

Susan Schmidt Bies: Bank Secrecy Act enforcement

Testimony by Ms Susan Schmidt Bies, Member of the Board of Governors of the US Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, US Senate, Washington DC, 3 June 2004.

* * *

Mr. Chairman, thank you for the opportunity to appear before the Senate Committee on Banking, Housing, and Urban Affairs to discuss the Federal Reserve's participation in efforts to combat money laundering and terrorist financing. The Federal Reserve and the other federal financial institutions supervisory agencies play a critical role in these efforts, and the Federal Reserve is actively engaged in a number of initiatives to refine and strengthen examination protocols in this area and to effectively deploy resources to prevent, identify, and address problems at the banking organizations supervised by the Federal Reserve.

In my remarks today, I will describe for you some of the important steps we are taking to fulfill our supervisory mission, to guide the institutions we supervise, and, in cooperation with the other banking and financial services regulators and the Treasury Department, to make every effort to use our supervisory tools to enhance the banking industry's role in preventing and detecting money laundering and terrorist financing. The Federal Reserve's anti-money laundering program is multifaceted. It involves work in bank supervision, applications, enforcement, investigations, training, coordination with the law enforcement and intelligence communities, and rule writing. This morning, I will touch on some of these aspects of the Federal Reserve's anti-money laundering program, but will concentrate on bank supervision efforts and enforcement matters.

I would like to begin with a few words about the Federal Reserve's supervisory philosophy in this area. The Federal Reserve has long shared Congress's view that financial institutions and their employees are on the frontline of the effort to combat illicit financial activity. The Federal Reserve believes that the banking organizations it supervises must take every reasonable step to identify, minimize, and manage any risks that illicit financial activity may pose to individual financial institutions and the banking industry. Accordingly, the Federal Reserve has required the financial institutions it supervises to put in place appropriate controls and risk management mechanisms, and has also devoted extensive resources to issuing guidance on legislative and regulatory requirements and sound banking practices, as well as to coordinating supervisory efforts with other agencies. In addition, the Federal Reserve uses its enforcement authority, where necessary, in the event that serious problems or risks cannot be satisfactorily addressed in the supervisory process.

Supervisory strategy and procedures for anti-money laundering and counter terrorist financing

It has been our longstanding policy that Federal Reserve supervisors incorporate a Bank Secrecy Act compliance and anti-money laundering program component into every safety and soundness examination conducted by a Reserve Bank. This means that on a regular examination cycle, examiners seek to determine if a banking organization's Bank Secrecy Act (BSA) and anti-money laundering (AML) compliance programs are satisfactory and are commensurate with the organization's business activities and risk profiles. Examinations are conducted at the state member banks, bank holding companies, Edge Act corporations, and U.S. branches and agencies of foreign banks supervised by the Federal Reserve. Every Reserve Bank has BSA/AML specialists and coordinators on its staff, and, since the late 1980s, the Board has had an anti-money laundering program in its supervision division overseen by a senior official. Simply put, Bank Secrecy Act and anti-money laundering compliance has for years been an integral part of the bank supervision process at the Federal Reserve. Furthermore, the Federal Reserve's enforcement program has a strong history of addressing both anti-money laundering and safety and soundness problems in formal actions, where necessary. While the number of actions may fluctuate somewhat from year to year, the Federal Reserve's exercise of its enforcement authority has been consistently strong and timely.

The Federal Reserve supervision process includes both on-site examinations and off-site surveillance and monitoring. The Federal Reserve generally conducts an on-site examination of each bank it supervises once every twelve to eighteen months, and at each examination staff reviews the institution's anti-money laundering procedures and its compliance with the Bank Secrecy Act, as

amended by the USA Patriot Act and new Treasury regulations. For large, complex banking organizations, the safety and soundness examination process is continuous, and anti-money laundering and BSA compliance is incorporated into examinations conducted throughout the year. The Federal Reserve always includes BSA/AML examinations in the supervisory strategy for every banking organization we supervise.

A key component of anti-money laundering examinations is the institution's compliance with the BSA compliance program requirement. The Federal Reserve and the other federal banking agencies have compliance program requirements for institutions they supervise. In general, the rules require a bank to establish, maintain, and document a program that includes:

- a system of internal controls to ensure ongoing compliance with the BSA,
- independent testing of the bank's compliance with the BSA,
- training of appropriate bank personnel, and
- the designation of an individual responsible for coordinating and monitoring day-to-day compliance with the BSA.

The Federal Reserve works to ensure that the banking organizations we supervise understand the importance of having in place an effective anti-money laundering program. When a Reserve Bank conducts a BSA/anti-money laundering examination of a banking organization under its supervision, the four components of the program establish the framework for the examination. To properly evaluate the effectiveness of a banking organization's anti-money laundering program, the Federal Reserve has developed comprehensive examination procedures and manuals, and regularly provides training for its examiners. The BSA/AML examination procedures are currently under revision to reflect newly issued regulations under the USA Patriot Act.

The Federal Reserve's BSA examinations are risk-focused. While a "core" BSA examination is required of all banking organizations, risk-focused procedures allow examiners to apply the appropriate level of scrutiny to higher-risk business lines, where necessary, and alleviate burden where high-risk products or customers are not present. In other words, a small state member bank with a low-risk customer base receives a considerably different and less burdensome BSA/AML examination than a large, complex banking organization with international operations.

The examination process

During every safety and soundness examination of banking organizations under Federal Reserve supervision, bank examiners specially trained in BSA requirements review the institution's previous and current compliance with the BSA. Examiners first determine whether the institution has included BSA/AML procedures in all of its operational areas, including retail operations, credit, private banking, and trust, and has adequate internal control procedures to detect, deter and report money laundering activities, as well as other potential financial crimes. As part of such an examination, bank examiners also review an institution's fraud detection and prevention capabilities, and its policies and procedures for cooperating with law enforcement (whether through responding to subpoenas, acting on information requests under section 314 of the USA Patriot Act, or otherwise).

Our supervision policy guidance in this area requires that examiners also conduct a review of the databases of Suspicious Activity Reports (SARs) and Currency Transaction Reports (CTRs) to determine if the banking organization that is about to be examined has filed such reports and that they appear complete and timely. Examiners are not doing this to count the number of SARs and CTRs, to compare their findings against other institutions, or to base any criticisms solely on a numerical count, but rather to make sure, for example, that the bank or U.S. branch of a foreign bank understands its obligations in this critical area and has taken steps to fulfill its responsibilities by filing timely and accurate reports with law enforcement and bank regulators.

The on-site examination begins as a review of the institution's written compliance program and documentation of self-testing and training, as well as a review of the institution's system for capturing and reporting certain transactions pursuant to the Bank Secrecy Act, including any suspicious or unusual transactions possibly associated with money laundering or other financial crimes. Transaction testing is generally conducted to verify these systems.

In those instances where there are deficiencies in the BSA/AML program, including failures to adequately document self-testing or training, obvious breakdowns in operating systems, or failures to implement adequate internal controls, the Federal Reserve's examination procedures require examiners to conduct a more intensified second-stage examination that would include the review of source documents and expanded transaction testing, among other steps.

There is an important correlation between the areas covered by a BSA/AML examination and an institution's overall risk management and internal controls. Thus, bank examiners take into account an organization's enterprise-wide corporate governance mechanisms and how they are applied. The Federal Reserve's bank examiners are able to apply a broad perspective and depth of organizational knowledge to the area of BSA/AML and to coordinate with examination and analytic staff to ensure that the safety and soundness and BSA/AML examinations are integrated and comprehensive. The Federal Reserve has found that there is an important synergy gained by integrating the safety and soundness and BSA/AML supervisory processes.

Enforcement actions

The Federal Reserve focuses significant resources on the prevention and early resolution of deficiencies within the supervisory framework. When problems are identified at a banking organization, they are typically communicated to the management and directors in a written report. The management and directors are requested to address identified problems voluntarily and to take measures to ensure that the problems are corrected and will not recur. Most problems are resolved promptly after they are brought to the attention of a banking organization's management and directors.

In some instances, however, examiners identify problems relating to anti-money laundering measures that are pervasive, repeated, unresolved by management, or otherwise of such serious concern that use of the Federal Reserve's enforcement authority is warranted. If the problem does not require a formal action, the Reserve Banks have the authority to take informal, non-public supervisory action, such as requiring the adoption of an appropriate resolution by an institution's board of directors or the execution of a memorandum of understanding between an institution and the Reserve Bank.

When informal action will not suffice, the Federal Reserve has authority to take formal, public enforcement action to compel the management and directors of a banking organization to address anti-money laundering and BSA compliance problems. These actions include written agreements, cease and desist orders, and civil money penalties, and are legally enforceable in court. These actions are not delegated to the Reserve Banks, and are undertaken only with the concurrence of the Board's General Counsel and the Board's Director of the Division of Banking Supervision and Regulation. Because these actions are public, they can have a significant impact on a banking organization, particularly one that is a public company. In determining whether formal action is appropriate, Federal Reserve staff considers all relevant factors, including the nature, severity, and duration of the problem, the anticipated resources and actions necessary to resolve the problem, and the responsiveness of the directors and management.

In cases where examiners have identified a violation of the compliance program requirement, the federal banking agencies are bound by law to take formal enforcement action. The same law requiring the banking agencies to promulgate rules requiring the four-part compliance program that I discussed earlier provides that if an institution fails to establish and maintain the required procedures, or if it has failed to correct any previously identified problem with the procedures, then the agency *must* issue a formal action requiring the institution to correct the problem. The Federal Reserve takes this responsibility very seriously and has issued a number of public actions against banking organizations in fulfillment of this statutory mandate. Federal Reserve staff exerts every effort to ensure that this statute is implemented consistently, and Board staff acts as a central coordinator for the examination and enforcement staff at the different Reserve Banks. Over the past three years, for example, the Federal Reserve has taken approximately twenty-five formal, public enforcement actions addressing BSA/AML-related matters. Actions have been taken against large banking organizations as well as smaller ones - the one constant is that the examination process identified regulatory violations in the organizations' compliance programs that, under the law, mandated the supervisory actions.

In addition to taking action itself, the Federal Reserve may refer a BSA-related matter to Treasury's Financial Crimes Enforcement Network (FinCEN) for consideration of an enforcement action based solely on BSA violations, rather than a program failure or issues relating to safety and soundness. Treasury has delegated to the federal financial banking agencies the authority to examine for BSA

compliance those institutions they normally examine for safety and soundness; however, Treasury has not delegated the authority to take an enforcement action, such as the assessment of a fine, for violations of the Bank Secrecy Act.

Federal Reserve staff coordinates enforcement actions with other regulators or agencies, including in the area of anti-money laundering. If a banking organization's problems involve entities supervised by different regulators, resolution of enterprise-wide problems may involve multiple enforcement actions. For example, the Office of the Comptroller of the Currency (OCC), FinCEN, and the Federal Reserve coordinated their recent enforcement actions against Riggs National Corporation; Riggs Bank, N.A.; and Riggs International Banking Corporation, the bank's Edge Act subsidiary, to ensure consistency and concurrent resolution of open issues. The Federal Reserve coordinates enforcement actions with state banking supervisors on a regular basis, and enforcement actions involving operations of foreign banking organizations may be resolved in cooperation with supervisors abroad. In several recent matters, there was close coordination with the U.S. Department of Justice as well.

The applications process

Before I describe some more aspects of the Federal Reserve's supervisory process, let me touch on a very important component of the Federal Reserve's anti-money laundering process - the processing of applications and notices filed with the Board. The Federal Reserve has had a longstanding practice of considering an applicant's compliance with anti-money laundering laws in evaluating various applications, including bank mergers and acquisitions of insured depositories by bank holding companies as well as applications filed by foreign banks to establish U.S. banking offices under the Foreign Bank Supervisory Enhancement Act. The USA Patriot Act included a provision memorializing our practice in the application area and required the Board to take into account the effectiveness of an applicant's BSA compliance program when it considers applications under various laws.

Under our longstanding protocols as well as the new law, every application matter considered by the Federal Reserve includes a BSA/AML compliance-related component whereby staff has to make specific judgments regarding an applicant's compliance with the law in this important area. While I cannot, of course, comment on specific cases, I can report to you that Board staff has on some recent occasions advised banking organizations considering expansion or other activities requiring the filing of applications with the Federal Reserve to concentrate instead on their BSA/AML programs. While not the full equivalent of an enforcement action, I am sure that you can appreciate the fact that every banking organization that is seeking or planning on seeking Federal Reserve approval of an application makes every effort possible to ensure that its anti-money laundering program is considered to be fully satisfactory by examiners and that any deficiencies that may be identified are addressed as expeditiously as possible. The applications process gives the Board a strong tool in the BSA/AML area.

Guidance to banking organizations

Turning back to the Federal Reserve's normal supervision process, Board and Reserve Bank supervisors seek to provide guidance to banking organizations to assist them to fully understand applicable regulatory requirements and what is expected by the regulators. While financial institutions are, of course, fully responsible for their own compliance, the supervisors play an important role in ensuring that regulatory requirements are correctly understood and uniformly applied. This is particularly true in areas such as compliance with new regulations promulgated since the USA Patriot Act.

The Federal Reserve views its supervisory role as including initiatives to enhance awareness and understanding by examiners throughout the Federal Reserve System, by banking organizations under Federal Reserve supervision, and by the financial industry at large. To promote a full understanding of anti-money laundering requirements, the Federal Reserve issues Supervision and Regulation letters, which are used to advise Reserve Bank supervisory staff, supervised institutions, and the banking industry about policy matters; provides on-going training to examiners; speaks regularly before the financial industry; and issues guidance in conjunction with other regulators and Treasury. These initiatives are meant to respond to or anticipate questions that arise regarding anti-money laundering requirements. The Federal Reserve is keenly aware of the resources that anti-money laundering and counter-terrorist financing requirements demand of financial institutions and believes that it is our duty to assist them in meeting their obligations.

Federal Reserve resource commitment

The Federal Reserve's BSA/AML function ranges from supervising and regularly examining banking organizations subject to Federal Reserve supervision for compliance with the BSA and relevant regulations, to requiring corrective action for detected weaknesses in BSA/AML programs, to enhancing money laundering investigations by providing expertise to the U.S. law enforcement community, and to providing training to U.S. law enforcement authorities and various foreign central banks and government agencies. Over the past three years, for example, Federal Reserve experts in BSA/AML-related matters have participated in special reviews of funds transfers for federal law enforcement and intelligence authorities, taught classes at FBI and Department of Homeland Security training academies, held seminars for central bank and foreign supervisory authorities in over ten countries, including Botswana, Mexico, Russia and the United Arab Emirates, and engaged in discussions on AML-related matters at international fora such as the Basel Cross-border Group and the Financial Action Task Force on Money Laundering (FATF).

Over the course of the past ten plus years, the Federal Reserve's anti-money laundering program has grown dramatically. From a senior official at the outset assigned to coordinate the Federal Reserve's BSA activities in the late 1980s, to the creation and staffing in early 2004 of a new section within the Board's Division of Banking Supervision and Regulation dedicated solely to anti-money laundering efforts (the Anti-Money Laundering Policy and Compliance Section), the Federal Reserve continues to commit a growing number of its resources to BSA/AML compliance. In 1993, the Federal Reserve System began the practice of designating a senior examiner at each of the twelve Reserve Banks to serve as a Bank Secrecy Act coordinator for the BSA examiners at that Reserve Bank. The number of senior BSA examiners throughout the System has grown tremendously, particularly since the enactment of the USA Patriot Act and the increasing complexity of BSA examinations. The web of BSA examiners throughout the Federal Reserve System is brought together through a direct communication channel with the Board's AML Policy and Compliance Section. This communication is an important tool for gathering examination experiences and providing consistent guidance throughout the Federal Reserve System.

By any standard, the Federal Reserve has taken a leadership role in the U.S. government's and international banking and regulatory community's anti-money laundering efforts.

Supervisory coordination

Due to the complexity of financial institutions today, it is imperative that the Federal Reserve coordinate with a long list of agencies on issues tied to the Bank Secrecy Act. First, the Federal Reserve views the Department of the Treasury and FinCEN as important partners due to their leadership role in administering the Bank Secrecy Act. In addition, for a number of complex financial institutions, the Federal Reserve shares supervisory and regulatory responsibilities with the OCC, Federal Deposit Insurance Corporation, and the Office of Thrift Supervision at the federal level, with the banking agencies of the various states, and with foreign banking authorities for the international operations of U.S. banks and the operations of foreign banks in the United States.

This network of partners requires a high degree of coordination. The regulatory authorities communicate constantly regarding BSA-related matters. For example, among bank regulators, there are a number of electronic systems in place that allow secure access to examination information. This allows regulators to monitor the status of organizations under their direct or indirect purview. It is also the Federal Reserve's practice to notify relevant functional regulators when a supervisory action may have impact on an institution subject to their supervision.

In addition, bank regulators collaborate in the development of consistent examination procedures and examiner training. The USA Patriot Act required a surge of rulemaking activity, and the Federal Reserve and its regulatory colleagues continue to advise Treasury as it completes this important work.

Law enforcement coordination

The Federal Reserve routinely coordinates with federal and state law enforcement agencies with regard to potential criminal matters, including anti-money laundering and financial crime activities. This coordination may occur when the Federal Reserve takes action to address matters that are also addressed in a criminal proceeding, when the financial condition of a bank is affected by a criminal matter, or when law enforcement draws on Federal Reserve staff expertise in its investigative work.

The Federal Reserve maintains open channels of communication with law enforcement, whether through interagency working groups or informal staff level contacts.

Conclusion

The Federal Reserve believes that banking organizations should take reasonable and prudent steps to combat illicit financial activities such as money laundering and terrorist financing, and to minimize their vulnerability to risks associated with such activity. For this reason, the Federal Reserve's commitment to ensuring compliance with the Bank Secrecy Act continues to be a high supervisory priority. The Federal Reserve has an important role in ensuring that criminal activity does not pose a systemic threat, and, as important, in improving the ability of individual banking organizations in the United States and abroad to protect themselves from illicit activities.

Thank you again for inviting me today to explain the Federal Reserve's work in this important area.