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FEDERAL DEPOSIT INSURANCE
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TESTIMONY OF

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ON

BANK SECRECY ACT ENFORCEMENT, MONEY LAUNDERING AND CRIMINAL ACTIVITY IN INSURED FINANCIAL INSTITUTIONS

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION,
REGULATION AND INSURANCE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

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Room 2128, Rayburn House Office Building

Good morning, Mr. Chairman and members of the Committee. I am pleased to testify today on behalf of the Federal Deposit Insurance Corporation.

The FDIC insures approximately 14,300 of the nation's commercial banks and some 500 savings banks. I represent the FDIC's Division of Bank Supervision which is responsible for the supervision and examination of approximately 8,300 state chartered banks that are not members of the Federal Reserve System. While some of these institutions have assets over $1 billion, most are smaller banks serving the financial needs of their local communities. The FDIC examines these banks for safety and soundness, as well as for compliance with Federal laws and regulations, including the Bank Secrecy Act ("BSA") and the Treasury's currency reporting regulations.

My testimony today will describe the actions taken by the FDIC as a result of the enactment of the Money Laundering Control Act of 1986 and address other issues concerning the Bank Secrecy Act and bank fraud and insider abuse. I will begin by outlining the steps we have taken to require banks to monitor their own compliance with the BSA.

REQUIRED PROCEDURES FOR MONITORING BANK SECRECY ACT COMPLIANCE

On January 27, 1987, the FDIC Board of Directors adopted a rule requiring all insured state nonmember banks to establish and maintain procedures to assure and monitor compliance with the Bank Secrecy Act. Other federal regulators

adopted substantially the same regulation. The rule, which became effective on April 27, 1987, requires banks to install and maintain a compliance program that, at a minimum, provides for:

(1) A system of internal controls to assure ongoing compliance;

(2) Independent testing of compliance by bank personnel or by an outside party;

(3) A designated individual or individuals responsible for coordinating and monitoring day-to-day compliance; and

(4) Training for appropriate personnel.

The regulation requires a written compliance program that is approved by the bank's board of directors, with the approval noted in the board meeting minutes.

On May 16, 1987, the FDIC issued guidelines elaborating on the four minimum requirements of the FDIC's new regulation. A copy of the guidelines is attached as an Appendix. The guidelines stress that the new rules require banks to adopt internal procedures to insure compliance with the Treasury's regulations, but that the FDIC regulation does not supplant any of the Treasury rules. The guidelines notify banks that, in order to meet the minimum standards of the regulation, they must provide written instructions and copies of the Treasury's reporting forms to all employees involved in transactions with customers. The guidelines also emphasize that merely installing procedures that meet the minimum requirements will not be sufficient to satisfy our regulation if banks handle a large volume of currency, operate from numerous locations, or operate offices in border areas or in areas where money laundering or drug trafficking is prevalent. These

banks must install extensive controls, plans and procedures that go beyond the minimum requirements set forth in our rule. The guidelines notify banks that they will be cited for having an ineffective compliance program if numerous or serious violations of the Treasury's rules are discovered, even if their formal policies and procedures seemingly satisfy the regulatory standard. In other words, we are looking for substance over form.

In addition to promulgating the new BSA regulation and guidelines, the FDIC has taken steps to insure greater compliance with Treasury's regulations. On May 13, 1987, the FDIC notified all FDIC-supervised banks of changes in the Treasury's currency reporting regulations and advised them of their obligation to comply with those rules on or before the effective dates.

All State nonmember banks also have been supplied with the interagency examination procedures used by examiners. We have encouraged their use by bank auditors in order to check their own banks for compliance with the new independent testing requirement.

The new regulatory requirements place the responsibility for conducting BSA compliance audits squarely on the financial institutions. The FDIC's regulatory guidelines direct banks to conduct a compliance audit at least annually and strongly suggest that this responsibility be assigned to the internal audit department or to the bank's outside CPA firm.

In addition to directing bank regulators to require banks to adopt BSA compliance programs, the Money Laundering Control Act authorizes the agencies to use powerful new enforcement tools. Specifically, a cease and desist order

may be issued if the FDIC finds that an insured nonmember bank has failed to establish and maintain procedures to assure compliance with BSA regulations or to correct problems with its compliance procedures that have been cited by examiners. Civil money penalties of up to $1,000 a day for any single violation also can be assessed for failure to assure BSA compliance. These new civil enforcement powers enable regulators to take swift action against a bank while any possible criminal violations are pursued by the Internal Revenue Service on a separate track. Prior to the enactment of these amendments, civil action often was delayed, sometimes for lengthy periods, pending the outcome of a criminal investigation.

RIGHT TO FINANCIAL PRIVACY ACT

The letter of invitation requested comments on the Right to Financial Privacy Act ("RFPA"). The Money Laundering Control Act amended the RFPA to protect banks from civil suit for wrongful disclosure of RFPA-protected information if the bank's disclosure to law enforcement agencies is limited to:

(1) the name of any individual involved in suspected illegal activities;
(2) other identifying information about any individual or account involved in suspected illegal activities; and
(3) the nature of the suspected illegal activities.

Legislative history suggests that these amendments were designed to encourage banks to be good citizens and report suspected illegal activity. We believe the amended Act is adequate in this regard although there is currently some debate about what constitutes "suspected illegal activity." According to bank officials, it would be extremely helpful if guidance were available to aid

them in distinguishing "suspected illegal activity" from merely suspicious behavior. The FDIC, in conjunction with the Bank Fraud Enforcement Working Group, is currently revising the criminal referral form that is used by banks to report apparent crimes. After it is revised, the new form will direct banks to report suspected violations of the new money laundering statutes and to report transactions that are structured to evade currency reporting requirements -- the latter constituting a new offense under the law. When we inform them of these revisions to the criminal referral form, we also intend to offer guidance to FDIC-supervised banks on what constitutes a suspected violation of these new statutes.

When viewed in concert with the new money laundering statutes and the criminal reporting requirements, last year's amendments to the RFPA more clearly define the responsibilities of financial institutions to report suspected crimes in a prompt and concise fashion. Nonetheless, we believe additional amendments would be desirable to aid law enforcement and to protect public confidence in the banking system. Adding an insider exemption, such as the one proposed by this Committee in the last session, would improve the quality of examiner-generated referrals naming insiders and might permit prosecutors to undertake more cases involving bank employees without having to convene a Grand Jury. Such an exemption would thereby improve the efficiency of the system and the probability of prosecution.

We do not believe, however, that the insider exemption would stimulate significantly the flow of information from banks to federal law enforcement agencies about the suspected fraud and abuse of top-level managers. Moreover,

recent analysis of major criminal referrals involving FDIC-supervised banks reveals a growing proportion of fraud committed by outsiders, or by outsiders in conjunction with insiders. In our view, the insider exemption is not broad enough to effectively improve the criminal referrals of major cases and might complicate matters where both insiders and outsiders are suspected.

As an alternative, we recommend the RFPA amendment proposed by the Bank Fraud Enforcement Working Group. That amendment would permit the transfer, without notice to the customer, of financial information lawfully in the possession of one government authority -- such as a bank supervisory agency -- to another government authority -- such as the Justice Department -- for a law enforcement purpose within the jurisdiction of the receiving agency.

CHANGE IN BANK CONTROL ACT AMENDMENTS

The Money Laundering Control Act of 1986 made four major changes to the Change in Bank Control Act. Two of the changes clarified the FDIC's authority to investigate Change in Control Notices and to seek temporary or permanent injunctions to enforce compliance. The requirement to publish Notices of Changes in Control likewise validated an existing FDIC requirement directing the proposed acquirors to publish notice of their intentions in a local newspaper. Another amendment provided a 60-day review period for change in control notifications, an additional 30-day period in the discretion of the agency, and up to two additional 45-day periods for certain specified reasons. Prior to these amendments to the Change in Bank Control Act, the time for review was 60 days, an additional 30 days (agency discretion was not specifically mentioned) and unlimited additional time for certain specified reasons.

In the great majority of cases, the prescribed time periods are adequate to provide the necessary review before a proposed change in control may take place. But there have been occasions where, for reasons beyond the control of the FDIC, a final evaluation of an acquiror could not be made within the prescribed time. For example, if during an investigation of an acquiring party it is learned that the party is the subject of a Grand Jury investigation, the FDIC may not be able to determine the outcome prior to the expiration of the change-in-control time limits. We then are placed in the position of being unable to deny a change in control due to the absence of an appropriate basis for denial. However, the subject eventually may be charged with crimes, conviction of which would have provided a basis for denial. We are disadvantaged not only by our inability to obtain the result of the Grand Jury investigation, but also by the fact that our own investigation of the subject may be delayed or limited as a result of the ongoing Grand Jury investigation.

We are working through the Bank Fraud Enforcement Working Group to resolve this problem either through better cooperation or by proposing an amendment to Rule 6-E of the Grand Jury Secrecy Rules.

The Money Laundering Control Act also directed the regulatory agencies to make an independent determination of the accuracy and completeness of any information furnished by an acquiror in connection with a Notice of Acquisition of Control. Prior to this amendment to the Change in Bank Control Act, the type and scope of each investigation was left to the agency's discretion. We have issued new guidelines to our Regional Directors implementing this provision. These new guidelines formalize the investigation

requirements and, in some areas, expand the scope of investigation into the financial position and background of prospective acquirors of insured state nonmember banks.

Regional Directors are expected to make an independent determination of the completeness of any information required in connection with a Change in Control Notice and to prepare a report of their findings. The sources of background information have been expanded to include credit reporting agencies, news services, court records and independent appraisers. In addition, regional offices are authorized to require audited financial statements, to directly verify personal assets and liabilities and to conduct special investigations to determine the accuracy of the information submitted by a prospective acquiror.

At this time we would not recommend any additional substantive amendments to the Change in Bank Control Act. However, we would support some clarifying language and minor amendments to permit agency discretion in determining the accuracy of information submitted by a proposed acquiror and to provide an unlimited time period for reviewing a Notice under specified circumstances.

BANK FRAUD AND BANK FAILURES

The letter of invitation requested our views on the relationship between fraud and bank failures. Clearly, fraud and insider abuse are important factors in bank failures. Immediately prior to the closing of an insured bank, FDIC examiners attempt to assess the extent to which insider abuse and/or apparent criminal activity may have contributed to the failure of the institution.

Based on these assessments, we have concluded that serious insider abuse, fraud and/or apparent criminal activity contributed significantly to about one-third of the bank failures in recent years. This ratio has remained relatively constant over the past two years and so far in 1987. Except in a few obvious cases, it is difficult to isolate apparent criminal conduct from the broader conduct of insider abuse prior to a bank failure and virtually impossible to state unequivocally that such criminal conduct led to the bank's demise. Nevertheless, we estimate that outright criminal activity was a major contributing factor in 12 to 15 percent of bank failures.

Rather than concentrating on whether bank fraud and insider abuse is the cause of a bank failure, in our view it is much more useful to focus on bank fraud as a major national problem in both open and closed institutions. To illustrate, the FBI is currently investigating criminal conduct in almost 300 bank failure cases. However, over 7,000 cases of bank fraud and embezzlement are pending at the FBI, 3,000 of which involve losses over $100,000. As these figures indicate, bank fraud is not disproportionately associated with failed banks.

EFFORTS TO ADDRESS BANK FRAUD AND INSIDER ABUSE

Over the past two and one-half years, the FDIC -- of its own accord and in conjunction with the Bank Fraud Enforcement Working Group -- has taken several major steps to attack fraud and insider abuse in the nation's banking system. For example:

The criminal reporting system has been completely revised to require banks, by regulation, to report apparent crimes to U.S. attorneys, federal investigators and to the FDIC on a standard referral form.

Communication and cooperation with law enforcement agencies has been improved significantly through a network of personal contacts.

In March 1987, FDIC published a list of time tested "Red Flags" and other warning signs of fraud and abuse to be used as an aid to examiners and auditors.

The FDIC also has designated some 60 senior examiners as bank fraud specialists who will be given specialized training in bank fraud and insider abuse.

Training opportunities for examiners, investigators and liquidators have been greatly increased by the addition of an interagency school on white collar crime, joint FBI/examiner training sessions and expanded coverage in the FDIC schools.

The FDIC has designated special review examiners and regional counsel in regional offices to prepare criminal referrals, coordinate investigative assistance and testimony, and advise banks and other examiners on criminal laws and criminal referral requirements.

Liquidators and other employees of the Division of Liquidation now are given special training and refresher courses on bank fraud and insider abuse and investigation techniques.

Computer systems at both the FDIC and in the Justice Department have been installed to collect information about criminal referrals for tracking and analytical purposes and to identify subjects of criminal referrals by name recognition.

In addition to these steps, we are emphasizing the importance of codes of conduct and enhanced audit capabilities to deter and prevent fraud and abuse. We currently are considering a proposal to require FDIC-supervised banks to have an annual outside audit of their financial statements.

We believe these initiatives, together with the overhaul of the federal criminal code (specifically the new bank fraud statute, the amended bank bribery statute and the money laundering statutes), provide the necessary tools to deal with the problem. The resources to effectively use the tools, however, are in short supply. An acute shortage of prosecutors exists in certain sections of the country -- most notably Texas, Oklahoma and Southern California. As a result, we are concerned that many of the FBI's 3,000 cases that involve losses over $100,000 will not be prosecuted before the expiration of the applicable statutes of limitations.

INTERAGENCY COOPERATION

The Bank Fraud Enforcement Working Group has been mentioned several times already. This group was established by the Attorney General in late 1984 to

address the growing problem of bank fraud and insider abuse in the nation's financial institutions. The group's success in achieving its original goals has exceeded our expectations. The Bank Fraud Enforcement Working Group is largely responsible for the programs dealing with bank fraud and abuse that I mentioned earlier.

We have embarked on a similar approach to address money laundering and our Bank Secrecy Act responsibilities. At the direction of the Treasury Department, the Bank Secrecy Act Working Group was formed in May, 1986, to review and evaluate all aspects of the Bank Secrecy Act, to coordinate and promote more efficient BSA enforcement and to insure better cooperation and communication between Treasury and the various agencies assigned the responsibility to enforce the BSA regulations. Subgroups have been organized and are currently discussing the following issues:

(1) a plain English revision of the Treasury's currency reporting regulations;

(2) uniform reporting of violations and civil money penalty referrals;

(3) targeting of examinations;

(4) ways to transfer administrative rulings and other guidance to financial institutions; and

(5) guidelines for granting customer exemptions.

In short, the agencies are working closely together to improve regulatory efficiency and to inform the banking and thrift industries of their legal and moral obligations under the Bank Secrecy Act.

CONCLUSION

In testimony before this Subcommittee last year, we stated that the FDIC had begun to review Bank Secrecy Act compliance during safety and soundness examinations rather than only during compliance examinations and that we had begun conducting targeted examinations based on information provided to us by the Customs Service, IRS or Treasury. Our current examination strategy is to review for BSA compliance at safety and soundness examinations, at compliance examinations -- if a safety and soundness examination has not been conducted during, or is not scheduled for, the calendar year -- and at targeted examinations as directed by the Washington Office. Follow-up visitations are contemplated in cases where civil enforcement action is likely or has been initiated.

I would like to stress, however, the difficulty in detecting money laundering during the bank examination process. Even under the best of conditions -- when examination resources are not as strained as they are today -- FDIC examiners' presence in insured banks is limited to a few weeks out of each two- to three-year period. The examiner reviews only a sample of transactions, over a period of about two weeks, and visits only a few selected offices of the bank. Clearly, a review based on a small sample of

transactions cannot predict absolutely that failures to file currency transaction reports did not occur on the days not sampled. Moreover, corrupt employees can circumvent the bank's controls and conceal violations from examiners. Therefore, the examination process cannot assure day-to-day compliance.

The examination process also is not designed, and cannot be counted on, to detect suspicious activity emanating from outside the bank. What it can do effectively is to insure that banks install and operate internal controls and procedures to comply with BSA rules. The new compliance requirements promulgated under the Money Laundering Control Act that mandate internal controls, independent testing and training apply directly to day-to-day bank operations. As a result, the ability of the bank regulators to assure compliance with BSA regulations has been strengthened significantly.

This concludes my prepared statement. I will be pleased to answer any questions the Committee may have. Thank you.