

Testimony of

John J. Byrne

On Behalf of the

American Bankers Association

Before a Joint Hearing of the

House Financial Services Oversight and Investigations Subcommittee

and

The House International Relations International Terrorism and Nonproliferation
Subcommittee

United States House of Representatives

May 4, 2005



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Subcommittee Chairwoman Kelly, Subcommittee Chairman Royce, Ranking Member Gutierrez, Ranking Member Sherman, and Members of the subcommittees, I am John Byrne, Director of the Center for Regulatory Compliance of the American Bankers Association (ABA). ABA appreciates this opportunity to discuss how the financial industry is addressing compliance with the USA PATRIOT Act and all of the laws covering financial institutions' anti-money laundering (AML) obligations.

ABA, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

ABA and our members continue to work with our government partners in training financial institution employees to effectively detect and report the myriad of financial crimes that involve money laundering and terrorist financing. We plan to address the expected interagency BSA-AML examination procedures later this summer. We have trained hundreds of thousands of bankers since the passage of the Money Laundering Control Act in 1986.¹ The industry's commitment to deterring money laundering continues unabated.

Among other things, ABA holds an annual conference with the American Bar Association on money laundering enforcement, produces a weekly electronic newsletter on money laundering and terrorist financing issues, offers online training on Bank Secrecy Act (BSA) compliance, and has a standing committee of more than 80 bankers who have AML responsibilities within their

¹ A 2003 survey by ABA Banking Journal and Banker Systems Inc. found that Bank Secrecy/AML/OFAC was the number one compliance area in terms of cost to the banking industry. It is also interesting to note that in banks under \$5 billion in assets, 75.6 percent of the employees said that compliance was not their only job.

institutions. In addition, we provide telephone seminars on important and often confusing issues such as money services business (MSBs) relationships and compliance with Section 326 of the USA PATRIOT Act.

In May 2004, ABA repeated a series of recommendations regarding “needed areas of improvement to USA PATRIOT Act oversight.” Since then, there has been clear movement and commitment for further action from the highest levels of the federal banking agencies. However, ABA remains concerned about the quality of communication that exists between these same agencies and their examiner forces. Although there are significant signs of improvement, we hope all communication problems will be remedied as soon as possible.

ABA and the 50 state banking associations stressed these themes in a January 10 letter to all federal banking agencies, as well as to the Department of the Treasury and the Financial Crimes Enforcement Network (FinCEN). This letter is attached. Please note that a response was received on April 18. We are hopeful that the major issues are being addressed.

To update Members on the various industry AML challenges, we offer the following observations and recommendations:

1. The detection of terrorist financing by banks or other financial institutions, whether through charities or any other entities, will not be successful without effective government intelligence and continued private sector involvement in organizations such as the Financial Action Task Force (FATF);
2. Whether in terms of BSA compliance or how banks work with MSBs, effective compliance with evolving AML requirements necessitates accompanying guidance. For example, it is counterproductive to label an entity “high risk” without also issuing guidance on how to mitigate that risk; and,
3. Until the financial sector receives improved guidance and a more balanced approach to examiner oversight, the volume of suspicious activity reports (SARs) that banks submit to regulators will continue to skyrocket, frustrating government efforts to accurately detect genuinely threatening activity.

Consistent Examination Procedures, Though Pending, Are Desperately Needed

ABA has previously emphasized to Congress that the banking agencies need to reach agreement on how the financial services industry will be examined for compliance under the PATRIOT Act and the other AML requirements. We are pleased to note that there is formal movement on coordination of examination procedures by the agencies and final procedures are now due out June 30. We will discuss one glaring problem – assessment of the adequacy of SAR programs, later in this testimony.

While we repeat our 2003 and 2004 calls for Congress to ask the regulatory agencies to report on and clarify their efforts in this area, ABA is pleased that the agencies are exhibiting a commitment to greater consistency in 2005. For example, not only has FinCEN Director William Fox expressed public support for uniform assessments, but he has also directed the Bank Secrecy Act Advisory

group (BSAAG) to form a subcommittee on examination issues. This subcommittee, co-chaired by ABA and the Federal Reserve Board, has met several times – as recently as April 29 – to discuss the pending interagency examination procedures.

Uniform exam procedures will assist with the industry concerns about examination inconsistency and the continued threat of “zero tolerance” by these same errant examiners. However, we strongly urge Congress to ensure that all banking agencies engage in industry outreach when the AML exam procedures are made public. The agencies appear committed to such outreach and we believe a nationwide series of “town meeting-type” events will ensure that both sides will know what to expect in this complicated compliance area.

MSBs and Banks: An Example of Regulatory Confusion

A major challenge facing the banking industry is how to fulfill its obligations regarding appropriate relationships with MSBs. The banking industry certainly understands and appreciates the need to analyze the levels of risk involved with maintaining MSB relationships. We know the importance of providing banking services to all segments of society. For some, the remittance services that MSBs frequently provide are an essential financial product. Remittance flows are an important and stable source of funds for many countries and constitute a substantial part of financial inflows for countries that have a large migrant labor force working abroad.

The problem, however, is how much analysis is sufficient. At times, banks appropriately exit relationships due to the risk inherent with a particular MSB. At other times, banks want to continue certain valued relationships.

Officially recorded remittances received by developing countries are estimated to have exceeded \$93 billion in 2003. They are now second only to foreign direct investment (around \$133 billion) as a source of external finance for developing countries. In 36 out of 153 developing countries, remittances were larger than all capital flows, public and private combined.

Remittance flows go through both formal and informal remittance systems. Because of the importance of such flows to recipient countries, governments have made significant efforts in recent years to remove impediments and increase such flows. At the same time, however, there has been heightened concern about the potential for remittance systems, particularly those operating outside of the formal banking system, to be used as vehicles for money laundering and the financing of terrorism. It is believed that the risk of misuse of remittance systems would be reduced if transfers were channeled through remittance systems that are subject to regulations by governments.

To address the risks, a two-pronged approach is evolving: One prong involves efforts by governments to encourage the use of formal systems (such as banks) by lowering the cost and increasing the access of users and recipients to the formal financial sector. Such efforts should concentrate on the reduction of artificial barriers such as unnecessary regulatory standards that impose costs ultimately borne by consumers.

The second prong includes initiatives by governments to implement anti-money laundering standards for entities such as MSBs. This has clearly been occurring in the United States and, as we have heard from other witnesses, the MSB regulatory infrastructure is robust and effective.

A challenge that underlies this situation is that there exists in most countries a large pool of “unbanked” individuals. Such individuals are often accustomed to using both formal (and regulated) financial institutions and very informal (and unregulated) financial services providers. Economic and social incentives that move this group towards “underground” financial services providers ultimately harm the interests of the unbanked, of law-abiding financial services providers, and of the general public. Moreover, the underground financial services providers may service both law-abiding unbanked persons, as well as criminals. Thus, governmental actions that discourage the unbanked from entering depository institutions may have the effect of also making anti-money laundering goals far more difficult to attain. These facts have helped make it clear that the MSB-bank environment needs radical change.

The necessary services that MSBs provide are being severely hampered by regulatory excess. The federal banking agencies issued an interagency policy statement on March 30 and sorely needed interagency guidance on April 26, but this guidance now must be clearly communicated to examiners.

On March 8, I had the opportunity to co-chair a meeting of BSAAG on the MSB problem. For eight hours, we heard dramatic examples from 44 witnesses of lost business, economic failures and rampant regulatory confusion. The theme of confusion was echoed by all of the banks. For example, Alex Sanchez, head of the Florida Bankers Association told us:

Financial institutions are closing legitimate accounts. Particularly in the area of [MSBs], financial institutions feel compelled to close their accounts. Most of these are the accounts of perfectly legitimate businesses. Many of them in Florida are businesses run by small entrepreneurs. They are gas stations, convenience stores, and grocery stores. They serve as a place where paychecks can be cashed. Some of them serve as agents of regulated money transmitters. These accounts are closed not because there is any evidence that they are engaged in improper activity, but because they fit into a regulatory profile.

The Florida Bankers Association also surveyed its members and found that 58 percent have curtailed their activities with MSBs and 83 percent experienced a change of attitude or approach of examiners conducting examinations in this area.

Another banker emphasized the value of small MSBs:

One of the common types of small businesses in our community is the small grocery store or convenience store. These are the businesses that often serve the immigrant and less advantaged community. These businesses are the connecting point for many in our society to the economic system. They are legitimate businesses serving a genuine need. Under the current regulatory scheme, we can no longer serve them.

FinCEN and the federal banking agencies are to be commended for working toward guidance to address this policy morass. We urge the agencies to act swiftly and inform examiners to adjust their reviews of MSBs that are associated with banks.

Lack of SAR Guidance Results in Unnecessary Filings

With the increased number of entities required to file SARs as well as the heightened scrutiny by regulators on SAR policies and programs, it is essential for the regulatory agencies, law enforcement, and FinCEN to assist filers with issues as they arise.

Government advisories and other publications are a critical source for recognizing trends and typologies for money laundering and other financial crimes. As the industry emphasized in the April 2005 issue of the interagency-authored publication, **SAR Activity Review**, there are a number of examples of activities that are characteristic of financial crimes and that can be used as teaching tools. This information is extremely useful for training purposes. As the private sector co-chair of the **SAR Activity Review**, I can assure you ABA supports the efforts of FinCEN and the participating agencies in crafting a publication that provides necessary statistical feedback to the SAR filing community. The **SAR Activity Review** has provided a variety of examples of suspicious activities that offer tell-tale signs of such diverse activities as identity theft, bank fraud, and computer intrusion.

We are pleased that the 2004 edition of the **SAR Activity Review** provided, for the first time, summary characterizations of all of the major suspicious activity categories. This should assist filers in advancing their understanding of the reporting requirements.

As stated above, there are several problems affecting banks in the AML exam process related to SARs. ABA has previously mentioned the many examples of examiner criticisms received by our members during reviews of their SAR programs. Whether it has been criticism of the number of SARs that the institution has filed or “second-guessing” by examiners as to why a SAR was not filed, this situation demands immediate attention.

Moreover, regulatory scrutiny of SAR filings (and the recent civil penalties assessed against banks for SAR deficiencies) has caused many institutions to file SARs as a purely defensive tactic (the “when in doubt, file” syndrome) to stave off unwarranted criticism or second guessing of an institution’s suspicious activity determinations. In fact, the *American Banker* has reported that, in March 2005, the banking industry filed 43,000 SARs: a 40 percent increase from a year earlier.

As FinCEN Director William Fox stated so eloquently in the April **SAR Activity Review**:

While the volume of filings alone may not reveal a problem, it fuels our concern that financial institutions are becoming increasingly convinced that the key to avoiding regulatory and criminal scrutiny under the Bank Secrecy Act is to file more reports, regardless of whether the conduct or transaction identified is suspicious. These “defensive filings” populate our database with reports that have little value, degrade the valuable reports in the database and implicate privacy concerns.

We would like to commend Director Fox for addressing our previous recommendation, which we outlined in testimony in May 2004, by creating a BSAAG subcommittee on SAR issues. We hope and expect that Congress will tackle the issue of SAR confusion head on. I would note that the first meeting is scheduled for later this month.

Our members share the concerns expressed by Director Fox, but without improved examiner training there are no other options to defensive SAR filings. Our hope is that the examination procedures and a mechanism for receiving interpretations on SAR issues will result in returning SARs to their original place – forms filed only after careful analysis and investigations with no second-guessing by regulators.

The Financial Action Task Force and Typologies on Charities

As Congress reviews how best to detect terrorist financing conducted through charities, it must be restated that the financial profile for this crime gives no direction to the financial sector on what can be done to prevent this activity in the absence of additional government information. This crime is difficult, if not impossible, to discern as it often appears as a normal transaction. We have learned from many government experts that the financing of terrorist activities often can occur in fairly low dollar amounts and with basic financial products (e.g., retail checking accounts). Guidance in this area is essential if there is to be effective and accurate industry reporting. The bottom line is that terrorist financing can only be deterred with government intelligence. A renewed commitment by law enforcement to real “information sharing” must become a priority, not a second thought.

The financial industry continues to struggle over how to assess what types of risks are relevant to spotting terrorist financing. To date, the only public examples are the typologies listed by the FATF for charities or “non-government organizations” (NGO’s). The FATF “warning indicators” in this area do not, in our opinion, offer any real insight as to what types of activities are inherent to risky charities as opposed to risks in any other entities.

Consider this sample of FATF warning indicators, for example:

- “Incongruities between apparent sources and amount of funds raised or moved, such as situations in which large amounts of funds are apparently raised within communities that have a very modest standard of living;
- A mismatch between the pattern and size of financial transactions on the one hand and the stated purpose and activity of the NGO on the other;
- A sudden increase in the frequency and amounts of financial transactions for the account of an NGO or the inverse, that is, the NGO appears to hold funds in its account for a very long period;
- Large and unexplained cash transactions by NGOs; and,
- The absence of contributions from donors located within the country of origin of the NGO.”

And so on. None of these examples are specific to charities; instead the factors are inherent to any suspicious activity. ABA believes that government organizations such as FATF could benefit from developing typologies after active consultation with the private sector, a goal that ABA is pursuing

through the International Banking Federation.² There appears to be progress in this area, but we urge Congress to recommend to FATF that there be a formal opportunity for the financial sector to be part of the FATF efforts in the areas of money laundering and terrorist financing.³

An Update to ABA's Call for Revamping the Outdated CTR System

As ABA has previously testified, the 35-year-old rules related to cash transaction reporting (CTR) have become redundant and lost their usefulness. ABA believes that the time has come to dramatically address this reporting excess by eliminating CTR filings for transactions conducted by seasoned customers through their bank accounts.

ABA notes that the purpose of Subchapter II of Chapter 53 of Title 31 establishing the BSA regulatory regime is to require certain reports or records when they have "a high degree of usefulness" for the prosecution and investigation of criminal activity, money laundering, counter-intelligence and international terrorism. ABA and its members strongly believe that the current CTR reporting standards have long departed from this goal of achieving a high degree of usefulness.

ABA members believe that CTR filing has been rendered virtually obsolete by several developments:

- formalized customer identification programs;
- more robust suspicious activity reporting; and,
- government use of the 314(a) inquiry/response process.

We believe that CTRs are no longer analyzed to identify unknown criminal agents. Rather they are used, at most, to try to match already known suspects to locate potential account activity. As noted above, section 314(a) is much more efficient for identifying account activity of known suspects because it has the value of capturing accounts involving more than just cash transactions.

We believe that combining improved monitoring conducted by institutions as part of their SAR processes with better mining of SAR data by law enforcement as well as judicious use of the 314(a) process yields a more effective approach to law enforcement investigation of patterns of fraud, money laundering and terrorism funding. Consequently, we believe the time has come to recognize

²The International Banking Federation, or IBFed, was created in March 2004 "to increase the effectiveness of the financial services industry's response to multilateral and national government issues affecting their common interests." The banking associations of Europe, the United States, Australia and Canada make up IBFed and the countries represented by the Federation have more than 18,000 banks, including 700 of the world's top 1000 banks. For more information, see: <http://www.ibfed.org/bba/jsp/polopoly.jsp?d=306&a=2279>

³IBFed has met with FATF and while the organization was told that it does not qualify for "Observer" status within FATF because eligibility is confined to governmental groups, the FATF has expressed interest in having regular contact with the private sector to discuss open issues, current developments and to receive feedback on proposals and thoughts. This is a positive development that we hope will eventually lead to formal involvement in issues such as the one we discuss today.

the redundancy of CTR filings for seasoned customers with transaction accounts and to eliminate this inefficient use of resources by bankers and law enforcement.

Changing the thinking about mandating the collection of routine cash data would have the following benefits:

- The vast majority of the over 13 million CTRs filed annually would stop, saving many hours a year in filling out forms;
- Wasteful SARs would cease. These SARs amount to almost 50 percent of all BSA-required SARs. Rather than filing specious structuring reports, banks could focus their energies on detecting suspicious handling of currency regardless of artificial thresholds;
- Bank systems and resources could be redirected from CTR monitoring to support further improvement in suspicious activity reporting;
- Regulatory criticism of technical mistakes with CTR filings would cease;
- Issues surrounding the CTR exemption process would be eliminated; and,
- Law enforcement could redirect resources to better evaluating SARs.

While BSAAG has been reviewing the cash transaction system with an eye toward simply modifying elements such as the exemption process, ABA believes that a more comprehensive approach overall is needed.

Conclusion

ABA has been in the forefront of the industry efforts to develop a strong public-private partnership in the areas of money laundering and now terrorist financing. This partnership has achieved much success, but we know that more can be accomplished. We commend the Treasury Department, banking agencies, and FinCEN for their recent efforts to ensure a workable and efficient process. ABA will continue our support for these efforts.

Thank you and I would be happy to answer any questions.

January 10, 2005

Federal Deposit Insurance Corporation
Chairman Donald E. Powell
550 – 17th Street, NW
Washington, DC 20429

Federal Reserve Board
Chairman Alan Greenspan
Board of Governors
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Office of the Comptroller of the Currency
Julie Williams
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Office of Thrift Supervision
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Washington, DC 20552

Department of the Treasury
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Secretary of the Treasury
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Financial Crimes Enforcement Network
Director William J. Fox
P.O. Box 39
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Ladies and Gentlemen:

The ABA and the undersigned state banking associations have been long-time partners with the Treasury Department and the federal banking regulators in the effort to prevent money laundering and, more recently, terrorist financing. We are proud of the commendations our industry has received from a number of agency and Administration officials, such as Treasury Under Secretary for Terrorism and Financial Intelligence, Stuart Levey, who stated: “The financial industry has been tremendously helpful in combating terrorist financing and is eager and willing to do more.” However, we are concerned that our industry’s efforts are being complicated, and in some cases undermined, by a lack of clarity in regulatory examination and enforcement.

While we recognize that there are individual instances where financial institutions may have fallen short and needed to improve their AML (anti-money laundering) and BSA (Bank Secrecy Act) programs and procedures, the lack of consistency in examination oversight and compliance guidance is a major theme of regulatory complaints received by ABA and the state banking associations.

In general, our members report that no standard appears to exist for a proper AML compliance program. What we hear from the regulatory leadership in Washington is often at odds with the information banks receive from field examiners. During conferences, seminars, and examinations throughout the country, bankers have heard language that indicates a “zero tolerance policy” for AML deficiencies. With the millions of daily transactions in the banking industry, a zero tolerance

threshold is simply unachievable, as has been recognized by Administration and regulatory officials in Washington.

Certainly the federal banking agencies and the Treasury Department understand that there is a strong “culture of compliance” in the U.S. banking industry. Our bankers want to work with regulators to address deficiencies wherever they occur, although it is difficult to do this when the standards are unclear and moving. Our compliance professionals are well trained in a variety of regulatory areas, but they are being overwhelmed by the sheer volume of obligations for regulatory compliance.

It must be emphasized that this massive regulatory burden has been so exacerbated by mandates such as Sarbanes-Oxley and the unclear rules on BSA that it is literally driving some community banks to sell to larger institutions. In addition, the difficulty of attracting individuals to serve on bank boards of directors has been increasing due to concerns about regulatory costs and the potential for punitive enforcement actions. It is clear that guidance and communication are essential.

One major area in need of guidance is the filing of suspicious activity reports (SARs). SARs, a major tool for law enforcement to investigate crimes against banks, are in danger of becoming routine filings that simply dilute FinCEN’s database. The increase can be attributed to “defensive filing” by banks that fear regulatory criticism or, worse, enforcement actions because of failing to file a SAR. FinCEN Director William Fox has also recognized this problem and urged that BSA compliance be handled correctly by bank examiners.¹

To achieve that goal, Director Fox has directed the Treasury’s Bank Secrecy Act Advisory Group (BSAAG) to look at methods to improve the current examination process. ABA co-chairs this subcommittee and continues to compile examples of what we believe to be erroneous interpretations of the BSA and AML requirements by bank examiners. These examples will be used by the BSAAG subcommittee. We are pleased to note that one crucial goal – to achieve consistent, common examination procedures – is currently being pursued by the bank regulatory agencies through interagency procedures, due mid-year 2005. We respectfully recommend that this process be completed as quickly as possible.

In addition, ABA and the undersigned associations urge the Treasury Department and the bank regulators, to also consider:

- joint industry/government training of bankers and examiners on BSA/AML obligations when the procedures are released;

¹ Director Fox spoke to the American Bankers Association and American Bar Association in October 2004 and addressed defensive filing of SARs: “We all know this phenomenon is occurring – we have both empirical and anecdotal evidence we can cite. We have seen financial institutions file reports in ever increasing numbers – often upon the recommendation of their lawyers or risk management teams – when the facts as presented do not meet this standard. I suspect that this over compliance is occurring for a reason. It is occurring because financial institutions are – justifiably in my view – unwilling to accept the regulatory or reputational risk associated with an action by the government that would make it appear that the institution is soft on anti-money laundering or, even worse, on terrorist financing.”

- a BSA staff commentary, FAQs and/or centralized regulatory guidance to achieve consistency in BSA/AML interpretations; and
- establishment of a BSAAG subcommittee to look at the variety of issues arising from the SAR process, particularly the problem of defensive filing.

The banking industry remains committed to work with the government in any way possible to further our joint goal of fighting money laundering and terrorist financing. The banking industry has always been a willing partner in stemming the flow of illegal funds through legitimate financial institutions. Continued joint efforts in this area must, and will, continue. However, we urge the Administration and the regulatory agencies to address the inconsistency and uncertainty that the industry is facing. Thank you for considering our concerns.

Sincerely,

American Bankers Association
 Montana Bankers Association
 Alabama Bankers Association
 Nebraska Bankers Association
 Alaska Bankers Association
 Nevada Bankers Association
 Arizona Bankers Association
 New Hampshire Bankers Association
 Arkansas Bankers Association
 New Jersey Bankers Association
 California Bankers Association
 New Mexico Bankers Association
 Colorado Bankers Association
 New York Bankers Association
 Connecticut Bankers Association
 North Carolina Bankers Association
 Delaware Bankers Association
 North Dakota Bankers Association
 Florida Bankers Association
 Ohio Bankers League
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 Oregon Bankers Association
 Idaho Bankers Association
 Pennsylvania Bankers Association
 Illinois Bankers Association
 Puerto Rico Bankers Association
 Indiana Bankers Association
 Rhode Island Bankers Association
 Iowa Bankers Association
 South Carolina Bankers Association
 Kansas Bankers Association
 South Dakota Bankers Association
 Kentucky Bankers Association
 Tennessee Bankers Association
 Louisiana Bankers Association
 Texas Bankers Association
 Maine Bankers Association
 Utah Bankers Association
 Maryland Bankers Association
 Vermont Bankers Association
 Massachusetts Bankers Association
 Virginia Bankers Association
 Michigan Bankers Association
 Washington Bankers Association

Minnesota Bankers Association West Virginia Bankers Association

Mississippi Bankers Association Wisconsin Bankers Association

Missouri Bankers Association Wyoming Bankers Association