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Statement by

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before the

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Regulation and Insurance

of the

Committee on Banking, Finance and Urban Affairs

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I am pleased to appear on behalf of the Federal Reserve Board to offer additional testimony on the issue of money laundering. The Federal Reserve has a strong commitment to implementing appropriate policies to ensure compliance with laws enacted to eliminate money laundering.

My goal today is to more fully inform the Committee of efforts by myself and by staff to press for greater international cooperation by bank supervisors in addressing the use of banking organizations to launder money. In addition, the Committee has asked for a status report on the studies required under the Anti-Drug Abuse Act of 1986 and that I address the subject of bank fraud and insider dealing. Finally, I will provide further information on the Federal Reserve's supervisory efforts to ensure compliance with the Bank Secrecy Act and other laws to discourage the use of banks and the payments system generally for laundering money.

International Cooperation

The Federal Reserve shares the concerns of this Committee and believes that the effectiveness of efforts to discourage money laundering could be further enhanced by initiatives on an international level. For the past year, the Federal Reserve, together with the other Federal banking agencies, has worked to secure the cooperation of bank supervisory authorities in other countries of the world. Discussions have been held among members of the Basle Committee on Bank Regulation and Supervisory Practices¹ with the goal of obtaining a consensus on how best to proceed with efforts to discourage criminal elements from using the international payments system for the purpose of laundering money. The subject was first raised with the Basle Committee in a meeting in Washington last June. Although all members of the Committee

¹The Basle Committee was established at the end of 1974 by the central bank governors of the Group of Ten industrialized countries with the objective of strengthening collaboration among national authorities in their prudential supervision of international banking. The Committee, whose members are officials of the central banks and supervisory agencies, meets three times a year at the Bank for International Settlements in Basle, Switzerland.

were clear in their view that abuse of the banking system in the form of currency laundering was a serious matter, many felt that the primary responsibility for monitoring and detecting this activity rested largely with law enforcement authorities.

Nonetheless, the Committee agreed that the subject should be reviewed, and at the December 1986 meeting the U.S. delegation agreed to draft a paper outlining the issue and making recommendations.

In addition, this paper will propose rules of conduct that could be utilized by banks in any country to discourage the use of the payments system for illegal transactions. In constructing this proposal, we have consulted with other countries for the purpose of incorporating their ideas as well as seeking their support of a more active role for bank supervisors. We expect that in the next few weeks a draft of an initial proposal will be ready for review by the Basle Committee and we are attempting to put the item on the Committee agenda for the regular meeting later this month. We recognize that encouraging foreign

supervisors to endorse the concept that international banks should adopt a code of conduct falls short of the extensive currency reporting requirements in place in the United States; however, we are hopeful that this effort, in combination with the activities of our federal law enforcement authorities, will make a meaningful contribution toward inhibiting the use of the banking system for illicit money laundering.

Attempts to eliminate money laundering through legislation are, of course, not confined to the United States. Recently, Switzerland for example has proposed laws designed to make money laundering a crime. It is our hope that other countries will follow suit. The proposed rules of conduct to which I have just referred endorse the concept that bank supervisory authorities should support legislation that would make money laundering a crime.

Federal Reserve efforts to encourage international cooperation in this area will not be limited to the Basle Committee. We intend to discuss this issue when appropriate at

formal and informal meetings with foreign bank supervisory authorities. It is our hope, however, that the work going on in the Basle Supervisors' Committee will serve as the principal vehicle for advancing effective constraints on the involvement of international banking institutions in money laundering activities.

International Studies

The Anti-Drug Abuse Act of 1986 requires that two studies be conducted and furnished to this Committee. Both of these studies are being prepared under the auspices of the Department of the Treasury in consultation with the Board of Governors. The Justice Department is also to contribute to one of the studies.

The first study deals with the results of discussions with central banks and other appropriate governmental authorities concerning the establishment of arrangements to facilitate the flow of information among supervisory authorities throughout the world. The flow of information among international supervisors is particularly important, and the Federal Reserve is discussing with international authorities the need to improve communications and

information-sharing procedures in order to strengthen supervisory activities vis-a-vis international banking organizations. We expect to be able to provide Treasury with the results of our discussions in sufficient time to ensure a timely response to this Committee.

The other study requires that information be furnished to this Committee on: (1) the extent to which foreign branches of domestic institutions are used to facilitate illicit transfers of currency and other monetary instruments or to evade reporting requirements; (2) the extent to which U.S. law is applicable to the activities of such foreign branches; and (3) methods for obtaining the cooperation of foreign countries for the purpose of enforcing money laundering laws and currency reporting requirements. The Federal Reserve and the Comptroller of the Currency were asked to assist the Treasury on Sections (2) and (3) of the study. While we are still in the process of developing materials to provide to the Treasury, we expect the study to be completed within the Committee's requested time frame.

Bank Fraud and Insider Dealing

I would now like to turn to the subject of bank fraud and insider dealings. Experience has demonstrated that insider abuse and misconduct, as well as criminal activities, are among the factors contributing to bank failures. Data provided by the Department of Justice and the Federal Bureau of Investigation confirm that criminal misconduct, such as fraud and embezzlement, is a serious problem. For example, the FBI recently reported that in 1985 it worked on 6,373 bank fraud and embezzlement cases--one third of which involved amounts exceeding \$100,000. In 1986, this number rose to 7,286--with a corresponding increase in the number of cases over \$100,000. The FBI reports that in 1985, the amount of reported dollar losses due to bank fraud and embezzlement totaled about \$850 million; in 1986, this total increased to over \$1.1 billion.

Over the last several years, the Federal Reserve by itself, and in conjunction with the other federal banking and law enforcement agencies, has taken a number of steps to address bank

fraud and insider abuse. A major part of this effort relates to our involvement in the Interagency Bank Fraud Enforcement Working Group (the "Working Group") that was formed in April 1985. The Working Group is comprised of officials from all of the Federal financial institution regulatory agencies, the Justice Department and the FBI. The principal results of the Working Group's efforts over the last two years include the following:

- o The Working Group developed and implemented a uniform criminal referral form to be used by all banks, bank holding companies, savings and loan institutions, and credit unions.
- o The Department of Justice developed and implemented a "significant referral" tracking system. For this purpose, a criminal referral is considered "significant" if the dollar amount of the suspected violation exceeds \$200,000, the suspected offense involves insider abuse by senior officials, or the violation involves, in the opinion of Board staff, activities or practices that

affect the integrity of the supervisory process or otherwise have nationwide implications. Each significant referral received by the Federal Reserve System is forwarded to the Fraud Section of the Department of Justice for tracking and special attention.

- o As a complement to these efforts, the Enforcement Section of the Board's Division of Banking Supervision and Regulation developed and implemented an automated system to monitor and track all of the Federal Reserve criminal referrals. Complete access to the Board's criminal referral recordkeeping system is available to all the agencies comprising the Working Group.
- o The members of the Working Group developed and distributed lists of key persons to be contacted at the local FBI offices, U.S. Attorney's offices, Federal Reserve Banks, and all district offices of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and Federal Home Loan Bank Board on

matters relating to criminal referrals and bank-related insider abuse and fraud. These lists provide important information for the staffs of the agencies responsible for criminal referral and follow-up.

- o The examiner training programs sponsored by the Federal Financial Institutions Examination Council have been expanded to include extensive instruction on the detection and investigation of insider abuse and misconduct within financial institutions. In addition, the members of the Working Group jointly sponsor white-collar crime seminars with the FBI.
- o At the urging of the Working Group, the Attorney General called upon each U.S. Attorney to intensify his or her bank fraud enforcement efforts. In a memorandum distributed in February 1987, the Attorney General asked all U.S. Attorneys to prepare inventories of bank fraud cases involving more than \$100,000 that are pending prosecutive decision or action, to make prompt

prosecutive determinations in those cases ready for decision, and to assign the needed personnel to complete the investigation of open cases with the goal of indictment or declination within nine months.

As part of this overall effort, the Federal Reserve Board has attempted to improve its communication and coordination with the enforcement agencies in this all-important area. I believe we have made considerable progress in strengthening our working relationships with the Department of Justice and the FBI at both the federal and local levels. There is also now, I believe, a better mutual understanding of the procedures and responsibilities of the federal financial institution supervisory agencies and the federal law enforcement agencies.

In addition to these interagency efforts, the Board has sought to enhance its supervisory and enforcement activities regarding insider abuse and misconduct. This is reflected in an increase in the number of formal enforcement actions taken by the

Board. In the period 1980-1982, the Federal Reserve System averaged 42 enforcement actions per year; from 1984-1986, the average number of enforcement actions had increased to 177. These figures include actions against state member banks, bank holding companies, and Edge Act Corporations. Moreover, during this period, there has been a significant increase in the number of enforcement orders addressing improper or abusive actions of bank officials. This increase in enforcement actions has occurred across the board -- involving civil money penalties and fines, cease and desist orders, and suspension and removal proceedings against officers and directors.

Board staff members are also working with their counterparts at the other Federal financial institution regulatory agencies to develop a joint legislative proposal for amending the agencies' enforcement statutes. The purpose of the proposal would be to clarify the agencies' authority to obtain reimbursement from individuals who violate applicable banking laws; broaden the agencies powers to issue cease and desist orders; strengthen

removal procedures; and codify existing interpretations of the Right to Financial Privacy Act. We believe these changes would strengthen the agencies' ability to address bank fraud and insider dealings, and it is our hope that a proposal will be ready soon for referral to the Congress.

Domestic Regulatory Activities

To conclude my testimony, let me describe the range of our domestic activities to fight money laundering in U.S. banks. First, the Federal Reserve provides several government agencies monthly reports on currency flows. These reports supply data on currency sent into and out of each of the 37 Federal Reserve offices. The purpose of the report is to establish payment patterns throughout the U.S. so that marked deviations in normal patterns can be identified and enforcement resources more efficiently deployed.

In addition, Reserve Banks provide currency shipping and receiving data to government agencies covering cash flows between the Federal Reserve and a particular depository institution which

is ordering or depositing cash. That information also is useful in establishing marked deviations in normal depositing and ordering patterns. The Federal Reserve is fully cooperative in responding to any requests for data of this type.

Examinations

The Board believes that the most effective way to ensure that banks are meeting the recordkeeping and reporting requirements of the Bank Secrecy Act is to conduct on-site examinations. The Federal Reserve has developed detailed examination procedures in this area and has held special training sessions for examiners as well as bankers. It is our policy to review compliance with the Bank Secrecy Act at each examination of a state member bank or Edge Act Corporation. In 1986, 844 such examinations were conducted and through the first quarter of 1987 an additional 227 examinations were completed. The number and intensity of our reviews of currency reporting requirements have increased steadily in the past five years.

During the period covered by these examinations deficiencies were discovered in 256 banks. These deficiencies included failure to file currency transaction reports, filing incomplete or inaccurate currency transaction reports, improper maintenance of exemption lists, and poor recordkeeping practices. In all cases, the banks have been required to initiate corrective action and in 16 cases the violations resulted in our forwarding details to the Justice Department for further review. Of course, as a matter of policy, every violation is reported to the Department of Treasury on a quarterly basis.

While considerable effort has been expended in recent years to ensure that adequate and in-depth examinations are being conducted, the Federal Reserve reviews on a regular basis its practices and procedures in an effort to strengthen its oversight activities. In addition, as already noted, the Federal Reserve actively participates in the Bank Secrecy Act Interagency Working Group that is chaired by the Treasury Department. This working group has developed new procedures that are designed to assist in

detecting violations of law. These procedures are currently in the process of being integrated into our examination instructions.

Regulation

Pursuant to the Anti-Drug Abuse Act of 1986, the Federal banking agencies have developed regulations that require banks to establish and maintain procedures to ensure compliance with the Bank Secrecy Act. The Federal Reserve published its regulations for this purpose as amendments to Regulation H on January 27, 1987. These amendments require banks to implement a written program that must be approved by the bank's directors to assure compliance with the recordkeeping and reporting requirements of the Bank Secrecy Act. The compliance program must, at a minimum, include four elements: (i) a system of internal controls; (ii) independent testing for compliance; (iii) designation of individual(s) to be responsible for compliance; and, (iv) appropriate training of employees.

Non-compliance with this regulation will result in the issuance of a cease and desist order. Although no such orders have

yet been issued based on this recently published regulation, the Board has included requirements to strengthen compliance with the Bank Secrecy Act in other formal supervisory actions. Between 1980 and 1986, the Board or the Reserve Banks entered into 165 enforcement orders or agreements with State member banks.

Provisions requiring corrective action relative to the Bank Secrecy Act were included in 25 of these enforcement orders.

Industry Education

In addition to focusing on strengthening regulations and examining procedures, efforts have been directed at educating banks and the public on the requirements of the Bank Secrecy Act and on Federal Reserve policies and procedures regarding currency reporting. Board staff members have participated in seminars and programs intended to educate bankers about the Bank Secrecy Act, especially as it relates to the Regulation H amendments and the requirements for currency reporting. We believe these seminars have been particularly helpful and have achieved a substantial degree of participation among bank managers and compliance

personnel. Regional programs conducted through our District banks have also provided opportunities for bank compliance officers to discuss issues and ask questions relating to the Bank Secrecy Act.

In order to provide assistance and guidance for state member banks in developing compliance programs, the Federal Reserve has developed and issued guidelines and sample documentation. These materials have been widely distributed and, we understand, have been particularly useful to banking organizations in developing compliance programs.

Applications

Any banking organization or bank holding company making application to the Federal Reserve receives a careful scrutiny to determine whether the organization is in compliance with the currency recordkeeping and reporting requirements of the Bank Secrecy Act. When violations exist, procedures require that a thorough analysis be performed that looks carefully at the nature of the violations, efforts taken by the Bank to cure the deficiencies, and procedures developed to prevent any future

occurrence. Applicants are required to provide detailed responses on the cause of the violations and to submit copies of their compliance programs, and procedures, and their related internal audit reports. Normal processing of any application is suspended until all questions relating to Bank Secrecy Act compliance are fully resolved. From the beginning of 1985 through May, 1987, 125 applications involved issues relating to Bank Secrecy Act compliance. In 25 of these cases, resolution of the compliance problems resulted in a delay in the processing of the application beyond the normal 60 day period.

Those cases that involve serious issues of noncompliance and that can not be resolved by furnishing additional information may require a special examination. These examinations are conducted either by the Federal Reserve or the regulatory agency responsible for the primary supervision of the applicant banking organization. No action is taken on any application until satisfactory compliance is demonstrated and any associated issues

are resolved. An ongoing investigation by any law enforcement agency, would also suspend processing of the application.

Conclusions

The Federal Reserve shares this Committee's concern that banking organizations not be used to launder funds or participate in other illegal or improper activities. To this end, we have devoted considerable effort and resources to monitor State member banks compliance with the Bank Secrecy Act and the Anti-Drug Abuse Act of 1986. We have tightened our examination procedures, put in place policies for carefully reviewing a bank's compliance record at the time an application is made, and taken steps to ensure that criminal referrals are made in a timely fashion with appropriate follow-up. The Federal Reserve has also contributed to banker educational programs and provided guidance to banking organizations for complying with the Bank Secrecy Act. Finally, we are pursuing cooperative efforts on the international level that we hope will heighten awareness of the need to strengthen supervisory and enforcement activities worldwide.

Despite these intense efforts, we recognize that we must remain vigilant and continue our efforts to improve compliance with the Bank Secrecy Act. Mr. Chairman, Members of the Committee, the Federal Reserve intends to continue to place strong emphasis on its oversight responsibilities for Bank Secrecy Act compliance and to contribute fully to efforts to eliminate money laundering.