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Statement by

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before the

Subcommittee on Financial Institutions Supervision,
Regulation and Insurance

of the

Committee on Banking, Finance and Urban Affairs

United States House of Representatives

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I appreciate the opportunity to appear before the Subcommittee today on behalf of the Federal Reserve Board to discuss whether existing laws to protect our nation's financial institutions from becoming havens for tax evaders, drug traffickers and other money launderers can be strengthened and whether new laws should be enacted.

I shall begin by focusing on the Bank Secrecy Act and on the various legislative proposals to strengthen the Act. As requested, I will then discuss whether certain titles of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRICA) need to be amended to provide the banking agencies with more effective means of curbing the use of financial institutions by criminal elements for illegal gains. Finally, I will offer the Federal Reserve's views on what might be done, in cooperation with foreign central banks and international organizations, to curtail money laundering activities.

Bank Secrecy Act

The Federal Reserve, together with the other banking agencies, has the responsibility for monitoring financial institutions to determine their compliance with the Bank Secrecy Act. In this regard, the Federal Reserve monitors state member banks and Edge Act corporations, a responsibility delegated to it by the Department of the Treasury, which has primary responsibility for enforcement of the statute. Enacted in 1970, the Bank Secrecy Act,

among other things, requires financial institutions to report certain currency transactions in excess of \$10,000 to the Treasury Department. As you know, the reporting and record-keeping requirements of the Bank Secrecy Act were designed to frustrate criminal activities that generate large sums of cash, such as drug trafficking, by putting the spotlight on large currency transactions.

As the Subcommittee is aware, in recent years there have been an unfortunate number of instances, including some involving large banking organizations, where financial institutions neglected to report currency transactions as required by law. In most cases these violations were not due to criminal intent on the part of financial institutions, but rather to their failure to put in place or enforce controls designed to ensure that transactions covered by the Act would be properly reported.

The widespread publicity surrounding these reporting failures heightened the awareness of financial institutions as to the importance of complying with the Bank Secrecy Act. Many banks conducted in-house compliance audits to find transactions that should have been reported under the law. Many of those that did find them voluntarily admitted their failure to report the transactions and paid substantial fines. These and other institutions have since made special efforts to tighten their compliance controls. As a matter of fact, the volume of Currency Transaction Report (CTR) filings has increased dramatically.

Therefore, in my view, it is time to consider streamlining and modernizing the reporting process-- especially for large institutions that must submit a high volume of CTRs to the IRS. This could include, for example, the use of computer-generated tapes and other technology to minimize the avalanche of paper. An additional benefit of such an approach might be improved compliance.

Federal agencies have also recognized that their enforcement procedures needed to be strengthened and, as a result, have made a concerted effort to improve compliance under the Bank Secrecy Act. Specifically, they have expended additional time and effort to increase the awareness of both financial institutions and examiners as to the requirements of the Bank Secrecy Act. An interagency working group, composed of representatives of federal banking and law enforcement agencies, has been strengthening enforcement procedures and improving communication and coordination among government agencies. Among other things, the group agreed recently to adopt uniform Bank Secrecy Act examination procedures. The group meets on a regular basis and will continue to explore methods to enhance the agencies' abilities to carry out their responsibilities under the Act.

In addition, the Federal Reserve has instructed its examiners to implement in-depth assessment procedures for Bank Secrecy Act compliance during all full-scope examinations. Previously, examiners conducted an in-depth

review only when a preliminary assessment of a bank's internal systems revealed some reason to intensify the investigation. The Federal Reserve has also expanded coverage of the Bank Secrecy Act in its training program for bank examiners.

Proposed Money Laundering Bills

Despite improved compliance with the Bank Secrecy Act, we know that better record-keeping alone will not put an end to money laundering in this country. Those engaged in money laundering are a resourceful lot and have incentives to circumvent even the most carefully crafted rules and regulations. Indeed, the ability to circumvent the law is an essential requirement for success in drug trafficking and other such activities. The use of "smurfs" to circumvent the existing law is a case in point. (Smurfs, or "runners," are couriers who convert funds derived from illicit activities into multiple transactions each less than \$10,000 in order to evade the currency reporting requirements of the Bank Secrecy Act.)

Yet efforts to curtail money laundering by making it more difficult and risky are clearly in the public interest and should continue. At present, however, the burden of the Bank Secrecy Act clearly falls more on depository institutions than on those directly involved in money laundering. While the reports required under the Act have been recently utilized to more effectively target money

laundering, they cannot in and of themselves put an end to laundering activities. In the Board's view, it is more appropriate to strengthen enforcement through better utilization of current resources, and to strengthen prosecution by making money laundering a crime, rather than to increase reporting burdens.

Because of the link between money laundering and cash-based criminal activity, the Board supports legislative efforts to limit the use of financial institutions by money launderers. Four of the bills before the Subcommittee (H.R. 2785, 1367, 1474, and 1945) would make money laundering a federal crime. This would approach the problem more directly; under present law, criminal activities are only indirectly tracked by monitoring currency transactions involving financial institutions.

Two proposed bills (H.R. 4573 and 3892) are aimed at giving enforcement authorities additional tools to prevent one common means of evading the Bank Secrecy Act--namely, structuring transactions involving more than \$10,000 into multiple transactions of a lesser amount. The Board supports efforts to limit such "structuring."

While we generally support the objectives of the bills before the Subcommittee, it is important that their provisions be closely evaluated to ensure that they pass a reasonable cost-benefits test. It is not possible to review in detail all of the provisions of these bills at this

hearing. However, we do want to stress that in this attempt to strengthen our laws, care should be taken to avoid the collection of more information than is necessary. For such an exercise does not significantly contribute to law enforcement efforts, and only adds to the costs of banking, which are passed on to the consumer.

With regard to specific bills, H.R. 1474 contains a provision that would require federal supervisory agencies to verify compliance with the Bank Secrecy Act in the course of every examination they perform. We currently check for such compliance when making regularly scheduled commercial bank examinations and are implementing numerous steps to strengthen our ability to carry out this function more effectively. We also perform carefully targeted examinations when the need arises. In those instances, in order to make more cost-effective use of our resources, we would like to retain the flexibility to determine the parameters and frequency of such visits. For these reasons, we suggest that the provision not be adopted by the Subcommittee.

H.R. 1474 would also provide that every exemption to the Bank Secrecy Act's requirements be approved by Treasury. Under current regulations, it is the responsibility of the financial institution to determine whether its customers are eligible for such exemptions. We agree with the testimony by Treasury before this Subcommittee that it is not desirable to shift this

determination to Treasury and away from the financial institutions that, after all, are in a better position to know the identity and transactional habits of their customers. Such a shift would be unduly burdensome to Treasury and to the financial institutions that would have to supply Treasury with the detailed information needed to make its determinations. Perhaps it would be better to retain current law which allows Treasury, by regulation, to make any such changes it deems necessary. H.R. 3892 would require Treasury to review annually all exemptions to currency reporting requirements granted by a financial institution to its customers. We suspect that this requirement might also prove unduly burdensome to Treasury and financial institutions.

H.R. 1474 would require that all outgoing international wire and other electronic transfers be reported on a Currency or Monetary Instrument Report. While we generally believe that wire and other electronic transfers should be included among the types of transactions regulated by the Bank Secrecy Act, we agree with the testimony given by Treasury before this Subcommittee which stated that this particular reporting requirement should not be imposed by statute. We question whether the burden imposed by the reporting requirement would be offset by the usefulness of the information that the reports would generate. Such information is more effectively acquired through Treasury's existing authority to require specific

financial institutions to provide copies to Treasury of all wire transfers taking place within a particular period of time.

H.R. 4280 would require a financial institution to keep special records relating to any cash transaction in excess of \$3,000. It is already within Treasury's ability to require this type of record-keeping by regulation as needed, provided it would assist law enforcement efforts in ways that would justify the burden imposed on financial institutions.

H.R. 4280 would establish that the amounts subject to currency transaction reporting requirements be at least \$10,000. Currently, Treasury has the authority to vary this amount as necessary to carry out its enforcement responsibilities. We believe that it is useful for Treasury to maintain its ability to respond to changing criminal practices rather than to mandate by statute, as this bill would do, a specific size of transaction to be covered.

H.R. 3892 contains a provision that would include any foreign subsidiary or affiliate of a United States commercial bank in the definition of financial institution for purposes of the Bank Secrecy Act. This would appear to subject these entities to reporting requirements, including filing CTRs for cash or currency transactions of \$10,000, regardless of whether they involve U.S. dollars. The Treasury regulations, as we understand them, do not extend

the reach of the present reporting requirements beyond our borders. H.R. 3892 would, for the first time, give extra-territorial effect to the reporting requirements, with the likely result of placing U.S. banks, in some instances, in conflict with local law and raising important areas of friction with many host countries who have been particularly sensitive to the extraterritorial application of U.S. law.

FIRICA:

Title I, Supervisory Control Over Depository Institutions

You asked that we revisit certain titles of FIRICA to determine whether they too could be strengthened to keep criminal elements from using financial institutions for illegal gains.

The basic thrust of Title I is to provide the bank regulatory agencies with enhanced tools for combating violations of banking laws and unsafe and unsound activities. Title I authorizes, among other things, the use of civil money penalties for violations of various banking laws (including the Board's Regulations D and O, Section 23A of the Federal Reserve Act, and the Bank Holding Company Act) and provides for enforcement authority against individuals, as opposed to institutions.¹

¹With regard to the authority of the bank regulatory agencies to take enforcement actions directly against individuals, I note that the U.S. Court of Appeals for the
(Footnote Continued)

Important though these powers are, we should bear in mind that the Federal Reserve Board is not a criminal law enforcement agency. While our examiners are trained in detecting questionable transactions, any suspected criminal activities are referred to appropriate law enforcement authorities. Therefore, the referral process is critical to successful prosecution under Title I.

The Federal Reserve has been working diligently to improve the criminal referral process. In August 1985, the Federal Reserve distributed to the financial institutions it supervises a uniform criminal referral form. Moreover, the Federal Reserve recently developed and implemented procedures to ensure that criminal referrals involving activities that may affect the safety and soundness of a bank or bank holding company are submitted directly to the Fraud Section of the Department of Justice for high level attention. In addition, procedures have been established to ensure that criminal forms submitted to the Federal Reserve are properly handled. Computer systems also have been

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Seventh Circuit, in the Larimore v. Comptroller of the Currency case, determined last week that the Comptroller of the Currency could not use its cease and desist authority to seek monetary damages from individuals for violations of law and unsafe or unsound banking practices. This decision was in conflict with other Court of Appeal's decisions, and it may severely limit the ability of the agencies to seek appropriate relief against individuals in matters, for example, involving unjust enrichment. In order to clarify the Federal Reserve's as well as the other bank regulatory agencies' authority in this area, it may be useful for Congress to consider legislation directed at this problem.

developed to track and cross-check the referrals against the activities of the Enforcement Section of the Board's Division of Banking Supervision and Regulation. In this manner, we are better coordinating the actions that must be taken under both civil and criminal law when illegal activity is suspected.

Title VI, Change in Control

Under the Change in Bank Control Act of 1978, bank regulatory agencies have the authority to act on notices involving changes in the control of insured banks and bank holding companies. The Federal Reserve is responsible, in particular, for notices involving state member banks and bank holding companies. Change in Control notices generally must be processed in 60 days. During this period, the reviewing agency considers among other factors, the financial condition and character of the prospective owner or owners. One important objective of this process is to weed-out individuals with criminal backgrounds, either by disapproving the Change in Control or, in effect, by allowing them to disqualify themselves by withdrawing their notice.

Typically, supervisory authorities are familiar with individuals who are seeking to gain control of a financial institution. Change in Control investigations in such cases proceed in a timely fashion. However, there are sometimes cases, such as those involving foreign individuals

or individuals who previously have not been involved in banking, where the applicant's background is not known. These cases require the reviewing agency to draw on information from law enforcement agencies and foreign banking agencies. Such information often is not received until well into the 60-day review period, making it necessary to invoke the 30-day extension period allowed under the Change in Bank Control Act in order to make a thorough investigation. We can, however, conceive of situations in which even the 30-day extension period would not be sufficient. Thus, we would favor an amendment to the Change in Bank Control Act that would allow the Board to extend the processing period in those rare situations when it is necessary to collect and evaluate additional information about potential criminal activity.

Title XI Right to Financial Privacy Act

The Right to Financial Privacy Act ("RFPA") was intended to protect bank customers' privacy rights, while enabling federal regulatory and law enforcement agencies to carry out their responsibilities under the law. The RFPA, among other things, prohibits access to the financial records of a customer of a financial institution by government authorities, unless the customer has authorized such disclosure, or the financial records are obtained pursuant to specified agency or law enforcement actions and the customer is given notice of such disclosure. Disclosure

also may fall within one of the other limited exceptions to the notice requirement, such as when the information is obtained through the examination process.

The RFPA, however, does not preclude any financial institution from notifying a government authority that it has information which may be relevant to a possible violation of any statute or regulation. In August of 1985, the Board adopted a uniform interagency criminal referral form for the use of the financial institutions under its jurisdiction. Similar forms subsequently were adopted by the other federal regulatory agencies. The form has been carefully structured to elicit information that we were not getting before, perhaps because of perceived RFPA problems. Out of the approximately 400 referrals made by these institutions since that time, only three have lacked necessary information due to perceived RFPA problems and these instances did not involve Bank Secrecy Act violations. We believe that the adoption of these forms by all supervisory agencies will address through administrative action many of the difficulties experienced by the law enforcement agencies in this area.

International Cooperation

I would now like to turn to the subject of international cooperation. In general, the Federal Reserve maintains extensive contact with foreign bank supervisory authorities in order to discuss broad supervisory issues relating to banking, such as capital adequacy and liquidity. The most visible example of such contact is the Basle Committee on Banking Regulations and Supervisory Practices, which consists of representatives from the central banks and bank supervisory agencies of the major industrial countries. In addition, the Federal Reserve regularly sends a representative to regional meetings of bank supervisors from the Caribbean, Latin America and Asia.

In our view, international steps to assist enforcement efforts are best handled through initiatives such as those undertaken by the Department of Justice to institute mutual legal assistance treaties between the United States and other countries. Such treaties include specific provisions addressing the use of international banking facilities for criminal activities. The Federal Reserve stands ready to assist the Justice Department by making quick referrals of suspected criminal activity to the appropriate authorities and by providing advice on international transactions.

At the same time, the Federal Reserve will continue efforts to heighten the sensitivity of banking authorities abroad to the problems of money laundering

through the international banking system. In June 1985, this subject was raised informally by the Federal Reserve's representative to the Basle Supervisory Committee. Another occasion for such discussions will be the forthcoming meeting of the Committee which is to be held in Washington at the end of June. A portion of the meeting has already been scheduled to include a discussion of current issues before United States banking authorities, and our representative plans to use this occasion to discuss the possibilities for greater cooperation and communication.

It is important to point out, however, that the ability of bank supervisors to deal with activities such as drug trafficking and money laundering is limited. It is, for example, difficult to monitor international financial transactions given the number and volume of such transactions each day. Moreover, even if such monitoring were feasible, it would be problematic, at best, to hope to draw valid conclusions regarding ultimate origins or destinations of individual transactions.

Further, both foreign and domestic bank supervisors usually are not empowered to investigate criminal activity and, therefore, must refer any evidence of illegal conduct to their respective law enforcement authorities. Foreign bank supervisors may also face serious legal obstacles when disclosure of information on individual customers is involved. It is with regard to these kinds of

obstacles that mutual assistance treaties are particularly useful.

Conclusion

In conclusion, I would like to emphasize that the Federal Reserve Board, in conjunction with other federal agencies, has intensified its efforts to address the problem of criminal activity involving financial institutions. The Bank Secrecy Act is but one of the several areas on which we have been focused. Bank fraud, officer and director misconduct, and insider abuse have also received special attention.

We understand the critical importance of promoting improved enforcement and prosecution of bank-related criminal activity, and we look forward to working with the Subcommittee as it reviews and weighs the merits of the various proposals before it.