

**Regulatory Lapses in Monitoring Anti-Money Laundering Performance  
by Financial Institutions\***

by

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I discuss the key new regulations that impose anti-money laundering obligations on U.S. financial institutions. These obligations have been superimposed on the performance of normal banking activities. Society has determined that national security requires banks to play a part in responding to this need, much as airlines have been given the responsibility to participate in the screening of passengers and their belongings before permitting them to board. It is useful also to consider the inordinate foreign demand for U.S. banknotes as a source of large cash deposits in U.S. banks that constitute one of the roots of the money laundering problem. In this context I shall refer to the Federal Reserve's Extended Custodial Inventory Program although it involves only financial institutions that have accepted a contractual agreement to participate in this program, not the entire class of financial service institutions.

Compliance with money laundering regulation has been spotty because regulators have been lax in enforcing the rules to insure financial institution safety and soundness. One general observation about bank safety and soundness regulation, whether or not the overall results were favorable, is that regulators did not publicize the name of an individual institution whose performance fell short of regulatory standards. Market participants might have had suspicions about the integrity of the institution in such a case, but its public reputation would not have been

\*I thank Richard Porter for acquainting me with the sources for this paper

at risk. I now turn to the new regulations to which financial institutions have been subject in the past two decades. Loss of reputation is at stake if an institution is singled out for violating these legal requirements.

### **Anti-Money Laundering and Other New Financial Institution Regulations**

It is not only recent legislation that imposes on U.S. financial services institutions the obligation to fulfill the demands of a broad purpose that society values. The U.S. Community Reinvestment Act, for example, is social engineering to assure that banks do not discriminate against residents of low-income districts in allotting mortgage loans. Banks may believe that the Act impugns the impartiality of their judgment of the credit-worthiness of mortgage applicants, but they nevertheless must comply.<sup>1</sup>

Anti-laundering legislation is of the same genre as the Community Reinvestment Act. It is designed to prevent the movement of illicit cash through U.S. financial institutions. Three laws prescribe their basic anti-money obligations: the Money Laundering Control Act of 1985, the Bank Secrecy Act of 1970, and the USA Patriot Act of 2002, which amended both prior laws.

The Bank Secrecy Act, as amended, requires the institutions to: (1) establish anti- money laundering programs, an internal audit function, and appoint an employee training officer; (2) verify the identity of persons seeking to open accounts; (3) exercise due diligence when opening and administering accounts for foreign institutions, wealthy foreign individuals including senior foreign political figures. The Treasury Department also is authorized to require institutions and other firms to file reports on large currency transactions.

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<sup>1</sup> Many small community banks with \$250 million assets have complained about the time and money needed to comply. Two of the four regulators (Office of Thrift Supervision and the FDIC) have published proposals to reduce the number of banks subject to the law to those with \$1billion in assets. The thrift office activated its proposal on October 1. October 20 was the deadline for public comment on the FDIC's proposal. The two other regulators

The Money Laundering Control Act was the first in the world to make money laundering a crime. It prohibits any person from knowingly engaging in a transaction which involves the proceeds of a long list of specified unlawful activity including terrorism, drug trafficking, and fraud. The Patriot Act expanded the list to include foreign crimes involving bribery and misappropriation of funds. It is therefore illegal for a U.S. bank knowingly to accept funds that were the proceeds of foreign corruption.

The Secretary of the Treasury is the primary federal regulator of enforcing anti-money laundering laws, and the Comptroller of the Currency within the Treasury Department is responsible for overseeing banks with a national banking charter. The agency of the Treasury that has primary responsibility for money laundering is FINCEN, the Financial Crimes Enforcement Network. In addition, the Financial Action Task Force represents a group of OECD countries that is trying to coordinate efforts to combat money laundering internationally.

Despite the legislation, a prominent Washington, D.C. national bank has recently been found guilty of infringement of statutory and regulatory anti-money laundering requirements, and regulators have been charged with disinclination to compel the bank to correct its deficiencies.

Riggs Bank is a well-known long-standing institution incorporated in Delaware, which operates primarily in the Washington, D.C. metropolitan area but also maintains foreign offices in London, Berlin, the Bahamas, the Isle of Jersey, and a subsidiary in Miami. The bank, with over \$6 billion in assets as of last year, is the principal operating subsidiary of a holding company, Riggs National Corporation. The bank provides retail, corporate and institutional banking services, and wealth management services to high-income individuals through its

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(Comptroller of the Currency and the Federal Reserve Board) appear to be ready to introduce the same limit on the size of banks that must comply. Some tougher community development standards may be imposed.

domestic and international banking departments. A specialty of Riggs is Embassy banking, administering accounts at more than 95% of foreign missions and embassies located in Washington.

Riggs has large numbers of foreign clients as well as some from countries with risks of money laundering and foreign corruption. The bank since 1997 has been repeatedly charged with disregard for anti-money laundering requirements and facilitation of suspicious activities, principally on the handling of accounts for Augusto Pinochet, which the bank concealed from the Comptroller of the Currency as well as of turning a blind eye to evidence of foreign corruption for Equatorial Guinea, its officials and family members. The bank's accounts with Saudi Arabia are still under investigation.

In May 2004 Riggs paid the Office of the Comptroller \$25 million to settle allegations that it had failed to report, detect, or even look for clearly suspicious transactions in accounts related to foreign embassies. The Federal Reserve Board at the same time ordered the parent company of the bank to take steps to insure that the bank reports suspicious financial transactions to federal authorities. The Federal Reserve also ordered Riggs to close its Miami subsidiary and to seek Fed approval before it pays any dividends or buys back stock.

With its reputation in tatters, in July Riggs agreed to be bought by Pittsburgh-based PNC Financial Services Group for about \$700 million. Thus a historic name will be gone from Washington banking.<sup>2</sup> Riggs still faces serious legal problems as the investigation of its failure to abide by regulators' strictures continues. This August Riggs placed its chief risk officer on leave.

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<sup>2</sup> In a bid to replace Riggs Bank as Washington's premier diplomatic bank, HSBC Bank, a global institution with headquarters in London, will open a D.C. branch in November. Riggs, which is winding down its \$1 billion in embassy banking, has agreed to refer its embassy clients to HSBC.

Embassies have established accounts with other banks including Citibank, Wachovia, and Bank of America Corp. A small community bank in Potomac has also won a few small embassy clients.

The regulators themselves, as has been noted, are under a cloud. The examiners from the Office of the Comptroller identified the deficiencies in the Riggs weak anti-laundering program, but were slow to use enforcement tools. More disturbing, the Comptroller's Examiner-in-Charge at Riggs until he retired in 2002 then joined Riggs staff. The former examiner appeared before his former agency in connection with matters relating to Riggs compliance, and attended meetings with the agency for two years without prior approval of the Comptroller's ethics office. The Federal Reserve was also charged with being slow and passive in implementing its oversight role.

There is no agreement among various Congressional investigating bodies about how to remedy the problem of regulatory agency failure to provide effective oversight of bank anti-money laundering performance. The investigators concluded that the scandal is not limited to Riggs, that it is not an isolated case, but symptomatic of a pattern of ineffective enforcement by federal regulators.

There are at least two other banks besides Riggs and UBS (mentioned below) that have been in the news recently in connection with money laundering lapses. One is the New York branch of the Dutch banking giant ABN Amro. It is being investigated by regulatory and law enforcement officials for its dealings with foreign financial institutions. FRBNY alleged that the bank was improperly moving funds of questionable origin through the financial system. Dozens of accounts were transferred to ABN Amro in New York from the Bank of New York when it was under investigation in the 1990s.

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HSBC has affiliates in 76 countries, some of which have strict secrecy laws; U.S. authorities believe secrecy laws impede rules designed to prevent international money laundering. HSBC says it has rigorous controls at its affiliates and will follow regulations closely.

ABM Amro in July agreed in a 14-page document to sever relationships with nearly 100 correspondent loosely regulated banks in Eastern Europe, the Mediterranean, and Caribbean because of questions of compliance with money laundering regulations. The Justice Dept. is investigating \$885,000 in transfers from Latvia thru ABN Amro in NY that were allegedly part of a fraudulent deal to avoid Russian taxes. That and similar transactions are part of a broader pattern of fraud, tax and money laundering involving millions of dollars, passed through ABN Amro in NY by banks in Russia and Eastern Europe.

A provision in the Patriot Act put the legal onus on banks to know the identity of their customers and where their money comes from. In the 1990s Bank of New York moved more than \$7 billion from Russia, believed to be proceeds of corruption, tax evasion and organized crime through correspondent accounts with Russian banks. Two Bank of New York executives pleaded guilty to money laundering and haven't yet been sentenced. The bank wasn't punished pending full cooperation.

Correspondent accounts allow foreign banks to conduct dollar-denominated transactions and move funds into the US without setting up a US branch, simply by paying fees to a host bank that has a US banking license. ABN Amro has also cut off its correspondent banks in Cyprus, an offshore banking center that caters to the Russian market. ABN Amro failed to certify that its customers weren't foreign shell banks, entities that exist primarily on paper for the purpose of moving money secretly. It agreed to enhance its filings of Suspicious Activity Reports on unusual transactions.

Another institution that regulators have targeted for lack of compliance is Beacon Hill, a small Manhattan firm not licensed by NY State doing suspicious money transmitting business all over the world. Chase opened 40 accounts with Beacon Hill in 1994. Chase in NY took on

Beacon Hill after its London office shut down Beacon Hill in 1994 for suspicious activities. Between 1997 and 2000 Chase moved \$6.5 billion in wire transfers for Beacon Hill. Its clients included offshore shell corporations and money exchange houses in Brazil, and Uruguay. Money was linked to the drug trade, some to official corruption and government fraud in Brazil. Beacon Hill also transmitted \$32 million to accounts in Pakistan, Lebanon, Jordan, Dubai, Saudi Arabia and other Middle East countries. Investigators have not discovered the real parties behind the transactions because Beacon Hill record-keeping was sloppy. Its business was run out of a pooled account that served many customers so it was impossible to connect specific deposits to specific transfers out of the account.

In February Beacon Hill was convicted of operating as a money transmitter without a license. Morgan Chase was not charged with any crime. The NY State Banking Dept and NY Fed were asked in March whether Chase violated “Know your clients rule.” Morgan Chase has since stopped dealing with wholesale money transmitters.

Another big US financial institution in trouble for failure to prevent suspected money laundering is Citigroup. Japanese regulators in September ordered Citigroup to shut down its four private banks in Japan for other violations as well. The publicity has damaged Citigroup’s reputation probably more than its revenues.

One of the charges brought against Riggs was that over a two-year period it accepted cash deposits of \$1 million or more in bank notes in six separate transactions. It did not treat them as unusual or requiring scrutiny. Cash is a traditional way of hiding the source of income.

### **The Extended Custodial Inventory Program**

U.S. banknotes have for many years been a preferred banknote medium for residents of foreign countries the purchasing power of whose domestic currency is unstable and lacks anonymity. Foreigners have no problem obtaining U.S. banknotes. It is estimated that over \$400 billion of \$680 billion in circulation is held abroad. Of course, not all suspicious money transactions are conducted with cash. It is easy to transfer funds by wire from even the least advanced countries. Riggs was also charged with failure to conduct routine or special monitoring of frequent and sizeable transfers of funds across international lines.

Providing the banknotes that foreigners demand is a financial benefit for U.S. taxpayers, so it makes sense for the Federal Reserve to have introduced the Extended Custodial Inventory Program in 1996 primarily to facilitate the distribution abroad of a new design \$100 note. The primary purpose of the program then shifted to enhance the international banknote distribution system, which began to function in January 1998. The program maintains inventory of Federal Reserve notes in strategically located international distribution centers. Currently, a total of eight facilities are operated in five cities by five banks: American Express Bank (London), Bank of America (Hong Kong, Zurich), HSBC (London, Frankfurt, Hong Kong), Royal Bank of Scotland (London), and United Overseas Bank (Singapore). These five cities are now the principal hubs for the distribution of U.S. banknotes. Thirty institutions worldwide participate in wholesale buying and selling the notes that are exported to international markets by the Federal Reserve Bank of New York.

The Federal Reserve Bank of New York manages the program, and negotiates an Agreement with each of the five bank operators. The Agreement specifically prohibits operators from engaging in transactions affecting the program inventories with countries subject to sanctions by the Treasury Department's Office of Foreign Asset Controls. The operators are

required to provide the New York Fed with monthly reports of all countries that engaged in U.S. dollar transactions with the operator and the volume of those transactions.

Until late October 2003 one other bank was an operator of the banknote inventory program. The bank was UBS, which operated a site in Zurich. The Federal Reserve Bank of New York terminated its contract with UBS in connection with investigation of the discovery by U.S. armed forces in Baghdad of \$650 million of U.S. currency with a New York Fed wrapping. (More has since been found.) Serial number records identified a sample of the notes as part of twenty-four shipments to several operators including UBS. The other operators provided information concerning the counterparties to whom they sold the banknotes in question. UBS eventually revealed that it had sold the notes to Iran, it claimed, by mistake, and gave a false explanation for its failure to account for the sale in its monthly report to the New York Fed. The Iranian transaction violated the Agreement UBS had signed prohibiting shipment of currency to countries subject to sanctions by the Treasury Department's Office of Foreign Assets Control. UBS was also fined a \$100 million civil money penalty for deceptive conduct. Investigation of the trail of the currency to Iraq continues.

The case of UBS differs from that of Riggs. Riggs did not exercise due diligence in performing its anti-money laundering regulatory obligations. UBS violated a commitment it had explicitly agreed to abide by. The test of even well-conceived regulation is whether it works.

Financial regulation imposes costs on the regulated, so regulation fosters incentives to avoid them. Regulators in reaction to avoidance behavior by the regulated find ways to tighten the rules they originally imposed. In the following round the regulated again try avoidance, to which the regulators again respond. This is the dialectic of regulation. It applies not only to financial regulation but also to regulation in general. Money laundering regulation however,

appears to be an exception. This may, however, be a case of Regulatory Capture – regulators who become so cozy with the firms they are supposed to regulate that they are loath to enforce anti-money laundering regulation.

To sum up: Even when regulation has been socially beneficial, as in the case of anti-money laundering, some U.S. banks have acted to aid and abet money laundering. The reason is that the international money transmittal business is lucrative. The potential loss of fat fees earned from that business if those banks stopped dealing with wholesale money transmitters whose activities are suspicious accounts for their misbehavior. There is a corresponding indifference on the part of regulators to the urgency of enforcing compliance. This is a matter that requires the attention of top-level authorities in charge of public safety.

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