



# Audit Report



OIG-08-034

TERRORIST FINANCING/MONEY LAUNDERING: OTS  
Examinations of Thrifts for Bank Secrecy Act and Patriot Act  
Compliance Were Often Limited

May 15, 2008

Office of  
Inspector General

Department of the Treasury

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## Abbreviations

AML	anti-money laundering
BSA	Bank Secrecy Act
CDD	Customer Due Diligence
CIP	Customer Identification Program
CTR	Currency Transaction Report
ECEF	Electronic Continuing Examination Folder
FFIEC	Federal Financial Institutions Examination Council
FinCEN	Financial Crimes Enforcement Network
MSB	money services business
OTS	Office of Thrift Supervision
ROE	Report of Examination
SAR	Suspicious Activity Report

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*The Department of the Treasury  
Office of Inspector General*

May 15, 2008

John M. Reich  
Director  
Office of Thrift Supervision

As regulator of the thrift industry, the Office of Thrift Supervision (OTS) charters federal savings and loan associations, adopts regulations governing the operation of the thrift industry, conducts examinations of federal and state-chartered savings institutions and their holding companies, and supervises compliance with federal laws and regulations and OTS directives. In fiscal year 2006, OTS supervised 853 savings associations, with assets totaling \$1.6 trillion, and 481 holding companies, with assets totaling approximately \$7.7 trillion.

OTS examines thrifts for safety and soundness and for compliance with consumer laws. OTS also examines thrifts for compliance with the Bank Secrecy Act (BSA)<sup>1</sup> and title III of the USA PATRIOT Act (Patriot Act).<sup>2</sup> (Hereafter we refer to these examinations jointly as BSA examinations.) OTS combines safety and soundness and compliance examinations and produces one report of examination (ROE) that contains the results. OTS reported that it conducted 1,272 BSA examinations and cited over 262 thrifts for violations from January 2005 through September 2006. Most violations were remedied during the examination process, though 40 enforcement actions were initiated.

The objective of our audit was to determine whether OTS's examination coverage was sufficient to determine thrift compliance with BSA and the Patriot Act. We also reviewed how OTS reported the results of its examinations to ensure that thrifts took appropriate corrective actions for noncompliance with BSA. Using OTS's guidance for conducting and reporting BSA examinations,

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<sup>1</sup> Pub. L. No. 91-508 (codified, as amended, at 12 U.S.C. § 1829b; 12 U.S.C. §§ 1951-1959; 31 U.S.C. § 5311 et seq.).

<sup>2</sup> Pub. L. No. 107-56. The acronym USA PATRIOT stands for "Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorists."

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we reviewed the most current examinations conducted by OTS's four regions for a sample of 95 thrifts.<sup>3</sup> Upon selecting current examinations for review that covered the period of calendar years 2004 through 2006, we requested and reviewed the examinations performed just prior to these examinations, usually 12 to 18 months earlier, to compare the scope of both examinations and determine whether problems previously identified in the BSA program had been corrected. We also interviewed the examiners for the sampled thrifts to discuss our observations relative to the reviewed examinations. We conducted our fieldwork from January 2006 through July 2007. Appendix 1 contains a more detailed description of audit objectives, scope, and methodology.

## Results in Brief

We found that OTS examiners often performed limited examinations of thrifts to evaluate BSA and Patriot Act compliance. For 82 of the 95 thrifts, we found in the most recent examinations we reviewed that examiners did not evaluate whether significant compliance program elements had been implemented by thrifts. The examiners frequently accepted that the thrift programs were up to standard because the thrifts had policies and procedures in place for certain BSA and Patriot Act program areas, without determining the manner in which these policies and procedures were implemented. In other cases, examiners did not fully understand the new provisions which were added to the BSA with the enactment of the Patriot Act. This resulted in limited reviews, or no additional testing in situations that posed a potential risk to the thrift. Areas in which examinations were limited included 314(a) information sharing,<sup>4</sup> customer identification programs

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<sup>3</sup> Our original sample was to have included 100 thrifts - 40 in the Northeast, 20 in each of the Midwest and Southeast regions, and 20 in the West. In the Northeast, we reported our results for only 37 thrifts, because 3 thrifts had examinations that were conducted by the state of Ohio under an alternating examination agreement with OTS. In the West, we reported our results for only 18 thrifts because 1 thrift's most current examination was a limited review conducted to assess the thrift's compliance with provisions of an enforcement order and for 1 thrift, our random sample yielded 2 examinations for the same institution.

<sup>4</sup> Section 314(a) of the Patriot Act, with implementing regulations published in 31 CFR Part 103.100, provides for a sharing of information between a financial institution and a federal law enforcement agency investigating terrorist activity or money laundering. FinCEN presents the request for information to the financial institution which is required to expeditiously search its records to determine whether it maintains or has maintained any account related to the subject of the request.

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(CIP),<sup>5</sup> customer due diligence (CDD) activities,<sup>6</sup> and separation of duties of thrift officials who perform independent testing or day-to-day BSA functions and are also responsible for the administration, oversight, direction and monitoring of the thrift's compliance program. By not evaluating whether program elements were implemented, we believe examiners could draw incorrect conclusions about the effectiveness of thrift programs.

For each thrift in our sample, we also found that at least one or more BSA compliance examination areas lacked evidence of review or the examiner's assessment of work that was warranted in the particular BSA compliance area. OTS guidance requires examiners to document in their workpapers the judgments made during examinations and the basis for selecting areas subject to review.<sup>7</sup> We found that the review of a thrift's electronic banking activities, specifically Internet banking, most often lacked evidence of examiner review. Also, although OTS's information technology group examines the authentication processes<sup>8</sup> at thrifts, the information technology group does not routinely share the results of the examinations with compliance examiners. Problems with authentication processes may affect the adequacy of BSA controls.

In addition, we found that OTS's regions were inconsistent when reporting findings regarding outdated or incomplete written BSA

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<sup>5</sup> Section 326 of the Patriot Act of 2001, with implementing regulations published in 31 CFR 103.121, requires institutions to implement a CIP when accounts are opened. The CIP requires that reasonable procedures be established by institutions for verifying the identity of any person seeking to open an account and for maintaining records of the information used to verify the person's identity. Procedures should also include a determination of whether the person appears on any lists of known or suspected terrorists or terrorist organizations issued by any federal government agency.

<sup>6</sup> Section 312 of the Patriot Act, added a new subsection (i) to 31 USC 5318 of the BSA with implementing regulation published at 31 CFR 103.181 at July 23, 2002 through January 4, 2006 followed by 31 CFR 103.176 and 31 CFR 103.178. These regulations require an institution to maintain a due diligence program with policies, procedures, and controls that are reasonably designed to detect and report any known or suspected money laundering or suspicious activity conducted or involving certain accounts managed by the institution as part of its anti money laundering program.

<sup>7</sup> OTS's examination handbook also states that conclusions made about the effectiveness of the OTS examination process are in part determined by the adequacy of workpaper documentation. The documentation of procedures and subsequent conclusions in the examination program leaves an effective audit trail for users of the completed programs.

<sup>8</sup> Authentication processes are used to validate the identity of the thrift's account holders who are accessing Internet-based financial services.

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programs, in some cases representing the findings as recommendations for enhancement and in other cases as BSA violations. OTS guidance states that required elements that are missing from written BSA programs should be considered violations and entered as such into OTS examination system records and ROEs. We also observed that OTS's Midwest and Southeast regions used a standard form that identified violations cited in the examinations to ensure they were properly reported, which made it easier to trace examination findings from the workpapers to the ROE and OTS's Electronic Continuing Examination Folder (ECEf).<sup>9</sup>

We are recommending that the Director of OTS (1) reinforce the need for examiners to adhere to existing BSA examination related guidance, and assess if it is necessary to provide supplemental guidance and training to ensure examination consistency and documentation of examinations; (2) for thrifts that offer electronic banking services, have compliance examiners consult with examiners performing information technology examinations to determine if there are additional BSA-related risks; and (3) provide guidance to examiners to ensure they consistently cite thrifts for violations when their written BSA programs are missing required elements.

### **OTS Response and OIG Comments**

In a written response to this report, which is included as appendix 2, OTS's Deputy Director, Examinations, Supervision and Consumer Protection, stated that in general OTS concurred with our three recommendations and has mechanisms in place to address them. In this regard, OTS provides on-going BSA training to examiners through internal and external conferences, meetings, and examiner schools, and will reinforce the need for examiners to adhere to existing BSA examination guidance and assess whether supplemental guidance is necessary. OTS will implement a process to ensure that compliance examiners consult with information technology examiners to determine if there are BSA-related risks at particular institutions. Furthermore, OTS is also currently working with the other federal banking agencies to issue interagency guidance on BSA violations which is intended to ensure additional

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<sup>9</sup> ECEf is an Intranet-based OTS system for storing and relating documents related to a particular thrift.

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consistency among the federal banking agencies when citing violations. Additionally, OTS is enhancing an existing program through which BSA violations are discussed among managers to ensure consistent supervisory responses. The steps OTS has taken or planned meet the intent of our recommendations.

The Deputy Director, however, took exception to our characterization of BSA examinations as limited. He said the examinations are risk-focused and that the scope of the BSA examination is tailored at each savings association by considering an association's demonstrated ability to manage BSA compliance responsibilities, the association's track record, and any changes that have occurred since the prior examination. Examiners are instructed to, at a minimum, use the core examination minimum procedures to ensure that the institution has an adequate BSA compliance program. He stated that OTS examiners are instructed to include work paper information that is relevant to support critical or adverse examination findings in the ROE. Examiners only include documentation consistent with the risks associated with the reviewed areas and are instructed to complete and file only those documents where work was performed in areas applicable to the examination. The Deputy Director said that examiners do not document areas that are not applicable to the examination program, because documenting why certain examination areas do not apply to an association would significantly increase examination time and burden on the industry.

We agree that examiners should not create unnecessary work paper documentation. However, OTS's own guidance states that examiners should document in their work papers the judgments they make during examinations and the basis for selecting areas to review. The guidance also states that the effectiveness of OTS's examination process is in part reflected in the adequacy of work paper documentation. Moreover, we looked for evidence that examiners assessed risk when conducting their examinations, either in the work paper documentation or in a formal risk assessment prepared by either the thrift or the examiner, and often found no evidence that risk was assessed.

In addition, the Deputy Director commented on the significant expansion of BSA and Patriot Act regulatory requirements during



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the time period of our audit and changes in examination guidance included in the Federal Financial Institutions Examination Council manual that was issued in June 2005 and updated in 2006 and 2007. He said that not every statement in the manual can be construed as a regulatory requirement. He illustrated this point by referring to CDD requirements and dual controls and separation of duties, which he said are not regulatory requirements.

On the topic of CDD, the Deputy Director said that CDD as required by Section 312 of the Patriot Act refers specifically to correspondent accounts for foreign financial institutions and private banking accounts for non-U.S. persons. He stated that (1) Section 312 account activity is not common to savings associations, (2) the examples in our report do not relate to CDD required by Section 312, and (3) customer due diligence expectations would follow risk based principles as other areas of the BSA.

Regarding dual controls and separation of duties, the Deputy Director noted that with the exception of the requirement that a savings association conduct an independent test of its BSA/AML compliance program, there is no regulatory requirement, only a recommended best practice.

We agree that the Deputy Director is correct in his assessment of CDD and dual controls and separation of duties. As appropriate, we clarified some of the wording in our report related to this discussion. We also realize the examination manual is not to be construed as a regulatory requirement. However, the manual represents the collective effort of all of the federal banking agencies, the Financial Crimes Enforcement Network and the Office of Foreign Assets Control of what constitutes an adequate and appropriate examination and what should be documented. We used the manual's more expansive views of what constitutes appropriate CDD and internal controls in evaluating the adequacy of OTS's examination coverage.

In this regard, the manual provides guidance as a best practice for an overall due diligence program to assess the appropriateness and comprehensiveness of the bank's CDD policies, procedures and processes for obtaining customer information and assessing the value of this information in detecting, monitoring, and reporting

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suspicious activity while still defining regulatory requirements of Section 312 of the Patriot Act. While we cannot comment as to the degree correspondent accounts for foreign financial institutions and private banking accounts for non-U.S. persons are common or not common to savings associations, it should be noted that there were thrifts in our sample that had customers who potentially posed a risk to the institutions where CDD is an appropriate control. These customers included money services businesses and foreign individuals and businesses. For the sampled thrifts, we found that examiner BSA coverage was not always sufficient to ensure that the thrifts had appropriate CDD processes to address these risks.

The manual also addresses internal controls and states that a financial institution should provide for dual controls and segregation of duties, and employees who complete the reporting forms (e.g., suspicious activity reports, currency transaction reports and currency transaction report exemptions) should not also be responsible for filing the reports or granting the exemptions. We noted thrifts in each of the OTS regions in which a compliance officer or BSA officer also performed day-to-day BSA functions, or the compliance officer was the same person as the BSA officer, but the examiners did not raise a concern or indicate the compensating controls to mitigate the lack of segregation of duties.

The Deputy Director concluded his response by stating among other things that OTS is committed to ensuring that savings associations are in compliance with BSA/AML requirements and that OTS has devoted significant resources in this area.

## Background

OTS examines thrifts for safety and soundness and to ensure compliance with various laws, including BSA and the Patriot Act.<sup>10</sup>

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<sup>10</sup> OTS was created when the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 abolished the Federal Home Loan Bank Board and transferred all examination and supervisory activities to OTS under the Department of the Treasury. OTS's primary statutory authority is the Home Owners' Loan Act, enacted in 1933 to help stabilize the real estate market which had depreciated significantly during the Depression. Thrifts were originally established to promote personal savings through deposit accounts and homeownership through mortgage lending. Although lending for home mortgages remains a significant activity, thrifts now offer many other services.

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On April 11, 2002, the OTS Director announced an initiative to improve the examination process by combining safety and soundness and compliance into one examination. Instead of using two separate examination teams, OTS now conducts a single, comprehensive examination with one team, producing one ROE. The BSA examination is part of the compliance examination, which also reviews consumer protection and other required program components. An overall compliance rating from 1 (best) to 5 (worst) is assigned to the thrift following the examination.

Thrifts are required to establish and maintain a program to monitor compliance with BSA and title III of the Patriot Act.<sup>11</sup> Each thrift is to develop and provide for the continued administration of a written program approved by the thrift's board of directors and reasonably designed to assure and monitor compliance with BSA regulations. At a minimum, the program must (1) provide for a system of internal controls to ensure ongoing compliance, (2) provide for independent testing by in-house personnel or an outside party, (3) designate the individual(s) responsible for coordinating and monitoring day-to-day compliance, and (4) provide training for appropriate personnel.

Under BSA, thrifts are required to file a Currency Transaction Report (CTR) for each cash transaction exceeding \$10,000 (unless a specific exemption applies) and a Suspicious Activity Report (SAR) when they detect a known or suspected transaction related to a money laundering activity or other violation.<sup>12</sup>

In August 2004, OTS incorporated the review of thrifts' compliance with the requirements of title III of the Patriot Act into its BSA examination procedures. These requirements include implementation of a CIP to verify customer identity; implementation of a CDD program,<sup>13</sup> and sharing of information with law enforcement agencies and other financial institutions.

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<sup>11</sup> 12 C.F.R. 563.177.

<sup>12</sup> 12 CFR 563.180.

<sup>13</sup> FinCEN stated through 67 Federal Register 48348 dated July 23, 2002 that Section 312 took effect July 23, 2002, whether or not Treasury had issued a final rule implementing the provision. Accordingly FinCEN issued an interim final rule promulgated at 31 CFR 103.181 effective July 23, 2002, that banks must comply with 31 USC 5318(i) pending Treasury's issuance of a final rule. For banks, this interim final rule stated that anti-money laundering programs are to include special due diligence programs for

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OTS's regions—the Northeast, Midwest, Southeast, and West—are required to conduct a full-scope, onsite examination of each thrift they oversee every 12 or 18 months, depending on the thrift's asset size and compliance rating.<sup>14</sup> Institutions with both assets over \$500,000 and higher risk compliance ratings are generally examined every 12 months, while institutions with less assets and risk are scheduled at least every 18 months for an examination.

OTS's Northeast and Midwest regions have written agreements with several states to take turns conducting the examinations scheduled each examination cycle. In states in which examinations alternate between OTS and the state, OTS has to ensure that the continuity of BSA examinations is not disrupted, which could affect whether issues are appropriately followed up on for corrective action. According to OTS, examiners generally rely on the states' ROEs for the results of the state compliance examinations. The written agreements between OTS's Northeast and Midwest regions allow OTS to obtain the states' workpapers for review. By reviewing state ROEs and accompanying workpapers, OTS examiners can determine the completeness of the BSA examination conducted by the state, review any areas documented, and establish the scope of any necessary follow-up examinations conducted by OTS.

In June 2005, the Federal Financial Institutions Examination Council (FFIEC), of which OTS is a member agency, issued the *Bank Secrecy Act/Anti-Money Laundering Manual* (BSA/AML

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financial institutions that included thrift institutions. The 31 USC 5318(i) requires U.S. financial institutions to establish due diligence policies, procedures, and controls reasonably designed to detect and report money laundering through correspondent accounts and private banking accounts that U.S. financial institutions establish or maintain for non-U.S. persons. A correspondent account is an account established to receive deposits from, make payment on behalf of a foreign financial institution or handle other financial transactions related to such institution. A private banking account is an account or combination of accounts that (1) requires a minimum aggregate deposit of funds or other assets of not less than \$1 million, (2) is established on behalf of one or more individuals who have a direct or beneficial ownership interest in the account, and (3) is assigned to, or is administered or managed by an officer, employee or agent of a financial institution and the direct or beneficial owner of the account.

<sup>14</sup> When we initiated our review, OTS had four regions. A fifth OTS region was established in April 2007 and officially opened in July 2007. Designated the Central region, it is responsible for oversight of thrifts and their holding companies in Ohio, Illinois, Indiana, Wisconsin, and Michigan.

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manual).<sup>15</sup> The FFIEC BSA/AML manual provides comprehensive guidance for federal bank regulators to follow when conducting BSA examinations. BSA guidance in the FFIEC BSA/AML manual was prepared collaboratively by the federal banking agencies and the Financial Crimes Enforcement Network (FinCEN). The manual provides explanatory material related to BSA, anti-money laundering, and terrorist financing, and a detailed set of examination steps to ensure that complete and consistent BSA examinations are conducted. FFIEC issued updates of the manual in 2006 and 2007.

The FFIEC manual's minimum examination procedures for BSA/AML are scoping and planning for the examination, a BSA/AML risk assessment, a BSA/AML compliance program review, and the development of conclusions to finalize the examination. The FFIEC BSA/AML manual contains additional core examination procedures which OTS officials told us are not required for every examination but are selected by the examiner based on the scope of the examination. OTS officials stated that the minimum procedures provide examiners with sufficient flexibility to tailor the procedures based on risk. In addition, examiners are provided expanded examination procedures for areas such as electronic banking and money services businesses (MSB) that are used based on the risks identified at the thrift.

The core procedures include the following sections as described:

- *Customer Identification Program (CIP)* - assess the institution's compliance with the statutory and regulatory requirements for CIP.
- *Customer Due Diligence (CDD)* - assess the appropriateness and comprehensiveness of the institution's CDD policies, procedures, and processes for obtaining customer information and assess the value of this information in detecting, monitoring, and reporting suspicious activity.

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<sup>15</sup> FFIEC, established under title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978, is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the examination of financial institutions by the federal bank regulators.

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- *Suspicious Activity Reporting* - assess the institution's policies, procedures, and processes and overall compliance with the statutory and regulatory requirements for monitoring, detecting, and reporting suspicious activity.
  - *Currency Transaction Reporting* - assess the institution's compliance with statutory and regulatory requirements for reporting large currency transactions.
  - *Currency Transaction Reporting Exemptions* - assess the institution's compliance with statutory and regulatory requirements for exemptions from the currency transaction reporting requirements.
  - *Information sharing* - assess the institution's compliance with statutory and regulatory requirements for section 314 information requests.
  - *Purchase and Sale of Monetary Instruments* - assess the institution's compliance with statutory and regulatory requirements for the recording of information required for the purchase and sale of monetary instruments for currency in the amounts between \$3,000 and \$10,000, inclusive.
  - *Funds Transfers* - assess the institution's compliance with statutory and regulatory requirements for funds transfers.

OTS can take enforcement action when warranted to ensure compliance with laws and regulations.<sup>16</sup> OTS uses informal (non-public) and formal enforcement action. Informal enforcement action is generally used if the thrift's overall condition is sound; however, it is necessary to obtain the thrift's board of directors or management's written commitment to correct problems and weaknesses. Formal enforcement action, such as a cease and desist order, is used when a thrift has significant compliance problems, especially when there is a threat of harm to the association, depositors, or the public. OTS publishes formal enforcement actions on its website.

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<sup>16</sup> OTS's Regulatory Handbook, Section 371, (June 2003).

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## Findings

### Finding 1 **OTS Examiners Often Performed Limited Examinations to Evaluate BSA and Patriot Act Compliance**

For the thrifts in our sample, we found that examiners often performed limited BSA examinations and did not always evaluate, through transaction testing or other means, whether significant BSA and Patriot Act compliance program elements had been implemented. We also could not determine whether examiners reviewed certain high risk issues, such as transactions involving MSBs and electronic banking, because examiner workpapers did not sufficiently document evidence of work performed or examiner's judgment as to whether a review of these BSA compliance areas was warranted.

#### **BSA Examination Procedures Require an Adequate Assessment of BSA Compliance**

In July 2005, OTS began using the FFIEC BSA/AML manual for its BSA examinations. It provides for a standard format to guide examiners through examinations and to document results. Before release of the FFIEC BSA/AML manual, OTS's BSA examination guidance was contained in the OTS Examination Handbook, Section 1400, Compliance Oversight Examination Program. The OTS guidance did not mandate a standard examination format.

Both the old guidance and the current FFIEC guidance, however, require that examiners adequately assess a thrift's BSA compliance program. An adequate assessment of a thrift's BSA compliance program requires examiners to determine whether the thrift's internal BSA compliance program has been appropriately designed and implemented. The guidance states that the thrift's program should be written, include appropriate internal controls, assign responsibility to a BSA officer, provide for independent audit of the program and include employee training on BSA policies, procedures, processes, and regulatory requirements.

OTS stressed in its internal guidance that examiners perform a risk-based examination that emphasizes the thrift's demonstrated ability

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to manage its compliance responsibilities. Using the risk-based focus, OTS examiners refine the scope of their compliance examinations by considering factors such as a thrift's risk profile.<sup>17</sup> OTS examiners are instructed to minimize time spent on areas in which the compliance systems appear strong and the likelihood of problems of noncompliance is extremely small or nonexistent. They are instructed to document in their workpapers the judgments they make and their basis for selecting the operations, products, or regulatory areas subject to review.

The 2005 FFIEC BSA/AML manual put more emphasis on risk assessment and provides general guidance to examiners for conducting these assessments. Although no particular format is specified, the risk assessment should cover the areas of the thrift's business that are most vulnerable to noncompliance with BSA and Patriot Act requirements. The guidance further states that if the thrift does not perform the risk assessment, then the examiner should.

To provide guidance on the FFIEC BSA/AML manual examination procedures, OTS senior management issued a July 2005 memorandum<sup>18</sup> to the examiner staff. In the description of the procedures included in the manual, the memorandum provided guidance for transaction testing in the BSA examinations. It stated that transaction testing is required at each examination. This testing can be conducted by utilizing the results of the thrift's independent testing procedures or by completing any of the transaction testing procedures provided in the examination manual. The memorandum stated that the examiner staff may limit the scope of the transaction testing if the (1) independent test review was comprehensive and no significant findings were made; (2) examiner has no concern with the thrift's BSA compliance program; and (3) thrift has a history of strong compliance.<sup>19</sup>

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<sup>17</sup> Among the factors OTS guidance cites for identifying a thrift's risk profile are changes to or expansions of business operations and strategies; substantive changes to compliance policies, procedures, systems, or controls; extent of regulatory violations or deficiencies and corrective actions in reports to management and the board; and areas where the thrift and similarly situated thrifts experienced problems.

<sup>18</sup> New Directions 05-05, FFIEC BSA/AML Examination Manual, (July 2005).

<sup>19</sup> An examiner from the West region stated that this region did not start using the formatted FFIEC procedures until 2006. In 2005, the region created its own checklist to be used for its BSA



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The subsequent versions of the FFIEC BSA/AML manual issued in 2006 and 2007 provided more emphasis on the importance of transaction testing in the BSA examinations. The updated manuals stated that transaction testing is an important factor in forming conclusions about the integrity of the bank's overall controls and risk management processes and should be performed during each examination. The extent of transaction testing conducted should be based on such factors as examiner's judgment of risks, controls, and the adequacy of independent testing.

**OTS Examiners Frequently Limited Work Performed to Evaluate Implementation of BSA Compliance**

For 82 of 95 thrifts we reviewed, or 86 percent, we found that examiners in the most recent examinations performed limited reviews of thrift BSA compliance programs. Table 1 provides the number of thrifts by region with limited BSA examinations and the percentage of the thrifts in our sample.

**Table 1: Number and Percent of Thrifts by Region With Limited BSA Examinations**

	Northeast	Southeast	Midwest	West	Total
Number of thrifts in our sample	37	20	20	18	95
Number of thrifts with limited BSA examinations	33	17	17	15	82
Percent of thrifts with limited BSA examinations	89	85	85	83	86

Source: OIG review of OTS BSA examination workpapers and ROEs.

We found examiners limiting their reviews to determining if the thrifts had BSA policies and procedures for information sharing and CIP requirements, accepting thrift assurances that they knew their

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examinations that incorporated the steps outlined in the FFIEC BSA/AML manual. We found that the region's checklist did address all areas of review presented in the FFIEC BSA/AML manual.

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customers, confusing CDD<sup>20</sup> with CIP, and not following through to identify mitigating factors when thrifts did not maintain dual controls.<sup>21</sup>

Table 2 summarizes our findings, by region, of reasons for the limited examinations. For the majority of the thrifts, examiners assessed compliance only by verifying the existence of policies and procedures for information sharing and CIP requirements. In these cases, we did not find evidence of how the examiners were satisfied that the thrift was properly implementing these policies and procedures. At some of the thrifts we found that policies and procedures for information sharing and CIP were addressed in independent audit work; however, in several cases we did not see evidence of this.

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<sup>20</sup> In the examinations we discuss in this section, when we did not see evidence that the examiners reviewed for compliance with 31 CFR 103.181 which refers specifically to correspondent and private banking accounts, we asked examiners what work was performed for CDD. The examiners provided responses that addressed customer due diligence in general terms. The 2005 FFIEC BSA/AML manual provided guidance for an overall due diligence program to assess the appropriateness and comprehensiveness of the bank's customer due diligence policies, procedures and processes for obtaining customer information and assessing the value of this information in detecting, monitoring, and reporting suspicious activity while still defining regulatory requirements of Section 312 of the Patriot Act.

<sup>21</sup> Dual controls exist when the individual performing a procedure is different from the individual monitoring the performance. For example, the individual who files SARs at a thrift is different from the individual monitoring the filing.

**Table 2: Reasons for Limited BSA Examination Procedures by Region in the Most Recent Examination**

Reason	Northeast	Midwest	Southeast	West	Total
Number of thrifts with limited BSA examinations	33	17	17	15	82
Limited information sharing review to policies and procedures	20	15	15	11	61
Limited CIP review to policies and procedures	24	13	8	10	55
Examination procedures not performed because the thrift assured examiners that it knew its customers	4	1	5	1	11
Uncertain about CDD requirements	3	1	1	2	7
Acceptance that dual controls and separation of duties are not maintained	4	2	2	0	8

Source: OIG review of OTS BSA examination workpapers and ROEs.

Note: These columns, if added, would total more than the number of thrifts in our sample. That is because many of the thrift BSA examinations were limited by more than one reason.

When we found limitations in the most recent examination of a thrift, we also reviewed the prior examination to determine whether the scope of the previous examination was similarly limited. For information sharing and CIP, we found that over one third of the thrifts had been reviewed only for the existence of policies and procedures for two consecutive examinations. More specifically, in reviewing the examinations conducted just prior to the current examinations, which altogether covers a period of about 2 to 3 years, we found that for 38 thrifts, examiners reviewed only the existence of information sharing and CIP policies and procedures, respectively. By reviewing only the existence of policies and procedures, the examiners concluded that these aspects of the thrift compliance programs were up to standard. We also found several thrifts for which examiners did not perform a review of

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CDD because the thrift assured them that it knew its customers or examiners did not fully understand CDD and confused it with CIP. In addition, we found thrifts for which examiners failed to identify mitigating factors associated with insufficient separation of duties.

The following sections discuss the elements of the above table in more detail.

#### Testing of Compliance With Information Sharing Requirements Was Often Limited

According to the BSA regulations,<sup>22</sup> the thrift shall expeditiously search its records to determine if it maintains or has maintained any account for, or engaged in transactions with the individual, entity, or organization named in FinCEN's request. If the thrift does have this information, it is to be reported to FinCEN in the manner and time frame specified in FinCEN's request.

Although not a regulatory requirement, the core procedures for information sharing in the FFIEC BSA/AML manual includes a step to review the adequacy of the thrift's documentation to provide evidence of compliance with section 314(a) requests. This is in addition to the primary objective for determining the existence of policies, procedures and processes for 314(a) requests. This documentation includes copies of the 314(a) requests, a log with tracking numbers and sign off columns to show the records were checked, the date of the search, and search results. In addition, the manual states that copies of information returned to FinCEN along with supporting documentation should be retained by the thrift.

We reviewed examiner workpapers concerning thrift compliance with information sharing provisions of the Patriot Act and discussed testing performed with examiners. We found that their tests were frequently limited. For 61 of 95 thrifts in our sample we found that examiners reviewed only the written policies and procedures for the thrift's section 314(a) information sharing programs in their current examinations. Reviewing written policies and procedures, however, does not ensure that the thrift is contacting FinCEN in a timely manner in response to a search of its

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<sup>22</sup> 31CFR103.100.

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records for suspect names, account numbers, and other identifying information as required by regulation. For 4 of 95 thrifts in our sample we saw no evidence of examiner review of this compliance area. For the other 30 thrifts in our sample, we found adequate reviews of this compliance area were made. Examiners either reviewed thrift records and processing of requests or reviewed independent audit work to determine if FinCEN was properly contacted and records of FinCEN's requests and the thrift's responses to these requests were maintained.

OTS's headquarters officials stated that even though there are no recordkeeping requirements in the regulation, the examiner may perform a review to determine if the thrift's is maintaining a log of information sharing requests. Also, OTS's headquarters officials stated that FinCEN will contact OTS if a request goes unanswered. OTS seemed satisfied with this type of control to compensate for the limited review performed by the examiners.

#### Examiner Review of Compliance With CIP Requirements Was Often Limited

We reviewed examiner workpapers concerning thrift compliance with CIP provisions of the Patriot Act and discussed testing performed with examiners. We found that examiner tests were frequently limited. We question whether examiners performing these limited examinations could ensure thrift compliance with CIP provisions.

We found in the most recent examinations of 55 thrifts, examiners were reviewing only whether the thrift had written CIP policies and procedures and not, as required by the BSA regulations,<sup>23</sup> to determine whether the thrift maintained records of the information used to verify customer identities.<sup>24</sup> For these thrifts, we did not see evidence that the examiner had evaluated thrift compliance with this provision by doing transaction testing or had evaluated independent audit work associated with CIP. We did find, however, that CIP transaction testing was performed for 28 thrifts. Also,

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<sup>23</sup> 31 CFR 103.121.

<sup>24</sup> FFIEC Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual, (June 2005).

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examiners reviewed independent audit work for CIP for another 12 thrifts.

OTS's headquarters officials stated that the examiner evaluates the risk based on the thrift's business activity and makes a judgment of whether to test the thrift's CIP records. The question remains, however, as to how an examiner can ensure compliance with the provisions of the CIP regulation if the examiner does not perform a review of the thrift's records.

#### Examiners Relied on Thrift Assurances About Customers and Did Not Review Customer Activity That Posed a Potential Risk

We found in the most recent examinations in our sample of 95 thrifts that examiners did not perform certain tests to review thrift monitoring of customer accounts for suspicious activity. As shown in table 2, for 11 thrifts the tests were not performed because the thrifts claimed that they knew their customers. For 7 other thrifts, the examiners were uncertain about CDD requirements.

When we asked OTS's headquarters officials about an examiner not performing CDD tests because a thrift has assured an examiner that it knows its customers, the officials said that in that case a review of CDD is not always necessary. OTS's headquarters officials stated that Section 312 of the Patriot Act and its accompanying regulations<sup>25</sup> refer to CDD requirements for correspondent accounts for foreign financial institutions and private banking accounts for non-U.S. persons. OTS officials also said that correspondent for foreign financial institutions and private banking accounts for non-U.S. persons were not common account activities to thrift charters.

OTS officials are correct in their interpretation of Patriot Act requirements. However, though not a regulatory requirement, the FFIEC manual, which reflects the best judgment of the five federal banking agencies and FinCEN, states that the cornerstone of a strong BSA/AML compliance program is the adoption and implementation of comprehensive CDD policies, procedures, and processes for all customers, particularly those that present a high

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<sup>25</sup> 31 CFR 103.176, 31 CFR 103.177, 31 CFR 103.178, and 31 CFR 103.181.

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risk for money laundering and terrorist financing. The manual goes on to state that the objective of CDD should be to enable the bank to predict with relative certainty the types of transactions in which a customer is likely to engage. Moreover, these types of processes assist the financial institution in determining when transactions are potentially suspicious. We used this more expansive requirement in assessing the CDD examinations conducted by OTS examiners. Further, we found thrifts in our sample with potentially risky customers, including MSBs and foreign individuals and businesses.

When we asked OTS's headquarters officials about possible confusion among examiners about CDD and its requirements, as happened in the examinations of 7 thrifts in our sample, they said they are aware that certain examiners do not fully understand CDD requirements and how it is distinguished from CIP, and intend to correct the problem. Several of the examiners told us they had not performed a CDD review in these cases because of uncertainty as to the requirements. Other examiners referred to such procedures as CIP, which is the process by which a thrift verifies customers' identities when they open accounts. In addition, OTS's headquarters officials stated that if the thrift has assured the examiner through independent testing and internal control results that CDD is commensurate with a known customer risk profile, transaction testing may not be warranted.

Examples in which the examiners, despite potential risk, did not review the thrift's CDD follow below.

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- The examiner of one thrift said CDD was covered when he reviewed the thrift's CIP program. Despite the risk of many foreign individual and business depositors, the examiner reviewed only the account opening records of these depositors to ensure that the thrift obtained all of the required information. This examiner also documented in the ROE that he reviewed the procedures followed by the thrift to determine if these customers were on any list of known or suspected terrorists or terrorist organizations. However, the examiner said he did not take this review a step further, contrary to FFIEC BSA/AML manual guidance, to determine if the thrift was conducting ongoing monitoring of potentially high risk transactions.
  - An examiner found that another thrift was not conducting due diligence for its MSB customers' accounts for unusual or suspicious activity. When we asked why this was not cited in the ROE, the examiner said that at the time of this 2005 examination, OTS was allowing thrifts time to develop their CDD programs. Although the CDD regulations had been in effect since 2002, the examiner said that it was not until June 2005, when the FFIEC BSA/AML manual was issued, that guidance existed regarding what the CDD program required. The examiner added that prior to this guidance, OTS examiners focused on a thrift's ongoing monitoring of high risk accounts for CTR reporting purposes and not suspicious activity.

By way of contrast, however, other OTS examiners we interviewed well understood CDD requirements, and appropriately identified program weaknesses during their examinations, as shown below.

- One examiner documented in an examination that the thrift was performing appropriate CDD. The examiner reported that when concerns or patterns of unusual transactions are noted, the thrift's compliance officer is contacted to obtain additional information from the customer regarding this activity. The thrift conducts transaction analysis over time to monitor for unusual activity. The thrift also closed a customer account as soon as it was unable to verify data that was provided by the customer for a questionable transaction.



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- In another examination, the examiner found that an institution was not monitoring its high-risk accounts and that proper CDD was not performed. The examiner noted that management had just begun to review all of the past deposit history of the borrowers to identify unusual transactions. The examiner documented that the thrift's high-risk accounts, which were MSBs as noted in the thrift's risk assessment, had not been interviewed or visited to determine the extent of their business and the products and services they offered.
  - A similar concern was found by an examiner when he found that the thrift was not reviewing customer account activity. The examiner found that the thrift needed to establish customer profile forms on all customers exhibiting higher anti-money laundering or terrorist risk characteristics, based on the thrift's risk analysis, and review the transactions of these customers for unusual activity.

#### Dual Controls and Separation of Duties Were Not an Examiner Concern at Some Thrifts

OTS's guidance<sup>26</sup> and the 2005 FFIEC BSA/AML provide guidance to examiners about what constitutes good internal control in a thrift's BSA compliance program. The manual states that a thrift's BSA compliance program should provide policies, procedures, and processes for dual controls and segregation of duties. The manual also states that employees who complete reporting forms, such as SARs and CTRs, should not be responsible for filing the reports with Treasury.

The purpose of these controls is to allow the thrift to objectively monitor compliance with its BSA program independently from performing the procedures. This is a means of deterring circumvention of controls and allows the thrift to appropriately evaluate the effectiveness of its program.

We found examinations conducted for 8 of the 95 sampled thrifts in which the examiners did not discuss steps that the thrift had taken or could take to mitigate risk caused by the lack of

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<sup>26</sup> OTS's Compliance Self Assessment Guide, (December 2002).

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separation of duties. In these cases, the examiners noted instances where the thrifts had not established fully independent positions or functions, yet the examiners did not address compensating controls, such as an adequate independent audit function, that could allow these situations to be deemed acceptable. For example, in a Southeast thrift, the senior vice president served as both the thrift's internal auditor and compliance officer. The examiner only reported in the ROE that the combined function of the internal auditor, who is responsible for independently testing all thrift departments, and compliance officer, who is responsible for compliance with all programs (including lending, retail operations, BSA/AML, and fair lending), was becoming increasingly demanding as the thrift continued to grow and establish offices in other areas. This same thrift also had another separation of duties issue because the thrift's BSA officer, who is responsible for thrift BSA/AML compliance, was filing SARs.

When we discussed our concerns with OTS's headquarters officials, they stated that the examiners would be concerned only if the compliance officer was the same person as the BSA officer. If not, then examiners would not be concerned if, for example, the compliance officer also audited the BSA function at the thrift. However, they agreed that a compliance officer performing a BSA-related function, such as filing CTRs, would not be appropriate. If a BSA officer performs both a monitoring and filing procedure function such as for CTRs, however, OTS headquarters officials stated that this situation does not create a heightened risk of BSA/AML noncompliance and possible money laundering or terrorist financing, if it occurs at a small, low-risk community thrift with limited resources.

Nonetheless, we found cases in each of OTS's regions in which the examiners did not always raise a concern when a thrift's compliance officer or BSA officer also performed day-to-day BSA functions or if the compliance officer was the same person as the BSA officer. For example:

- A Northeast examiner noted that a thrift vice president conducted BSA-related reviews, such as monitoring large cash transaction reports for the filing of CTRs and SARs, and also submitted CTRs and SARs for processing. While the ROE stated

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that adequate policies and procedures were in place to ensure that business was being conducted in a sound manner, we could not identify any additional testing performed to reach this conclusion.

- A Southeast region examiner found that the BSA officer was responsible for filing SARs and that all employees of the thrift were to report suspicious activity to the BSA officer. The BSA officer also processed the thrift's wire transfers. No explanation was provided in the ROE of how the risk posed by these incompatible duties was mitigated.
- In a Midwest examination, the institution's vice president functioned as both the BSA officer and the compliance officer. The examiner reported that this individual performed in-house monitoring of the institution's BSA program and reported the results of this work to the thrift's board for review or action.
- For a West region thrift, the examiner reported that the thrift's internal auditor was responsible for filing SARs. The examiner, however, did not note this as a problem or identify how the thrift mitigated the resulting risk.

### **Examiners Generally Did Not Document Evidence of Review for Specific BSA Compliance Areas**

For all 95 thrifts in our sample, we found that OTS examiners did not document that one or more BSA compliance areas had been covered during the most recent examination. In these cases we did not see documentation of work performed, or of the examiner's judgment whether a review of these BSA compliance areas was warranted.

OTS's November 2004 written guidance states that an examiner should document in the workpapers the judgments made during examinations and the basis for selecting areas to review. This guidance also states that the effectiveness of OTS's examination process is in part reflected in the adequacy of workpaper documentation. Because the most recent examinations were conducted in 2005 and 2006, this guidance applied.

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When establishing the scope of the BSA examination, OTS's guidance states that the examiner should consider the risks based on the thrift's operations, the quality of management, and the ability of management and the board to monitor risk and take action to remedy problems. Based on this assessment, the examiner determines the appropriate areas to review and the examination procedures to use. In our review, we looked for evidence that the examiner made this assessment and, either documented the results of examination for critical BSA program areas or provided rationale for not examining these areas. Specifically, we looked for whether the examiner assessed the risk at the institution either informally in workpaper documentation or through a formal risk assessment prepared by the thrift or the examiner. When we found no evidence in the examination workpapers that certain assessments were made, we interviewed the examiners about the circumstances and the rationale examiners used to justify the lack of documentation for certain procedures.

Having examiners document these assessments has been more recently emphasized in the FFIEC manual. When first issued in 2005, the FFIEC BSA/AML manual did not address examination documentation. However, the 2006 and 2007 updates to the manual state that examination workpapers should be prepared in sufficient detail to support issues in the ROE. Additionally, for those findings not discussed in the ROE, the examiner should ensure that the workpapers thoroughly and adequately document each review as well as aspects of the institution's BSA compliance program that merit attention. The manual now also states that in formulating conclusions for the BSA examination, all relevant determinations should be documented and explained.

The areas of BSA compliance most frequently not addressed by the examiners for the 95 sample thrifts were: (1) electronic banking activities, specifically Internet banking (67 thrifts); (2) business relations with MSBs (57 thrifts); and (3) lending activities (47 thrifts).

Table 5 presents the number of thrifts in which specific BSA examination areas showed no evidence of review during the most recent examination.

**Table 3: BSA Compliance Areas for Which Workpapers Lacked Evidence of Review in the Most Recent Examination**

<b>Review area</b>	<b>Northeast</b>	<b>Southeast</b>	<b>Midwest</b>	<b>West</b>	<b>Totals</b>
Number of thrifts in our sample	37	20	20	18	95
Electronic banking	32	6	17	12	67
Money service businesses	33	5	12	7	57
Lending activities	33	3	7	4	47
Customer due diligence	12	3	10	4	29
Currency transaction reporting exemption	15	3	2	1	21
Purchase and sale of monetary instruments	9	2	3	4	18
Risk assessment	8	2	1	1	12
Review of prior BSA examination	6	0	1	0	7
Funds transfers	5	0	1	1	7
Independent testing	4	0	0	0	4
Information sharing	2	0	0	2	4
Written BSA program	2	0	0	0	2
Suspicious activity reporting	1	0	0	0	1
Internal controls	1	0	0	0	1
BSA officer	1	0	0	0	1
BSA training	1	0	0	0	1
Currency transaction reporting	1	0	0	0	1
Customer identification program	0	0	0	0	0

Source: OIG review of OTS BSA examination workpapers and ROEs.

For many of these thrifts, the examination workpapers for the prior examination also lacked evidence that certain BSA compliance areas had been reviewed in the prior examination. For example, we found no evidence that electronic banking had been reviewed for 53 thrifts during two consecutive examinations. This was also the case for 48 thrifts with respect to their business relationships with MSBs and 35 thrifts with respect to their lending activities.

In response to our inquiries about why documentation was not available to show that procedures for assessing BSA compliance had been performed, the OTS examiners and regional management officials provided the following explanations:

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- Examination documentation was not prepared when examiners did not find exceptions. We were told by a number of examiners and their manager, particularly in the Northeast region, that examiners were expected to “document by exception.” Therefore, if an examiner did not find a problem in an area, there may not be any documentation of examination of that area in the workpapers. When we asked the examiners about the examinations for those areas lacking documentation, they primarily relied on memory to tell us if procedures were performed and whether they did not document the results of their work because no problems existed. In these cases, we could not assess the accuracy of these explanations because no documentation existed to verify them.
  - The thrift did not have certain types of accounts to warrant the tests. According to some examiners, if a thrift did not have any activity in a particular area or a particular type of account, the review of that area was probably not documented in the workpapers. Without documentation, however, the examiners who provided this explanation were relying on their own recollections of thrift business at the time of the BSA examinations.
  - A risk assessment was not available. Although a thrift is not required to prepare a risk assessment, the 2005 FFIEC manual recommends that the thrift prepare a risk assessment, and if the institution has not, the examiner must prepare one. With or without a documented thrift risk assessment, to scope the BSA examination, examiners need to assess the thrift’s level of BSA/AML risk. For 12 sampled thrifts, we did not find evidence that the examiner had assessed risk at the institution in order to scope the BSA examination.
  - Examiners “waived” procedures because the thrift said it knew its customers. As discussed earlier, because of a thrift’s smaller size, the examiners often accepted without evidence that the thrift knew its customers and, as a result, waived review of the thrift’s CDD program.

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- Examiners lacked an understanding of certain requirements. As discussed earlier, some examiners did not know the difference between CDD and CIP.

OTS's headquarters officials stated that examiners are not required to document areas reviewed unless there are adverse findings, and questioned the need for detailed documentation of non-applicable areas. They said documenting why particular examination procedures did not apply to a thrift would significantly increase examination time and burden on the industry.

Because of our concern with the lack of evidence with electronic banking and the fact that Internet banking (a major component of electronic banking) is becoming a more common way of doing banking business for many customers and carries with it a certain amount of risk, we decided to look more closely at examiner reviews in this area. We noted the following:

- In the Northeast region, few thrifts in our sample were identified as having Internet banking. For those thrifts which did have Internet banking, no additional work was done in the BSA examination to evaluate online transactions.
- In the Southeast region, the examination documentation for 13 thrifts in our sample contained no evidence that the examiner reviewed the thrift's Internet banking services. Of these, 6 thrifts had examinations conducted using the FFIEC examination procedures, which required that a risk profile be prepared and the risk associated with electronic banking be identified by the thrift. For all of the 6 thrifts, the examiners did not recall the work that was performed because the workpapers lacked documentation.
- In the West region, the examiner noted in the examination program of one sampled thrift that electronic banking was a high risk business line. However, we did not find evidence in the examination documentation that work was performed to review the thrift's use of electronic banking for customer transactions.

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We asked examiners whether they reviewed electronic banking in those cases in which we did not see supporting documentation. In general the examiners said they thought electronic banking was more of a risk if the thrift allowed customers to open accounts online. If a bank did not allow accounts to be opened online but only allowed customers to do online transactions once a customer's account was opened, the examiners believed that these transactions would be subject to the thrift's BSA compliance program controls and did not represent the same risk for the thrift.

Although OTS's information technology group<sup>27</sup> examines the authentication processes at thrifts,<sup>28</sup> we found that the information technology examiners did not routinely share the results of their examinations with compliance examiners. For example, in a Southeast region examination, we found that the information technology examiner who reviewed these controls at the thrift did not coordinate with the examiners conducting the BSA examination to determine the impact of a problem with the thrift's electronic banking authentication controls on the thrift's CIP program. OTS's examiners who conducted the information technology exam considered the problem to be a concern for fraud or identity theft but not CIP. We received a similar response from OTS's headquarter officials who stated that although Internet banking is a high risk area and would generally warrant a review, they believed that this was more of an identity theft or fraud concern, and did not believe that there was a link between information technology issues such as authentication controls and CIP.

OTS's headquarters officials stated that information technology reviews do not focus on whether controls are adequate to reasonably protect the bank from money laundering and terrorist

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<sup>27</sup> OTS's information technology examiners review technology risks and controls at thrifts that have complex operations and activities. Regional managers determine whether to assign an information technology examiner based on factors such as the volume and type of internal processing conducted and use of complex applications, systems networks, or equipment. When scoping a thrift's examination, the examiner-in-charge is to consult with the regional information technology examination manager regarding these concerns.

<sup>28</sup> OTS issued a memorandum to chief executive officers of thrifts on the subject of authentication in an Internet banking environment. In this guidance, OTS states the need for thrifts to do risk-based assessments, customer awareness, and implement security measures to validate customers accessing thrifts' Internet-based services. OTS also states that examinations of thrifts are to include a review of the authentication methods and controls as they relate to this guidance.



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financing but that reviews of authentication methods and controls for Internet-based services generally focus on the need for risk-based assessments, customer awareness, and security measures such as password controls. We believe that even if the information shared from these examinations is limited, it is still of value to the examiner who is assessing authentication controls that are relied upon to satisfy customer identification requirements for new accounts opened online.

### **OTS Quality Assurance Reviews Found the Need for Examiners to Improve Their BSA Examinations**

OTS regional officials conduct periodic quality assurance reviews of their examination programs to assess examiner compliance with examination guidance, including the BSA compliance program. These reviews are conducted annually for a sample of examinations.

We reviewed BSA quality assurance reviews OTS performed in 2005 for each of the regions because these were the most current set of quality control reviews at the time of our review. We found that the scope of the quality assurance reviews included a review of examiner workpaper documentation and the reporting of findings in the ROEs and ECEF.

We found that 3 of the 4 regions identified aspects of the BSA examination program needing improvement, as follows:

- In the Northeast, a January 2006 quality assurance review report identified the need for documentation improvements. The report suggested that examiners be provided examples of workpapers that thoroughly documented areas reviewed and conclusions reached to improve the quality of examination documentation by regional examiners. The report recommended that any violations corrected during the review period or during the examination be reported on the violations page of the ROE and in OTS's examination system.
- In the Midwest, a December 2005 quality assurance review report suggested that the region remind examiners to

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document decisions about the scope of their work and the basis for selecting (and not selecting) certain procedures for review and specific transactions for testing. The report also said examiners should be reminded about the requirement to conduct transaction testing during each examination.

- In the Southeast, a January 2006 quality assurance review report recommended that the region improve the processes for issuing and communicating new guidance to its staff in a more efficient, uniform, and timely manner. The report noted that examiners within the region had been inconsistent in their examinations, following different versions of BSA examination program guidance that had been available within the region at the time. The report also noted that some examiners did not adopt the procedures in the FFIEC BSA/AML manual until October 2005 although the manual was issued in June 2005 and was adopted by OTS effective mid-July 2005. Additionally, the quality assurance reviewers found that compliance examiners did not consistently index draft ROEs to the supporting workpapers, and recommended that this be required of all staff.

We could not determine whether these quality reviews had been effective in improving examination quality. The reviews were too close to the dates of the examinations in our sample for us to observe an effect.

## **Finding 2**

### **OTS Examiners Did Not Consistently Cite a Violation When Written BSA Program Elements Were Missing**

OTS examiners found that elements were missing in the written programs for 28 thrifts. The examiners reported the missing elements as BSA violations for 17 thrifts in accordance with OTS guidance and the BSA regulations. However, for 11 thrifts with similar findings, the examiners only made suggestions or recommendations to the thrifts to improve their BSA programs. The matters were not cited as BSA violations. It is important for an OTS examiner to cite these deficiencies as BSA violations so that the thrift is made aware that immediate corrective action is needed, and to set the stage for possible future enforcement action in case the thrift does not address the violation.

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## **Regulations Require Thrifts to Have a Written BSA Compliance Program**

Thrifts are required to establish and maintain procedures reasonably designed to assure and monitor compliance with BSA.<sup>29</sup> Specifically, each thrift is to have a written BSA program that is approved by the thrift's board, and these procedures are used by the thrift's staff on a day to day basis to implement the program. The BSA compliance program is to include, at a minimum, a system of internal controls to assure ongoing compliance, provide for independent testing for compliance by in-house personnel or an outside party, designate an individual responsible for coordinating and monitoring day-to-day compliance, and provide training for appropriate personnel. The thrift is also required to have a written CIP program.

## **Guidance for Citing Violations for Missing Elements of a Thrift's Written BSA Program**

OTS guidance issued in April 2004<sup>30</sup> states that as a fundamental BSA regulation thrifts are required to have a written program that works effectively. Therefore, according to the guidance, a thrift is in violation of the regulation when it has no written program, when the written program is missing necessary elements, or when the written program is adequate but not being followed. The guidance provides that when a written program exists but lacks elements required by regulation, the examiner is to record a violation for each missing or inadequate element.

Violations that are determined to be substantive are to be reported in the ROE. According to OTS instructions, examiners are to consider a thrift's overall record when determining if a violation is substantive.<sup>31</sup> The following specific factors are to be considered: (1) the severity of the violation, (2) the time span of the violation, (3) whether the violation is widespread or isolated, (4) whether the violation is systemic, (5) related findings on prior exams, and

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<sup>29</sup> 12 C.F.R. 563.177.

<sup>30</sup> OTS, New Directions Bulletin 04-05, Bank Secrecy Act and Anti-Money Laundering Programs (Apr. 5, 2004).

<sup>31</sup> OTS, Report of Examination Instructions (November 2004).

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(6) the risk profile of the association. To be considered a repeat substantive violation, OTS must have previously brought it to the thrift's attention in the ROE, in a discussion with management, or by other means. Substantive violations are to be reported in the ROE and in ECEF. All "technical" violations<sup>32</sup> are to be noted in the workpapers and listed in the ECEF. Examiners are to discuss technical violations with management. Recommendations made to thrifts to enhance their BSA program or policy are generally not included in the ECEF and may or may not be included in the ROE.

The FFIEC BSA/AML manual provides information on the requirements for the thrift's BSA compliance program. The manual states, consistent with BSA statutes and regulations, that the program must be in writing, approved by the thrift's board of directors, and noted in the minutes of the board of directors meeting at which it was approved. In this regard, the written program cannot consist only of policy statements, and practices specified must coincide with the thrift's written policies, procedures, and processes. The program must provide for the following minimum requirements: (1) a system of internal controls to ensure ongoing compliance (internal controls are the thrift's policies, procedures, and processes designed to limit and control risks and to achieve compliance with the BSA), (2) independent testing of BSA compliance, (3) designation of an individual or individuals responsible for managing BSA compliance (i.e., the BSA compliance officer), and (4) training for appropriate personnel. In addition, CIP must be included as part of the BSA compliance program.

If examination findings are not properly recorded as violations, they are not entered into the ECEF for future corrective action and review in subsequent BSA examinations. If OTS finds that the thrift fails to take corrective action and the thrift continues to be noncompliant, properly recording the violations provides OTS with a sound basis for appropriate enforcement action.

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<sup>32</sup> A technical violation is one that does not rise to the level of substantive. Per OTS guidance, an example of a technical violation would be the failure of the thrift to completely or correctly fill out a BSA form in an isolated instance.

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## Missing BSA Program Written Elements Were Not Consistently Treated as Violations

When OTS examiners found incomplete written BSA programs, these findings were not always treated as violations, as OTS's guidance and BSA regulations require. We found inconsistencies, particularly among regions, regarding whether BSA requirements that were not addressed in the thrifts' written BSA programs were reported as violations.

We found that the Northeast consistently cited incomplete written BSA programs as violations. In contrast, the Southeast region did not. We also found that the Midwest region was inconsistent in its reporting of this type of deficiency, sometimes citing a violation and sometimes not.

Table 6 below summarizes the number of thrifts by region which were missing at least one element of the written BSA program and the number of thrifts cited with a violation.

**Table 4: Thrifts With One or More Missing Elements in Their BSA Program**

OTS Region	Number of Thrifts With This Deficiency	Number of Thrifts Cited for Violation	Number of Thrifts Not Cited for Violation
Northeast	9	9	0
Southeast	5	0	5
Midwest	12	7	5
West	2	1	1
Totals	28	17	11

Source: OIG review of OTS BSA examination workpapers and ROEs.

We observed the following with respect to how missing BSA written program elements were treated by the regions:

- In the Northeast region, one thrift was cited with a violation because the thrift needed to revise its written BSA program to include certain CIP program requirements and address monetary instrument sales and wire transfers. Another thrift in the region was cited with a violation for a written BSA

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program that also did not include complete CIP procedures, and CTR exemption procedures.

- The Southeast region, on the other hand, did not cite a violation for 5 thrifts although they were missing one or more parts of the following required elements in their written BSA compliance programs: independent testing, BSA training, CIP, 314(a) information sharing, filing CTRs, CTR exemptions, and filing SARs.
- The Midwest region cited a violation for 7 thrifts for missing one or more parts of the written BSA program, including internal controls, independent testing, BSA training, CIP, and others. Three thrifts were cited in violation when only a single element was missing for their BSA program. The region, however, did not cite violations at 3 other thrifts for similar missing BSA written program elements.

Regional officials we interviewed often took the position that the missing elements in the thrifts' written BSA programs did not constitute violations because the examiners had made a judgment that the deficiency had little impact on the thrifts' otherwise appropriate implementation of internal controls, designation of a BSA officer, independent testing, and BSA training. In addition, regional officials said that the examiners also considered if the missing element in the written BSA program was a legal or regulatory requirement or an item that would enhance existing internal controls. We found that these determinations were generally not documented in the examination workpapers. Both of these explanations, however, disregard the fact that there is a requirement for the thrift to have a complete written BSA program, and that the thrift's practices must coincide with these written policies, procedures, and processes.

### **Two Regions Are Using Exception Sheets to Document Examination Results**

While not required by OTS guidance, we found that two regions, the Midwest and Southeast regions, documented examination findings on exception sheets, which made it easier to trace examination findings from the workpapers to the ECEF and ROE.

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Each examination finding appeared on a separate sheet, on which the examiner noted the area in which the finding was made, specifically indicated if the finding represented a violation, and described the finding. The documentation indicated the thrift's response and any corrective action to be taken.

The Northeast and West regions did not use these forms. We had to interview examiners and review related workpapers to identify examination findings, and whether they were considered of sufficient severity to rise to the level of a regulatory violation. These factors dictate whether the results are to be reported in the ECEF or ROE.

## Recommendations

We recommend the OTS Director do the following:

1. Reinforce the need for examiners to adhere to existing BSA examination related guidance, and assess if it is necessary to provide supplemental guidance and training to ensure examination consistency and documentation of examinations.

### Management Response

OTS will reinforce the need for examiners to adhere to existing BSA examination guidance and assess whether supplemental guidance is needed. OTS also provides on-going BSA training to examiners in internal and external conferences, meetings and examiner schools. These BSA/Patriot Act discussions are made in Compliance I, Compliance II, and Advanced Compliance Examiner Schools.

### OIG Comments

OTS's plan to reinforce existing BSA examination guidance and assess the need for reinforcing guidance satisfies the intent of our recommendation.

2. For thrifts that offer electronic banking services, have compliance examiners consult with examiners performing

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information technology examinations to determine if there are additional BSA-related risks.

Management Response

OTS will implement a process to ensure compliance examiners consult with information technology examiners to determine if there are BSA-related risks at particular institutions.

OIG Comments

OTS's plans to implement such a process, once done, satisfies the intent of our recommendation.

3. Provide guidance to examiners to ensure that they consistently cite thrifts for violations when written BSA programs are missing required elements.

Management Response

OTS is working with other federal banking agencies to issue interagency guidance on BSA violations to ensure consistency among the federal banking agencies when citing violations. In addition, OTS is enhancing an existing program in which managers based in Washington, D.C. and regional offices will discuss BSA/AML violations also in an effort to promote consistent citing of violations in lieu of this pending guidance.

OIG Comments

OTS's participation with other banking agencies to issue the interagency guidance and its effort to promote consistency in citing violations is responsive to the recommendation. Once the interagency guidance is issued, OTS will need to assess its impact on current policies, procedures, and training.



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We would like to extend our appreciation to OTS for the cooperation and courtesies extended to our staff during the audit. If you have any questions, please contact me at (617) 223-8640 or Sharon Torosian, Audit Manager, at (617) 223-8642. Major contributors are listed in appendix 3.

/s/  
Donald P. Benson  
Audit Director

The objective of the audit was to determine whether the Office of Thrift Supervision's (OTS) examination coverage was adequate to ensure compliance with the Bank Secrecy Act (BSA) and USA PATRIOT Act (the Patriot Act). We also reviewed how OTS reported the results of its examinations to ensure that thrifts took appropriate corrective actions for noncompliance with these laws.

We interviewed officials at OTS headquarters and in the regional offices to obtain an overview of OTS's responsibilities, strategies, tracking systems, and resources dedicated to ensure compliance with BSA and the Patriot Act by OTS-regulated thrifts.

We reviewed applicable laws and regulations related to BSA and the Patriot Act, and OTS's examination and enforcement manuals, programs, and guidance. We reviewed the Federal Financial Institutions Examination Council *Bank Secrecy Act/Anti-Money Laundering Manual* to ensure that all provisions of BSA and the Patriot Act were addressed.

We selected a random sample of examinations of OTS-regulated thrifts by OTS region (Northeast, Midwest, Southeast, and West). Our sample resulted in a selection of 40 thrifts in the Northeast region and reviewed the most current examinations for each,<sup>33</sup> 20 examinations in the Midwest region, 20 examinations in the Southeast region, and 20 examinations in the West region. The time period covered by these examinations was calendar years 2004 through 2006.

The asset sizes of the institutions in our sample are shown in table 5 below.

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<sup>33</sup> We conducted audit survey work (which we generally do prior to initiating a full audit) in the Northeast region and selected 40 thrifts for review and analysis of their examinations from a listing of thrifts as of December 2005. During our full audit, we selected another 60 examinations, this time from a list of examinations completed between July 2005 and July 2006. This resulted in a selection of 20 current examinations each from the Midwest, Southeast, and West regions. These examinations were for 99 thrifts because our random sample of examinations for the West yielded 2 examinations for the same institution.

Table 5: Asset Size of Thrifts in BSA Examinations Sampled

<b>OTS Region</b>	<b>Less than \$100 million</b>	<b>\$100 million to less than \$250 million</b>	<b>\$250 million to less than \$500 million</b>	<b>\$500 million to less than \$1 billion</b>	<b>\$1 billion to less than \$5 billion</b>	<b>\$5 billion and over</b>	<b>Total Thrifts</b>
Northeast	13	13	6	4	3	1	40
Midwest	8	6	3	1	2	0	20
Southeast	5	5	4	6	0	0	20
West	2	2	8	4	0	3	19
<b>Totals</b>	<b>28</b>	<b>26</b>	<b>21</b>	<b>15</b>	<b>5</b>	<b>4</b>	<b>99</b>

Source: OIG Analysis of OTS data.

Note: Our sample had a total of 99 thrifts; however, for 3 thrifts in the Northeast, the state examiners performed the most recent BSA examination, and for 1 thrift in the West, the current examination was limited to assessing the thrift's compliance with a formal enforcement action. We did not include these 4 thrifts in our sample and reported the results of our review for 95 thrifts.

We also requested and reviewed the examination performed immediately prior to each of the current examinations in our sample. This effectively doubled the number of examinations we reviewed to 79 in the Northeast region (one thrift had a relatively new charter and OTS had not performed an earlier examination), 40 in the Midwest region, 40 in the Southeast region, and 40 in the West region. We also did not use in our analysis 3 examinations in the Northeast region because they were conducted by states under agreements with OTS for alternating examinations.

We reviewed all of OTS's examination workpapers, reports of examination, and examination system data for the current and most recent prior BSA examinations to evaluate the completeness, timeliness, and reporting of the results for these BSA examinations. We evaluated examination results using criteria in effect at the time of the examination.

We visited the Northeast region's satellite office in Braintree, MA, and regional office in Jersey City, NJ, and the Southeast region's Atlanta, GA, office. We addressed our questions and discussed issues regarding our sample BSA examinations with OTS's examiners in the Northeast and Southeast regions during our visits and with the Midwest and West regions in telephone conference calls with regional staff and examiners.

Appendix 1  
Objective, Scope, and Methodology

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We performed our audit fieldwork from January 2006 through July 2007. We conducted our audit in accordance with generally accepted government auditing standards.

Appendix 2  
Management Response



**Office of Thrift Supervision**  
Department of the Treasury

Timothy T. Ward  
*Deputy Director, Examinations, Supervision, and Consumer Protection*

1700 G Street, N.W., Washington, DC 20552 • (202) 906-5666

April 9, 2008

Donald P. Benson  
Director  
Office of Inspector General  
Department of the Treasury  
Washington, DC 20220

Dear Mr. Benson:

Thank you for the opportunity to review and comment on the Office of Inspector General (OIG's) draft audit report entitled, *OTS Examinations of Thrifts for Bank Secrecy Act and Patriot Act Compliance Were Often Limited*. The audit was conducted to assess the adequacy of the Office of Thrift Supervision's (OTS) examinations of saving associations' compliance with Bank Secrecy Act (BSA) and USA PATRIOT Act (Patriot Act) requirements. The audit also reviewed how OTS reported the results of its examinations to ensure that associations took appropriate corrective actions for noncompliance with the BSA.

The OIG recommends OTS:

- Reinforce the need for examiners to adhere to existing BSA examination related guidance, and assess if it is necessary to provide supplemental guidance and training to ensure examination consistency and documentation of examinations.
- Provide guidance to examiners to ensure that they consistently cite thrifts for violations when written BSA programs are missing required elements.
- For thrifts that offer electronic banking services, have compliance examiners consult with examiners performing information technology examinations to determine if there are additional BSA-related risks.

In general, OTS concurs with the recommendations and has mechanisms in place to address them. OTS provides on-going BSA training to examiners in many ways, including internal and external conferences, meetings, and examiner schools. OTS includes BSA/Patriot Act discussions in its Compliance I, Compliance II, and Advanced Compliance Examiner Schools. We will reinforce the need for examiners to adhere to existing BSA examination guidance and assess whether supplemental guidance is needed.

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To address the second recommendation, OTS is currently working with the other federal banking agencies to issue interagency guidance on BSA violations which is intended to ensure additional consistency among the federal banking agencies when citing violations. Additionally, OTS is enhancing an existing program through which BSA/AML violations are discussed among managers based in Washington, DC and regional offices, to ensure consistent supervisory responses. Lastly, OTS will implement a process to ensure that compliance examiners consult with information technology examiners to determine if there are BSA-related risks at particular institutions.

Before commenting on specific findings in the OIG report, I would like to clarify that OTS conducts a risk-focused examination process rather than “limited” examinations as characterized in the OIG report. In addition, many of the findings in the OIG report related to examiners not documenting procedures that they did not perform, or areas they did not review, even though our examination process does not require such documentation.

#### **Risk-focused Examination Process**

The scope of a Bank Secrecy Act (BSA) examination is individually tailored for each savings association through a “top-down/risk-focused” approach, similar to those of the other federal banking agencies. This approach emphasizes an association’s demonstrated ability to manage its BSA compliance responsibilities, the association’s track record, and any changes that have occurred since the prior examination. The examination will include a review of deficiencies noted in prior OTS examinations or internal reviews, as well as a review of an association’s compliance with existing supervisory directives or enforcement actions. The scope of the examination is also guided by the comprehensive risk profile of the association and its vulnerabilities relative to money laundering or terrorist financing. Associations that may be at elevated BSA/AML risk are identified based on lines of business, geographic location, or customer base.

During the examination, examiners review the association’s policies, systems, and controls. Consistent with the other federal banking agencies, OTS examiners use the *Federal Financial Institutions Examination Council Bank Secrecy Act/Anti-Money Laundering Examination Manual* (Manual) for conducting a review of an association’s BSA compliance. They focus on the association’s BSA compliance program for overseeing, managing, and monitoring its anti-money laundering and counter-terrorism financing programs, including any aspect of the compliance program conducted through vendors or affiliates. The specific procedures performed during an examination vary depending on whether examiners discover problems or internal control weaknesses.

The Manual, which guides BSA/AML examination for the federal banking agencies, makes clear that it is structured to allow examiners to tailor the BSA examination scope and procedures to the specific risk profile of the association. Examiners are instructed to, at a minimum, use the four



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sections included in the “Core Examination Overview and Procedures for Assessing the BSA/AML Compliance Program” to ensure that the institution has an adequate BSA compliance program commensurate with its risk profile. These minimum procedures include Scoping and Planning; BSA/AML Risk Assessment; BSA/AML Compliance Program; and Developing Conclusions and Finalizing the Examination. The minimum procedures provide examiners with sufficient flexibility to tailor the procedures based on risk.

Based on the risk profile of the institution determined during the scoping and planning process, examiners may determine that additional procedures *beyond* the minimums are warranted. The specific examination procedures beyond the minimums will depend on the BSA/AML risk profile of the institution, quality and quantity of independent testing, the financial institution’s history of BSA/AML compliance, and other relevant factors.

#### Work Papers

An important part of the risk-focused examination approach is directing examiner resources to an institution’s most relevant or material risk areas. Examiners are instructed to include work paper information that is relevant to support critical or adverse examination findings in the report of examination. The level of documentation should be consistent with the risks associated with the reviewed areas. Areas of an examination with higher risk or concerns will naturally require a more substantial level of documentation and conclusions that are more detailed. Examiners are instructed to complete and file only those documents where work was performed in the area relating to the examination program. Examiners do not provide documentation of areas that were not applicable to the examination. Documenting why an expanded examination program does not apply to a savings association would significantly increase examination time and burden on the industry. Such documentation would also diminish examination resources needed to identify and address relevant BSA/AML risks.

For example, the report notes that documentation for 13 thrifts in the sample contained no evidence that the examiner reviewed the thrift’s Internet banking services. Examiner review of Internet banking would not necessarily be warranted unless independent testing was found to be inadequate and the association presented a high-risk profile (e.g., an association that provides on-line account opening with high dollar and high volume Internet transactional products.) If an association merely allows customers to conduct online transactions once an account is opened, these transactions will be routinely captured by the association’s monitoring systems and do not necessarily require an expanded review.

#### **Findings in the OIG Audit Report**

The audit reviewed current and prior examinations covering a period from 2002 through 2006 in an area that has experienced rapid and significant change. There was significant expansion in regulatory requirements during the time period. For example, some of the more material BSA and Patriot Act regulatory changes during the review period include:

Appendix 2  
Management Response

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- Final regulations implementing Customer Identification Program requirements of the Patriot Act that became effective October 2003.
- The first edition of the Manual, jointly issued by the Federal Banking Agencies and FinCEN in June 2005, as one of a number of initiatives to coordinate efforts to address BSA compliance which became effective for examinations conducted in the 3<sup>rd</sup> quarter 2005.
- The Manual was updated in 2006 and 2007 to incorporate new guidance and regulatory requirements. It should be noted that the OIG's review covered examinations through July 2006, which was prior to the issuance of the 2006 and 2007 Manual updates.
- In January 2006, FinCEN issued final regulations implementing due diligence provisions for U.S. financial institutions that maintain correspondent accounts for foreign financial institutions<sup>1</sup> and enhanced scrutiny requirements for private banking accounts for non-U.S. persons.<sup>2</sup>

The Manual is intended to provide guidance to examiners and contains a compilation of regulatory requirements, narrative guidance, best practices, and red flags. Therefore, not every statement in the Manual can be construed to be a regulatory requirement. We would like to clarify several points made in the OIG report to illustrate this point.

Customer Due Diligence – The report notes that OTS examiners did not review customer due diligence procedures as required by Section 312 of the USA Patriot Act with implementing regulations at 31 CFR 103.176, 31 CFR 103.177, 31 CFR 103.178, and 31 CFR 103.181. These regulations refer to customer due diligence requirements for correspondent accounts for foreign financial institutions and private banking accounts for non-U.S. persons. This type of account activity (foreign correspondent accounts and private banking accounts for non-U.S. persons) is not common to savings associations.

Additionally, the examples in the OIG report do not relate to customer due diligence for foreign correspondent and private banking accounts as required by Section 312. For instance, it is noted that an examiner “did not perform additional CDD procedures because the thrift was non-public (it only accepted customers who were family members of the thrift’s personnel) and the examiner accepted that the thrift knew the account holders.” In this instance, customer due diligence expectations would follow the same risk-based principles as other areas of the BSA.

Dual Controls and Separation of Duties – The report noted that examiners noted instances where thrifts had not established fully independent positions or functions, yet the examiners did not report these instances as findings that needed to be addressed. For example, it was noted that thrift’s BSA officer was also filing SARs. With the exception of the requirement that a savings

<sup>1</sup> 31 CFR 103.176

<sup>2</sup> 31 CFR 103.178



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association conduct an independent test of its BSA/AML Compliance Program (performed by a person not involved with the BSA/AML function), there is no regulatory requirement, only a recommended best practice, for dual controls or separation of duties. The BSA officer would be prohibited from performing the independent testing of the Compliance Program; however, the officer is not prohibited from filing SARs. Examiners would not be concerned about the BSA officer at a small, low-risk community thrift with limited resources performing both a monitoring and report filing function.

OTS is committed to ensuring that savings associations are in compliance with BSA/AML requirements and has devoted significant resources to this area. We are also committed to working with FinCEN and the Department of the Treasury to achieve the goals set forth in the BSA Regulatory Efficiency and Effectiveness Initiative, announced by Secretary Paulson in June 2007, to ensure that compliance obligations are treated in a manner commensurate with actual risk.

If you have any questions or need additional follow-up information, please do not hesitate to contact us.

Sincerely,

/s/ Timothy T. Ward

Timothy T. Ward  
Deputy Director, Examinations, Supervision  
and Consumer Protection

Appendix 3  
Major Contributors to This Report

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Sharon Torosian, Audit Manager  
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Ken D. Harness, Referencer

**Department of the Treasury**

Office of Strategic Planning and Performance Management  
Office of Accounting and Internal Controls

**Office of Thrift Supervision**

Director

**Financial Crimes Enforcement Network**

Director

**Office of Management and Budget**

OIG Budget Examiner