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Protecting Financial System Integrity

An oft-stated goal of anti–money laundering (AML) regimes is to protect the integrity of the financial system, particularly banks, which are at the core of that system. Other types of financial and nonfinancial institutions such as money service providers and real estate agents, which also are generally covered by the AML regime, are important to financial system development but less so for the day-to-day functioning of the economy. Banking services are central to the smooth functioning of a market economy.

The role of AML regimes in supporting efforts to protect and facilitate functional financial systems is well established. For example, the 2003–08 Strategic Plan of the US Treasury's Department's Financial Crime Enforcement Network (FinCEN 2003a, 8) links its AML activities directly to achieving one of Treasury's key objectives, which is to "preserve the integrity of financial systems." In Title III (the International Money Laundering Abatement and Anti–Terrorist Financing Act Sec. 302 (a) (3)) of the USA PATRIOT Act of 2001, the US Congress reported: "Money launderers subvert legitimate financial mechanisms and banking relationships by using them as protective covering for the movement of criminal proceeds and the financing of crime and terrorism, and, by so doing, can threaten the safety of United States citizens and undermine the integrity of United States financial institutions and of the global financial and trading system upon which prosperity and growth depend."

Nor are AML regimes important only to the US financial system. William Gilmore (1999, 83) quotes the Australian president of the Financial Action Task Force (FATF), Tom Sherman, as stating in 1992: "Combating money laundering is not just a matter of fighting crime but of preserving the integrity of financial institutions and ultimately the financial system as a whole."

This chapter examines the nature of the AML goal to protect financial system integrity and presents a framework for examining how well the regime is accomplishing that goal. Looking at the limited available evidence through the lens of that framework leads to the tentative conclusion that the AML regime appears to have made substantial progress in protecting the financial system, but we offer several qualifications regarding that progress.

Financial System Integrity as an AML Goal

Much of the initial focus of the global AML regime was on the core financial system and particularly banks, since the banking system plays a central role in the collection and movement of funds. While the principal objectives were to make it more difficult (expensive) for criminal offenders to launder the proceeds of their crimes, and to employ the financial system in the investigation and prosecution of those crimes, an important subsidiary objective has been to protect the integrity of the financial system itself. Thus, for example, in a report on customer due diligence for banks, the Basel Committee on Banking Supervision (2001, 2) noted that "know-your-customer" policies and procedures "are critical to protecting the safety and soundness of banks and the integrity of banking systems."

Society today disapproves of turning drug revenues into legitimate funds. Financial institutions that accept money from drug dealers, even if they do not face criminal charges, are perceived to be less than law-abiding. The role of mainstream financial institutions, particularly banks, is to provide public goods such as banking services and liquidity to the financial system and the economy, and they are expected to share and abide by generally accepted social and ethical codes of behavior. Further, since core financial institutions to varying degrees are regarded as quasi-public utilities with access to such government safety nets as deposit insurance, access to the discount window, and payment services, they have now been called upon to assist in supplying another public good, which is the prevention of money laundering. In the process, they help protect the integrity of the core financial system as a whole.

In this context, once the social objective to combat money laundering has become well established, a bank's reputation suffers if it becomes associated in the public mind with that crime, though the seriousness of that decline in reputation may vary from society to society. In Switzerland, for example, it can be very serious, since asset management accounts for as much as half of Swiss banks' output, and private clients generate as much as 85 percent of this business (Pieth and Aiolfi 2003, 20). The Swiss bankers' association contracts for polls on the subject, and a 2004 survey of public attitudes toward Swiss banks found that 80 percent of respondents believed that their banking institutions enjoy a positive reputation abroad (M.I.S. Trend 2004). At the same time, 57 percent felt that Switzerland is not doing enough to fight money laundering, but 76 percent want to maintain bank secrecy. This nicely illustrates the tensions and cross-currents around this subject. In other countries, moreover, reputation may not be as valuable an asset, so banks may be less sensitive to being perceived as committing a violation related to money laundering. It can be said, however, that if banks and other financial institutions at the center of the financial system are to play their assigned role in the economy, their customers should at the very least trust them. Such confidence helps to prevent runs on banks, which can undermine the stability not only of the financial system but also of the economy as a whole.

Finally, given the AML regime, a financial institution that fails to establish appropriate AML-compliance procedures incurs legal and financial liability that can impact its bottom line as well as its reputation. Money-laundering regulations can be viewed as a way to insulate banks and similar institutions from direct connections with illegal activities. To this end, supervisors of banks and other core financial institutions have over time implemented a structure to induce institutions to take their AML responsibilities seriously. Supervisors have linked compliance to sound risk management, which is central to minimizing the costs of financial intermediation to the institution and the system as a whole. They have embraced a proactive supervisory posture in support of compliance with the overall regime.

Senator John Kerry (D-Mass.), drawing on his experience as chairman and ranking member of the US Senate Subcommittee on Terrorism, Narcotics, and Operations, has described the interaction of organized crime, corruption, money laundering, and a weakened financial system in Russia (Kerry 1997, 164–65). Criminal groups intent on hiding the proceeds of their crimes gain control of banks, which allows them to corrupt the business and financial system more broadly, which in turn taints the government and other institutions of society. Ultimately the phenomenon spreads and mixes with money laundered from crimes in other countries.

At the extreme, as argued in a report by the UK Performance and Innovation Unit (2000, chapter 3, 7), "the accumulation of criminal assets in a country's financial system can influence decisions about national banking policies or about co-operation in international investigations, transparency and accountability rules." The case of the Bank of Credit and Commerce International (BCCI) illustrates this extreme. BCCI caused substantial disruption to the international financial system when its nefarious activities were finally uncovered in 1991. The institution was found guilty of numerous violations of the banking laws in a number of countries. BCCI was a thoroughly corrupt institution that operated outside the laws and regulations of a large number of countries, and its collapse resulted in losses for a range of creditors, mostly individuals but some governments as well. BCCI had been viewed by many of its customers as a sound institution, and its operations supposedly had been examined—incompletely as it turned out—by supervisory authorities in major nations. Thus, the AML regime has to be judged on the basis of the extent to which it protects the integrity of international as well as national financial systems.

Evaluating Progress

How can the effectiveness of the AML regime in protecting the integrity of national or international financial systems be measured? Indirect indicators, if available and carefully interpreted, should provide a reasonable picture. Examining actual money-laundering prosecutions can provide evidence on general use of the financial system for money-laundering purposes (particularly in the placement phase) and the nature of that use. It should be possible to distinguish among institutions that are corrupt and actively solicit money-laundering business, those that have willing or rogue employees who provide such services on an ad hoc and noninstitutionalized basis, and those that are unwitting accomplices in money-laundering operations. Within this third category of unwitting accomplices, it also is important to distinguish institutions that have deficient internal AML controls that may contribute to facilitating money laundering.

With respect to the integrity of major national financial systems and the global financial system, as a first approximation the test of success of the AML regime should be whether institutions have been linked to either of the first two money-laundering categories in terms of laundering the proceeds of crimes committed in their home countries. A distinction must be made between a bank's internal systems and business activities that aid and abet money laundering and therefore can reasonably be associated with weakening financial system integrity (a relatively low hurdle), and on those internal systems and business activities that fail to stop money laundering and deter the underlying crime (a much higher hurdle).

In addition, scrutiny of suspicious activity reports (SARs) submitted by and about institutions should aid in identifying each institution's potential vulnerability, though there are biases and defects in such measures that might warrant controls for other factors such as size, location, and clientele. If institutions that show up frequently in prosecutions file small numbers of SARs, that information might indicate that they are failing to meet their responsibilities. However, extreme threats to the integrity of a country's financial system, which might create financial instability on the scale of BCCI, are difficult to detect or measure systematically other than after the fact. BCCI was an example of a fraud and conspiracy conducted from within the institution itself. Had the crimes been detected at an earlier date, the implications of the BCCI collapse would have been essentially the same.

These types of data are not generally or systematically available to the public in the United States or any other country, which constrains the ability of researchers to conduct either type of analysis. For this study, we developed two databases of cases. We drew upon those databases to suggest how the analysis of money-laundering cases might be used to produce a fuller assessment of the progress of the AML regime in protecting core financial system integrity.

The first database included international cases reported in seven annual FATF reports on money-laundering typologies and in occasional reports by the Egmont Group, an international association of financial intelligence units (FIUs). Of 223 cases entered in the database, 185 involved core financial institutions, exclusively banks, and excluding such entities as casinos and insurance companies. Because these exercises were designed to identify and share information about new methods of laundering money, they are not necessarily a representative cross-section of money-laundering prosecutions that in principle would best serve this type of analysis. Given that qualification, 3 percent of the cases involved active solicitation by the bank, and 3 percent involved the activities of rogue employees. In the remaining 94 percent of cases, the banks were unwitting accomplices, although it was not possible to determine whether or the extent to which their internal AML controls (or lack of them) could be blamed.[1]

The second database included 60 cases of money laundering assembled from descriptions in various sources, such as books, newspaper articles, and the *National Money Laundering Strategies*.[2] Because cases reported by the media, in particular, are likely to be sensational, the bias probably is in the direction of direct involvement by banking institutions or their employees that were judged to be culpable. We were able to identify the role of banks in 55 of these cases.[3] Six involved active solicitation, four involved rogue employees, and six fell under the heading of negligence with respect to AML controls. However, in the remaining cases, which constituted 71 percent of the total, the banks were unwitting accomplices.[4]

Fourteen of the cases involved large banks, and of these, one case involved active solicitation, two involved rogue employees, four involved negligence on the part of the banks, and seven involved banks as unwitting accomplices to money laundering. With respect to the predicate crime, six of the 14 were drug cases, all in the first half of the 1990s, and three were

1. Interestingly, 59 percent of the cases involved more than one bank as part of the money-laundering operation.

2. This sample is neither exhaustive nor necessarily random. Had we deliberately set out to find cases in which large banks had been involved in money laundering, there certainly would have been a different distribution of the nature of bank involvement in cases and types of cases.

3. In 75 percent of the cases, the underlying (predicate) crime was committed at least in part in the United States, while in 62 percent of cases the initial placement of proceeds of the crime was in the United States.

4. Fairly consistent with the findings using the first database, 62 percent of the cases in this second database involved more than one bank as part of the money-laundering case.

corruption or kleptocracy cases, while real estate fraud and gambling accounted for one case each. The three remaining cases involved bank violations of money-laundering (Bank Secrecy Act) rules and regulations, one (Bank of New York) was associated with a rogue employee, and two were the result of negligence.

The anecdotal information provided through the second database of cases suggests that in recent years only a small number of US institutions have been involved in active solicitation of money-laundering business. Even in cases where a financial institution is found to have actively solicited money-laundering business, however, it is not necessarily closed down. Such was the case of the Broadway National Bank in New York City, as was described in box 5.1. In these situations, the interests of law enforcement authorities sometimes differ from those of the supervisory authorities, in that the former may value the deterrent effect of closing down an institution while the latter are concerned about financial stability and not provoking a costly run on the bank. A compromise is often found by removing or charging officers of the institution and imposing a large fine, while at the same time rehabilitating the institution with new owners and management under the watchful eyes of the supervisors.

In a case like that of Great Eastern Bank of Florida, also described in box 5.1, the bank received a substantial fine for what might be called gross negligence, but its offense was not quite in the category of active solicitation of money-laundering business.

Similarly, the number of large US institutions with willing employees who facilitate money laundering from within appears to have been small in recent years. The most prominent recent case involved the Bank of New York, through which $7 billion was laundered by way of an account belonging to Benex, a company linked with a purported Russian mobster. One of the bank's vice presidents pleaded guilty to money laundering, but the bank itself was not accused of wrongdoing (*New York Times,* September 5, 1999, 3-1). It was, however, subjected to extensive and expensive supervisory guidance to improve its compliance with AML laws and regulations. This type of case as well as some in the third category—unwittingly assisting money laundering in a context in which the institution's deficient AML compliance regime contributed to the problem—now routinely result in financial penalties and costly and ongoing supervisory scrutiny until the institution has demonstrated improvements in its compliance procedures. It appears possible that JP Morgan Chase will be subjected to similar formal sanctions in the wake of the criminal conviction of Beacon Hill Service Corporation as an unlicensed money transmitter that used JP Morgan Chase to make $6.5 billion in wire transfers over a six-year period (Morgenthau 2004). We assume the institution has already been subjected to informal sanctions as part of its annual supervisory examinations.

Supervisors also review SARs submitted by institutions in order to identify an institution's potential vulnerability to rogue employees or weak AML compliance systems. Along with regular reviews of an appropriate sample of money-laundering prosecutions, supervisors could support efforts to measure regime effectiveness, as well as make the regime more transparent, by issuing a periodic public scorecard of AML regime progress in protecting the integrity of the financial system.[5]

An illustration of some of these points came in the spring of 2004, when the attention of the local Washington, DC, community focused on various money-laundering allegations involving Riggs National Bank, a financial institution that dates back 165 years and has served a number of presidents.[6] What is known is that Riggs, a relatively small regional bank with about $4.2 billion in deposits, catered extensively to deposits from the diplomatic community, which reportedly accounted for almost 25 percent of its total. An estimated 95 percent of Washington embassies had Riggs accounts. Among other transgressions, the bank allegedly failed to submit required reports involving large cash transactions by Saudi Arabian accounts. A senior vice president was fired and is under criminal investigation for participation in a possible money-laundering operation involving corruption and the president of Equatorial Guinea. The bank is also suspected of collaborating with former Chilean President Augusto Pinochet to hide some of his wealth that may have had questionable origins. A $25 million fine was imposed on the bank, and it was put under close management scrutiny by the Office of the Comptroller of the Currency and the Federal Reserve System, the severest penalty short of closing the institution. In effect, the bank's reputation was ruined, and its owners were forced by a combination of market forces and supervisory encouragement to put it up for sale.[7]

The Riggs case illustrates three aspects of money laundering as it relates to efforts to protect the integrity of the core financial system. First, Riggs demonstrated "willful and systematic" lack of compliance with mandated internal controls involving money laundering, and it was this failure rather than an actual conviction for money laundering that triggered the regulators' stern responses. Second, a bank can so tarnish its reputation via such failure that it is no longer viable as a stand-alone institution even if it retains substantial institutional value. Third and related, some of the principal money laundering–related failures involved a special category of private banking—providing services to embassies and their governments. The

5. Although US bank supervisors routinely use this type of information in connection with their AML examinations of individual banks, we were not able to gain access to the data.

6. The Riggs case was not included in the anecdotal database because the full story was still coming out as our study was completed.

7. The offer by the PNC Financial Services Group valued at about $24 per share is higher than the Riggs stock, which reported is closely held, has traded since 1998; Riggs stock had traded as low as $10 a share since then and only slightly below $15 a share in the year before its announced sale.

clear lesson is that this type of private banking, along with government officials, should not receive special treatment under the AML regime.

Conclusions

Several qualified conclusions can be drawn from evaluating the progress of the AML regime in protecting the integrity of the core financial system. The regime, which has now been in place in major jurisdictions for more than 15 years, has altered how banks and other core financial institutions approach their responsibilities and conduct business. The AML regime has induced banks to take seriously their obligation to avoid direct contact with criminal money by putting in place reporting systems and developed monitoring techniques that make them less attractive for money laundering. The emerging global AML regime makes it more difficult to use banks and mainstream financial institutions to place funds, although there is little evidence that these efforts have made money laundering substantially more expensive. Nevertheless, the global regime appears to have largely achieved one of its primary goals, which is to eliminate the threat from money laundering to the integrity of banking systems, at least for large institutions in the major jurisdictions.

This is not to say that the threat has been permanently eliminated—witness the Beacon Hill case referred to earlier—or that more cannot or should not be done to promote further global progress. Financial institutions that have been unwitting accomplices to money laundering could have had tighter AML controls in place. Those controls might have been helpful in detecting the underlying crime or, more likely, might have prompted the criminals to take their business elsewhere.

The assessment in this chapter should be qualified in four important respects. First, the principal concern in connection with money laundering and the integrity of core national financial systems and the global system has to do with the placement stage of the three-stage laundering process. It is at that stage that the financial institution, and by extension its financial system, is most vulnerable to corruption and the loss of reputation. Preventing the involvement of core financial institutions in money laundering at the layering or integration stages is a different and more difficult matter.

The global AML regime has recently been extended to correspondent banking relationships, which often are an integral aspect of the layering and integration stages of money laundering. The USA PATRIOT Act contained some tough and groundbreaking provisions to address the correspondent banking aspect of the AML regime. In addition, recommendation 7 of the 2003 FATF Forty Recommendations incorporates new provisions with regard to cross-border correspondent banking and similar relationships. Detection of money laundering in the layering and integration stages of the anti–money laundering process requires close cooperation between the AML regime's prevention and enforcement pillars. Extensive use of a financial institution in a major jurisdiction in these later stages could undermine the institution's stability, integrity, and reputation, in turn undermining customer confidence in the financial system.

Second, financial institutions could be used more extensively and effectively in connection with the investigative element of the AML regime's enforcement pillar. One example is in sting operations, and another is in more effective use of SARs and similar reports. As noted in chapter 4, the US private sector has been quite critical of the government's tendency to operate as a one-way street on money laundering with respect to the provision of information. Similar complaints can be found in the KPMG (2003) report on the reporting regime for SARs in the United Kingdom. One sometimes hears complaints that banks and their supervisors resist cooperating with law enforcement authorities.[8]

Third, the jury is still out with respect to money laundering in connection with the "private banking" activities of major international banks. There have been major problems in the recent past, such as the difficulties that occurred in Mexico as a result of the United States' Operation Casablanca in 1998 (chapter 4). Such activities often involve the proceeds of crimes—such as corruption—committed outside the home countries of major financial institutions, and therefore only indirectly affect the integrity of those countries' financial systems. Nevertheless, in response to these and other concerns related to public confidence in banking systems, 12 major private international financial institutions adopted Global Anti–Money Laundering Guidelines for Private Banking in October 2000 (Wolfsberg Group 2002).[9] In addition, recommendation 6 of the 2003 FATF Forty Recommendations calls for enhanced due diligence with respect to "politically exposed persons" whose source of wealth may not be legitimate.

Finally, the tentative assessment that the global AML regime is generally effective in protecting the integrity of core financial systems of major countries leaves to one side the issue of institutions at least notionally headquartered outside major financial centers, as well as their capacity to abuse and undermine the integrity of the global financial system. Again, these

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8. Martin Mayer wrote in the *New York Times* (January 14, 2004) that the Federal Reserve Board would not allow regional banks to reveal the identity of purchasers of large blocks of US currency. He did a disservice to the public and the AML regime by putting forward his unsupported accusation. The Federal Reserve routinely shares such information with law enforcement agencies.

9. The Wolfsberg Group revised its guidelines for private banking in 2002 and also adopted principles on the suppression of this financing of terrorism and AML principles for correspondent banking. In 2003, the group issued a statement on procedures for monitoring, screening, and searching, which carries CDD beyond initial customer contacts and establishment of an account relationship. The procedures can be used for investigative purposes and have the potential to help identify layering operations.

institutions and jurisdictions pose less of a direct threat to the financial systems of the major countries, but the risks are not negligible. This concern, as well as those regarding the proceeds of corruption often associated with private banking, is more relevant to the role of the AML regime in targeting the global "public bads" of terrorism, kleptocracy, and failed states, which will be discussed in chapter 7.

While the global AML regime appears to have successfully protected the integrity of banks via core financial institutions headquartered in the major financial centers, the regime may not have reduced the total volume of criminal proceeds laundered globally; the activity has perhaps been pushed into more peripheral institutions and jurisdictions. As a result, the AML regime has been expanded to pursue laundering taking place through those institutions and locations. The net effect may have been positive with respect to protecting the integrity of the core financial system but minimal with respect to achieving other AML goals.