviews of Treasury programs and operations, except for those of the Internal Revenue Service (IRS) and the Troubled Asset Relief Program (TARP), and keeps the Secretary of the Treasury and Congress fully informed.[17] Treasury OIG is comprised of five divisions: (1) Office of Audit, (2) Office of Investigations, (3) Office of Small Business Lending Fund Oversight, (4) Office of Counsel, and (5) Office of Management. Treasury OIG is headquartered in Washington, DC, and has an audit office in Boston, MA.

Treasury OIG has oversight responsibility for one federal banking agency--the Office of the Comptroller of the Currency (OCC). OCC is responsible for approximately 1,400 national banks and 575 federal savings associations with total assets of $10 trillion, comprising 71 percent of the U.S. banking system. Treasury OIG also oversees several offices created by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) which are (1) the Office of Financial Research (OFR), (2) the Federal Insurance Office, and (3) the Offices of Minority and Women Inclusion within Treasury's Departmental Offices and OCC. Additionally, Treasury OIG oversees Treasury's role related to the financial solvency of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) under the Housing and Economic Recovery Act of 2008, to include Treasury's Senior Preferred Stock Purchase Agreements established for the purpose of maintaining the positive net worth of both entities ($187 billion as of March 31, 2013, covering net worth deficiencies through December 31, 2013). Finally, Treasury OIG oversees Treasury's administration of approximately $24 billion in non-IRS funding provided by the American Recovery and Reinvestment Act of 2009 (Recovery Act).

By statute, the Treasury Inspector General also serves as the Chair of the Council of Inspectors General on Financial Oversight (CIGFO).

17 The Treasury Inspector General for Tax Administration performs oversight of IRS, and a Special Inspector General performs oversight of TARP.

Completed and In-Progress Work on Financial Oversight

Congressional Request on Small Community Bank Supervision

On February 10, 2012, the Chairman of the Senate Committee on Banking, Housing, and Urban Affairs requested that the Inspectors General of the FDIC, the Department of the Treasury, the Board, and the National Credit Union Administration conduct audits of their respective agencies' examination processes for small community banks and credit unions. We reviewed OCC's examination process for small community banks and reported that:

- OCC's districts had established timeliness benchmarks for examinations that were generally consistent, and mostly met;
- OCC examiners use the Comptroller's Handbook and the Uniform Financial Institutions Rating System in the administration of examinations in order to promote consistency in the examination process;
- OCC districts have quality assurance programs to monitor and evaluate the administration of examinations;
- OCC Ombudsman and district supervisory offices provide a means by which banks can question examination results formally and informally; and
- community banks made few appeals to question examination results.

Our review identified the need for (1) OCC's Western District to expand its quality assurance program to include comprehensive reviews of its examination process; (2) OCC to update and revise its policies and procedures regarding appeals, to include the responsibilities of both the Ombudsman's office and the supervisory district offices, and ensure that guidance provides consistency in the interpretation, application, and documentation of the appeals process; and (3) OCC personnel to enter examination data correctly into its supervisory tracking system so that OCC can more effectively monitor and measure actual examination timeliness against benchmarks. OCC agreed with our recommendations to address these matters.

Review of the Financial Stability Oversight Council's Response to a Congressional Inquiry Related to Raising the Debt Limit

In letters dated October 2011 and January 2011, the Ranking Member of the Senate Committee on Finance requested that CIGFO review responses to inquiries by the Ranking Member to the voting members of the Financial Stability Oversight Council (FSOC) in late July and early August 2011 regarding the debt limit. Based on work performed by Treasury OIG, the Treasury Inspector General/CIGFO Chair responded to the request in August 2012 by reporting on matters related to (1) Treasury's cash projections during July and August 2011, (2) contingency plans developed by FSOC voting member agencies if the debt limit had not been raised or if there was a credit rating downgrade on the United States, (3) FSOC's compliance with statutory requirements for identifying risks and responding to emerging threats to financial stability, and (4) FSOC's reporting on systemic risks surrounding the debt limit.

We reviewed Treasury's daily cash balance projections as of July 21, 2011, for the period July 28 to August 31, 2011. We noted that absent an increase to the debt limit, our analysis of these projections showed that a sufficient cash balance would not be available to meet all incoming due obligations by August 11, 2011. Furthermore, the cash deficit would grow with each day that the debt limit was not raised. We also determined that FSOC met its statutory requirements under Dodd-Frank to identify, respond, and report on systemic risks and emerging threats to the U.S. financial system. According to the Treasury's Deputy Assistant Secretary for the FSOC, individual FSOC members recognized the fiscal policy challenge, but there was no collective initiative by FSOC to create an FSOC-directed and coordinated set of contingency plans had the debt limit not been raised.

Review of OCC Identification of Emerging Risks

We reviewed how OCC processes identify emerging risks to financial institutions' safety and soundness and then translate the risks identified into action.

We reported that (1) OCC had processes to identify emerging safety and soundness risks to financial institutions and took actions to address those risks; (2) OCC's processes and actions did not prevent the failures of 75 OCC-regulated banks from 2008 through May 2012. Many of the banks that failed during this timeframe were susceptible to the same risks that gave rise to the bank failures of the 1980's and 1990's, and (3) OCC identified current risks to financial institution's safety and soundness. According to OCC, reliance on fees and exotic instruments as well as strategic risks associated with banks' entry into new business products posed the greatest risks to bank's safety and soundness.

Our review identified the need for OCC to (1) periodically assess the effectiveness of the September 2011 guidance (Supervisory Memorandum 2011-5) to ensure, among other things, examination staff are assigning CAMELS management component ratings based on actions and results, rather than commitments, and that adverse ratings are appropriately assigned for poor or missing practices identified in examinations; and (2) ensure that banks and examiners are responding appropriately to risks identified including, but not limited to over-reliance on fees and exotic instruments, as well as risks that are identified.

Review of Treasury's Controls over the Separation of Funds and Activities (In Progress)

House Report 112-550, Report on the Financial Services and General Government Appropriations Bill, 2013, contains a committee recommendation directing Treasury OIG to report on the separation of funds and activities between mandatory-funded offices, such as the Office of Financial Research, and discretionary-funded offices that carry out related or overlapping work, such as the Office of Domestic Finance or Office of Economic Policy. To address this congressional interest, we are conducting a review to assess Treasury Departmental Offices' controls over the separation of funds.

OCC Oversight of Foreclosure Related Consent Orders (In Progress)

In 2010, OCC, working with the former Office of Thrift Supervision (OTS), the Board of Governors of the Federal Reserve System (FRB), and the Federal Deposit Insurance Corporation (FDIC), initiated a review of foreclosure practices at 14 major mortgage servicers and 2 related third party mortgage service providers.[18] This review noted significant deficiencies and weaknesses in foreclosure processing. In April 2011, these agencies entered into consent orders with the mortgage servicers and third party mortgage service providers subject to review. We began a review to assess OCC's: (1) oversight of servicers' efforts to comply with consent orders; (2) determination of qualifications and independence of consultants hired by servicers in accordance with consent orders; (3) oversight of consultants' efforts to perform outreach, conduct file reviews, and review homeowner claims of financial harm; and (4) oversight of the single integrated claims process established by OCC, servicers, and the consultants. In January 2013, OCC negotiated a change to the terms of the consent orders for 12 of the 14 mortgage servicers. We plan to close this audit effort by issuing a report and starting a new review focusing on the new process to provide payments to potentially harmed borrowers under the amended consent orders.

Joint Evaluation of Enforcement Actions Against Institution-Affiliated Parties and Individuals (In Progress)

We recently initiated an evaluation of OCC's pursuit of enforcement actions (EA) against institution-affiliated parties and individuals associated with failed institutions. We are performing the evaluation jointly with the OIGs of FDIC and FRB, who are reviewing this area at their respective agencies. Our objective for the evaluation is to study OCC's programs for pursuing EAs. To accomplish our objective, we plan to (1) describe OCC's processes for investigating and pursuing EAs against institution-affiliated parties, (2) determine the results of OCC's efforts in investigating and pursuing EAs, (3) assess key factors that may impact OCC's efforts in pursuing EAs, and (4) describe OCC's coordination with FDIC in FDIC's pursuit of professional liability claims against individuals and entities associated with failed institutions. The scope of the evaluation will include evaluating statistical and other information pertaining to these processes for the 5year period, January 2008 through December 2012.

Failed Bank Reviews

In 1991, Congress enacted the Federal Deposit Insurance Corporation Improvement Act (FDICIA) amending the Federal Deposit Insurance Act (FDIA). The law was enacted following the failures of about a thousand banks and thrifts from 1986 to 1990, which resulted in billions of dollars in losses to FDIC's Deposit Insurance Fund. The amendments require that banking regulators take specified supervisory actions when they identify unsafe or unsound practices or conditions. Also added was a requirement that the Inspector General for the primary federal regulator of a failed financial institution conduct a material loss review when the estimated loss to the Deposit Insurance Fund is "material." As part of the MLR, OIG auditors determine the causes of the failure and assess the supervision of the institution, including the implementation of the prompt corrective action provisions of the act.[19] As appropriate, Treasury OIG also makes recommendations

18 Pursuant to Dodd-Frank, the functions of OTS were transferred to OCC, FDIC, and FRB on July 21, 2011, and OTS was abolished 90 days later. OTS functions were transferred principally to OCC.

19 Prompt corrective action is a framework of supervisory actions for insured institutions that are not adequately capitalized. It was intended to ensure that action is taken when an institution becomes financially troubled in order to prevent a failure or minimize the resulting losses. These actions become increasingly severe as the institution falls into lower capital categories. The capital categories are well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized.

for preventing any such loss in the future.

Prior to the enactment of Dodd-Frank in July 2010, FDICIA defined a material loss as a loss to the Deposit Insurance Fund that exceeded the greater of $25 million or 2 percent of the institution's total assets. Dodd-Frank redefined the loss threshold amount to the Deposit Insurance Fund triggering a material loss review to a loss that exceeds $200 million for 2010 and 2011, $150 million for 2012 and 2013, and $50 million for 2014 and thereafter (with a provision to temporarily raise the threshold to $75 million in certain circumstances). The act also requires a review of all bank failures with losses under these threshold amounts for the purposes of (1) ascertaining the grounds identified by OCC for appointing FDIC as receiver and (2) determining whether any unusual circumstances exist that might warrant a more in-depth review of the loss. This provision applies to bank failures from October 1, 2009, forward.

From the beginning of the current economic crisis in 2007 through March 22, 2013, FDIC and other banking regulators closed 470 banks and thrifts. One hundred and twenty-eight (128) of these were Treasury-regulated financial institutions. Of these 128 failures, 54 resulted in a material loss to the Deposit Insurance Fund, so an MLR was required. As of March 22, 2013, we completed 54 required material loss reviews. In total, the estimated loss to FDIC's Deposit Insurance Fund for these 54 failures was $32.9 billion.

Treasury Management and Performance Challenges Related to Financial Regulation and Economic Analysis

In accordance with the Reports Consolidation Act of 2000, the Treasury Inspector General annually provides the Secretary of the Treasury with his perspective on the most serious management and performance challenges facing the Department. In a memorandum to the Secretary dated October 25, 2012, the Inspector General reported two management and performance challenges that were specifically directed towards financial regulation and economic recovery. Those challenges were: Transformation of Financial Regulation and Management of Treasury's Authorities Intended to Support and Improve the Economy.

Transformation of Financial Regulation

With the intention to prevent, or at least minimize, the impact of a future financial sector crisis on the U.S. economy, Dodd-Frank placed a great deal of responsibility within Treasury and on the Treasury Secretary. Accordingly, this challenge, among other things, primarily focused on a number of Dodd-Frank mandates related to the Department of the Treasury. It broadly addressed the challenge of implementing an effective FSOC that timely identifies and strongly responds to emerging risks. It also recognized FSOC's accomplishments over the previous year including the designation of systemically significant financial market utilities.

This management and performance challenge also included the other regulatory challenges that the Treasury Inspector General had previously reported. Specifically, it acknowledged the number of Treasury-regulated financial institutions that had failed since the beginning of the current economic crisis and their multi-billion losses to FDIC's Deposit Insurance Fund. With respect to those failures and associated losses, the challenge stated that although many factors contributed to the turmoil in the financial markets, our work found that OCC and the former OTS did not force timely correction of unsafe and unsound practices by numerous failed institutions under their supervision. It also addressed foreclosure processing issues such as weak management oversight, foreclosure document deficiencies, poor oversight of third parties involved in the foreclosure process, and inadequate risk control systems. This resulted in the federal banking regulators issuing formal enforcement actions against 14 mortgage servicers and 2 third party providers. As noted above, we are currently reviewing OCC's oversight of the servicers' efforts to comply with the enforcement actions.

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

This challenge, among other things, focused on a number of broad authorities the Congress provided to Treasury to address the financial crisis under the Housing and Economic Recovery Act and the Emergency Economic Stabilization Act, both enacted in 2008, the Recovery Act, and the Small Business Jobs Act of 2010. It acknowledged that certain authorities in the Housing and Economic Recovery Act and the Emergency Economic Stabilization Act expired, but pointed out the fact that challenges remain in managing Treasury's outstanding investments. To a large extent, Treasury's program administration under these acts have matured, however, the long-term impact on small business lending resulting from investment decisions under the Small Business Jobs Act are still not clear.

Another challenge that the Treasury Inspector General reported for a number of years is Treasury's anti-money laundering and terrorist financing/Bank Secrecy Act enforcement efforts. Among other things, this challenge pointed out our particular concern with respect to ensuring continued cooperation and coordination of all organizations involved in anti-money laundering and combating terrorist financing efforts. Specifically, we expressed our concern that neither the Financial Crimes Enforcement Network nor the Office of Foreign Assets Control have the resources or capability to maintain compliance with their programs without significant help from other organizations.

As a final note, although not yet reported as a management and performance challenge, the Treasury Inspector General highlighted an area of concern – cyber security. Not surprisingly, Treasury's systems are interconnected and critical to the core functions of government and the Nation's financial infrastructure. In this regard, information security remains a constant area of concern and potential vulnerability for Treasury's systems. As a result, an economic and national security challenge for which Treasury must be prepared, is to provide leadership to defend against the full spectrum of threats against financial institutions in particular, and the financial sector in general. Many U.S. banks face cyber threats to their infrastructures on a continuous basis. Recent examples include denial of service attacks against a number of large U.S. banks. Organized hacking groups leverage known and new vulnerabilities and use different methods to make attacks hard to detect and even harder to prevent. Given the evolving cyber-threat environment Treasury will need to build on existing partnerships among financial institutions, regulators, and private entities in the financial sector, in order to be well-positioned to identify and respond to emerging cyber threats against financial institutions and the broader financial sector.

Appendix A:
Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities

Prepared by the Council of Inspectors General on Financial Oversight

2013

Abbreviations and Acronyms

ANPR	Advanced notice of proposed rulemaking
CFTC	Commodity Futures Trading Commission
CHIPS	Clearing House Interbank Payments System
CIGFO	Council of Inspectors General on Financial Oversight
CME	Chicago Mercantile Exchange, Inc.
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
DTC	The Depository Trust Company
FICC	Fixed Income Clearing Corporation
FMU	Financial market utility
FRB	Board of Governors of the Federal Reserve System
FSOC or Council	Financial Stability Oversight Council
ICE Clear Credit	ICE Clear Credit LLC
NPR	Notice of proposed rulemaking
NSCC	National Securities Clearing Corporation
OFR	Office of Financial Research
PCS	Payment, clearing, and settlement
SEC	U.S. Securities and Exchange Commission
Title I	Dodd-Frank Wall Street Reform and Consumer Protection Act, Title I—Financial Stability
Title VIII	Dodd-Frank Wall Street Reform and Consumer Protection Act, Title VIII—Payment, Clearing, and Settlement Supervision
Treasury	The Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

July 12, 2013

The Honorable Jacob J. Lew
Chair, Financial Stability Oversight Council
Washington, D.C. 20220

Dear Mr. Chairman:

I am pleased to present you with the Council of Inspectors General on Financial Oversight (CIGFO) report titled, Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities.

As the designation of financial market utilities (FMUs) is one of the key authorities given to FSOC by the Dodd-Frank Wall Street Reform and Consumer Protection Act, I proposed convening a working group to assess the rules, procedures, and practices established by FSOC and its members to determine which FMUs should be designated as systemically important. The proposal was approved, and a CIGFO Working Group completed a review.

This CIGFO report recommends that FSOC (1) establish a formal structure for the FMU Committee; (2) determine a course of action with regard to foreign-based FMUs consistent with the authorities of Title VIII; (3) continue deliberations on the process and rules regarding possible future designation of payment, clearing and settlement activities conducted by financial institutions; (4) define the nature, frequency, and communication of updates on designated FMUs from the FMU regulators; and (5) establish a timeline for periodic reviews of non-designated FMUs that may be systemically important.

I would like to take this opportunity to thank the support of the FSOC members, especially those Treasury officials who assisted with this effort.

CIGFO looks forward to working with you on this and other issues. In accordance with the Dodd-Frank Act, CIGFO is also providing this report to Congress.

Sincerely,

Eric M. Thorson
Chair
Council of Inspectors General on Financial Oversight

Enclosure

Executive Summary

Why and How We Conducted the Review

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) created a comprehensive regulatory and resolution framework designed to reduce the severe economic consequences of economic instability. The Financial Stability Oversight Council (FSOC or the Council), established by the Dodd-Frank Act, is charged with identifying risks to the nation's financial stability, promoting market discipline, and responding to emerging threats to the stability of the nation's financial system. Title VIII of the Dodd-Frank Act–Payment, Clearing, and Settlement Supervision (Title VIII), authorizes FSOC to designate financial market utilities (FMUs) as "systemically important" if FSOC determines that the 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. FSOC-designated FMUs are then subject to enhanced risk management requirements and enhanced supervision under Title VIII. On July 18, 2012, FSOC voted unanimously to designate eight FMUs as systemically important.

> **Financial market utilities** 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.

The Dodd-Frank Act also established the Council of Inspectors General on Financial Oversight (CIGFO). CIGFO's statutory functions include oversight of FSOC. In this regard, the law authorizes CIGFO to convene a working group, by a majority vote, for the purpose of evaluating the effectiveness and internal operations of FSOC. In January 2013, Eric Thorson, CIGFO Chair and Department of the Treasury (Treasury) Inspector General, proposed convening a working group to assess the application of the rules, procedures, and practices established by FSOC and its members to determine which FMUs should be designated as systemically important and therefore subject to the requirements of Title VIII. CIGFO unanimously approved the proposal and formed a Working Group.

To accomplish its objective, the CIGFO Working Group reviewed the processes and procedures FSOC used to designate the eight FMUs as systemically important. As part of that review, the Working Group reviewed (1) how FSOC established the universe of FMUs for consideration and (2) FSOC processes going forward to review FMU activity, to designate additional FMUs and, when appropriate, to rescind an FMU designation.

What We Learned

Title VIII authorizes certain activities for FSOC to perform during the FMU designation process. These activities include, among others, prescribing rules to administer FSOC's authority to designate FMUs as systemically important, requesting information from FMUs, consulting with regulatory agencies, and providing FMUs with notice of final determination of designation. We determined that FSOC carried out the designation activities as established in Title VIII with respect to the designation of the eight FMUs as systemically important.

To assist in carrying out the designation activities, FSOC created the Designations of Financial Market Utilities and Payment, Clearing, and Settlement Activities Committee (FMU Committee). In obtaining information during the designation process, the FMU Committee relied on the FSOC member agencies that regulate FMUs, namely the Commodity Futures Trading Commission (CFTC), the Board of Governors of the Federal Reserve System (FRB), and the U.S. Securities and Exchange Commission (SEC).[20] Although the FMU Committee did not have final decision-making authority, preliminary recommendations during the FMU designation process were made at the FMU Committee level and then moved through the Deputies Committee[21] to FSOC for a final vote. We found that the FMU Committee carried out its activities in the designation process as intended by FSOC. However, we noted that the FMU Committee did not have a designated chairperson and did not keep a record of its meetings.

We also learned that during the FMU designation process, FSOC decided not to consider for designation at this time, foreign-based FMUs; retail FMUs;[22] or payment, clearing, and settlement (PCS) activities conducted by financial institutions. However, we were told that deliberations continue within FSOC regarding (1) foreign-based FMUs and (2) the designations of PCS activities. We were also told that the designation of retail FMUs is not part of the Council's current work and that no estimate of when or if retail FMUs will be designated has been established.[23]

While the Council relies on the respective regulators of the designated FMUs to monitor their activities and report updates to the Council, there is no agreement or process established in writing by FSOC that defines the nature, frequency, and communication of such updates. Additionally, since the designation of eight FMUs in July 2012, FSOC has not conducted additional reviews of FMUs that may be systemically important, nor has it established a schedule for doing so.

Recommendations

Because of the critical role the FMU Committee will likely play in the future, we are recommending that FSOC establish a formal structure for the FMU Committee, including designating a chairperson and keeping a record of committee meetings to document, among other things, its deliberations and key recommendations.

Regarding foreign-based FMUs, we are recommending that FSOC determine a course of action consistent with its authorities, as foreign-based FMUs may be systemically important to the stability of the U.S. financial system. Because Title VIII authorizes FSOC to designate PCS activities conducted by financial

20 According to FSOC staff, this reliance was based on two important factors: (1) these regulatory agencies were the ones with subject matter expertise on FMUs, and (2) in part, to reduce the burden on companies under consideration. To the extent that regulatory agencies already had information relevant to the designation process, the Council relied on the agencies to provide this data rather than request that each company re-submit information, thus reducing the burden on the companies.

21 The Deputies Committee coordinates and oversees the work of the interagency staff committees and is made up of a senior official from each FSOC member agency.

22 Retail FMUs, such as MasterCard and Visa, manage or operate systems for mostly consumer payments of relatively low value and urgency.

23 In this regard, the final rule on designating FMUs as systemically important articulates the Council's rationale, namely that these retail payments systems are generally low-value systems for which there appear to be readily available and timely alternative payment mechanisms.

institutions as systemically important, the Council should also continue its deliberations on the possible future designation of PCS activities.

We are recommending that FSOC define the nature, frequency, and communication of updates on designated FMUs from the respective regulators of the FMUs. We are also recommending that FSOC establish a timeline for periodic reviews of non-designated FMUs that may be systemically important.

FSOC Response

In a written response, FSOC stated that with respect to the recommendation to establish a formal structure for the FMU Committee, the Council is examining ways to further enhance the governance of the Council's staff committees. In regard to the recommendations on foreign-based FMUs and PCS activities, the FMU Committee is expected to continue its discussions on these matters at its upcoming meetings and will communicate any developments to the Deputies Committee and the Council as appropriate. Specific procedures and rules for the future designation of PCS activities are not being considered by the FMU Committee at this time, but may be developed in the future. The FMU Committee will be asked to continue the work it has begun by proposing specific procedures to address the recommendations on updates on designated FMUs from the FMU regulators and establishing a timeline for periodic reviews of non-designated FMUs. FSOC's response is provided as Appendix IV.

CIGFO Working Group Comments

As a whole, we consider FSOC's commitments and planned actions responsive to our recommendations. We recognize that certain commitments and planned actions are matters of on-going work of the FMU Committee and the Council. For other actions, FSOC should establish estimated completion dates for implementation.

Results of CIGFO Working Group Review

Introduction

Title VIII authorizes FSOC to designate FMUs as systemically important if FSOC determines that the failure of 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. This report presents the results of the CIGFO Working Group's audit of FSOC's implementation of Title VIII. This is the second report that a CIGFO Working Group has issued to the Council and the Congress as part of CIGFO's responsibility to oversee FSOC under the Dodd-Frank Act. CIGFO issued its first report in June 2012. That report discussed the results of CIGFO's examination of the controls and protocols that FSOC and its federal agency members employ to safeguard from unauthorized disclosure, non-public information collected by, and exchanged with, FSOC federal agency members.[24]

24 CIGFO, Audit of the Financial Stability Oversight Council's Controls over Non-public Information, (June 22, 2012).

Background

FSOC was established to create joint accountability for identifying and mitigating potential threats to the stability of the nation's financial system. By creating FSOC, Congress recognized that financial stability would require the collective engagement of the entire financial regulatory community.

As shown in the table on the next page, FSOC consists of 10 voting members and 5 nonvoting members and brings together the expertise of federal financial regulators, state regulators, and an insurance expert appointed by the President with Senate confirmation.

Table 1: FSOC Membership

Federal and Independent Members	State Members
• Secretary of the Department of the Treasury, Chairperson (v)	• State Insurance Commissioner
• Chairman of the Board of Governors of the Federal Reserve System (v)	• State Banking Supervisor
• Comptroller of the Currency (v)	• State Securities Commissioner
• Director of the Consumer Financial Protection Bureau (v)	
• Chairman of the Securities and Exchange Commission (v)	
• Chairperson of the Federal Deposit Insurance Corporation (v)	
• Chairperson of the Commodity Futures Trading Commission (v)	
• Director of the Federal Housing Finance Agency (v)	
• Chairman of the National Credit Union Administration Board (v)	
• Director of the Office of Financial Research	
• Director of the Federal Insurance Office	
• Independent member with insurance expertise (v)	
(v) Indicates Voting Member	

The purposes of FSOC are to:

- identify risks to the financial stability of the U.S. that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace;
- promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the U.S. Government will shield them from losses in the event of failure; and
- respond to emerging threats to the stability of the U.S. financial system.

Within Treasury, a dedicated policy office, led by a Deputy Assistant Secretary, functions as the FSOC Secretariat and serves as a mechanism to bring issues to the Council through a coordinated process. Voting members of FSOC provide a federal regulatory perspective and an independent insurance expert's view. The nonvoting members offer different insights as state-level representatives from bank, securities, and insurance regulators or as the directors of offices within Treasury – the Office of Financial Research (OFR) and the Federal Insurance Office.

To carry out its mission, FSOC uses a committee structure.[25] Individual committees handle key responsibilities and are staffed by personnel from FSOC members. For example, the FMU Committee supports FSOC in identifying, recommending, and reviewing designations of FMUs and PCS activities as systemically important. Recommendations and activities of the FMU Committee are subject to review by the Deputies Committee and ultimate decision-making authority is retained by the Council itself.

Congress made the following findings in Title VIII:

- The proper functioning of the financial markets is dependent upon safe and efficient arrangements for the clearing and settlement of payment, securities, and other financial transactions.
- FMUs that conduct or support multilateral PCS activities may reduce risks for their participants and the broader financial system, but such utilities may also concentrate and create new risks and thus must be well designed and operated in a safe and sound manner.
- PCS activities conducted by financial institutions also present important risks to the participating financial institutions and to the financial system.
- Enhancements to the regulation and supervision of systemically important FMUs and the conduct of systemically important PCS activities by financial institutions are necessary to provide consistency, promote robust risk management and safety and soundness, reduce systemic risks, and support the stability of the broader financial system.

25 FSOC's committee structure includes the Deputies Committee and the Systemic Risk Committee. The Systemic Risk Committee has two sub-committees – the Institutions Sub-committee and the Markets Sub-committee. There are also five Standing Functional Committees – the Designations of Nonbank Financial Companies Committee; the FMU Committee; the Heightened Prudential Standards Committee; the Orderly Liquidation Authority, Resolution Plans Committee; and the Data Committee.

In addition, Congress stated that the purpose of Title VIII is to mitigate systemic risk in the financial system and promote financial stability by:

- authorizing FRB to promote uniform standards for the (1) management of risks by systemically important FMUs and (2) conduct of systemically important payment, clearing, and settlement activities by financial institutions;
- providing FRB an enhanced role in the supervision of risk management standards for systemically important FMUs;
- strengthening the liquidity of systemically important FMUs; and
- providing FRB an enhanced role in the supervision of risk management standards for systemically important payment, clearing, and settlement activities by financial institutions.

Audit Approach

The objective of our audit was to assess the rules, procedures, and practices established by FSOC and its members to determine which FMUs should be designated as systemically important and therefore be subject to the enhanced risk management and supervision provisions of Title VIII. We conducted our audit fieldwork from February through April 2013 in accordance with generally accepted government auditing standards.

As members of the CIGFO Working Group, each participating Office of Inspector General collected information on its FSOC federal member(s) regarding FSOC's process for designating FMUs. We collected similar information from the FSOC Secretariat and FSOC non-federal members. The information was gathered using a CIGFO Working Group-developed questionnaire and document request based on the designation process activities outlined in Title VIII.

The Working Group participants presented the results of their respective questionnaires and document reviews to the applicable FSOC member and FSOC Secretariat, who were given the opportunity to provide additional comments. We consolidated and reviewed the results to determine and assess FSOC's process for designating FMUs and to identify potential opportunities to strengthen the process. We provided an exit briefing on the overall results of our work to FSOC representatives on May 31, 2013.

FSOC's Process for Designating FMUs

FSOC Followed Designation Process Activities Outlined in Title VIII

Title VIII gives FSOC the authority, on a non-delegable basis and by a vote of no fewer than two-thirds of members then serving, including an affirmative vote by the Chairperson of the Council (the Secretary of the Treasury), to designate those FMUs that FSOC determines are, or are likely to become, systemically important.

To help carry out its authority to designate FMUs as systemically important, FSOC established the FMU Committee, one of five standing functional committees. According to the FSOC Secretariat, the FMU Committee is a collaborative, staff-level group that supports the work of the Council, and operates on a consensus basis; its discussions and work products are deliberative in nature. The FSOC Secretariat stated the committee has no autonomous decision-making authority delegated to it by the Council. However, preliminary recommendations regarding the designation of FMUs were made at the FMU Committee level and then moved through the Deputies Committee to the Council, which made the final decisions. Examples of recommendations made by the FMU Committee included: (1) the wording of various versions of the advanced notice of proposed rulemaking (ANPR),[26] the notice of proposed rulemaking (NPR),[27] the final rule[28] as well as the subcategories of the considerations listed in the final rule; and (2) the identification and recommendation of the eight FMUs that the Council ultimately voted on for designation as systemically important.

The FMU Committee held its initial meeting in January 2011 and then generally met monthly from March to November 2011. The FMU Committee began meeting more frequently from January to May 2012 as FSOC's final determination on designating FMUs neared in July 2012. Since May 2012, the FMU Committee has met three times. Examples of discussion items during the these meetings included updates on designated FMUs, the process for considering additional FMUs for designation, and the framework for periodically reviewing designated FMUs.

We determined that FSOC carried out designation activities established in Title VIII. The activities are described below.

<u>Determining considerations</u> - *Title VIII specified that FSOC take into consideration the following when determining whether an FMU is or is likely to become systemically important.*

- The aggregate monetary value of transactions processed by the FMU
- The aggregate exposure of the FMU to its counterparties[29]
- The relationship, interdependencies, or other interactions of the FMU with other FMUs or PCS activities
- The effect that the failure of or disruption to the FMU would have on critical markets, financial institutions, or the broader financial system
- Any other factors the Council deems appropriate

In its final rule, which is described below, FSOC incorporated these considerations but did not identify any other factors in accordance with the fifth consideration.

<u>Rulemaking</u> - Title VIII authorizes FSOC to prescribe rules and issue orders to administer its authority for the designation process. FSOC published an ANPR on December 21, 2010, regarding the designation criteria, followed by the publication of a NPR on March 28, 2011. The ANPR invited public comment on the criteria and analytical framework that should be applied by the Council in designating FMUs under Title VIII. The NPR described: (1) the FMU designation processes and procedures established under the Dodd-Frank Act and (2) the criteria to be used by the Council for determining systemic importance of FMUs.

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26 75 Fed. Reg. 79,982

27 76 Fed. Reg. 17,047

28 76 Fed. Reg. 44,763

29 Counterparties include other participants in a financial transaction.

The Council published the final rule on July 27, 2011, which included a two-stage designation process described in the NPR. Stage One consists of a data-driven process to result in the FMU Committee identifying a preliminary set of FMUs for possible designation. During Stage One, the FMU Committee considers factors such as, but not limited to, the number of transactions processed, cleared, or settled by the FMU; the value of transactions processed, cleared, or settled by the FMU; credit exposures to counterparties; the role of an FMU in the market served; and the availability of substitutes. During Stage Two, the FMUs identified in Stage One undergo a more in-depth review, with a greater focus on qualitative factors, in addition to other institutional and market specific considerations.

> <u>Requesting information</u> – To assist in its assessment of whether an FMU is systemically important, Title VIII authorizes FSOC to request information, reports, or records directly from the FMU under consideration. In this regard, Title VIII requires FSOC to coordinate first with the FMU's appropriate regulatory agency to obtain this information. For the most part, during the designation process, FSOC relied on its agency members who were also the FMUs' regulators (CFTC, FRB, and SEC) to communicate with the FMUs for the purpose of obtaining information.

FSOC member agencies told us that the information they received for the purposes of evaluating each FMU under consideration for designation was adequate. During our review, we inquired whether OFR[30] had a role in the designation process for the eight FMUs. We were told that OFR did not play a role.

> <u>Consultation with supervisory agencies</u> – Title VIII requires FSOC to consult with the relevant regulatory agency and the FRB before making any determinations of designation or rescission. The FSOC Secretariat stated that the FMU Committee consulted with and relied on input from the FMU regulators, which included the FRB, to determine the population of FMUs to be considered for designation because the regulators had the expertise. During the designation process, methods used for consultation with the FMU regulators and among the FMU Committee members included email correspondence, in-person meetings, telephone conferences, and document and information sharing via SharePoint.

> <u>Advance notice of proposed determination</u> – Title VIII requires FSOC to provide FMUs with advance notice of the proposed determination of the Council, and offer the FMUs the opportunity to request a hearing within 30 days from the date of the advance notice.

In a memorandum dated December 19, 2011, the FMU Committee unanimously recommended to the Council, through the Deputies Committee, that eight FMUs be advanced from Stage One to Stage Two of the designation process. On December 21, 2011, the Council voted unanimously to approve the eight FMUs advancement to Stage Two. In letters dated January 4, 2012, FSOC provided written notices to the eight FMUs that the Council was considering them for a proposed determination, and invited the eight FMUs to submit information to FSOC for or against the proposed designations. According to the FSOC Secretariat, several FMUs responded by submitting information about their companies that further helped in the designation process, and one FMU requested a meeting with FSOC staff to discuss concerns regarding the competitive

30 Created under Title I of the Dodd-Frank Act, the purpose of OFR is to support FSOC in fulfilling the purposes and duties of the Council, and to support member agencies, by (1) collecting data on behalf of the Council, and providing such data to the Council and member agencies; (2) standardizing the types and formats of data reported and collected; (3) performing applied research and essential long-term research; (4) developing tools for risk measurement and monitoring; (5) performing other related services; (6) making the results of the activities of the office available to financial regulatory agencies; and (7) assisting such member agencies in determining the types and formats of data authorized by the act to be collected by such member agencies.

implications of being designated. The FSOC Secretariat stated the requested meeting was not considered to be a formal hearing in the context of Title VIII.

On May 22, 2012, FSOC sent letters informing the eight FMUs that the Council proposed to designate each entity systemically important. The letters provided advance notice of proposed designation and informed each FMU of its right to request a hearing on or before June 21, 2012. None of the eight FMUs requested a hearing.

Final vote – As authorized by Title VIII, FSOC voted on July 18, 2012, to designate the eight FMUs as systemically important. The eight designated FMUs are the same eight FMUs that received the notice of the proposed designation in May 2012.

Notice of final determination - In letters dated July 18, 2012, FSOC notified the eight FMUs of the final determination of the Council, as required by Title VIII.[31] As authorized by the Dodd-Frank Act, CFTC, FRB, and SEC separately established through a rulemaking process, additional standards for designated FMUs under their supervisory authority. The eight designated FMUs and their regulators are listed in Table 2. We provide a description of the eight designated FMUs in Appendix III.

Table 2: Eight FMUs Designated as Systemically Important

Financial Market Utility	Regulator for purposes of Title VIII
The Clearing House Payments Company, L.L.C., on the basis of its role as operator of the Clearing House Interbank Payments System (CHIPS	FRB
CLS Bank International	FRB
Chicago Mercantile Exchange, Inc.	CFTC
The Depository Trust Company	SEC
Fixed Income Clearing Corporation	SEC
ICE Clear Credit LLC	CFTC
National Securities Clearing Corporation	SEC
The Options Clearing Corporation	SEC

We concluded that the FMU designation process followed by FSOC conformed to Title VIII. Our review, however, identified the following areas for improvement or continuing effort by FSOC related to the FMU Committee structure and deliberations on designating foreign-based FMUs and PCS activities.

31 FSOC also issued a press release the same day announcing the designations of the eight FMUs.

FSOC Should Establish a Formal FMU Committee Structure

While the FMU Committee supported FSOC in the designation process, it operated in a somewhat unstructured manner. It did not have a charter or a designated chairperson. The FMU Committee had meeting agendas, but it did not keep a record of its meetings to document whether the committee discussed the agenda items or to provide detail on the Committee's deliberations or recommendations. In a September 2012 report, the Government Accountability Office (GAO) noted a similar absence of detailed records on the part of FSOC and its committees, and how this made it difficult to assess FSOC's performance.[32]

The FSOC Secretariat stated that the FMU Committee wanted an open and collaborative process. The FSOC Secretariat also stated that at the FMU Committee's most recent meeting on March 20, 2013, there was some discussion of formalizing certain aspects of the FMU Committee structure. While FSOC's committees are not required by law to keep a record of its meetings,[33] we believe it is important to document: (1) recommendations made, (2) agreed upon actions to be taken, and (3) assignment of any tasks or responsibilities. Such a record would also provide the means for assessing committee performance over time and may be useful to new FMU committee members. Furthermore, keeping a record of meetings should not hinder the FMU Committee's desire for an open and collaborative process.

FSOC Should Determine a Course of Action with Regard to Foreign-based FMUs and Continue Deliberations on the Process and Rules Regarding Possible Future Designation of PCS Activities as Systemically Important

During Stage One of the FMU designation process, FSOC identified certain foreign-based FMUs as potential candidates for designation as systemically important. However, FSOC decided not to pursue possible designation at the time pending further deliberations. According to the FSOC Secretariat, this matter is still under review.

Also, in its final rule on designations of FMUs, FSOC acknowledged its Title VIII authority to designate PCS activities conducted by financial institutions as systemically important and stated that it expects to address these designations in a separate rulemaking. As of May 2013, FSOC had not published a proposed rule for the designation of PCS activities as systemically important. The FSOC Secretariat told us that the FMU Committee discussed this point at its two most recent meetings (in December 2012 and March 2013) and further discussions are expected on the matter.

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32 GAO, Financial Stability: New Council and Research Office Should Strengthen the Accountability and Transparency of Their Decisions (GAO-12-886; Sept. 2012). In the report, GAO stated that while FSOC released minutes from its meetings as required by its bylaws, it did not keep detailed records of deliberations or discussions that take place at these meetings or at the committee level. GAO also stated that while no specific level of detail was required for FSOC minutes, the limited documentation of discussions made it difficult to assess FSOC's performance.

33 As the seminal statute on government committees, the Federal Advisory Committee Act (FACA) outlines several guidelines and requirements that must be followed such as the creation of a charter before any business is conducted, public notification of committee meetings in the Federal Register, and the keeping of minutes. However, the DoddFrank Act states that FACA does not apply to FSOC or to any special advisory, technical, or professional committee appointed by the Council, except that, if such a committee has one or more members who are not employees of or affiliated with the U.S. Government, the Council shall publish a list of names of the members of such committee.

In its work going forward, FSOC should determine a course of action with regard to foreign-based FMUs consistent with its authorities and continue deliberations on the processes and rules regarding possible future designations of PCS activities as systemically important.

With regard to retail FMUs, the final rule on the designation of FMUs as systemically important states "FSOC has decided against including in the final rule any categorical exclusion for FMUs operating retail payment or other systems, because there are not clear distinctions between various types of systems, and because such an exclusion would impair the Council's ability to respond appropriately to new information, changed circumstances, and future developments." In addition, the final rule states that the Council does not expect to focus on "FMUs that operate low-value systems for which there appear to be readily available and timely alternative payment mechanisms," including retail payment systems. Accordingly, the FSOC Secretariat told us that the designation of retail FMUs is not part of the Council's current work and that it is not possible to estimate when or if retail FMUs will be designated.

FSOC'S Process for Monitoring FMUs

In the preamble to its NPR, the Council proposed, on at least an annual basis, to continue to evaluate whether there are other FMUs that require designation, and whether previous designations of systemically important FMUs should be rescinded. The preamble to the final rule states that the "Council believes that a periodic review of any FMUs that are potentially systemically important, but that have not been designated as such, is important to evaluate any new developments in the roles these FMUs have in the financial system. As a result, the Council anticipates conducting reviews of both designated FMUs and potentially systemically important FMUs on a periodic basis. However, the Council believes that it is important to retain flexibility in the timing for periodic reviews in order to take into account evolving market conditions. Accordingly, the Council is not including a provision regarding periodic reviews in the final rule."

FSOC intends to rely on the designated FMUs' regulators (CFTC, FRB, and SEC) for ongoing reviews. According to the FSOC Secretariat, the regulators provided general updates on the designated FMUs at the December 2012 and March 2013 FMU Committee meetings. The FSOC Secretariat also stated the FMU Committee has discussed the scope and substance of future updates by FMU regulators, such as whether there are any changes in designated FMUs' market share or business plans. At this time, however, there is no agreement or process established in writing that defines the nature, frequency, and communication of such updates.

Furthermore, the FSOC Secretariat stated that the Council is working out a timeline for performing reviews of non-designated FMUs to determine whether any warrant further consideration regarding possible designation. The FSOC Secretariat also stated that this is an ongoing topic of conversation, including at the two most recent quarterly FMU Committee meetings.

While Title VIII does not include specific provisions for the periodic review of both designated and non-designated FMUs, FSOC acknowledged the importance of these activities in its NPR. Further, the preamble to the final rule states that the Council anticipates conducting reviews of both designated FMUs and those that may become systemically important, on a periodic basis. As such, we believe it is important for FSOC to define the nature, frequency, and communication of updates on designated FMUs from the respective FMU regulators and to establish a timeline for periodic reviews of non-designated FMUs that may be systemically important.

Conclusion and Recommendations

We determined that FSOC carried out the activities prescribed in Title VIII by establishing a process and issuing rules to designate FMUs as systemically important, and that it followed the process and rules in designating the FMUs to date. FSOC relied on the work of the FMU Committee during the designation process and voted unanimously to accept the recommendations from the FMU Committee. We did note that the FMU Committee operated without a formal structure and did not keep a record of its meetings. Additionally, FSOC decided not to designate any foreign-based FMUs or PCS activities conducted by financial institutions at this time, although deliberations are on-going. Although the designated FMUs' regulators are conducting on-going monitoring, FSOC has not defined the nature, frequency, and communication of updates on designated FMUs by the FMU regulators, or established a timeline for periodic reviews of non-designated FMUs that may be systemically important.

Accordingly, we recommend that FSOC:

4. Establish a formal structure for the FMU Committee, including designating a chairperson to ensure the proper functioning of the committee, and keeping a record of committee meetings to document, among other things, its deliberations and key recommendations.

   <u>FSOC Response</u>

   FSOC is focused on continuously improving governance over its activities. Council staff is already examining ways to further enhance the governance of the Council's staff committees, and this recommendation will be included as part of that review.

   <u>CIGFO Working Group Comment</u>

   FSOC's commitment to include this recommendation in its current review of ways to enhance the governance of its staff committees is responsive to our recommendation. That said, we believe that establishing a formal structure for the FMU Committee and keeping a record of committee meetings are critical to improved governance.

5. Determine a course of action with regard to foreign-based FMUs consistent with the authorities of Title VIII.

   <u>FSOC Response</u>

   The FMU Committee is expected to continue its discussions on this matter at its upcoming meetings and will communicate any developments to the Deputies Committee and the Council as appropriate.

   <u>CIGFO Working Group Comment</u>

   FSOC's commitment to continue its discussions is responsive to our recommendation. The CIGFO plans to request periodic updates from FSOC on its deliberations and actions regarding foreign-based FMUs.

6. Continue deliberations on the process and rules regarding possible future designation of PCS activities conducted by financial institutions as systemically important.

   <u>FSOC Response</u>

The FMU Committee is expected to continue its discussions on this matter at its upcoming meetings and will communicate any developments to the Deputies Committee and the Council as appropriate. Proposals for the designation of PCS activities will be considered in the ordinary course of the FMU Committee's work. Specific procedures and rules for the future designation of PCS activities are not being considered by the FMU committee at this time, although such procedures and rules may be developed in the future as a result of FMU Committee discussions or as directed by the Council.

<u>CIGFO Working Group Comment</u>

FSOC's commitment to continue its discussions with respect to PCS activities is responsive to our recommendation.

7. Define the nature, frequency, and communication of updates on designated FMUs from the FMU regulators.

<u>FSOC Response</u>

The FMU Committee will be asked to continue the work it has begun in this area by proposing specific procedures to address this matter.

<u>CIGFO Working Group Comment</u>

FSOC's planned action is responsive to our recommendation. FSOC should establish an estimated timeframe for completing and implementing specific procedures.

8. Establish a timeline for periodic reviews of non-designated FMUs that may be systemically important.

<u>FSOC Response</u>

The FMU Committee will be asked to continue the work it has begun in this area by proposing specific procedures to address this matter.

<u>CIGFO Working Group Comment</u>

FSOC's planned action is responsive to our recommendation. FSOC should establish an estimated timeframe for completing and implementing specific procedures.

APPENDIX I: Objective, Scope and Methodology

Objective

The audit objective was to assess the application of the rules, procedures, and practices established by FSOC and its members to determine which FMUs should be designated as systemically important and therefore subject to the requirements of Title VIII of the Dodd-Frank Act. This included determining how FSOC established its universe of FMUs and what processes FSOC has going forward to review FMU activity to designate additional FMUs as systemically important and, when appropriate, to rescind an FMU designation.

Scope and Methodology

The scope of this audit included the process FSOC used to designate eight FMUs as systemically important in July 2012 and its processes going forward to review FMU activity.

To accomplish our objective, we:

- interviewed representatives of FSOC's member agencies through the use of a structured questionnaire. We designed the questionnaire to determine and review FSOC's process for designating FMUs as systemically important, and to solicit information on the FSOC member agencies' involvement in the process as well as their views on how the process worked. We developed the questions based on designation process activities outlined in Title VIII of the Dodd-Frank Act. We also obtained relevant documentation from the FSOC member agencies;
- reviewed the ANPR, NPR, the final rule, and an overview of the planned FMU designation process for the purpose of determining conformity with Title VIII;
- compared information on FMUs obtained from FSOC with information we obtained from FSOC member agencies that regulate FMUs; and
- reviewed other related documentation such as FMU Committee membership information, FMU metrics data, recommendation memorandums on FMUs prepared for the Council, FMU notification letters, and FMU Committee meeting invitations and agendas. As noted in our report, the FMU Committee did not keep a record of its meetings, so we obtained testimonial evidence about its proceedings.

We performed audit fieldwork from February through April 2013. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

APPENDIX II:
Timeline of Significant FMU Designation Events

Date	Event
12/21/2010	FSOC published an advance notice of proposed rulemaking regarding the designation criteria in section 804 of Title VIII. (75 Fed. Reg. 79,982)
3/28/2011	FSOC published a notice of proposed rulemaking regarding the designation criteria in section 804 of Title VIII. (76 Fed. Reg. 17,047)
7/27/2011	FSOC published its final rule outlining the criteria, processes, and procedures for the designation of FMUs. (76 Fed. Reg. 44,763) The final rule notes that FSOC expects to address the designation of payment, clearing, or settlement activities as systemically important in a separate rulemaking.
12/19/2011	The FMU Committee sent a memo through the Deputies Committee to the Council recommending that eight FMUs move from Stage One to Stage Two of the designation process.
12/21/2011	FSOC voted unanimously to advance the eight FMUs from Stage One to Stage Two of the designation process.
1/4/2012	FSOC sent written notification to the eight FMUs of the Council's consideration for designation of their company as systemically important. The notification letters also invited the FMUs to submit information about their companies to FSOC by February 3, 2012.
5/10/2012	Members of the FMU Committee met with the Clearing House Payments Company L.L.C., at the company's request. The meeting focused on the company's concerns regarding the competitive implications of being designated.
5/22/2012	FSOC unanimously approved the proposed designation of the eight FMUs as systemically important. FSOC sent written notification to the designated FMUs. The notification letters also informed the FMUs that they had 30 days to request a hearing if they disagreed with the proposed determination of the Council or the Council's proposed findings of fact. None of the designated FMUs requested such a hearing.
7/18/2012	After voting unanimously on May 22, 2012, to designate the eight FMUs as systemically important, FSOC sent written notification to the eight FMUs.

APPENDIX III: Description of Designated FMUs

Company	Description
The Clearing House Payments Company, L.L.C., on the basis of its role as operator of the Clearing House Interbank Payments System (CHIPS)	The Clearing House Payments Company, L.L.C. is the world's largest private sector payments operator and the legal entity that operates CHIPS, which is a multilateral system operated for the purposed of transferring payments among its 52 participants. The 52 participants are U.S. commercial banks, foreign banks with offices in the U.S., and one private banker. These participants constitute some of the largest banks in the world by asset size and include bank subsidiaries of 22 financial institutions considered to be global systemically important financial institutions by the Financial Stability Board.[34] An important feature of CHIPS is that it can bilaterally and multilaterally net payments for settlement. CHIPS is the only private sector system in the U.S. for settling large-value U.S. dollar payments continuously throughout the day. CHIPS settles approximately $1.6 trillion on average per day.
CLS Bank International	CLS Bank International operates the largest multicurrency cash settlement system to mitigate settlement risk for the foreign exchange transactions of its members, who are financial institutions, and their customers. Through its services, CLS Bank International significantly reduces settlement risk and provides substantial liquidity savings through its use of multilateral net funding. CLS Bank International settles an average daily value of 4.77 trillion U.S. dollar equivalent, representing 68 percent of foreign exchange market activity in CLS Bank-eligible currencies and products.
Chicago Mercantile Exchange, Inc.	Chicago Mercantile Exchange, Inc. (CME) is one of the largest central counterparty clearing services providers in the world, clearing 96 percent of the entire market for U.S. futures, options on futures, and commodity options. CME provides central counterparty clearing services for futures, options, and swaps that can be used by market participants for a variety of purposes. In 2011, CME cleared contracts with an average daily gross notional value in the trillions of U.S. dollars and average daily gross notional values in the millions of U.S. dollars of over-the-counter credit default swaps.
The Depository Trust Company	The Depository Trust Company (DTC) serves as the central securities depository for substantially all corporate and municipal debt and equity securities available for trading in the U.S. DTC is a wholly owned subsidiary of the Depository Trust & Clearing Corporation. DTC provides securities movements for National Securities Clearing Corporation's net settlements, and settlement for institutional trades (which typically involve money and securities transfers between custodian banks and broker/dealers), as well as money market instruments. In 2011, DTC maintained custody and ownership records for approximately $39.5 trillion in securities. The peak daily gross value of transactions processed by DTC in 2011 was equal to $728.8 billion.

34 The Financial Stability Board was established to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. Its members include national authorities responsible for financial stability, international financial institutions, sector-specific international groups of regulators and supervisors, and committees of central bank experts. The U.S. members on the board are FRB, SEC, and Treasury.

Company	Description
Fixed Income Clearing Corporation	Fixed Income Clearing Corporation (FICC) plays a prominent role in the fixed income market as the sole clearing agency in the U.S. acting as a central counterparty and provider of significant clearance and settlement services for cash-settled U.S. Treasury and agency securities and the non-private mortgage-backed securities markets. FICC is a wholly owned subsidiary of the Depository Trust & Clearing Corporation. FICC is made up of two divisions, the Government Securities Division (FICC/GSD) and the Mortgage Backed Securities Division (FICC/MBSD), each providing clearing services in a different portion of the fixed income market. In 2011, FICC/GSD processed 40.5 million transactions in U.S. government and agency securities worth \$1.1 quadrillion on a gross basis. Through multilateral netting, FICC/GSD reduced the value of financial obligations requiring settlement in 2011 from \$1.1 quadrillion to \$230 trillion. In 2011, FICC/MBSD processed mortgage backed securities transactions worth approximately \$64.8 trillion, which through multilateral netting was reduced in value to \$3 trillion.
ICE Clear Credit LLC	ICE Clear Credit LLC (ICE Clear Credit) is the world's largest clearinghouse for credit default swaps. ICE Clear Credit clears a majority of the credit default swap products in the U.S. that are eligible for clearing by a central counterparty. ICE Clear Credit is the only clearinghouse worldwide that clears foreign sovereign credit default swaps. Since 2009, ICE Clear Credit has cleared over 300,000 credit default swap transactions whose notional value is in the trillions of U.S. dollars. In 2011, ICE Clear Credit cleared a peak daily gross volume of 7,222 index contracts, 14,708 single-name contracts, and 5,680 sovereign contracts.
National Securities Clearing Corporation	National Securities Clearing Corporation (NSCC) provides clearing, settlement, risk management, central counterparty services and a guarantee of completion for certain transactions for virtually all broker-to-broker trades involving equities, corporate and municipal debt, American depository receipts, exchange-traded funds, and unit investment trusts. NSCC is a wholly owned subsidiary of Depository Trust and Clearing Corporation. In 2011, the corporation cleared \$220.7 trillion worth of trades on a gross basis, which represented nearly all broker-to-broker equity and debt trades executed on the major U.S. exchanges and most other equity trading venues.
The Options Clearing Corporation	The Options Clearing Corporation is the world's largest equity derivatives clearing organization. The types of options cleared include those on equities, indices, currency, and commodities though equity options accounted for approximately 93 percent of total clearing volume. The corporation is the sole issuer and settling agent for all stock options, equity index options, and single-stock futures listed on U.S. exchanges. The dollar value and volume of options transactions handled by the Options Clearing Corporation includes substantially all of the equity options traded on U.S. options exchanges. The peak daily gross volume for the corporation in 2011 was approximately 41.5 million option contracts, 383,000 futures contracts, and 89.3 million stock loan shares.

Source: FSOC 2012 Annual Report and websites of the FMUs

APPENDIX IV: FSOC Response

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

UNDER SECRETARY

June 17, 2013

The Honorable Eric M. Thorson
Chair, Council of Inspectors General
on Financial Oversight (CIGFO)
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Re: Response to CIGFO's Draft Audit Report: *Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities: Report to the Financial Stability Oversight Council and the Congress*

Dear Mr. Chairman:

Thank you for the opportunity to review and respond to your draft Audit Report, *Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities: Report to the Financial Stability Oversight Council and the Congress*, dated June 2013 (the Report). The Financial Stability Oversight Council (Council) and its members and member agencies appreciate the Council of Inspectors General on Financial Oversight (CIGFO) Working Group's review of the processes and procedures used by the Council to designate eight financial market utilities (FMUs) as systemically important. This letter responds, on behalf of the Secretary of the Treasury as Chairperson of the Council, to the Report. The staffs of Council members and member agencies previously provided comments and technical suggestions to CIGFO staff.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) authorizes the Council to designate an FMU as "systemically important" if the Council determines that the failure of 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. Designated FMUs become subject to the heightened prudential and supervisory provisions of Title VIII of the Dodd-Frank Act.

CIGFO found that the Council carried out the designation activities as established in the Dodd-Frank Act. CIGFO also found that the Designations of FMUs and Payment, Clearing, and Settlement Activities Committee (FMU Committee) carried out its activities in the designation process as intended by the Council. CIGFO further concluded that the Council carried out the activities prescribed in the Dodd-Frank Act by establishing a process and issuing rules to designate FMUs as systemically important, and that the Council followed that process and those rules in designating the eight FMUs in 2012.

In addition to these findings, CIGFO makes five recommendations to the Council. First, CIGFO recommends that the Council establish a formal structure for the FMU Committee, including designating a chairperson and keeping a record of meetings to document, among other things, its key recommendations. Although the FMU Committee documented all of its recommendations to the Council, the Council nevertheless is focused on continuously improving governance over its activities. Council staff is already examining ways to further enhance the governance of the Council's staff committees, and this recommendation will be included as part of that review.

The next two recommendations are that the Council should continue its deliberations on the process and rules regarding the possible future designation of payment, clearing, or settlement (PCS) activities carried out by one or more financial institutions as systemically important; and that the Council should determine a course of action with regard to foreign-based FMUs consistent with the authorities of Title VIII. As noted in the Report, the FMU Committee is expected to continue its discussion of both of these matters at its upcoming meetings. Consistent with its practice thus far, the FMU Committee would communicate any developments to the Deputies Committee and the Council as appropriate. Proposals for the designation of PCS activities or additional FMUs will be considered in the ordinary course of the FMU Committee's work based on the facts and circumstances of the individual proposal. Specific procedures and rules for the future designation of PCS activities are not being considered by the FMU Committee at this time, although such procedures and rules may be developed in the future as a result of FMU Committee discussions or as directed by the Council.

The final two recommendations are that the Council should define the nature, frequency, and communication of updates on designated FMUs from the FMU regulators; and that the Council should establish a timeline for periodic reviews of non-designated FMUs that may be systemically important. As Chairperson of the Council's Deputies Committee, I will ask the FMU Committee to continue the work it has begun in these areas by proposing specific procedures to address both of these matters.

Thank you again for the opportunity to review and comment on the Report. We recognize that CIGFO has an important oversight role, and we value CIGFO's input and recommendations. The Council looks forward to working with you in the future.

Sincerely,

Mary J. Miller

Mary J. Miller

2

APPENDIX V: CIGFO Working Group

Department of the Treasury – Lead Agency

Eric M. Thorson, Inspector General, Department of the Treasury, and CIGFO Chair

Theresa Cameron	Marla Freedman	Clyburn Perry III
Jeff Dye	Michael Maloney	Bob Taylor
April Ellison	Susan Marshall	

Board of Governors of the Federal Reserve System

Jason Derr	Eva Su
Anna Saez	Michael VanHuysen

Commodity Futures Trading Commission

Tony Baptiste

Federal Deposit Insurance Corporation

Travis Sumner	Peggy Wolf

Federal Housing Finance Agency

Katie Kimmel	Tara Lewis	Andrew W. Smith

National Credit Union Administration

Marvin Stith

Securities and Exchange Commission

Kelli Brown-Barnes	Steve Kaffen	William Garay
Jacqueline Wilson		

Special Inspector General for the Troubled Asset Relief Program

Jessica Byars	Jonathan Lebruto

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FEDERAL DEPOSIT INSURANCE CORPORATION 1933

FEDERAL HOUSING FINANCE AGENCY OFFICE OF INSPECTOR GENERAL
FHFA OIG

OFFICE OF INSPECTOR GENERAL NATIONAL CREDIT UNION ADMINISTRATION
NCUA

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