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RISK MANAGEMENT AND REGULATORY FAILURES AT RIGGS BANK AND UBS: LESSONS LEARNED

HEARING

BEFORE THE

SUBCOMMITTEE ON
OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

JUNE 2, 2004

Printed for the use of the Committee on Financial Services

Serial No. 108–91

U.S. GOVERNMENT PRINTING OFFICE

95–062 PDF WASHINGTON : 2004

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
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RISK MANAGEMENT AND REGULATORY FAILURES AT RIGGS BANK AND UBS: LESSONS LEARNED

Wednesday, June 2, 2004

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 2:13 p.m., in Room 2128, Rayburn House Office Building, Hon. Sue W. Kelly [chairwoman of the subcommittee] Presiding.

Present: Representatives Kelly, Gutierrez, Moore, Maloney, and Matheson.

Chairwoman KELLY. The subcommittee on Oversight and Investigations will examine risk management and regulatory failures at Riggs Bank and UBS, lessons learned this afternoon.

Two weeks ago, this subcommittee explored proposals to streamline and federalize our current system to prevent money-laundering and terror financing. The recent cases involving Riggs Bank and UBS reveal regulatory and risk-management breakdowns that also must be examined in order to strengthen our Government's ability to enforce our anti-money laundering laws.

This afternoon, the subcommittee will investigate the noncompliant and inexcusable behavior of these two banks, along with the inadequate response of our regulators. In the OCC's oversight of the Riggs Bank's case, we find no better illustration of the inherent weaknesses of a fragmented regulatory regime.

We find a regulator that was reportedly aware of noncompliance by Riggs with high-risk foreign clientele as far back as 1997, perhaps even earlier, and does nothing about it. We find a regulator that was slow to act even after the September 11 terrorist attacks inside our borders made the threat posed by terror-funding networks all too clear. We find a regulator with credibility so diminished that Riggs shamelessly continued to violate the Bank Secrecy Act even after a full-time OCC examiner was placed on the bank's premises following last summer's consent order.

I am very interested in hearing directly from the OCC about how this happened. I am also deeply concerned that we are combating illicit funding networks inside our country with the regulatory structure that was not designed to be part of our arsenal in a war on terror.

Though a lot of great strides forward have been taken, particularly with the creation of the Office of Terrorism and Financial In-

telligence, the TFI, and with an elevated focus on improving FinCEN's capability, it is evident that this is still a work in progress. The time has come to replace slow-footed regulatory systems with one that is centralized, multi-dimensional and focused intentionally on preventing our financial institutions from being exploited by criminals and terrorists.

Therefore, this subcommittee will continue to pursue proposals that centralize our examination and compliance assets, that establish a criminal enforcement authority, that will restore the credibility of our regulators. Such reforms should establish clear lines of oversight, improve our ability to quickly detect and respond to suspicious activity and will make clear to financial institutions that, from now on, brazen violators are going to be going to jail instead of just paying a civil fine.

Our hearing today also focuses on UBS's contract with the Federal Reserve Bank of New York to serve as an extended custodial inventory which facilitates the international distribution of U.S. Currency. Beginning with its contract in 1996, UBS was in violation of its agreement to repatriate old U.S. banknotes and distribute—re-distribute new banknotes on behalf of the Federal Reserve. The bank knowingly traded U.S. currency through the ECI with countries subject to restrictions from the Office of Foreign Asset Control, including Cuba, Iran, Libya, and Yugoslavia. The most serious and disturbing violation has been the discovery that officers and employees at UBS intentionally falsified documents to side-step detection by U.S. authorities.

Though these actions and the company's failure to implement internal controls made it exponentially more difficult to detect suspicious activity, it is also important to examine how and why routine oversight by the Federal Reserve and the OCC didn't raise any concerns. In fact, this subcommittee is deeply concerned that contract violations would likely still be occurring today had our military not been in a position to find U.S. dollars from the Federal Reserve Bank of New York on the ground in Iraq. As such, I believe that we must investigate all ECI contracts to ensure that foreign governments and financial institutions are cooperating with our Government.

While Riggs Bank and UBS illustrate two distinct regulatory meltdowns, they both speak clearly to the need for improving our efforts to stop terrorist financing. It may create new and unfamiliar responsibilities for financial institutions, but it is a moral and ethical responsibility and a license required to do business in this country.

We thank our witnesses for their testimony and hope that they can shed some light on these issues. I look forward to continuing this discussion in the subcommittee's hearing next week regarding the oversight of the Department of Treasury and the agency's anti-money laundering efforts.

I turn now to Mr. Gutierrez.

[The prepared statement of Hon. Sue W. Kelly can be found on page 32 in the appendix.]

Mr. GUTIERREZ. Thank you Madam Chairwoman. Thank you for calling this hearing today. It is important, especially given recent events, as we closely examine our anti-money laundering efforts

and whether they are sufficient. I am pleased we will be looking—we will hear from the regulators about how these problems occur and what steps have been taken to prevent their re-occurrence.

The last time Congress was this concerned with the actions of UBS was when the Senate Banking Committee was investigating the sources of Holocaust financing and UBS attempted to shred documents which showed the extent of its involvement. I would have hoped that UBS would have learned from the experience to take U.S. law and the U.S. Congress much more seriously. I also recall the reluctance of Swiss banking authorities to cooperate at that time. While I understand that the Swiss Federal banking economist was much more helpful in this effort, most foreign bank supervisors simply lack the supervisory tools and authority of our regulators here in the U.S.

I think, perhaps, this extended custodial inventory, ECI, business should be restricted to U.S. Institutions so that we can ensure no dealings with OFAC nations, and nations' activities can be closely supervised by U.S. Regulators who need to take an active role in monitoring these activities.

While this fine of a $100 million seems very large, it is merely, I believe, a drop in a bucket of a $1 trillion institution. It is a one-time penalty that may not have the deterrent effect against misconduct that we may have hoped for. In this case, the ECI business wasn't particularly profitable for the bank—or they say—so the termination of the contract and the exclusion from the part of their business isn't likely to hurt their financial bottom line very much. It might make more sense to punish an institution of the size of UBS by restricting their conduct in a more profitable area, such as their ability to operate in the United States or making them sell off certain aspects of their business which we know to be profitable.

I am also deeply troubled by the Riggs situation. It represents not merely a failure of one institution's internal controls, but a fundamental flaw in its regulation. It is my understanding that the flaws in Riggs systems were long outstanding and systematic, dating well before the Patriot Act. The recent consent order is something that should have happened 2 years ago, if not earlier. I don't understand why the OCC was not more vigilant on this front and why it took them so long to take these actions.

I also understand that Rigg's problems were initially discovered by the FBI, rather than the OCC, and that the irregularities in New Guinea were discovered by the bank itself and not the OCC. I don't understand, in a risk-based supervisory system, why the OCC was not more closely monitoring Riggs and why these actions were not brought to light much sooner and appropriate action taken. 9/11 was a wake up call for the industry and should have been for all regulators as well. Our safety depends on banks and bank regulators to be on the front lines to prevent terrorists from using international financial systems to fund their activities.

I am gravely concerned that the regulator has not made this responsibility a higher priority, and their resources may be spread too thin to fulfill their obligations. I have previously expressed this concern about the OCC's attempt to broaden their portfolio into areas the Congress has not authorized. And I think, in fact, the fi-

nancial services committee is on the record in agreeing with me on this point.

One final point which I mentioned at our May 18 hearing, the OCC issued, its fine, late on a Thursday. On that Friday, a Maryland woman called her Congressman. She was very concerned about her bank account at Riggs Bank. She was referred to the Banking Committee staff. And she said that she wanted to talk to the regulator. My staff supplied the phone number for the OCC's Customer Assistance Group. But unfortunately, they don't operate on Fridays. They only talk to consumers 4 days a week and then only from 9 to 4, so that woman had to wait from Thursday night till Monday before she could possibly reach someone at the OCC.

I would like to know what consumers are supposed to do when the OCC is not operating its call center. I think this agency is not concerned about consumers, and I have to doubt its commitment to an anti-money laundering effort.

Thank you again, Chairwoman Kelly, for calling this hearing, on this hearing, on this issue.

Chairwoman KELLY. Thank you, Mr. Gutierrez.

Ms. Maloney? Whoops. Mr. Moore?

Mr. MOORE. Madam Chairperson, I will simply welcome the witnesses here today.

I want to listen and learn, and I appreciate your convening this hearing.

Chairwoman KELLY. Thank you.

Mr. Matheson?

Mr. MATHESON. I will just reiterate what Mr. Moore said. I am looking forward to the hearing. Thank you, Madam Chairwoman, for calling it.

Chairwoman KELLY. Thank you.

I am going to just simply say that, without all objection, all Members' opening statements will be made part of the record. One of the reasons for this is that we have a very busy schedule right now, and we were going to, with unanimous consent, we will just make them all part of the record.

Chairwoman KELLY. Now, I would like to introduce our panel. With us today are the representatives from the Office of the Comptroller of Currency and the Federal Reserve Bank of New York.

Our first witness, Mr. Daniel Stipano, was appointed deputy chief counsel of the OCC in December of 2000. He is also a member of the Treasury Department's Bank Secrecy Act Advisory Group and the National Interagency Bank Fraud Working Group. Prior to this appointment, Mr. Stipano served as director of the OCC's Enforcement and Compliance Division since 1995.

Our second witness is Mr. Thomas C. Baxter, Jr., general counsel and executive vice president of the legal group at the Federal Reserve Bank of New York. Mr. Baxter has assumed this role since 1995 and also serves as its deputy general counsel of the Federal Open Market Committee. His principal responsibility is to supervise the day-to-day operation of the New York Fed's legal group. That is a big job. We thank you.

And we thank you for being here. We thank you for your testimony today. And without objection, your written statements will be made part of the record.

If you have not testified before a committee before, you will be recognized for a 5-minute summary of your testimony. There are lights there that will come on the boxes. The green light means you have 5 minutes. The yellow light means, please sum up in 1 minute, and the red light means, if you haven't already summed up, please try to do that as quickly as possible. Thank you very much.

And we will begin with you, Mr. Stipano.

STATEMENT OF DANIEL P. STIPANO, DEPUTY CHIEF COUNSEL, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. STIPANO. Chairwoman Kelly, Ranking Member Gutierrez and members of the Subcommittee, I appreciate this opportunity to discuss the OCC's supervision of Riggs Bank N.A. and particularly our efforts to bring Riggs into compliance with the Bank Secrecy Act. The OCC and FinCEN recently assessed a $25 million civil money penalty against Riggs for violations of the BSA. The OCC also took a separate cease and desist action to supplement the Order issued against the bank in July 2003.

The OCC first identified deficiencies in Riggs procedures several years ago. Beginning in the late 1990s, we recognized the need for improved processes at Riggs and for improvements in the training in, and awareness of, the BSA's requirements and in the controls over their BSA processes. Prior to 9/11, the OCC visited the bank at least once a year and sometimes more often to either examine or review the bank's BSA compliance program.

Over this time frame, OCC examiners consistently found that Riggs' program was either satisfactory or generally adequate, meaning it met the minimum requirements of the BSA, but we nonetheless continued to find weaknesses and areas of its program that needed improvement. We addressed those weaknesses using various informal supervisory actions.

After 9/11, the OCC escalated its supervisory efforts to bring Riggs' compliance program to a level commensurate with the risks that were undertaken by the bank. In 2002, the OCC conducted a series of anti-terrorist financing reviews at our large or high-risk banks, including Riggs. As a result of these reviews and other internal assessments, plus published reports of suspicious money transfers involving the Saudi Embassy accounts, our concerns regarding Riggs' anti-money laundering program were heightened. Thus we conducted another examination of Riggs in January 2003.

The focus of that examination was on Riggs' embassy banking business and, in particular, the Saudi Embassy accounts. The examination lasted for approximately 5 months and involved agency experts in the BSA and anti-money laundering area. It disclosed serious BSA compliance program deficiencies that resulted in the bank's failure to identify and report suspicious transactions occurring in the Saudi Embassy accounts.

The finding from the January 2003 examination formed the basis for the July 2003 cease and desist order.

Throughout this examination, there was regular contact with the FBI investigators. We provided the FBI with voluminous amounts of documents and information on the suspicious transactions, and we hosted a meeting with the FBI to discuss these documents and

findings. Throughout this process, we provided the FBI with expertise on both general banking matters and on some of the complex financial transactions that were identified.

The OCC began its next examination of the bank's BSA compliance in October 2003. The purpose of this examination was to assess compliance with the Order and the USA PATRIOT Act and to review accounts related to the Embassy of Equatorial Guinea. The examiners found that, as with the Saudi Embassy accounts, the bank lacked sufficient policies, procedures, systems and controls to identify suspicious transactions concerning the bank's relationship with Equatorial Guinea. The findings from this examination as well as from previous examinations formed the basis for the OCC's recent civil money penalty and cease and desist actions.

In retrospect, as we review our BSA-compliance supervision of Riggs during this period, we should have been more aggressive in our insistence on remedial steps at an earlier time. We also should have done more extensive probing and transaction testing of the Embassy accounts. As described more fully in my written testimony, we have reevaluated our BSA supervision processes in light of this experience, and we will be implementing changes to improve how we conduct supervision in this area.

While not to be minimized, the Riggs situation must be put in broader context. Unlike other financial institutions which have only recently become subject to compliance program and suspicious activity reporting requirements, banks have been under such requirements for years. Not surprisingly, banks are widely recognized as the leaders among the financial services industry in the anti-money laundering area. The role of the OCC and the other Federal banking agencies is not that of criminal investigators, but rather to ensure that the institutions we supervise have strong anti-money laundering programs in place. As a consequence of our supervision, most banks today have strong anti-money laundering programs, and many of the largest national banks have programs that are among the best in the world.

In conclusion, the OCC is committed to preventing national banks from being used wittingly or unwittingly to engage in money laundering, terrorist financing or other illicit activities. We are ready to work with Congress, the other financial institutions regulatory agencies, law enforcement and the banking industry to continue to develop and implement a coordinated and comprehensive response to the threat posed to the Nation's financial system by money laundering and terrorist financing.

[The prepared statement of Daniel P. Stipano can be found on page 54 in the appendix.]

Chairwoman KELLY. Thank you very much.

Mr. Baxter.

STATEMENT OF THOMAS BAXTER, JR., GENERAL COUNSEL AND EXECUTIVE VICE PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK, ACCOMPANIED BY KATHERINE WHEATLEY, ASSISTANT GENERAL COUNSEL, AND MICHAEL LAMBERT, FINANCIAL SERVICES CASH MANAGER

Mr. BAXTER. Chairwoman Kelly, Representative Gutierrez and Members of the subcommittee, my name is Thomas Baxter, and I

am the general counsel and executive vice president of the Federal Reserve Bank of New York.

At the New York Fed, I have responsibility for the Legal Department, Security and the Court Secretary's Office. With me today are two representatives of the Federal Reserve Board, Katherine Wheatley, assistant general counsel, and Michael Lambert, financial services cash manager.

Chairwoman KELLY. We welcome their presence. Thank you very much, Mr. Baxter.

Mr. BAXTER. We appreciate your invitation and are privileged to appear before you to discuss the Federal Reserve's operation of the extended custodial inventory, or ECI program, and our responses to UBS's misconduct in operating one of our ECI facilities.

The U.S. dollar is the most desired form of money in the world. In many ways, our dollar represents the strength of the American economy. The dollar is so desired around the world because it is a stable, always-reliable medium of exchange and store of value. Today, I will be speaking about the Federal Reserve's operation of the ECI program, and I should start by describing that program.

In operation since 1996, when the Treasury, Secret Service and Federal Reserve collectively decided to launch it, the ECI program has been a great success. The program sustains the quality of the U.S. dollar banknote, helps to deter counterfeiting and provides an efficient and effective mechanism for the distribution of those notes in our largest market, the market outside of the United States. We estimate that up to two-thirds of our currency, or over $400 billion, circulates outside of the United States.

The ECI program involves the use of financial institutions, mainly commercial banks, that are highly active in the international currency distribution business as Federal Reserve contractors. These institutions agreed to extend the Federal Reserve's reach into major financial centers of other countries and hold inventory of our most popular product, that is the Federal Reserve note. They do this by holding in custody for us in their vaults U.S. dollar notes that we expect to distribute abroad or old and unfit notes that we wish to repatriate. The, quote, "extended custodial inventory," unquote, facility, helps to assure the quality of our product and its efficient distribution.

With respect to quality, the ECI facility performs two important functions. First, it positions us to better monitor and control the quality of our product by identifying counterfeit notes. The ECIs are well situated to detect such notes, to remove them from circulation, to provide intelligence to law enforcement authorities, both here and abroad, and to distribute new authentic notes. They perform similar functions with respect to what we at the Federal Reserve call unfit notes, which is a cash-processing codeword for worn and dirty.

As for the efficiency of our distribution network, through our ECI contract partners, we are positioned in high-volume, wholesale banknote markets. Currently, these markets are located in London, Frankfurt, Zurich, Hong Kong and Singapore. At the present time, we have ECI contracts with American Express Bank, Bank of America, HSBC Bank USA, the Royal Bank of Scotland and United Overseas Bank. Our ECI contractors bring into the markets they

serve new fit notes quickly, and with similar expedition, they repatriate unfit or old-design notes to the United States for destruction.

They have ready a substantial inventory of notes to satisfy the periodic spikes in supply and demand encountered in a world full of uncertainties. Because these notes are Federal Reserve property, the ECI contractors do not have to finance the inventory when it is not needed. This leads me to my first point.

The experience that we have had with UBS does not change the fact that the ECI program is a success, nor should it detract from the importance of the program to the Federal Reserve, the Treasury, and the Secret Service. I hasten to add that I am in no way trying to minimize what UBS did. The breach by UBS of our contract was wrongful, and the concerted acts of deception by UBS carried out over a long period of time, violated our laws.

The Federal Reserve terminated the contract with UBS in October of 2003. And we assessed a $100 million civil money penalty against UBS on May 10, thereby remedying the breach and punishing UBS's deception. This leads to my second point, which looks at how we respond when someone doing our business performs badly.

The prompt corrective action taken to terminate the Federal Reserve's contractual relationship with UBS and to punish deception by UBS with a large monetary penalty demonstrates a resolve that Federal Reserve operations will be conducted to the highest standards and in full compliance with U.S. legal requirements. In this regard, it is noteworthy that our ECI contracts in essence export U.S. legal requirements, including OFAC restrictions, to offshore facilities. The U.S. sanctions regime generally cannot be applied extra-territorially.

When the Federal Reserve learned that UBS breached its contractual obligations to abide by the restrictions of the U.S. sanctions program and engaged in U.S. dollar transactions with impermissible jurisdictions, we acted swiftly and surely. We terminated our contract with UBS and debited UBS's account with us for the entire inventory maintained in the Zurich vault.

In a day, UBS lost an entire business line that had been profitable throughout the 8 years that UBS served as an ECI contractor. The forfeiture of profitable business is a financial consequence. UBS also suffered a reputational injury. Through the related action of our colleagues at the Swiss Federal Banking Commission, UBS is forbidden from reentering the wholesale external banknote business without the permission of the commission. This leads to my third point.

The Federal Reserve will not tolerate deception. We will not tolerate deception from those banking organizations that we supervise, and we will not tolerate deception from those with whom we contract to execute important Federal programs. The ECI program is one such program. To transact business out of the Zurich facility with Iran, Cuba, Libya, and Yugoslavia, as UBS did, UBS personnel needed to act covertly and to hide their activity from the Federal Reserve. The people who engaged in such conduct in Switzerland have lost their jobs. The business franchise is no more. In the civil money penalty that we announced on May 10, UBS paid

a heavy price for the deceit of the banknote personnel which it formally employed.

Turning for just a moment back to the ECI program, the imposed penalty gave our remaining ECI operators 100 million reasons to be truthful. And on top of all of that, the Swiss Federal Banking Commission issued a formal, public, quote, "reprimand," unquote to the largest bank in Switzerland. The banknote personnel of UBS deceived people at the Banking Commission just as they deceived us. Our colleagues at the Banking Commission joined with us in finding such deception inexcusable and warranting that reprimand. This brings me to my fourth and my final point.

At the Federal Reserve, we are dedicated to continuous improvement, and we know that all internal controls can be bolstered through the lessons of experience, including our own unfortunate experience in the UBS matter. That experience has shown that our primary control for compliance with the country restrictions in the contract, namely, truthful monthly reporting of currency transactions by country, was just not sufficient. With the country reports that we received from UBS, we did not follow the old audit admonition, quote, "trust but verify," unquote. Since February of this year, our ECI contracts have a number of new features that enhance the control environment and provide for the necessary verification. One is the requirement that management of our ECI contractors attest yearly on contract compliance and accurate reporting and that an independent public accounting firm certify to the Federal Reserve that the management attestation is fairly stated. This Sarbanes-Oxley inspired change shows our commitment to continuous improvement.

Another new feature is a 17-point procedural program that spells out the ECI contractor's responsibilities for OFAC and anti-money laundering compliance. This program provides for OFAC risk-assessments, requires the implementation of ECI program internal controls, establishes operational responsibility for compliance and specifies internal and external audit requirements. Moreover, each ECI operators policies and procedures directed at OFAC's compliance will be reviewed by a team of experts from both the New York Feds and OFAC.

Let me conclude by summarizing my four points. The ECI program is important and successful because it fosters the excellent quality of U.S. currency, and it has efficient distribution outside the United States. When someone performs poorly in the ECI program, you can be assured that the Federal Reserve will respond with prompt force, full corrective action. If there is deception in addition to poor performance, as was the case with UBS, the consequences will be severe. Finally, we will strive to continuously improve our internal controls and the ECI program by borrowing the best ideas and by learning lessons from our experiences. Thank you for your attention. And I look forward to answering any questions you may have.

[The prepared statement of Thomas Baxter Jr. can be found on page 36 in the appendix.]

Chairwoman KELLY. Thank you Mr. Baxter. I am sure there will be questions.

I am going to turn to you, Mr. Stipano. I have seen news reports that indicate that your agency was aware of compliance problems at Riggs as far back as 1998, 1997 or 1999 and I see your testimony says late 1990s. When exactly, what month and year, did the OCC recognize problems and violations were occurring at Riggs?

Mr. STIPANO. Well, I can't give you the month, but I can give you the year. As far back as 1997, we cited the bank for deficiencies in its Bank Secrecy Act compliance program. The types of deficiencies that were flagged at the time tended to have to do with the individual elements of a compliance program, in other words, with training, internal controls, testing, et cetera. Those deficiencies were somewhat technical in nature and were not really at a level that would normally require use of formal enforcement action to correct.

Chairwoman KELLY. Is there—Mr. Stipano, I am going to ask you this again.

Mr. STIPANO. Okay.

Chairwoman KELLY. I would like to know a month. If it was 1997, what month?

Mr. STIPANO. I don't have that information at my fingertips. We would be happy to provide it to you though.

Chairwoman KELLY. I would appreciate if you will do that.

[Subsequently Mr. Stipano advised Mrs. Kelly that the month was August of 1997.]

Mr. STIPANO. We will do that.

Chairwoman KELLY. I think that is important for us to know.

Mr. STIPANO. Understood.

Chairwoman KELLY. The problems you just outlined, training, testing, internal controls, why did it take 6 years for the SAR reports, that problem not to come to light? Your agency knew that there were violations at Riggs. It took an unusual step in 2003 to put a full-time examiner on-site, but it wasn't until 2004 that you took some action by assessing a fine.

I think you would agree that eradicating terror financing is one of the most time-sensitive issues that has ever faced our financial regulatory system. I want to know why the agency dawdled before taking any real action if you knew about these problems. You knew about them 3 years before 9/11. But even after that wake-up call, it took another 2 years before you got a full-time examiner on site, and the violations were still continuing with your full-time examiner.

I just—you know, I just—it boggles my mind. I am sure it probably boggles yours. But I would like to know why the agency dawdled in not taking any real action here.

Mr. STIPANO. I don't know that I would characterize us as having dawdled.

But I would agree that, with hindsight, there certainly were judgments that we made that turned out not to be the correct ones. Let me go back a little bit in time because I think it is useful to look at our supervision of Riggs, both pre-9/11 and post 9/11. Pre-9/11, we did many examinations of the bank focusing on the adequacy of their BSA compliance program, which is our charge. The bank had a program and was in compliance with the regulation. In

other words, the regulation requires that all banks have a program in place and that it cover four areas. The bank had that. But it didn't perform on each of those elements as well as it needed to. There were deficiencies. The training needed to be better. The controls needed to be beefed up. What we did not know at that time were the types of substantive violations of the BSA that were discovered as a result of our examination in 2003.

I think there are a couple of reasons for that. And I will be very up front with you. The first is that we trusted management too much to get the problems fixed. In the vast majority of cases where you have these types of violations, the examiners bring them to the attention of management and the board, and the problems get fixed. And that is usually the end of it. That didn't happen at Riggs. There was an effort made to fix the problems, but the effort took a long time. It took longer than it should have, and we were willing to give management too much slack.

The other error in judgment that was made during that time frame was that we under-estimated the risk in the Embassy accounts. Pre-9/11, embassy accounts were not viewed by the OCC or anyone else that I know of as high-risk accounts. The types of things that we were focusing on for in-depth examinations were foreign private banking, foreign correspondent, accounts, accounts with Russian entities, accounts with countries that are on the Financial Action Task Force list, but not embassy accounts. As it turned out, there was a lot of risk in those embassy accounts, but it did not come to light until after 9/11.

Chairwoman KELLY. I am looking now at an OCC examination. It is entitled Bank Secrecy Act, the OCC Examination Coverage of Trust and Private Banking Services issued by the Office of Inspector General, November 29, 2001. In there, there is a chart that lists your rate of coverage and testing high-risk transactions for foreign correspondent banking at 0 percent. In other words, in November of 2001, the IG's report says you weren't even looking at this stuff. And that's November of 2001. You still weren't looking at this. With unanimous consent, I am going to insert this into the record.

[The following information can be found on page 74 in the appendix.]

Chairwoman KELLY. But that, sir, begs the question about what those people were doing between 2001, November, and 2003, when you finally put somebody in the bank. I am not asking you a question. I am simply making a statement here that there had to be some knowledge somewhere, institutionally within the OCC I suspect, that would have brought to bear some more information gathering and better oversight on foreign transactions.

What kind of an interaction did you have with bureaus like FinCEN and the Fed after the OCC became aware of the Riggs problems? When did the law enforcement get involved? And I would like to know what—it was a result of the investigation into the report of the financial link between the Saudi ambassador's wife and the 9/11 hijackers. Was that what triggered this? What triggered this?

Mr. STIPANO. Maybe it would be useful for me to walk you through the chronology, post 9/11. You are absolutely correct; 9/11 turned the world on its head, including our world in the regulatory

agencies. Our immediate response in the aftermath of 9/11 was to work with law enforcement to identify where the accounts of the 9/11 hijackers were, as well as where the accounts of other individuals and entities that were linked with the hijackers were.

A process was put into place 5 weeks after 9/11 whereby the FBI could provide us with the names of suspected terrorists and people who were linked to terrorism, and we would blast it out by e-mail to every one of our financial institutions, who would then be obligated to report back and identify the account. So that was something we did immediately after 9/11.

Another major initiative at that point was to implement the PATRIOT Act, which was passed a few weeks after 9/11. It put some requirements in place very quickly. But very little of that statute was self-effectuating. It required that regulations be written. So we worked on various work teams with the Treasury Department and the other Federal financial institutions regulators to write regs to implement the PATRIOT Act.

Another step that had to be taken was to write new exam procedures. Pre-9/11, our focus in this area was on money laundering. Post-9/11, now we are looking at something relatively new, terrorist financing. So we needed new exam procedures. These were all things that were done in the immediate month after 9/11.

In the summer of 2002, we embarked on a series of anti-terrorist financing reviews at most of our large banks and our other high-risk banks, including Riggs. The purpose of those reviews was to, determine the extent of compliance with the PATRIOT Act requirements that were in place as of that time, and to see what the banks were doing to deter and prevent terrorist financing. And to the extent that we discerned weaknesses, we would then follow up with a more full-scope exam.

Riggs was, as I said, part of that group that was examined with these anti-terrorist-finance exams. And it disclosed weaknesses. So that was part of our impetus for doing the January of 2003 exam.

Now, in the meantime, that fall, there were published accounts of Riggs accounts related to the Saudi Embassy that may have been used to funnel information to people associated with the hijackers. Obviously, became aware of that and that caused us to focus with particularity on the Saudi Embassy accounts. Up to that point, other than the normal types of supervisory interactions that we would have with the Fed on any bank that has a holding company, there was not extensive contact with other agencies. There was not with FinCEN, and to my knowledge, there was not with the FBI.

Once that examination began, that all changed. The exam we did in January of 2003 involved some of our best agency experts. It went on for 5 months. It was an intensive drill-down type of look at the Saudi accounts, and it discovered all kinds of problems, mainly a lack of sufficient know-your-customer documentation and a failure to file suspicious activity reports in noncompliance with the BSA.

This information was provided to the FBI. We had many meetings with the FBI. I shared a lot of information with them, and at the conclusion of the examination, we made a referral to FinCEN

for the assessment of civil money penalties under the Bank Secrecy Act.

Chairwoman KELLY. Okay. I think that we can talk about that further because it brings questions in my mind about when you say that there was no contact between your agency, FinCEN, FBI and the Treasury prior to this. It just—I hope that that has changed.

Mr. STIPANO. But at that point, there really wouldn't have been a reason to. I mean, we would normally make a referral to FinCEN under guidelines that FinCEN and the banking agencies agreed to many years ago. Prior to that January 2003 exam, systemic BSA violations had not been discovered, so there would not have been a basis for a referral to FinCEN. And we were unaware of any criminal violations that would have necessitated a contact with the FBI.

Chairwoman KELLY. Well, in 1997, there were some areas of concern. And it didn't improve, and it continued to not improve. I think we should—I think we should maybe get into another dialogue about this, and I will have some further follow-up questions on it as I think.

But the report that was—a report that was issued by the Treasury Inspector General found that you really lacked, as I pointed out, sufficient testing of the high risk transactions that were commonly associated with money laundering or lacked review and evaluation of critical BSA reports that banks are required to file. Now, that is—I am quoting from the inspector general's report that I put into the record. Specifically, examiners did not test wire transfers, transactions with foreign correspondent banks, currency transaction reports or suspicious activity reports. In fact, when they looked at that, you had a 0 percent score.

The report concluded that the OCC should ensure that examiners complete transactional testing of high-risk BSA areas, and this was November 2001. And it notes that the OCC management concurred with that recommendation. So the management, the OCC knew in 2001 that there were shortcomings there. And, you know, if you—the OCC scored 0 percent in high-risk areas. You wonder then, there are some other things on that chart. You wonder about some of these other areas. And if you thought you were performing at a certain standard, you think that you maybe now might be overstating your ability to handle the issues? I was adding up this—your testimony, the number of people who worked for the OCC. You have taken on a lot. And I am wondering if you are overstating your ability to handle the issues.

In the Riggs case, that bank is located just a couple miles from its own regulator, the OCC, in a high-threat area with the largest embassy banking clientele. You begin to wonder how many warning signs it takes, how many IG reports it takes. And you begin to wonder that—how can the American people have any confidence to handle this financial oversight? You know, banking regulators have had every warning and every opportunity, and I am not so sure we can win any longer.

On a scale of 1 to 10, how would you rate banking regulators' ability to oversee the BSA compliance right now?

Mr. STIPANO. 9. This is not a new area for us, Chairwoman Kelly. This is something that we have been doing for decades. And I am

not saying that we are perfect and that—I am not saying that the supervision that we did in Riggs was perfect. But our job is to ensure that banks have strong anti-money laundering programs, and banks have been under that requirement for 17 years.

The OCC has been very aggressive and vigorous in this area. For example, since 1998, we have taken 78 formal enforcement actions against banks and their institution-affiliated parties that were based in whole or in part on violations of the Bank Secrecy Act. Some of those cases are among the most significant money-laundering cases that the United States Government has ever brought, and the OCC played a key role in those cases.

As a consequence of our vigilance in this area, most banks have excellent BSA compliance programs, and some of the largest national banks have programs that are among the best in the world. They are the model that nonbanking financial institutions are trying to achieve.

And, frankly, I think the real area of concern and one of the best things that the PATRIOT Act did was it extended the types of requirements that banks are under, like the compliance program requirement and the SAR filing requirement, to a whole host of industries that previously had not been subject to those requirements: money transmitters, pawn brokers, broker-dealers, et cetera. And the task now is to get those industries up to the level where the banks are.

Chairwoman KELLY. Finally, I look inside here, and you say you have nearly 17,000 examiners in the field. It seems to me that what happened with Riggs may not be an isolated case. I think that there may be difficulty in communications with other agencies. I think that maybe it might be time, for the sake of the American people's trust in our financial system, to let the agency egos be put aside and start recommitting to working together so that you can share information.

I am very concerned that information has not and may still not be shared between agencies. The problem is, one, when a regulator goes in and begins to look at the things they are charged to look at, they get very involved in the paper work, the appropriate forms filled out, the appropriate forms filed and the appropriate filing cabinets. It does us no good, in terms of bank regulation and enforcement, to have everything go into a filing cabinet and not be enforced. And I am very concerned that we maybe think about not only civil but criminal enforcement and possibly think about ensuring that compliance is assisted by a criminal enforcement program within the Treasury.

Do you think it would have made a difference last year, if Riggs—when Riggs was kind of shamelessly flaunting all your regulations in your face—-if someone had been able to pick up in Treasury, at that moment, and had criminal enforcement powers for the BSA? I mean, right now, the IRS is the only one that has that power. Wouldn't it be helpful that maybe we have criminal enforcement capability with people who are familiar with the controls and the systems of the financial institutions to put it all together?

When your reports come in and say, wait a minute, this is a red flag, something needs to happen. What do you think about that?

Mr. STIPANO. I think it would be very, very difficult for another agency or group of agencies to duplicate or improve on the job that the banking agencies do when it comes to assessing the adequacy of a BSA compliance program for a couple of reasons. One is that we have at our disposal thousands of bank examiners who are skilled experts at doing this, and that would not be true with another agency. And the type of work that is involved, assessing controls, assessing training, testing, is within the particularized skill sets of most bank examiners. So handing that function to another agency, in my view, would be a step backward and would not improve compliance in the anti-money laundering area.

That said, I agree with you that there is room for improvement when it comes to coordination among Government agencies and information-sharing. One area where I think that the Government is lacking is that information-sharing often is a one-way street from the banks and from the banking agencies to criminal law enforcement. There has been improvement since the PATRIOT Act. The process that I described to you previously, of sending out the control list, has now been codified under Section 314 of the PATRIOT Act. That is a significant development that has made it much easier for law enforcement to target accounts of potential terrorists. But that is relatively new.

What I think would help the banking agencies probably more than anything would be for the Treasury Department and FinCEN in particular to better utilize the data that they have to provide us with analytical reports that would allow us to be better at identifying the risks and concentrating our resources on the high-risk banks and the areas within the banks that pose the greatest degree of risk. That is something that I understand is a very high priority with FinCEN presently and something that they hope to accomplish.

Chairwoman KELLY. Well, right now, FinCEN doesn't have the ability to enforce anything. They are collecting. And they are collecting information. Streamlining and centralizing.

I heard you talk about streamlining, but I think also maybe we need to think about centralizing information so that it can be appropriately examined with one oversight and be responded to, so we don't have another instance where it has taken since 1997 before people throw up their hands and said, "Oh my goodness, there is something happening here." that is—streamlining and centralizing might be good. It is not necessarily always one of the things that we do with the Federal Government, but in this instance, it might be a good thing. So maybe we can talk about that also.

Mr. STIPANO. I just want to be clear on this point though because our view is that, while errors in judgment were made on Riggs, Riggs was an anomaly and the system as a whole presently functions very well. It can be improved, and we hope to improve it. And the way to improve it is through better coordination among agencies and increased information-sharing. The solution, in our view, is not to junk the present system and replace it with something else, because I don't believe that you will replace it with a system that is better than the one you have right now.

Chairwoman KELLY. Well, Mr. Stipano, I am not interested in junking the present system, but I am interested in making sure

that we don't walk out of here this afternoon and find that, on the front pages of the newspapers tomorrow morning, there is another Riggs situation.

I think it is very important that we look at how the examinations are being done, how information is being collected, how it can be better collected in a place so that it can be reacted to by the people who have the enforcement capability. And if there is not an appropriate enforcement capability at the agency in charge, which in this case is the Treasury, then the Treasury probably should have that enforcement capability. And it may be something that we want to think about.

It is just—I am just throwing this out here, because I think it is clear there was a break down in the system. And when that happens, we need—it is right and appropriate for us to take a look at how to better that system so that doesn't happen again.

Mr. Baxter, I would like to ask you a couple of questions. There are indications that the Fed saw hints of OFAC related problems at UBS early in the ECI program and had some conversations with the bank. Please tell us if those concerns were ever communicated to OFAC. Also, please tell us why there was not much more stringent attention to the problem if there was even a hint of OFAC-related problems.

Mr. BAXTER. Chairwoman Kelly, first, with respect to whether we had an early warning of a problem at UBS involving OFAC, the answer is no.

In 1998, following the merger between UBS and Swiss Bank Corporation, Federal Reserve officers felt it was appropriate to remind the UBS management that came in at the time of the responsibilities for OFAC compliance under the contract. But that was triggered not by concern that there was a compliance failure. It was a concern about management change that attended the merger of Swiss Bank Corp and UBS.

With respect to notification to the office of foreign assets control, we first learned of an OFAC problem on June 25 of 2003 when an officer who was visiting the Zurich facility learned that there had been transactions of cash with Iran, which of course was not permitted under the contract in early July. All of that information was communicated to our colleagues at OFAC, and I should emphasize that we communicated the information that we had at the time, information that was not correct in several different respects, but the information was timely communicated by the Federal Reserve to OFAC as soon as we learned that we had a problem.

Chairwoman KELLY. Did the Fed send correspondence after the UBS merger to warn them of interaction with OFAC-listed countries?

Mr. BAXTER. I wouldn't characterize it as a warning. I would characterize it as a reminder, and the concern was specifically generated by the fact that anytime there is a merger, particularly a merger of the dimension of the UBS-Swiss Bancorp that with management change come new people, and the new people might not be mindful of the special contractual requirements that we exported through our contract to Switzerland. And in Switzerland there were no prohibitions on transactions by Swiss banks with Cuba, with Iran; there were restrictions with Libya and Yugo-

slavia. So it was appropriate for us to remind periodically not only UBS, but other ECI operators that there were special restrictions exported from the United States by contract.

Chairwoman KELLY. I just turned to Mr. Gutierrez, because earlier in his opening statement he talked about whether or not the ECI should be with American-owned banks only.

Why wouldn't some aggressive steps, having been taken in 1996, make certain that ECIs around the world were operated by U.S. banks? Why wouldn't they, by definition, have to observe the OFAC sanctions? Is there some reason why that didn't happen?

Mr. BAXTER. First, with respect to the point about U.S. institutions—and it is a very good point because, as U.S. persons, branches abroad of U.S. banking organizations are subject to OFAC requirements, so they would not need to be reminded or they would not need to be required in a contract. But there are also specific reasons why the Federal Reserve looks to foreign institutions in certain locations. And let me give you a case in point, and the case in point happens to be UBS.

At the time we started our ECI program, we were particularly concerned about replacing a $100 note with a new note, and one of the places that the old $100 note was very, very popular was in the former Soviet Union. At that point in time, there was an American bank called Republic National Bank that was serving the former Soviet Union. That American bank decided that it was no longer interested in the Russian business. And so we were in the position of wanting to reach into Russia to deal with the replacement of the $100 note, and we needed to find an ECI contractor who could do that.

UBS was the contractor who stepped forward. So in that particular case, we looked to a foreign institution to fill in for a U.S. institution that no longer exists, but at the time it was withdrawing voluntarily from that particular business, business that the Federal Reserve, the Treasury, and the Secret Service and the American ambassador at the time felt was very important to pay attention to with respect to the replacement of that $100 note.

So there are reasons that we look to particular foreign institutions to extend our reach into certain jurisdictions, like Zurich back in 1996, like Singapore with respect to United Overseas Bank; and those are reasons to look to foreign institutions to service us. And what we do with the foreign institutions is, we basically apply through the contract the OFAC restrictions.

Chairwoman KELLY. Thank you.

Mr. Gutierrez.

Mr. GUTIERREZ. Thank you very much. Welcome to you all and thank you for your testimony. I want to go back to Mr. Stipano.

The chairwoman and you, through her questions, spoke a little bit about the Riggs situation in 1998 and 1999. Now, I will put words in your mouth, so you can correct anything that you said, that one of the reasons was that your auditors believed what was being said by the answers that were given by Riggs employees back to your regulators and auditors; is that what you said?

Mr. STIPANO. I don't know if I would characterize it exactly that way.

Mr. GUTIERREZ. Why don't you recharacterize it, because I want to know exactly what happened.

Chairwoman Kelly said, well, what happened, you were there for 1 year, 2 years, 3 years; and you said, well, one of the reasons was—I understood that they lied to you. And you kind of phrased it a little nicer and said, they didn't quite—we kind of believed them.

Mr. STIPANO. I wouldn't say that they lied to us, but I think that what was going on in that pre-9/11 period was that our examiners were finding deficiencies with the bank's BSA compliance program at every exam. They weren't the kinds of deficiencies that were flagged in the 2003 exam where we looked in depth at the Saudi Embassy accounts, but there were problems, and we brought these problems to the attention of bank management and the board. They were discussed during the exams. They were written up in the exam reports, and we secured what we believed was a commitment from bank management to fix them.

What would happen is really what I would term more accurately as "foot dragging." The changes that we wanted to have made were made, but they were made slowly. There was not a real responsiveness. And looking back at this with hindsight, I think that——

Mr. GUTIERREZ. You trusted them.

Mr. STIPANO. We trusted them. And in hindsight, we shouldn't have done it.

Mr. GUTIERREZ. I guess we finally found a word to describe why it might have taken the OCC as long, because you trusted them. But it seemed to me that an organization such as yours, which is safety and soundness and is the regulator, there shouldn't be issues of trust. I mean, you know, was it trust but verify? And I don't think you were verifying, because similar things popped up later on.

It should have been caught earlier. And just so that we don't think it is the chairwoman and I who have decided, because they sent you down here—they usually send one of the counsels down here. Mr. Hawke is good at doing that, but he acknowledged, and these are his words in the New York Times, he says "We should have gotten tougher earlier, and I don't make any excuses for it. It's a fair criticism of our supervision of Riggs that we let things go on too long."

So when you describe a situation, which is a 9, in which Mr. Hawke, who I would characterize as a very self-assured person—I wouldn't say arrogant, but self-assured person, doesn't take much from anybody, right, tough—says, we took too long and which his deputy counsel, yourself, said, we trusted them too much, I think you can start wondering.

I mean, if the FBI came and said, yeah, we talked to the terrorists, but we trusted them and so the buildings came down, I think people might think it wasn't a 9-out-of-ten system that was working there. I mean, just understand that from our point of view that—just we trusted them, they took too long, there was foot dragging. You are the boss. I mean, when a regulator sends down bank examiners, I want them to shake up that bank. I want them to go all the way up the chain of command and say, we have a problem and we have to clean it up or—I think you know what the problem

is, Mr. Stipano, it is always the "or." Maybe they take the risk of getting caught and the fines and the penalties, which was one of my earlier questions.

We have to think of new fines and new penalties. I mean, this is like risk: What is my risk as a financial institution if I foot drag? What is the most that the OCC—maybe we need tougher penalties, and we have been doing some of that.

So it just seems to me that to say we trusted them, especially in this new age after we passed the PATRIOT Act, you can't trust anybody anymore. We can't trust the Riggs. We can't trust UBS.

I am sure the folks at the Federal Reserve Bank trusted them. They said, what a great company, they are really going to come on and do this job. And we can't do that. We need to monitor them, don't you think?

So 9 out of ten, I don't think in this particular case to say that this is just one. Which are the other cases in which you are trusting people today that tomorrow we are going to find out that that trust was ill conceived?

Mr. STIPANO. First of all, I always agree with Mr. Hawke. So I'd like to get that on the record.

Mr. GUTIERREZ. I don't, and in that, we don't share a common opinion.

Mr. STIPANO. Secondly, while I would characterize our overall efforts in this area as a 9, I certainly would not characterize our efforts with respect to Riggs as a 9. We made errors in judgment, and I think they are obvious and we have discussed them. But I don't think that Riggs is emblematic of our supervision broadly in any area and certainly not in the BSA area.

Mr. GUTIERREZ. Let me ask you a question. Do you still trust people? Do you still send your bank auditors out and say, we trust them, and walk away?

Mr. STIPANO. I believe you have to trust but verify.

Mr. GUTIERREZ. Okay. Well, I would like to know what kind of things you are doing differently, given that Riggs started in 1997, 1998, 1999, and finally, voila, this year we got a fine. So that is a long time, as we sit here, to watch an institution such as yours, that wants to expand.

Now you are sending out preemption notices to the States saying, not only do we want to do all the great things we did while Riggs was doing all of these nefarious things, we want to expand our authority; but we don't want to actually charge any more fees to our customers, the banks, in order to hire more employees in order to expand that authority.

So I see an institution that walks up here and says, we are doing everything fine, we are doing everything so great—this is Mr. Hawke, of course, not yourself—doing everything so great and now we want to preempt attorneys general and bank regulators and other people at the State level from issues and consumer complaints, that you want to now preempt stateside.

So I think you get my worry.

Let me just say that I read your testimony, and it was like on page 19 on the top that says "The examiners found that, as with the Saudi Embassy accounts, the bank lacked sufficient policies,

procedures and controls to identify suspicious transactions concerning the bank's relationship."

You found out about those irregularities at the Equatorial Bank, or did the Riggs people tell you about them or the FBI tell you about them? Because as I read that, it kind of sounds like, voila, our examiners found out about it. Did your examiners find out about it as I was led to believe when I first read that paragraph or did others bring it to your attention?

Mr. STIPANO. Let me give you an answer to that question. First of all, I don't think the sentence says that we found problems in the Equatorial Guinea accounts.

Mr. GUTIERREZ. It says "The examiners found that, as with the Saudi Embassy accounts, the bank lacked sufficient policies, procedures and controls," "the examiners found."

Mr. STIPANO. Right.

Mr. GUTIERREZ. Did the FBI or Riggs find it?

Mr. STIPANO. No. The examiners found that, just like with the Saudi accounts, the bank did not have policies and procedures with respect to Equatorial Guinea. What happened with Equatorial Guinea was that this was actually something that was going to be looked at during the January 2003 examination. There were published accounts of problems——

Mr. GUTIERREZ. I just read it and I just want to see. So if you can only find something once between the OCC, the FBI—what agency, who brought it to public attention first? Did the bank examiners show up and say, voila, we found this or did Riggs say it?

Mr. STIPANO. The examiners did not find the problems at Equatorial Guinea.

Mr. GUTIERREZ. That's what I am trying to say. So then, in other words, when I read your testimony and when I first read it, I said, hey, look, the examiners did a great job. They found this.

Actually, they didn't find it.

Mr. STIPANO. Congressman, with all due respect, I don't believe that is what that sentence says. The sentence says that they didn't find adequate policies and procedures with respect to those accounts, just as they didn't find adequate policies and——

Mr. GUTIERREZ. But really Riggs is the one that brought this to the attention of the OCC about the lack of procedures?

Mr. STIPANO. Not exactly.

Mr. GUTIERREZ. Fine. It is all right. What is, is. It will come up again——

Mr. STIPANO. Can I just finish the answer?

At the conclusion of the 2003 examination, we told the bank that the next time we are in there, this was going to be an area that we were going to look at. So the bank was on notice that this was priority and, frankly, that was one of the problems. And the reason for such a big sum of money penalty was that despite having been put on notice, they still did not clean up those accounts.

Mr. GUTIERREZ. All right. Let me just say that when your boss, Mr. Hawke, says nonsense about what banks are going to do, and I hear you give yourself a 9 out of 10, and I think that I with my staff kind of set the tone. So if I am out there saying that Congress, even though there has been a vote of the Banking Committee saying basically, the OCC is wrong, this committee has voted—and we

are kind of elected, the last time I checked. At least with everybody else there was no dispute in their election by the people.

When he says, nonsense, and this committee says to Mr. Hawke, let's sit down, which we have done on a number of occasions, and let's sit down with bank regulators and let's sit down with attorneys general and let's sit down with this committee and let's try to resolve our differences after this committee has taken a vote—not the Congress, but this committee has taken a vote—saying we think you have exceeded your authority and he says, no, nonsense, everything is fine, I guess that can, I believe, create a sense of arrogance within the institution when the boss basically says to Congress, after it has taken a vote in the committee, and uses those kinds of words when we believe we have a concern—and not only we, but a lot of other people think that there is concern.

Let me just ask you that when consumers now call you folks up, have a consumer complaint, am I right that those phones only operate Monday through Thursday from 9:00 to 4:00?

Mr. STIPANO. Congressman Gutierrez, I have to confess here. I am not the expert on our Customer Assistance Group.

Mr. GUTIERREZ. We called on a Friday, and it said it was closed. So you won't dispute that?

Mr. STIPANO. I don't know whether it is or not.

Mr. GUTIERREZ. Let me just tell you, we tried it, and it said 9:00 to 4:00 Monday through Thursday.

I was a former city council member back in Chicago, and I loved that job a lot, and one of the things that kept us very close was that if your cable didn't come on because the city council would authorize who got the cable license, people would call me up and say, I called the cable company and they won't fix it; and if I told them that I was allowing the cable company, which I had voted, as the city council, to only open up their offices from Monday through Thursday from 9:00 to 4:00, I don't know how long I would have stayed in the city council.

I think if people call up the gas company in Chicago or Commonwealth Edison that has the franchise to serve electricity, and they were only going to open from 9:00 to 4:00, as a matter of fact, if I decided that my city council office or my congressional office tomorrow was only going to operate from 9:00 to 4:00 Monday through Thursday, I think you would agree with me that I would have a problem in doing that.

And I think that you should understand that you have a problem and that when people complain to us that their complaint is well grounded, that government should work Monday through Friday 9:00 to 4:00—maybe that is not an 8-hour day—and that if you need more help, since you want to expand your authority and preempt the States, that maybe you should say, Congress, we don't agree with you, but we are going to open Monday through Friday.

Does it sound legitimate to you as the deputy counsel that you should operate Monday through Friday?

Mr. STIPANO. I do not deal with the Customer Assistance Group. I am open Monday through Friday, and I don't leave at 4:00. And I get calls from people all the time. In fact, usually if there is a problem in the BSA area, the call ultimately comes to me. I am not suggesting that I want to function as a shadow Customer Assist-

ance Group, but there are other people in the agency that can take calls——

Mr. GUTIERREZ. But the rest of the agency functions Monday through Friday, right?

Mr. STIPANO. The agency functions Monday through Friday.

Mr. GUTIERREZ. I suggest that all parts of the agency should function Monday through Friday, and I think we can probably give a lot of different examples about what would be wrong with not functioning Monday through Friday. It seems to me that that is the work week and that the financial institutions are open and people have problems; and it is wrong for agencies such as yours to want to preempt States and then say, we are only going to open our offices from Monday through Thursday from 9:00 to 4:00. It should be a better operation so that the public, which I have a concern about, is well served so that we are not getting messages that say we don't have to deal with you, Attorney General, the OCC says that has been preempted; let's call their offices, only to find your offices aren't open.

Because you want to know something. My State bank regulators in Illinois are open Monday through Friday. The attorney general of the State of Illinois is open Monday through Friday. And across this country I have yet to find a State bank regulator or attorney general, which your agency wishes to preempt, that is not open Monday through Friday. So I would expect that if you want to take over the responsibilities of those State agencies that at least you afford the public the same customer service that is currently being afforded them by attorneys general and State bank examiners, that we don't reduce the quality of service to the American people which you and I have made a vocation to carry out. I guess that is our point.

I have other questions, and we will submit them for the record. Thank you very much, Madam Chairman.

Chairwoman KELLY. Okay. Thank you.

Mrs. Maloney.

Mrs. MALONEY. Thank you, Madam Chair, for your hard work on this, and Ranking Member Gutierrez.

Welcome, Chief Counsel Stipano and General Counsel Baxter. I request that my opening statement be put in the record. I really would like to ask Mr. Stipano what aspects of the PATRIOT Act could help avert a repeat of the Riggs problem.

Mr. STIPANO. I think that there are provisions in the PATRIOT Act that are helpful and will be helpful going forward. But I think that the problems——

Mrs. MALONEY. Specifically, which ones would be helpful going forward?

Mr. STIPANO. I think that, first of all, section 312, which is the provision that requires due diligence and enhanced due diligence procedures for foreign private banking and correspondent accounts, that would be something that would be helpful because even though the Saudi Embassy accounts were not technically private banking accounts, in some ways they were operated like they were private banking accounts.

There is an interim final rule in place implementing section 312. My understanding is that the Treasury Department will soon be

issuing a final regulation which will codify this requirement, and I think——

Mrs. MALONEY. Why is it taking so long? We passed the PATRIOT Act and the anti-money laundering provisions almost 3 years ago. And we still haven't put the rule in place? I mean this is really outrageous.

Mr. STIPANO. We have all the other ones in place. I am not a spokesman for the Treasury Department, though. The Treasury Department has the pen on this particular regulation, and it is the Treasury Department that has to issue the rule. So maybe this is a question for your hearing next week. I don't really know the answer to that.

Mrs. MALONEY. Well, then when you were looking at Riggs, under what standard did you examine Riggs regarding the due diligence and the opening of accounts with the diplomatic community? Were you using the standard before 312 or the intent of 312, section 312?

Mr. STIPANO. We have a requirement that all banks have a compliance program, and among the things that are required as part of a compliance program are satisfactory internal controls. That would include due diligence procedures for all accounts and enhanced due diligence procedures for high-risk accounts.

The embassy accounts—at least the Saudi Embassy account is a high-risk account; and what the bank should have done was, first of all, they should have had better systems in place so that they knew the number of accounts that they had. Secondly, they needed to have better information on how those accounts would be used, what the sources of funds would be, where the funds would go.

Mrs. MALONEY. But when you knew about this in 1998 and 1999—it was well known to the OCC that they were not in compliance with the Bank Secrecy Act at Riggs—did you go to them and suggest that they have standards and procedures and due diligence, and then go back and just make sure they got the job done? I mean, this is serious stuff right now.

Every time I pick up the paper, New York, where I live, is Code Red, at least Code Orange. They are announcing terrorist attacks any day now, and we all know you can't attack without money. So if you crack down on the shipment of money, we can crack down on the ability of terrorists to act.

I mean, this is extremely serious and not to put the regs in place or even to have followed them or to have gone back—you talk about all the people you have in the field. What about who you have in Washington? You don't even have to leave the office. You are right here in Washington with Riggs. You can walk across the street and see them, practically.

And we knew, since 1998, they had problems with these high-risk accounts, and yet we didn't come in and crack down on it more. I mean, I find it quite frankly scandalous.

Mr. STIPANO. I couldn't agree with you more as to the seriousness of this matter, but what we knew in 1998 was very different from what we knew in 2003; and in 1998 what our examinations revealed were deficiencies in the compliance program, not wholesale violations of the Bank Secrecy Act. It was a much less grave type of violation.

They were brought to the attention of management. They were written up in the exam report. Commitments to fix the problems were obtained. But as I testified earlier, bank management did not follow through on these changes as quickly as they needed to, and hence, there were repeat violations.

There is no question, looking back at it with hindsight, we should have been more forceful with that bank at that point and not waited until 2003 to take a formal enforcement action.

Mrs. MALONEY. What does your enforcement action mean? Will they be fined? What is going to happen?

Mr. STIPANO. There actually are three actions that the OCC has taken. The first one was in July of last year, and that was a cease and desist order. It is a public enforcement document. It is about 20 pages long. It requires the bank basically to take steps to improve its anti-money laundering program.

That cease and desist order was supplemented by a second cease and desist order that was issued a few weeks ago and——

Mrs. MALONEY. What I don't understand is, why didn't you issue a cease and desist order the minute that the FBI alerted you to the problems at Riggs? It almost makes it sound as if the OCC doesn't take the Banking Secrecy Act issue seriously.

Is it a priority at the OCC, the BSA?

Mr. STIPANO. It absolutely is a priority. We were not alerted by the FBI. We found escalating problems with the bank's program through our exam process and because of published reports about connections between the Saudi accounts and the hijackers. That triggered this very extensive examination that we did last year which formed the basis for our subsequent enforcement actions.

Mrs. MALONEY. But you say that the BSA issues are a high priority of the OCC, but I am told that they are not even part of the National Bank Examiners Handbook, that most of the regulations that were issued in 2002 aren't even part of the examiners handbook. Now is that true——

Mr. STIPANO. No, that is not true. The——

Mrs. MALONEY.—that it is not fully updated? That the handbook is not fully updated?

Mr. STIPANO. We are in the process of updating it, and there should be a revised version out shortly, but——

Mrs. MALONEY. Why didn't you update it the minute that we passed the PATRIOT Act? This is serious business.

I can't tell you how quickly New York reacted in a thousand ways. We totally rebuilt the command center that was destroyed, within 19 hours, completely rebuilt it, and I can't believe you can't get the handbook updated with the information that we passed to combat money laundering and terrorist dollars flowing through our country. I mean, really it is beyond—it is a disgrace, I think, an absolute disgrace.

Mr. STIPANO. The PATRIOT Act required us to make lots of changes in our examination procedures and to write regulations, and that took time. We could have come out with a revised handbook earlier, but if the procedures weren't done and the regulations weren't written, it probably would not have been of great value to the examiners.

Mrs. MALONEY. It would not have been. Well, what more should we be doing to make sure that the type of actions at Riggs don't happen again?

Mr. STIPANO. I think there are a number of steps that the OCC is prepared to take.

Mrs. MALONEY. Such as?

Mr. STIPANO. Comptroller Hawke has directed our Quality Management Division to do a stem-to-stern review of the Riggs matter to find out what happened and to see what lessons we can learn from it. But even before that review is done, there are several steps that we can take right now, and we are taking them.

Mrs. MALONEY. When is your report on lessons learned from Riggs going to be due? In another 3 years?

Mr. STIPANO. No, it will not be. It will be a matter of months. In fact, the review has already begun.

Mrs. MALONEY. I would respectfully request that when it is done, it would be handed in to the chairwoman so she can give it to all of us, so we can all read it.

Chairwoman KELLY. Mr. Stipano, I would concur with that. We would like that report delivered as soon as possible.

Mr. STIPANO. As soon as it is completed, we will deliver it.

Chairwoman KELLY. I thought you said it was completed, sir.

Mr. STIPANO. No, no. I said the review has begun.

Chairwoman KELLY. The review has been done?

Mr. STIPANO. The review has begun.

Chairwoman KELLY. Has begun. And I am sorry, if the gentlewoman would yield, her question was how long do you expect that to take?

Mr. STIPANO. I don't know exactly how long it will take. My guess is it will probably be several months.

Chairwoman KELLY. Would you please inform us of the progress of that report on a regular basis?

Mr. STIPANO. Yes, we will.

The due date, by the way, is September 1.

Mrs. MALONEY. Reclaiming my time, what other steps can we take that are concrete to crack down on the terrorist money business?

Mr. STIPANO. We need to become better at identifying risk. One of the big problems with Riggs was that neither our examiners nor law enforcement nor anyone else recognized the risks in these embassy accounts.

There are a number of steps that we are taking to do that. One of them is the nationwide implementation of a risk identification system that has been developed by one of our district offices. It involves gathering information on products and services and various types of activities that banks are involved in and putting it in spreadsheet form and developing a methodology to quantify risks and identify banks that may be outliers.

We are also working on a new database that would use national bank-filed SARS to pinpoint operational risks generally, but also risks in the BSA area.

Third, we are working with FinCEN and the other banking agencies on ways to better use BSA data. FinCEN is sitting on a gold mine of information with the SARS data and the CTR data and

other data that they have. The ability of the government to connect the dots and provide that information to the banking agencies is absolutely essential because once we have that kind of information, we can target our resources to the areas of banks that are truly high risk.

As I mentioned earlier, we have also completed our examination procedures on three sections of the PATRIOT Act and we are about to come out with new procedures on a fourth section.

Mrs. MALONEY. Quite frankly, you don't need a database or a spreadsheet to know that Riggs, the international bank for most of the foreign governments in the country and the foreigners in the country, is a high-risk bank. I mean, it is common sense, and yet it was not looked at. So I hope that you improve. This should be a priority.

And I know you have a lot of smart people working in the OCC, and I have great respect for Comptroller Hawke. But it doesn't sound like the BSA issues are at the top of your concerns, and I think it should jump ahead of any concerns that you have to change your charter and everything else you have been trying to do, because this is critically national security and, really, the security of our people is at stake.

But I would like to go to Mr. Baxter and I would like to ask you about the Basle Capital Accords that are coming out that the Fed has been working on with the international community. When we finally solidify and come forward with these decisions on various capital requirements and so forth, do you think having an international standard is going to help us spotlight and see the type of problems that were at UBS? Do you think that would be helpful, or is that really not an issue? What is your feeling on that?

Mr. BAXTER. One of the things we see in the UBS matter is an example of operational risk, a failure of people, a failure of controls. These failures were observed not here in the United States, but in the operation that was being conducted in Zurich. It is a good illustration of operational risk as a type of risk being addressed in Basle II, and here is one vivid demonstration of operational risk.

It also, I think, Congresswoman, has relevance to what is being done at the Basle Committee because this occurred in a multinational banking organization.

UBS is an organization that conducts its operations in many countries. It has 65,000 employees around the world; 22,000 of them are in the United States. So you can see an operational risk problem and an institution that conducts its operation cross-border. So it is a good illustration of why operational risk is an important part of the risk quotient that is addressed in Basle II. It is also a good illustration of why the effort needs to be multinational and because this Basle II is being imposed on institutions that conduct their operation cross-border.

Mrs. MALONEY. Well, I was encouraged somewhat that the U.S. And Swiss authorities worked in cooperation with the U.S. management of UBS to investigate and correct the UBS systemic risk management lapses in Zurich.

But one of your statements earlier was alarming to me when you said one of the problems is that the personnel at the bank were not informed of the laws of the United States of America, of how we

treat these accounts, and that we certainly shouldn't be transferring money and so forth to Libya, et cetera, and these other countries. And it seems to me that that would have to be part of the protocol, to let people know what the laws are.

I mean, I find that an incredible—I can't believe that someone is that stupid that they don't inform everyone that this is the standard, because it is a U.S. bank, too, even though it is dealing with many different countries and just merged with the Swiss bank and so forth.

What is your comment on that? It is the stupidity defense, "I just didn't know." I think if you read the paper, you would have known that—any intelligent person reading the paper would have known that we had these certain guidelines and rules about transferring accounts and moneys and so forth to various countries.

Mr. BAXTER. Congresswoman, you are absolutely right that the people in the bank note trading area of the UBS in Zurich, they knew about the restrictions that were exported in our contract to them. They knew that they had to conceal what they were doing. They had to conceal what they were doing not only from the Federal Reserve, but also from the Swiss Federal Banking Commission, from the more senior management at UBS and from UBS's external and internal auditors.

They did it because they were willing to lie. They did it because they were willing to violate the law, and they paid a price for that. But there is no question that they knew of the limitations in that bank note trading area, and they knew they had to hide. And hide they did.

Mrs. MALONEY. Well, I misunderstood you in your earlier comments. I thought you stated that they did not know, that there were people with the Swiss bank, and they just merged with another bank and they weren't familiar.

But you say it is just a matter of just crime, and I am glad that we have cracked down on it, but what could we do in the future to make sure that doesn't happen again? How could we improve our oversight and our monitoring?

Mr. BAXTER. Well, it won't happen again with UBS because they are no longer in the——

Mrs. MALONEY. No longer in business, right. But other banks?

Mr. BAXTER. With the other five contractors, what we have done is implement this 17-point program through contract changes that were effective in February of this year.

In addition, we are planning visitations to each of our five contractors to review policies and procedures dealing with anti-money laundering and OFAC compliance in our offshore facilities.

Now, it will come as no surprise that we have heightened attention in those five contractors now, who have watched the $100 million penalty being assessed against UBS and have taken careful notice. So while this iron is hot, we going to make those visitations, we are going to review with our colleagues at OFAC the policies and procedures that are in place, and we are going to make suggestions to our ECI contractors as to how they can be improved.

So those are the things that we have got in train. We are also expecting in the late summer/early fall to start to receive the public accounting firm certifications, and those certifications will be at-

testing to the management representations we will receive both with respect to contract compliance and with respect to accurate reporting. And the check of those independent public accounting firms, in our view, is significant. It is significant in a Sarbanes-Oxley context and it is significant because we know those public accounting firms are very mindful of their own liability; and they will be making certifications directly to the Federal Reserve, and we will have a say in our contracts as to who those public accounting firms are and then the policies and procedures that they will follow with respect to their certifications.

So all of those things are in train, and all of those things, we expect, will give us much greater assurance that we will not see a repetition of the conduct we found with UBS in any of our other contractors.

Mrs. MALONEY. Did the Fed ever consider using only U.S. banks operating abroad for these functions? Wouldn't that have made things simpler since U.S. Banks are not allowed to deal with countries on the OFAC list?

Mr. BAXTER. You're right, Congresswoman. It does make things simpler, but that, in itself, is no guarantee of perfect compliance. Again, we get to that old audit admonition about trust but verify. So we feel that even with respect to our U.S. ECI contractors—and most of them are U.S. Institutions—that we can't only trust them, we have to trust and verify.

So the procedures that I mentioned with respect to the new contracts and the external certified public accounting firm attestations, those we are going to implement across the board regardless of nationality. They will apply to the U.S. institutions and the non-U.S. institutions.

With respect to the specific question, have we considered using only U.S. flag institutions, yes, we have considered that. The difficulty is to penetrate certain markets around the world, we feel we need to turn to some of our foreign commercial institutions for the reasons that led us to the UBS in 1996. And that is why, in Singapore, we are doing business with the United Overseas Bank.

So we are certainly mindful that the U.S. flag institution might be simpler and has some legal difficulties that are less than we find with the foreign flag carriers or institutions, but we haven't made the decision to use only American institutions at this point.

Mrs. MALONEY. Thank you very much. And I yield back the balance of my time, although I think I used it all up.

Chairwoman KELLY. That is quite all right. I thank you both.

But I have one follow-up question for you, Mr. Stipano. What happened to the auditors that failed to find the problems at Riggs? Are they still at OCC?

Mr. STIPANO. It is hard to answer that because we are talking about——

Chairwoman KELLY. I thought it was a fairly straight question. Are they still at OCC?

Mr. STIPANO. There are a lot of examiners who have examined Riggs during this time period. Some of them are still at OCC and some of them are not.

Chairwoman KELLY. What mechanism do you have in place to assess the performance of the bank examiners regarding the BSA compliance?

Mr. STIPANO. We have a couple of mechanisms. One is the performance appraisal process that the OCC uses for examiners and for other types of employees and another is the Quality Management Division. That is the division that Comptroller Hawke has directed to do a review of the Riggs matter and to report back on what went wrong.

Chairwoman KELLY. How long was that Quality Control Division in place?

Mr. STIPANO. I don't know offhand. It is not something recent.

Chairwoman KELLY. Years? Months?

Mr. STIPANO. In some form, I would say years.

Chairwoman KELLY. I think that this has been a very interesting hearing. I am interested that you were talking about the great amount of information that FinCEN has and talk about the ability to connect the dots. If we streamline what is going on with regard to regulatory agencies and perhaps centralize them, then they perhaps can have access to each other's information in a much more direct way that will result in better oversight, more rapid response. And certainly we don't want to see this kind of thing happen again for such an extended period of time.

We don't live in the world that we lived in prior to 9/11/2001. We live in a very different world. And part of that world is that we now—those of us who are charged with the responsibility of making sure that our country is safe and that our banking system is safe, we must think outside of the box, look outside of the box for solutions; that we will never let this kind of thing happen that happened with the Riggs Bank again.

I am concerned with not only what happened with OCC, but I also am concerned with the Fed in one aspect. The fine of $100 million sounds like a lot of money, but when you have a bank with more than $1 trillion in assets, that fine seems a mere slap on the wrist. I would hope that when an institution is fined, especially an institution that had in place people who were supposed to find this kind of malfeasance, I would hope that that institution would pay a much steeper price for not regulating and controlling their own employees' behavior.

Here in the United States we put people like that in jail when there is a fraud in a bank. We have bank fraud laws; those people go to jail. $100 million, it seems they got by on the cheap, and I am quoting a lot of other people who have also mentioned that to me.

I would hope that when you are considering fines of this nature again that the Fed would consider a healthier fine for any kind of malfeasance that is occurring.

This is a blow to our financial system in a way—both of these are blows to our financial system in a way that American people have a right to expect should not happen when we have institutions in place whose charge it is to make sure that it doesn't happen.

I appreciate the fact that you came here today. I appreciate the fact that you spent so much time with us, helping us understand

what did happen, what went wrong, and helping us understand how it is possible that we might be able to get through this and come out on the other end with a much better regulatory environment that will help protect America and America's financial institutions in a better way.

The Chair notes that some members may have additional questions for this panel which they may wish to submit in writing. So, without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and place their responses in the record.

I thank the witnesses for their appearances here today. This hearing is adjourned.

[Whereupon, at 3:57 p.m., the subcommittee was adjourned.]

A P P E N D I X

June 2, 2004

Statement of Chairwoman Sue Kelly
Subcommittee on Oversight and Investigations
"Risk Management and Regulatory Failures at Riggs Bank and UBS: Lessons Learned"
June 2, 2004

Two weeks ago, this Subcommittee explored proposals to streamline and centralize our current system to prevent money laundering and terror financing.

The recent cases involving Riggs Bank and UBS reveal regulatory and risk management breakdowns that also must be examined in order to strengthen our government's ability to enforce our anti-money laundering laws.

This afternoon, the Subcommittee will investigate the noncompliant and inexcusable behavior of these two banks along with the inadequate response of our regulators.

In the OCC's oversight of the Riggs Bank case, we find no better illustration of the inherent weaknesses of a fragmented regulatory regime.

We find a regulator that was reportedly aware of noncompliance by Riggs with high-risk foreign clientele as far back as 1999 -- perhaps even earlier -- and did nothing about it.

We find a regulator that was slow to act even after the Sept. 11 terrorist attacks inside our borders made the threat posed by terror funding networks all too clear.

We find a regulator with credibility so diminished that Riggs shamelessly continued to violate the Bank Secrecy Act even after a full-time OCC examiner was placed on the bank's premises following last summer's consent order.

I am very interested in hearing directly from the OCC about how this happened.

I am deeply concerned that we are combating illicit funding networks inside our country with a regulatory structure that was not designed to be part of our arsenal in a war on terror.

Though great strides forward have been taken, particularly with the creation of the Office of Terrorism and Financial Intelligence (TFI) and with an elevated focus on improving FinCEN's capabilities, it is evident that this is still a work-in-progress.

The time has come to replace a slow-footed regulatory system with one that is centralized, multi-dimensional, and focused intently on preventing our financial institutions from being exploited by criminals and terrorists.

Therefore, this subcommittee will continue to pursue proposals that centralize our examination and compliance assets, and that establish a criminal enforcement authority that will restore the credibility of our regulators.

Such reforms should establish clear lines of oversight, improve our ability to quickly detect and respond to suspicious activity, and will make clear to financial institutions that, from now on, brazen violators will be going to jail instead of just paying a civil fine.

Our hearing today also focuses on UBS's contract with the Federal Reserve Bank of New York to serve as an Extended Custodial Inventory (ECI), which facilitates the international distribution of U.S. currency.

Beginning with its contract in 1996, UBS was in violation of its agreement to repatriate old U.S. banknotes and redistribute new banknotes on behalf of the Federal Reserve.

The bank knowingly traded U.S. currency through the ECI with countries subject to restrictions from the Office of Foreign Asset Control (OFAC), including Cuba, Iran, Libya, and Yugoslavia.

The most serious and disturbing violation has been the discovery that officers and employees at UBS intentionally falsified documents to sidestep detection by U.S. authorities.

While these actions and the company's failure to implement internal controls made it exponentially more difficult to detect suspicious activity, it is also important to examine how and why routine oversight by the Federal Reserve and the OCC did not raise any concerns.

In fact, this Subcommittee is deeply concerned that the contract violations would likely still be occurring today had our military not been in a position to find U.S. dollars from the Federal Reserve Bank of New York on the ground in Iraq.

As such, I believe we must investigate all ECI contracts to ensure that foreign governments and financial institutions are cooperating with our government.

While Riggs Bank and UBS illustrate two distinct regulatory meltdowns, they both speak clearly to the need for improving our efforts to stop terror financing.

It may create new and unfamiliar responsibilities for financial institutions, but it is a moral and ethical responsibility and a license required to do business in this country.

We thank our witnesses for their testimony and hope they can shed some light on these issues. I look forward to continuing this examination in the Subcommittee's hearing next week regarding oversight of the Department of Treasury and the agency's anti-money laundering efforts.

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Prepared, not delivered

Opening Statement

Chairman Michael G. Oxley
Committee on Financial Services

"Risk Management and Regulatory Failures at Riggs Bank and UBS: Lessons Learned"

Subcommittee on Oversight and Investigations

June 2, 2004

Thank you, Chairwoman Kelly, for convening today's hearing before the Oversight and Investigations Subcommittee concerning two recent cases where bank misbehavior at a U.S. bank (Riggs) and a foreign bank (UBS) over an extended period of time ultimately led federal regulators to sanction those banks.

In both cases, high-prestige lines of business missed risk management and regulatory scrutiny because they did not generate high revenues. In both cases, flagrant violations continued to occur even after regulatory authorities began to inquire and demand remedial action.

Riggs Bank N.A. was recently fined a $25 million civil money penalty for Bank Secrecy Act noncompliance. As I understand it, Riggs allowed substantial sums of money to pass through diplomatic accounts over a number of years. It failed to comply with a number of Bank Secrecy Act reporting requirements, including the substantial changes made to these statutes following the September 11 events.

To compound the problem, once this behavior was revealed by the Office of the Comptroller of the Currency last year, it took many months to halt the improper money handling practices at Riggs, even with an OCC examiner on the premises!

The second situation involves the Union Bank of Switzerland (UBS) and its performance under a contract with the Federal Reserve Bank of New York (the Fed) to act as agent for the Fed in disbursing and receiving U.S. banknotes outside the United States through a vault in Zurich. In brief, UBS violated its "Extended Custodial Inventory" (ECI) contract by engaging in transactions to buy and sell U.S. banknotes with counterparties in countries subject to U.S. restrictions and then failing to disclose the transactions. Those countries were: Cuba, Iran, Libya, and two parts of the former Yugoslavia. The contract with the Fed specifically prohibited such transactions.

These transactions came to light by accident, when a cache of U.S. dollars originally shipped through the Zurich facility was discovered in post-Saddam Iraq. UBS aggravated the situation by taking over six months to identify and remedy pervasive weaknesses in their internal risk management structure that permitted the violations to continue up until the day the Fed terminated its contract with UBS.

The Federal Reserve fined UBS $100 million for this action. This is the second largest fine ever levied by the Fed, and the largest was against BCCI in the early 1990s. I question whether the magnitude of the UBS fine is sufficient in light of the gravity of the risk management failures and deliberate efforts to conceal prohibited activity. The fine seems roughly equivalent to the value of the ECI business. But it barely dents the quarterly earnings at UBS. I understand that the Swiss authorities also have taken regulatory action, but this information is not publicly available.

I thank Chairwoman Kelly for her leadership in inviting representatives of the OCC and the Fed here today to discuss these two important cases. We need to understand how these problems could have existed and, more importantly, could have persisted after regulatory inquiries had begun.

I am eager to hear our witnesses review these situations in some detail, especially regarding the apparent failure of the two banks' internal risk management and transaction reporting systems. Further, I want to hear about the regulators' efforts to correct these problems, and consider what recommendations they might have for avoiding similar problems in the future.

Our regulatory systems are designed to identify and stop money laundering as well as to disrupt terrorist financing schemes. While the inappropriate actions under discussion today were eventually exposed and stopped, they did operate for quite some time without American regulatory intervention. I want to know what we can to do to prevent such problems now and in the future.

One strength of democratic government is that problems are discussed openly and, when possible, remedied quickly. In both the Riggs and UBS cases, serious remedial action has been taken, and we now seek to learn from the mistakes. The Fed is to be commended for achieving an unprecedented level of cooperation and information-sharing with its Swiss counterpart, the EBK.

Again, my thanks to Chairwoman Kelly for convening this hearing and to our witnesses for their willingness to explore intricate and, often, unresolved matters related to these two cases for the public record. I look forward to an informative session.

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Testimony of Thomas C. Baxter, Jr.

Executive Vice President and General Counsel, Federal Reserve Bank of New York
Risk Management and Regulatory Failures at Riggs Bank and UBS: Lessons Learned
Before the Subcommittee on Oversight and Investigations, Committee on Financial Services, U.S. House of Representatives
June 2, 2004

Introduction

Chairwoman Kelly, Representative Gutierrrez and members of the Subcommittee, I am pleased to be here this morning to discuss certain recent events relating to the Federal Reserve's Extended Custodial Inventory ("ECI") program. With me from the Federal Reserve Board are Katherine Wheatley, Assistant General Counsel, and Michael Lambert, Financial Services Cash Manager. Today, I will focus on the Federal Reserve Bank of New York's ("New York Fed") responses to the deceptive conduct of one of the former operators of an ECI facility, namely UBS, a Swiss banking organization. UBS operated an ECI site in Zurich, Switzerland, until late October of 2003 when the New York Fed terminated its contract with UBS for serious breaches. More recently, the Federal Reserve assessed a $100 million civil money penalty against UBS for its deceptive conduct both in connection with its performance under the ECI contract, and with respect to the investigation into that performance.

My remarks today will cover four topics. First, I will provide some background regarding the ECI program. Second, I will review the chronology surrounding our discovery that UBS had violated its ECI Agreement with the Federal Reserve Bank of New York by engaging in U.S. dollar ("USD") banknote transactions with countries subject to sanctions by the U.S. Department of the Treasury's Office of Foreign Assets Control ("OFAC"), and, moreover, that certain former officers and employees of UBS had intentionally deceived the New York Fed in order to conceal

those transactions. Third, I will explain the rationale behind our decision to assess a civil money penalty in the amount of $100 million and will distinguish this punitive action from the earlier action for breach of contract and the remedial action of the Swiss supervisor, the Swiss Federal Banking Commission (referred to as the "EBK"). Fourth, I will discuss the steps the New York Fed has taken with respect to its remaining ECI operators so as to improve the controls relating to OFAC compliance.

Background on the ECI Program

Let me now describe the ECI program. The ECI program serves as a means to facilitate the international distribution of U.S. banknotes, permit the repatriation of old design banknotes, promote the recirculation of fit new-design currency, and strengthen U.S. information gathering capabilities on the international use of U.S. currency and sources of U.S. banknote counterfeiting abroad. ECI facilities function as overseas cash depots operated by private-sector commercial banks. These banks hold currency for the New York Fed on a custodial basis.

It is estimated that as much as two-thirds of the value of all Federal Reserve Notes now in circulation, or more than $400 billion of the $680 billion now in circulation, is held abroad. While many financial institutions trade U.S. dollars in the foreign exchange markets, no more than thirty institutions worldwide participate in the wholesale buying and selling of physical USD banknotes. Wholesale banknote dealers purchase approximately 90 percent of the U.S. banknotes that are exported to international markets from the New York Fed.

Working with the U.S. Department of the Treasury, the Federal Reserve introduced the ECI program as a pilot in 1996 to aid in the introduction of the $100 new

currency design note, and in recognition that an assured supply of U.S. currency abroad would help to alleviate any uncertainty that might have been associated with a new design. The pilot program succeeded in ensuring the orderly introduction of the new design banknotes by providing ready supplies of such notes, particularly in the European and former Soviet Union markets.

After supporting the successful introduction of the new design $100 banknote in 1996, the primary purpose of the ECI program shifted to enhancing the international banknote distribution system. Currently, there are a total of eight ECI facilities in five cities that are operated by five banks: American Express Bank (London), Bank of America (Hong Kong, Zurich), HSBC Bank USA (London, Frankfurt, Hong Kong), Royal Bank of Scotland (London), and United Overseas Bank (Singapore).

The New York Fed manages the ECI program and provides management oversight and monitoring of it. We coordinate the shipment and receipt of currency between our offices and the ECIs. All banknotes contained within an ECI vault and while being transported between the New York Fed and an ECI vault, remain on the books of the New York Fed. When banknotes are withdrawn from the ECI vault to fill a banknote order from a third party, or for an ECI operator's use, the ECI operator's account at the New York Fed is debited accordingly. When banknotes are deposited into the ECI vault and augment the New York Fed inventory, the operator's account at the New York Fed will be credited.

The relationship between ECI operators and the New York Fed is governed by an ECI Agreement and a Manual of Procedures for the ECI Program ("Manual of Procedures"). From the start of the ECI program, the ECI Agreement has

specifically prohibited ECI operators from engaging in transactions with OFAC sanctioned countries. In addition, since the beginning of the program, the ECI Agreement and the Manual of Procedures have required ECI operators to provide the New York Fed with monthly reports showing all countries that engaged in U.S. dollar transactions with the operator during the preceding month and the volume of those transactions.

The ECI program facilitates the international distribution of U.S. currency by maintaining sufficient inventory of Federal Reserve notes in strategically located international distribution centers. The ECIs also are a key part of the Federal Reserve's and Treasury's efforts to distribute currency to the major global financial markets during times of crises. In the wake of the September 11th attacks, when air transportation was seriously disrupted, having U.S. currency already positioned at the ECI facilities enabled the Federal Reserve to satisfy heightened international demand for U.S. currency in the major financial markets without any interruption of service.

In addition to its role in international currency distribution, the ECI program is critical to ensuring the quality of U.S. currency abroad. ECIs are required to sort currency purchased from market participants both by currency design (old and new) and into fit and unfit notes. These requirements ensure that old design and unfit notes are removed from circulation in a timely fashion. ECIs are also responsible for authenticating banknotes purchased in the market. The ECIs detect counterfeit notes as they circulate in significant offshore money markets, and quickly report information on the geographic sources of these counterfeit notes to the Secret Service.

Finally, the information provided by the ECIs to the New York Fed regarding country level flows of payments, and receipts of U.S. dollars is important to the Federal Reserve, the Treasury, and the United States Secret Service because it provides a valuable tool for estimating stocks and flows of U.S. currency abroad, particularly for countries about which little information was available previously. Before the ECI program, the United States had little or no access to this mission-critical information about overseas counterfeiting and currency flows that is now required by the ECI Agreements.

The Chronology

I will now turn to the chronology of events surrounding the discovery that UBS had engaged in ECI transactions with OFAC-sanctioned countries and had concealed those transactions from the New York Fed.

On April 20, 2003, the Sunday New York Times reported that U.S. armed forces had discovered, in Baghdad, approximately $650 million in United States currency. According to the article, the wrapping on the currency indicated that it originated, in part, from the New York Fed. Upon reading this article, I sent an e-mail directing staff at the New York Fed to attempt to determine how currency bearing the mark of the Federal Reserve Bank of New York might have traveled from our offices to Baghdad. Around the same date, staff from the Board of Governors of the Federal Reserve System ("Board of Governors") in Washington were contacted by the Treasury Department and asked to assist in tracing the same currency. Also at this time, staff at the New York Fed and other Reserve Banks received telephone calls from agents of the U.S. Customs Service seeking information regarding the discovered banknotes.

Within days, the New York Fed received serial numbers for a small sample of the banknotes found in Iraq. By April 24, 2003, our cash staff in East Rutherford, N.J., had determined, using serial number records, that the sampled notes were part of twenty-four shipments that had been sent from our offices to three of our ECI facilities: HSBC in London, Bank of America in Zurich and UBS in Zurich. Over the next few weeks, we received additional serial numbers from other samples of the discovered currency as well as serial numbers from samples of an additional $112 million that was discovered in Iraq shortly after the initial hoard. We successfully traced those serial numbers to the same three ECI facilities, as well as to HSBC's ECI facilities in Frankfurt and London; to the Royal Bank of Scotland's ECI facility in London; to a number of commercial banks in the United States and abroad; and to several foreign central banks.

In an effort to follow the currency trail further, in early May of 2003, we contacted each of the ECI operators, and one of the commercial banks that had done a large volume of relevant currency purchases, and asked them to provide us with information regarding the counterparties to whom they sold the identified banknotes. By the end of May, we had received responses from HSBC and Bank of America that included, for HSBC, specific counterparty information, and for Bank of America, more general country information, for the relevant shipments. No transactions with Iraq or any other OFAC-sanctioned countries were contained in these responses. Our investigative efforts to follow the trail of the currency discovered in Iraq are continuing.

UBS responded to our inquiry by advising that it did not track serial numbers for its banknote sales. In the alternative, UBS agreed to provide information

regarding shipments of currency from the ECI that corresponded closely to the dates on which the notes found in Iraq had been shipped from the New York Fed's New Jersey office to the UBS ECI. UBS also informed the New York Fed that Swiss law considerations precluded the sharing of specific counterparty names. Accordingly, only country destinations could be provided. On June 25, 2003, UBS provided a report to one of our cash officers, who was in Zurich for a periodic site inspection. The report purported to list the relevant shipments by date and included the countries to which the banknotes were sold and the amounts in each shipment. While no transactions with Iraq were identified, included in this report were entries representing eight shipments of banknotes to Iran. Of course, we had not expected such a disclosure as currency transactions with Iran were expressly prohibited by the ECI Agreement.

Upon learning that UBS had sold banknotes to Iran, we asked UBS to explain how these Iranian transactions could have occurred in view of the clear contractual prohibition in the ECI Agreement against shipping currency to countries that are the subject of regulations issued by OFAC. We also inquired as to why these transactions had not appeared on the monthly dollar transaction reports that UBS was required to provide to the New York Fed pursuant to the ECI Agreement. UBS responded that the transactions with Iran were done by mistake. Further, with respect to our specific questions directed at the false monthly reports, UBS banknote personnel provided a facially plausible, but false, explanation. The explanation was that the reports were the result of an innocent mistake and not an intentional deception.

In early July of 2003, New York Fed management concluded that the transactions by our ECI operator, UBS, with Iran constituted a material event that needed

to be reported. Consequently, on July 11, 2003, I sent a memorandum reciting the facts known then to the New York Fed's board of directors, which, under Section 4 of the Federal Reserve Act, exercises "supervision and control" of the Bank management. In addition, the New York Fed disclosed what we knew to senior staff at OFAC, the Board of Governors, and the Department of the Treasury. The UBS situation was discussed with the New York Fed's board of directors at its meeting on July 17, 2003. The directors concurred in the management recommendation to more fully understand the facts by involving UBS's home country supervisor, the EBK, and when the facts were fully understood, to make a decision with respect to contract termination.

On July 22, 2003, I met with representatives of the EBK in Switzerland to discuss how to move forward with an inquiry. I explained to the representatives that, to avoid termination of its ECI contract, UBS would have to provide the New York Fed with reassurance as to its compliance. I emphasized that the New York Fed could not tolerate a repeat violation. I also told the EBK that I was not satisfied with the explanation proffered by UBS concerning the monthly reports. It was agreed that the New York Fed would draft questions regarding UBS's compliance with OFAC regulations in the operation of the ECI and that Ernst and Young ("E&Y"), UBS's outside auditor, would review the operation and prepare responses to our questions.

In late July of 2003, E&Y began its review of UBS's ECI operation. During the course of this review, which concluded in October of 2003, E&Y learned that in addition to the transactions with Iran, UBS had also engaged in banknote purchase transactions with Cuba, another country on the OFAC list, and that the banknotes had been deposited into the ECI. E&Y also learned that, in preparing the monthly dollar

transaction reports, personnel in UBS's banknotes operation had concealed the Cuban transactions from the New York Fed. E&Y informed senior UBS personnel of its findings and encouraged UBS to disclose the information to the EBK and to the New York Fed.

In mid-October, UBS disclosed to the EBK that, in addition to the transactions with Iran, it had engaged in USD banknote transactions with Cuba that involved the ECI. The EBK advised UBS to disclose the transactions to the New York Fed. Late on Friday, October 24, 2003, representatives of UBS met with me at the New York Fed. They told me that UBS had engaged in transactions not only with Iran, but also with Cuba, and with Libya, yet another country on the OFAC list. On Tuesday, October 28, 2003, the New York Fed terminated its ECI Agreement with UBS for breach of Articles 8 and 9 of the Agreement which dealt with, respectively, UBS's monthly reporting obligations and its OFAC compliance obligations. Within a week of the termination, UBS disclosed that it had also engaged in transactions with Yugoslavia (the Republics of Serbia and Montenegro) during the time that Yugoslavia was subject to OFAC sanctions. New York Fed management promptly informed the New York Fed board of directors of the decision to terminate for breach, and the reasons for the decision.

After terminating the contract for breach, the New York Fed needed UBS's continuing cooperation in the investigation of the facts regarding the breach *and* the false reports. Senior management of UBS did cooperate with us in these specific matters. Further, we received extraordinary assistance from our supervisory colleagues at the EBK.

Following the termination of the ECI Agreement, UBS appointed an investigative steering committee and retained two respected law firms to conduct a full investigation into the operation of the Zurich ECI. The internal and external auditors of UBS were asked to assist. The EBK agreed to allow UBS to share the results of this investigation with the New York Fed on a confidential basis.

Over the next six months, the investigative team interviewed forty-eight UBS employees, many on multiple occasions, and reviewed several thousand documents, including e-mails. On December 3, 2003, the first report from the investigation was provided to the New York Fed. Between delivery of the first report and April of 2004, I, and other New York Fed officers met with representatives of UBS on three occasions and had many telephone conversations in which we reviewed the status of the investigation and requested that more work be done on specific issues. During this same time period, the UBS investigative team also provided us with numerous supplemental responses, documents, and updated chronologies. True to its commitment during the summer of 2003, the EBK enabled UBS to make full disclosure of the investigative results, and also enabled the New York Fed to interview members of the E&Y team that had reviewed UBS's ECI operations. On April 16, 2004, UBS provided the New York Fed with its final supplement to the December report.

The investigation confirmed that UBS engaged in USD banknote transactions, through the ECI, directly with four OFAC sanctioned countries: Cuba, Libya, Iran, and the former Yugoslavia, but not directly with Iraq. UBS consistently engaged in these transactions from the inception of the ECI program, notwithstanding the fact that the UBS personnel involved clearly understood that the ECI Agreement

prohibited such transactions. Moreover, UBS personnel took affirmative steps to conceal these transactions from the New York Fed, including, but not limited to, falsifying the monthly U.S. dollar transaction reports that it was contractually obligated to submit. UBS personnel continued their efforts to conceal these transactions even after the investigation was underway. The banknote personnel of UBS also affirmatively misled the EBK.

In early May of 2004, the New York Fed engaged the EBK in discussions regarding the appropriate supervisory response to UBS's conduct. Our goal was for the EBK to take remedial action in its capacity as UBS's home country supervisor, and for the Federal Reserve to take punitive action against UBS for its deceptive conduct with respect to an important U.S. program--our sanction regime. On May 10, 2004, the EBK publicly reprimanded UBS for the failures in internal control that permitted both the breach of contract and the deception. The EBK's decision acknowledged that UBS planned to discontinue its banknote trading business, and forbade UBS from restarting this business without the EBK's consent. Simultaneous with the EBK's announcement of its supervisory decision, the Federal Reserve announced the assessment of a $100 million civil money penalty against UBS.

The Civil Money Penalty Assessment

I now turn to my third topic and focus on the amount of the civil money penalty assessed by the Federal Reserve against UBS. At the outset, let me emphasize that the civil money penalty is directed at deception and the violation of U.S. laws relating to deception. The remedy for breach of contract was contract termination, and that occurred more than six months ago.

The Federal Reserve's statutory authority to assess a civil money penalty is expressly set out in Section 8(i) of the Federal Deposit Insurance Act ("FDI Act"). When the Federal Reserve determines that a financial institution has violated the law, as UBS did here, and that such a violation justifies the assessment of a civil money penalty, we look first to Section 8(i) to determine the range of the penalty that might be imposed. The statute carefully lays out a three-tiered approach to assessment. The tiers focus on both the likelihood that the violation will cause financial harm to the institution and on the degree of willfulness demonstrated by the institution in committing the violation. The greater the likelihood of harm and the more deliberate the act, the higher the maximum penalty.

UBS's conduct here constituted a tier two violation. Section 8(i)(2)(B) of the FDI Act provides that any depository institution that violates any law, which violation is part of a pattern of misconduct, shall pay a civil money penalty of not more than $25,000 for each day during which such violation continues. This formula, applied to UBS's multiple violations of law, permitted the Federal Reserve to assess a civil money penalty of $100 million.

While UBS is a $1 trillion institution, and has abundant financial resources, banknote trading was a very small piece of UBS's overall business. For the years 1999-2003, UBS's banknote trading business for all currencies with all countries had aggregate net profit of approximately $87 million. From 1996 through 2003, UBS earned net profit of slightly less than $5 million from its banknote transactions with countries subject to OFAC sanctions. Thus, the $100 million civil money represents a

penalty that is approximately twenty times the amount of the net profit that UBS derived from its wrongful conduct.

Clearly, however, we recognized the severity of UBS's actions. UBS had deceived us over an eight-year period in several different ways. In assessing the civil money penalty, however, we were mindful that the assessment should not be made in a vacuum. In 1992, the Board of Governors assessed a $200 million penalty against BCCI; and the $100 million civil money penalty assessed against UBS is equal to the next-highest penalty the Federal Reserve has ever assessed against an institutional respondent. Last year, in conjunction with a criminal disposition by the U.S. Department of Justice, the Federal Reserve assessed Credit Lyonnais a $100 million civil money penalty. While no two cases are alike, Credit Lyonnais engaged in a similar pattern of deliberate and repeated false statements to the Federal Reserve in connection with its secret acquisition of the Executive Life Insurance Company.

In considering whether the amount of the civil money penalty was sufficiently large, it is not enough to look only at the size of UBS's balance sheet and net profit. It is important to keep in mind that UBS is a Swiss institution with its own banking supervisor, the EBK, which has no authority to impose money penalties. A Swiss governmental reprimand to the largest bank in Switzerland is, to our knowledge, unprecedented in Swiss history. The EBK took that action, in no small measure, to demonstrate that it would not tolerate deception any more than we would. We gave special consideration to the EBK's views also because, as senior Treasury officials have noted in testimony before Congress, the EBK has demonstrated exceptional cooperation

in matters relating to the global fight against terrorist financing. As a bank supervisor active in that fight, the Federal Reserve appreciates the value of global cooperation.

In short, the $100 million civil money penalty that we assessed against UBS was appropriate. It was in proportion to the revenues UBS derived from its unlawful actions. It was in line with the Federal Reserve's history of civil money penalties. And, it was appropriate because we were able to act together with the EBK to craft supervisory action that is both punitive and remedial.

2004 Enhancement of ECI OFAC Compliance Requirements

Turning to my final point, I will describe the actions taken by the New York Fed in the wake of the discovery of UBS's deceit. These actions are aimed at ensuring that our ECI operators will not conduct ECI transactions directly with OFAC-sanctioned countries. Thus, through our ECI contracts, we are able to extend the reach of the OFAC sanctions to foreign jurisdictions. It is important to keep in mind, however, that the U.S. sanctions regime cannot be applied extraterritorially without limitation.

Immediately following the discovery that UBS had engaged in transactions with Iran, in July 2003, we directed inquiries toward each of the five banks with which we continue to maintain an ECI relationship. The banks responded by detailing for us the procedures each had in place to ensure their contractual compliance with the OFAC regulations and various Anti-Money Laundering ("AML") statutes and regulations. These responses gave us sufficient confidence to carry us through for the period necessary until we could amend our contracts to strengthen the OFAC and AML compliance provisions.

In the fall of 2003, the New York Fed began a process of amending all of the ECI Agreements and the accompanying Manual of Procedures to strengthen the compliance requirements supporting the OFAC sanctions programs. Each revised Agreement establishes the ECI operators' general responsibilities for OFAC compliance, while the new Manual of Procedures enumerates in detail minimum specific responsibilities. The new contracts and Manual of Procedures were all executed and became fully effective in February 2004.

In revising the ECI Agreements, two major changes were made to the OFAC Compliance Section. First, language was added to expressly provide that the ECI bank "agrees that ECI Banknote Activity is subject to the jurisdiction of the U.S. Department of Treasury's Office of Foreign Assets Control." Second, the Agreement was amended to include an acknowledgement from the operating bank that, with respect to banknote transactions, it must comply with the provisions of the U.S. Trading with the Enemy Act, the International Emergency Economic Powers Act, the Antiterrorism and Effective Death Penalty Act, and "any other similar asset control laws, to the extent that they are implemented by OFAC regulations."

Perhaps the most significant changes, however, relate to new audit requirements for the ECIs. A new section was added to the ECI Agreement requiring an annual audit of the operating bank's AML and OFAC compliance programs by a public accounting firm, hired at the ECI operator's expense. The ECI Agreement also provides that a management representative must attest that the ECI operator is complying with the contract. Then, in a Sarbanes-Oxley inspired provision, the contract requires that the public accounting firm must attest to the management assertion, and specifically, whether

the assertion is fairly stated. The contract also provides that the public accounting firm will render an opinion on whether the monthly reports that the ECI bank has provided to the New York Fed are accurate. The New York Fed is currently in the process of working with the public accounting firms concerning implementation of this requirement.

The Manual of Procedures was also expanded and now requires ECI operators to:

1. Establish a system of internal controls to ensure compliance with all OFAC regulations. Internal controls should be specific to all aspects of ECI Banknote Activity from account opening through the initiation and settlement of all transactions;
2. Perform and document a comprehensive OFAC risk assessment of all aspects of ECI activities, including any transactions that are processed through the ECI for another institution;
3. Designate a compliance officer responsible for monitoring compliance with all OFAC laws and regulations, and an officer responsible for overseeing any funds blocked as a result of any OFAC law or regulation;
4. Implement an audit program that will provide for independent testing of all aspects of the OFAC compliance program and for an annual comprehensive audit of each line of business relating to the ECI activities;
5. Provide appropriate OFAC compliance training for all employees in each line of business relating to ECI activities;
6. Maintain the most current OFAC List of prohibited countries, entities, and individuals;
7. Retain all OFAC-related records for a period of not less than five years; and
8. Require the OFAC compliance officer to develop a program to screen customers and transactions for OFAC compliance. The screening program shall, at a minimum:

a) Ensure that all new customers are compared to the OFAC list and formally approved for activity before any transaction is initiated with the customer;

b) Specify what information in the account is being compared, *e.g.*, accountholder, signatories, powers of attorney, beneficiaries, and/or beneficial owners;

c) Require that, whenever OFAC updates the OFAC List, a review shall immediately be performed of existing customers and of all electronic files used to maintain customer information;

d) Require periodic testing to ensure that existing customers and any electronic customer information files are effectively tested for OFAC compliance;

e) Require that all ECI activities be compared to the OFAC list and monitored for prohibited activity;

f) Implement an escalation program to ensure that any potential matches of customers or transactions be reported immediately to the OFAC compliance officer for review and disposition;

g) Implement effective controls to identify transactions that match an OFAC-sanctioned individual or entity;

h) Require that any identified transactions be reported to OFAC in accordance with OFAC regulations and to the New York Fed personnel identified in the ECI Agreement; and

i) Require that a history file of any customers or transactions initially identified as potential matches but subsequently approved by the OFAC compliance officer, be maintained under record retention policies for review by internal audit.

The changes to the Agreement and the expanded seventeen-point procedural program have strengthened ECI program internal controls, established

operational responsibility for compliance, and specified internal and external audit requirements. Moreover, each ECI operator's policies and procedures directed at OFAC compliance will be reviewed by a team from the New York Fed and OFAC. The first of these reviews is currently being planned.

I should note that, following the announcement of the assessment of the $100 million civil money penalty against UBS, we again directed inquiries to our ECI operators to learn their reactions to the Federal Reserve's action. All of the ECI operators viewed the penalty as significant and understood that it reflected the importance the New York Fed places on both strict compliance with the OFAC requirements of the ECI Agreement and the Manual of Procedures, and on the integrity of its ECI operators.

Conclusion

The ECI program serves an important U.S. function by ensuring that we supply USD banknotes to the global market in an efficient manner, and that the quality of, and confidence in, our currency is maintained at a high level. UBS' egregious conduct should not overshadow the ECI program's benefits. In terminating the UBS ECI contract, in assessing a $100 million civil money penalty against UBS for its deceptive conduct as a former ECI operator, and in working with the EBK to craft a coordinated regulatory response, the Federal Reserve acted decisively and properly to send a message about the importance it places on OFAC compliance. The remedial measures that we have put into place underscore the Federal Reserve's commitment to ensuring that all of our ECI operators will comply with U.S. sanctions in their ECI transactions.

Thank you for your attention, and I look forward to answering any questions you may have.

For Release Upon Delivery
2:00 p.m., June 2, 2004

TESTIMONY OF

DANIEL P. STIPANO

DEPUTY CHIEF COUNSEL

OFFICE OF THE COMPTROLLER OF THE CURRENCY

Before the

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

of the

COMMITTEE ON FINANCIAL SERVICES

of the

U.S. HOUSE OF REPRESENTATIVES

June 2, 2004

Statement required by 12 U.S.C. 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

I. INTRODUCTION

Chairwoman Kelly, Ranking Member Gutierrez, members of the Subcommittee, I appreciate the opportunity to appear before you today to discuss the challenges we at the Office of the Comptroller of the Currency (OCC) – and other financial institution regulators – face in combating money laundering in the U.S. financial system, and how we are meeting those challenges. I will also address the enforcement actions in this area we have recently taken against Riggs Bank N.A.

As the regulator of national banks, the OCC has long been committed to the fight against money laundering. For more than 30 years, the OCC has been responsible for ensuring that the banks under its supervision have the necessary controls in place and provide requisite notices to law enforcement to assure that those banks are not used as vehicles to launder money for drug traffickers or other criminal organizations. The tragic events of 9/11 have brought into sharper focus the related concern of terrorist financing. Together with the other federal banking agencies, the banking industry and the law enforcement community, the OCC shares the Subcommittee's goal of preventing and detecting money laundering, terrorist financing, and other criminal acts and the misuse of our nation's financial institutions.

The cornerstone of the federal government's anti-money laundering (AML) efforts is the Bank Secrecy Act (BSA). Enacted in 1970, the BSA is primarily a recordkeeping and reporting statute that is designed to ensure that banks and other financial institutions provide relevant information to law enforcement in a timely fashion. The BSA has been amended several times, most recently through passage of the USA PATRIOT Act in the wake of the 9/11 tragedy. Both the Secretary of the Treasury, through the Financial Crimes Enforcement Network (FinCEN), and the federal banking agencies, have issued regulations implementing the BSA, including regulations requiring all banks to have a BSA compliance program, and to file reports such as suspicious activity reports (SARs) and currency transaction reports (CTRs).

Due to the sheer volume of financial transactions processed through the U.S. financial system, primary responsibility for compliance with the BSA and the AML statutes rests with the nation's financial institutions themselves. The OCC and the other federal banking agencies are charged with ensuring that the institutions we supervise have strong AML programs in place to identify and report suspicious transactions to law enforcement, and that such reports are, in fact, made. Thus, our supervisory processes seek to ensure that banks have systems and controls in place to prevent their involvement in money laundering, and that they provide the types of reports to law enforcement that the law enforcement agencies, in turn, need in order to investigate suspicious transactions that are reported.

To accomplish our supervisory responsibilities, the OCC conducts regular examinations of national banks and federal branches and agencies of foreign banks in the United States. These examinations cover all aspects of the institution's operations, including compliance with the BSA. Our resources are concentrated on those institutions, and areas within institutions, of highest risk. In cases of noncompliance, the OCC has broad investigative and enforcement authority to address the problem.

Unlike other financial institutions, which have only recently become subject to compliance program and SAR filing requirements, banks have been under such requirements for years. For example, banks have been required to have a BSA compliance program since 1987, and have been required to file SARs (or their predecessors) since the 1970s. Not surprisingly, most banks today have strong AML programs in place, and many of the largest institutions have programs that are among the best in the world. There are now approximately 1.3 million SARs in the centralized database that is maintained by FinCEN. While the PATRIOT Act further augmented the due diligence and reporting requirements for banks in several key areas, one of its primary objectives was to impose requirements on nonbanking institutions that had long been applicable to banks.

The OCC's efforts in this area do not exist in a vacuum. We have long been active participants in a variety of interagency working groups that include representatives of the Treasury Department, law enforcement, and the other federal banking agencies. We also work closely with the FBI and other criminal investigative agencies, providing them with documents, information, and expertise on a case-specific basis. In addition, when we are provided with lead information from a law enforcement agency, we use that information to investigate further to ensure that BSA compliance systems are adequate.

We continue to work to improve our supervision in this area and we are constantly revising and adjusting our procedures to keep pace with technological developments and the increasing sophistication of money launderers and terrorist financers. For example, along with the other federal banking agencies, the OCC recently developed examination procedures to implement several key sections of the PATRIOT Act, and we expect to be issuing a revised version of our BSA Handbook by year end. We have also recently initiated two programs that will provide stronger and more complete analytical information to assist our examiners in identifying banks that may have high money laundering risk. Specifically, we are developing a database of national-bank filed SARs with enhanced search and reporting capabilities, and we also are developing and will implement nationwide, a new risk assessment process to better identify high-risk banks. Additionally, we are exploring with FinCEN and the other banking agencies better ways to use BSA information in our examination process to better identify risks and vulnerabilities in the banking system.

Recent events surrounding Riggs Bank N.A. have heightened interest in how the banking agencies, and the OCC in particular, conduct supervision for BSA/AML compliance. Together with FinCEN, the OCC recently assessed a record $25 million civil money penalty (CMP) against Riggs Bank N.A. The OCC also imposed a supplemental cease and desist (C&D) order on the bank, requiring the institution to strengthen its controls and improve its processes in the BSA/AML area. Along with the C&D order we issued against the bank in July 2003, these and other actions we have taken have greatly reduced the bank's current risk profile.

However, with the benefit of hindsight, it is clear that the supervisory actions that we previously took against the bank were not sufficient to achieve satisfactory and timely compliance with the BSA, that more probing inquiry should have been made into the bank's high risk accounts, and that stronger, more forceful enforcement action should have been taken sooner. While we do not

believe that Riggs is representative of the OCC's supervision in the BSA/AML area, we are nonetheless taking a number of steps to guard against a repeat of this type of situation. In this regard, the Comptroller has directed that our Quality Management Division commence a review and evaluation of our BSA/AML supervision of Riggs and make recommendations to him on several issues concerning our approach to and the adequacy of our BSA/AML supervision programs generally, and particularly with respect to Riggs.

II. BACKGROUND AND LEGAL FRAMEWORK

In 1970 Congress passed the "Currency and Foreign Transactions Reporting Act" otherwise known as the "Bank Secrecy Act" (BSA), which established requirements for recordkeeping and reporting by private individuals, banks and other financial institutions. The BSA was designed to help identify the source, volume and movement of currency and other monetary instruments into or out of the United States or being deposited in financial institutions. The statute sought to achieve that objective by requiring individuals, banks and other financial institutions to create a paper trail by keeping records and filing reports of certain financial transactions and of unusual currency transfers. This information then enables law enforcement and regulatory agencies to pursue investigations of criminal, tax and regulatory violations.

The BSA regulations require all financial institutions to submit various reports to the government. The most common of these reports are: (1) FinCEN Form 104 (formerly IRS Form 4789) – Currency Transaction Report (CTR) for each payment or transfer, by, through or to a financial institution, which involves a transaction in currency of more than $10,000; and (2) FinCEN Form 105 (formerly Customs Form 4790) – Report of International Transportation of Currency or Monetary Instruments (CMIR) for each person who physically transports monetary instruments in an aggregate amount exceeding $10,000 into or out of the United States. Bank supervisors are not responsible for investigating or prosecuting violations of criminal law that may be indicated by the information contained in these reports; they are, however, charged with assuring that the requisite reports are filed timely and accurately.

The Money Laundering Control Act of 1986 precludes circumvention of the BSA requirements by imposing criminal liability for a person or institution that knowingly assists in the laundering of money, or who structures transactions to avoid reporting. It also directed banks to establish and maintain procedures reasonably designed to assure and monitor compliance with the reporting and recordkeeping requirements of the BSA. As a result, on January 27, 1987, all federal bank regulatory agencies issued essentially similar regulations requiring banks to develop procedures for BSA compliance. The OCC's regulation requiring that every national bank maintain an effective BSA compliance program is set forth at 12 C.F.R. § 21.21 and is described in more detail below.

Together, the BSA and the Money Laundering Control Act charge the bank regulatory agencies with:

- overseeing banks' compliance with the regulations described, which direct banks to establish and maintain a BSA compliance program;

- requiring that each examination includes a review of this program and describes any problems detected in the agencies' report of examination; and
- taking C&D actions if the agency determines that the bank has either failed to establish the required procedures or has failed to correct any problem with the procedures which was previously cited by the agency.

The Annunzio-Wylie Anti-Money Laundering Act, which was enacted in 1992, strengthened the sanctions for BSA violations and the role of the Treasury Department. It contained the following provisions:

- a so-called "death penalty" sanction, which authorized the revocation of the charter of a bank convicted of money laundering or of a criminal violation of the BSA;
- an authorization for Treasury to require the filing of suspicious-transaction reports by financial institutions;
- the grant of a "safe harbor" against civil liability to persons who report suspicious activity; and
- an authorization for Treasury to issue regulations requiring all financial institutions, as defined in BSA regulations, to maintain "minimum standards" of an AML program.

Two years later, Congress passed the Money Laundering Suppression Act, which primarily addressed Treasury's role in combating money laundering. This statute:

- directed Treasury to attempt to reduce the number of CTR filings by 30 percent and, to assist in this effort, it established a system of mandatory and discretionary exemptions for banks;
- required Treasury to designate a single agency to receive SARs;
- required Treasury to delegate CMP powers for BSA violations to the federal bank regulatory agencies subject to such terms and conditions as Treasury may require;
- required nonbank financial institutions to register with Treasury; and
- created a safe harbor from penalties for banks that use mandatory and discretionary exemptions in accordance with Treasury directives.

Finally, in 2001, as a result of the 9/11 terror attacks, Congress passed the USA PATRIOT Act. The PATRIOT Act is arguably the single most significant AML law that has been enacted since the BSA itself. Among other things, the PATRIOT Act augmented the existing BSA framework by prohibiting banks from engaging in business with foreign shell banks, requiring banks to enhance their due diligence procedures concerning foreign correspondent and private banking accounts, and strengthening their customer identification procedures. The PATRIOT Act also:

- provides the Secretary of the Treasury with the authority to impose special measures on jurisdictions, institutions, or transactions that are of "primary money-laundering concern";
- facilitates records access and requires banks to respond to regulatory requests for information within 120 hours;
- requires regulatory agencies to evaluate an institution's AML record when considering bank mergers, acquisitions, and other applications for business combinations;

- expands the AML program requirements to all financial institutions; and
- increases the civil and criminal penalties for money laundering.

The OCC and the other federal banking agencies have issued two virtually identical regulations designed to ensure compliance with the BSA. The OCC's BSA compliance regulation, 12 C.F.R. § 21.21, requires every national bank to have a written program, approved by the board of directors, and reflected in the minutes of the bank. The program must be reasonably designed to assure and monitor compliance with the BSA and must, at a minimum: (1) provide for a system of internal controls to assure ongoing compliance; (2) provide for independent testing for compliance; (3) designate an individual responsible for coordinating and monitoring day-to-day compliance; and (4) provide training for appropriate personnel. In addition, the implementing regulation for section 326 of the PATRIOT Act requires that every bank adopt a customer identification program as part of its BSA compliance program.

The OCC's SAR regulation, 12 C.F.R. §21.11, requires every national bank to file a SAR when they detect certain known or suspected violations of federal law or suspicious transactions related to a money laundering activity or a violation of the BSA. This regulation mandates a SAR filing for any potential crimes: (1) involving insider abuse regardless of the dollar amount; (2) where there is an identifiable suspect and the transaction involves $5,000 or more; and (3) where there is no identifiable suspect and the transaction involves $25,000 or more. Additionally, the regulation requires a SAR filing in the case of suspicious activity that is indicative of potential money laundering or BSA violations and the transaction involves $5,000 or more.

III. OCC'S BSA/AML SUPERVISION

The OCC and the other federal banking agencies are charged with ensuring that banks maintain effective AML programs. The OCC's AML responsibilities are coextensive with our regulatory mandate of ensuring the safety and soundness of the national banking system. Our supervisory processes seek to ensure that institutions have compliance programs in place that include systems and controls to satisfy applicable CTR and SAR filing requirements, as well as other reporting and recordkeeping requirements to which banks are subject under the BSA.

The OCC devotes significant resources to BSA/AML supervision. The OCC has nearly 1700 examiners in the field, many of whom are involved in both safety and soundness and compliance with applicable laws including the BSA. We have over 300 examiners onsite at our largest national banks, engaged in continuous supervision of all aspects of their operations. In 2003, the equivalent of approximately 40 full time employees were dedicated to BSA/AML supervision. The OCC also has three full time BSA/AML compliance specialists in our Washington D.C. headquarters office dedicated to developing policy, training, and assisting on complex examinations. In addition, the OCC has a full-time fraud expert in Washington D.C., who is responsible for tracking the activities of offshore shell banks and other vehicles for defrauding banks and the public. These resources are supplemented by dozens of attorneys in our district offices and Washington D.C. headquarters office who work on compliance matters. In 2003 alone, not including our continuous large bank supervision, the OCC conducted approximately

1,340 BSA examinations of 1,100 institutions and, since 1998, we have completed nearly 5,700 BSA examinations of 5,300 institutions.

The OCC monitors compliance with the BSA and money laundering laws through its BSA compliance and money laundering prevention examination procedures. The OCC's examination procedures were developed by the OCC, in conjunction with the other federal banking agencies, based on our extensive experience in supervising and examining national banks in the area of BSA/AML compliance. The procedures are risk-based, focusing our examination resources on high-risk banks and high-risk areas within banks. During an examination, examiners use the procedures to review the bank's policies, systems, and controls. Examiners test the bank's systems by reviewing certain individual transactions when they note control weaknesses, have concerns about high-risk products or services in a bank, or receive information from a law enforcement or other external source.

In 1997, the OCC formed the National Anti-Money Laundering Group (NAMLG), an internal task force that serves as the focal point for all BSA/AML matters. Through the NAMLG, the OCC has undertaken a number of projects designed to improve the agency's supervision of the BSA/AML activities of national banks. These projects include the development of a program to identify high-risk banks for expanded scope BSA examinations and the examination of those banks using agency experts and expanded procedures; examiner training; the development of revised examination procedures; and the issuance of policy guidance on various BSA/AML topics.

Over the years, the NAMLG has had many significant accomplishments including:

- publishing and updating numerous guidance documents, including the Comptroller's BSA Handbook, extensive examination procedures, numerous OCC advisories, bulletins and alerts, and a comprehensive reference guide for bankers and examiners;
- providing expertise to the Treasury Department and the Department of Justice in drafting the annual U.S. National Money Laundering Strategy;
- providing expertise to the Treasury Department, FinCEN and the other federal banking agencies in drafting the regulations to implement the PATRIOT Act; and
- developing state-of-the-art training programs for OCC and other federal and foreign regulatory authorities in training their examiners in BSA/AML supervision.

To deploy its resources most effectively, the OCC uses criteria developed by NAMLG that targets banks for expanded scope AML examinations. Experienced examiners and other OCC experts who specialize in BSA compliance, AML, and fraud are assigned to the targeted examinations. The examinations focus on areas of identified risk and include comprehensive transactional testing procedures. The following factors are considered in selecting banks for targeted examinations:

- locations in high-intensity drug trafficking areas (HIDTA) or high-intensity money laundering and related financial crime areas (HIFCA);
- excessive currency flows;
- significant international, private banking, fiduciary or other high-risk activities;

- unusual suspicious activity reporting patterns;
- unusual large currency transaction reporting patterns; and
- fund transfers or account relationships with drug source countries or countries with stringent financial secrecy laws.

The program may focus on a particular area of risk in a given year. For example, our 2005 targeting program will focus on banks that have significant business activity involving foreign money services businesses. In prior years, our targeting focus has been on banks that have significant business activity in private banking, offshore banking, and lines of business subject to a high risk of terrorist financing.

Other responsibilities of the NAMLG include sharing information about money laundering issues with the OCC's District offices; analyzing money laundering trends and emerging issues; and promoting cooperation and information sharing with national and local AML groups, the law enforcement community, bank regulatory agencies, and the banking industry.

NAMLG has also worked with law enforcement agencies and other regulatory agencies to develop an interagency examiner training curriculum that includes instruction on common money laundering schemes. In addition, the OCC has conducted AML training for foreign bank supervisors and examiners two to three times per year for the past four years. Over 250 foreign bank supervisors have participated in this training program. Recently, the World Bank contracted with the OCC to tape our international BSA school for worldwide broadcast. The OCC has also partnered with the State Department to provide AML training to high-risk jurisdictions, including selected Middle Eastern countries. And we consistently provide instructors for the Federal Financial Institutions Examination Council schools, which are now patterned after the OCC's school. In total, the OCC's AML schools have trained approximately 550 OCC examiners over the past five years.

OCC's Enforcement Authority

Effective bank supervision requires clear communications between the OCC and the bank's senior management and board of directors. In most cases, problems in the BSA/AML area, as well as in other areas, are corrected by bringing the problem to the attention of bank management and obtaining management's commitment to take corrective action. An OCC Report of Examination documents the OCC's findings and conclusions with respect to its supervisory review of a bank. Once problems or weaknesses are identified and communicated to the bank, the bank's senior management and board of directors are expected to promptly correct them. The actions that a bank takes, or agrees to take, to correct deficiencies documented in its Report are important factors in determining whether more forceful action is needed.

OCC enforcement actions fall into two broad categories: informal and formal. In general, informal actions are used when the identified problems are of limited scope and magnitude and bank management is regarded as committed and capable of correcting them. Informal actions include commitment letters, memoranda of understanding and matters requiring board attention in examination reports. These generally are not public actions.

The OCC also may use a variety of formal enforcement actions to support its supervisory objectives. Unlike most informal actions, formal enforcement actions are authorized by statute, are generally more severe, and are disclosed to the public. Formal actions against a bank include C&D orders, formal written agreements and CMPs. C&D orders and formal agreements are generally entered into consensually by the OCC and the bank and require the bank to take certain actions to correct identified deficiencies. The OCC may also take formal action against officers, directors and other individuals associated with an institution (institution-affiliated parties). Possible actions against institution-affiliated parties include removal and prohibition from participation in the banking industry, CMPs and C&D orders.

In the BSA area, the OCC's CMP authority is concurrent with that of FinCEN. In cases involving systemic noncompliance with the BSA, in addition to taking our own actions, the OCC refers the matter to FinCEN. In the case of Riggs Bank, the OCC and FinCEN worked together on the CMP against the bank.

In recent years, the OCC has taken numerous formal actions against national banks to bring them into compliance with the BSA. These actions are typically C&D orders and formal agreements. The OCC has also taken formal actions against institution-affiliated parties who participated in BSA violations. From 1998 to 2003, the OCC has issued a total of 78 formal enforcement actions based in whole, or in part, on BSA/AML violations. During this same time period, the OCC has also taken countless informal enforcement actions to correct compliance program deficiencies that did not rise to the level of a violation of law.

Significant BSA/AML Enforcement Actions

The OCC has been involved in a number of cases involving serious BSA violations and, in some cases, actual money laundering. Some of the more significant cases involved the Bank of China (New York Federal Branch), Broadway National Bank, Banco do Estado de Parana (New York Federal Branch), and Jefferson National Bank. There are also dozens of other examples where the OCC identified significant money laundering or BSA non-compliance, took effective action to stop the activity, and ensured that accurate and timely referrals were made to law enforcement.

Bank of China, New York Federal Branch

In May 2000, OCC examiners conducting a safety and soundness examination discovered serious misconduct on the part of the branch and its former officials, including the facilitation of a fraudulent letter of credit scheme and other suspicious activity and potential fraud and money laundering. The misconduct, which resulted in significant losses to the branch, was subsequently referred to law enforcement. In January 2002, the OCC and the Peoples Bank of China entered into companion actions against the Bank of China and its U.S.-based federal branches. The bank's New York branch agreed to pay a $10 million penalty assessed by the OCC and the parent bank, which is based in Beijing, agreed to pay an equivalent amount in local currency to the People's Bank of China, for a total of $20 million. The OCC also required that the branch execute a C&D order which, among other things, required it to establish account opening and monitoring procedures, a system for identifying high risk customers, and procedures for regular,

ongoing review of account activity of high risk customers to monitor and report suspicious activity. The OCC also took actions against six institution-affiliated parties.

Broadway National Bank, New York, New York

In March of 1998, the OCC received a tip from two separate law enforcement agencies that this bank may be involved in money laundering. The OCC immediately opened an examination which identified a number of accounts at the bank that were either being used to structure transactions, or were receiving large amounts of cash with wire transfers to countries known as money laundering and drug havens. Shortly thereafter, the OCC issued a C&D order which shut down the money laundering and required the bank to adopt more stringent controls. The OCC also initiated prohibition and CMP cases against bank insiders. In referring the matter to law enforcement, we provided relevant information including the timing of deposits that enabled law enforcement to seize approximately $4 million and arrest a dozen individuals involved in this scheme. The subsequent OCC investigation resulted in the filing of additional SARs, the seizure of approximately $2.6 million in additional funds, more arrests by law enforcement, and a referral by the OCC to FinCEN. In November 2002, the bank pled guilty to a three count felony information that charged it with failing to maintain an AML program, failing to report approximately $123 million in suspicious bulk cash and structured cash deposits, and aiding and assisting customers to structure approximately $76 million in transactions to avoid the CTR requirements. The bank was required to pay a $4 million criminal fine.

Banco do Estado do Parana, Federal Branch, New York, N.Y (Banestado).

In the summer of 1997, the OCC received information from Brazilian government officials concerning unusual deposits leaving Brazil via overnight courier. The OCC immediately dispatched examiners to the branch that was receiving the majority of the funds. OCC examiners discovered significant and unusually large numbers of monetary instruments being shipped via courier into the federal branch from Brazil and other countries in South America, as well as suspicious wire transfer activity that suggested the layering of the shipped deposits through various accounts with no business justification for the transfers. The OCC entered into a C&D order with the federal branch and its head office in Brazil in January 1998 that required controls over the courier and wire transfer activities and the filing of SARs with law enforcement. The OCC also hosted several meetings with various law enforcement agencies discussing these activities and filed a referral with FinCEN. Shortly thereafter, the Brazilian bank liquidated the branch. In May of 2000, the OCC assessed a CMP against the branch for $75,000.

Jefferson National Bank, Watertown, New York

During the 1993 examination of this bank, the OCC learned from the Federal Reserve Bank of New York that the bank was engaging in cash transactions that were not commensurate with its size. OCC examiners subsequently discovered that several bank customers were depositing large amounts of cash that did not appear to be supported by the purported underlying business, with the funds being wired offshore. The OCC filed four criminal referral forms (predecessor to the SAR) with law enforcement pertaining to this cash activity and several additional criminal referral forms pertaining to insider abuse and fraud at the bank. The OCC also briefed several

domestic and Canadian law enforcement agencies alerting them to the significant sums of money flowing through these accounts at the bank. Based upon this information, law enforcement commenced an investigation of these large deposits. The investigation resulted in one of the most successful money laundering prosecutions in U.S. government history. The significant sums of money flowing through the bank were derived from cigarette and liquor smuggling through the Akwesasne Indian Reservation in northern New York. The ring smuggled $687 million worth of tobacco and alcohol into Canada between 1991 and 1997. The case resulted in 21 indictments that also sought the recovery of assets totaling $557 million. It also resulted in the December 1999 guilty plea by a subsidiary of R.J. Reynolds tobacco company and the payment of a $15 million criminal fine. The four criminal referral forms filed by the OCC in the early stages of this investigation were directly on point and pertained to the ultimate ringleaders in the overall scheme. These money laundering cases were in addition to the C&D order entered into with the bank, the prohibition and CMP cases that were brought by the OCC, and the insider abuse bank fraud cases that were brought by law enforcement against some of the bank's officers and directors. Seven bank officers and directors were ultimately convicted of crimes.

OCC Cooperation with Law Enforcement and Other Agencies

As the above cases illustrate, combating money laundering depends on the cooperation of law enforcement, the bank regulatory agencies, and the banks themselves. The OCC participates in a number of interagency working groups aimed at money laundering prevention and enforcement, and meets on a regular basis with law enforcement agencies to discuss money laundering issues and share information that is relevant to money laundering schemes. For example, the OCC is an original member of both the National Interagency Bank Fraud Working Group and the Bank Secrecy Act Advisory Group. Both of these groups include representatives of the Department of Justice, the FBI, the Treasury Department, and other law enforcement agencies, as well as the federal banking agencies. Through our interagency contacts, we sometimes receive leads as to possible money laundering in banks that we supervise. Using these leads, we can target compliance efforts in areas where we are most likely to uncover problems. For example, if the OCC receives information that a particular account is being used to launder money, our examiners would then review transactions in that account for suspicious funds movements, and direct the bank to file a SAR if suspicious transactions are detected. The OCC also provides information, documents, and expertise to law enforcement for use in criminal investigations on a case-specific basis.

The OCC has also played an important role in improving the AML and terrorist financing controls in banking throughout the world. For the past several years, the OCC has provided examiners to assist with numerous U.S. government-sponsored international AML and terrorist financing assessments. We have a cadre of specially trained examiners that has provided assistance to the Treasury Department and the State Department on these assessments in various parts of the world, including South and Central America, the Caribbean, the Pacific-rim nations, the Middle East, Russia and the former Eastern Bloc nations. In this regard, the cadre has participated in terrorist financing investigations, assessed local money laundering laws and regulatory infrastructure, and provided training to bank supervisors.

The OCC is also providing direct assistance to the Coalition Provisional Authority (CPA) of Iraq. Four OCC examiners are currently working in Iraq as technical assistance advisers to the CPA's Ministry of Finance and helping their counterparts at the Central Bank of Iraq develop a risk-based supervisory system tailored to the Iraqi banking system. The OCC examiners are assisting in the development of a law addressing money laundering and terrorist financing that is close to enactment by the CPA, the drafting of new policy and examination manuals to implement this law, and they are providing extensive AML training to Iraqi bank regulators.

IV. POST 9/11 ACTIVITIES AND THE IMPLEMENTATION OF THE USA PATRIOT ACT

In the immediate aftermath of the 9/11 terror attacks, the OCC participated in a series of interagency meetings with bankers sponsored by the New York Clearinghouse to discuss the attacks and their impact on the U.S. economy and banking system, and provided guidance to the industry concerning the various requests from law enforcement for account and other information. The OCC was also instrumental in working with the other banking agencies to establish an electronic e-mail system for law enforcement to request information about suspected terrorists and money launderers from every financial institution in the country. This FBI Control List system was in place five weeks after 9/11 and was the precursor to the current system established under section 314(a) of the PATRIOT Act, which is now administered by FinCEN. At the same time, the OCC established a secure emergency communications e-mail system for all national banks through the OCC's BankNet technology.

In October 2001, Congress passed the USA PATRIOT Act. The OCC has been heavily involved in the many interagency work groups tasked with writing regulations to implement the PATRIOT Act over the past few years. To date, these work groups have issued final rules implementing sections 313 (foreign shell bank prohibition); 319(b) (foreign correspondent bank account records), 314 (information sharing), and 326 (customer identification). The OCC was also involved in drafting the interim final rule implementing section 312 (foreign private banking and correspondent banking).

The OCC took the lead in developing the current 314(a) process for disseminating information between law enforcement and the banks. The OCC worked with the interested regulatory and law enforcement agencies, and drafted detailed instructions to banks concerning the 314(a) process and the extent to which banks are required to conduct record and transactions searches on behalf of law enforcement. The OCC also took the lead in drafting a frequently asked questions (FAQs) document to provide further guidance as to the types of accounts and transactions required to be searched, when manual searches for this information would be required, and the timeframes for providing responses back to law enforcement. Under the new procedures, 314(a) requests from FinCEN are batched and issued every two weeks, unless otherwise indicated, and financial institutions have two weeks to complete their searches and respond with any matches.

Throughout this process, the OCC continually assisted FinCEN in maintaining an accurate electronic database of 314(a) contacts for every national bank and federal branch, provided effective communications to the industry through agency alerts concerning the 314(a) system,

and participated in quarterly interagency meetings with fellow regulators and law enforcement agencies to ensure that the process was working effectively and efficiently.

The OCC also took the lead in drafting the interagency Customer Identification Program (CIP) regulation mandated by Section 326 of the PATRIOT Act, which mandates the promulgation of regulations that, at a minimum, require financial institutions to implement reasonable procedures for: (1) verifying the identity of any person seeking to open an account, to the extent reasonable and practicable; (2) maintaining records of the information used to verify the person's identity, including name, address, and other identifying information; and (3) determining whether the person appears on any lists of known or suspected terrorists or terrorist organizations provided to the financial institution by any government agency. The OCC is also the primary drafter of interagency FAQs concerning the implementation of the CIP rules. A second set of interagency FAQs will be issued shortly.

In order to assess PATRIOT Act implementation by the industry, in the summer of 2002, the OCC conducted reviews of all of its large banks to assess their compliance with the regulations issued under the PATRIOT Act up to that time, and to evaluate the industry response to terrorist financing risk. Although, at that time, many of the PATRIOT Act regulations had not yet been finalized, we felt it was important to ascertain the level of bank compliance with and understanding of the new requirements. The purpose of these reviews was to discern the types of systems and controls banks had in place to deter terrorist financing, and follow up with full-scope AML exams in institutions that had weaknesses. As a result of these reviews, the OCC was able to obtain practical first hand knowledge concerning how banks were interpreting the new law, whether banks were having problems implementing the regulations or controlling terrorist financing risk, and which banks needed further supervision in this area.

On October 20, 2003, the OCC issued interagency examination procedures to evaluate national bank compliance with the requirements of Section 313 and 319(b), and Section 314 of the PATRIOT Act. The procedures were designed to assess how well banks are complying with the new regulations and to facilitate a consistent supervisory approach among the banking agencies. OCC examiners are now using the procedures during BSA/AML examinations of the institutions under our supervision. The procedures allow examiners to tailor the examination scope according to the reliability of the bank's compliance management system and the level of risk assumed by the institution. An interagency working group is currently drafting examination procedures concerning Section 326 of the PATRIOT Act. The OCC is also the primary drafter of these procedures and we expect that they will be issued shortly.

OCC Outreach and Industry Education

As previously stated, the primary responsibility for ensuring that banks are in compliance with the BSA lies with the bank's management and its directors. To aid them in meeting this responsibility, the OCC devotes extensive time and resources to educating the banking industry about its obligations under the BSA. This has typically included active participation in conferences and training sessions across the country. For example, in 2002 the OCC sponsored a nationwide teleconference to inform the banking industry about the PATRIOT Act. This teleconference was broadcast to 774 sites with approximately 5,400 listeners.

The OCC also provides guidance to national banks through: (1) industry outreach efforts that include roundtable discussions with bankers and industry wide conference calls sponsored by the OCC; (2) periodic bulletins that inform and remind banks of their responsibilities under the law, applicable regulations, and administrative rulings dealing with BSA reporting requirements and money laundering; (3) publications, including the distribution of comprehensive guide in this area entitled Money Laundering: A Banker's Guide to Avoiding Problems; (4) publication and distribution of the Comptroller's BSA Handbook which contains the OCC's BSA examination procedures, and the Comptroller's Handbook for Community Bank Supervision which provides guidance on BSA/AML risk assessment; and (5) periodic alerts and advisories of potential frauds or questionable activities, such as alerts on unauthorized banks and FinCEN reporting processes. In addition, senior OCC officials are regular participants in industry seminars and forums on the BSA, the PATRIOT Act, and related topics.

Current Supervisory Initiatives

The OCC uses somewhat different examination approaches depending largely on the size of the institution and its risk profile. In large banks (generally total assets of $25 billion) and mid-size banks (generally total assets of $5 billion), OCC examiners focus first on the bank's BSA compliance program. These banks are subject to our general BSA/AML examination procedures that include, at a minimum, a review of the bank's internal controls, policies, procedures, customer due diligence, SAR/CTR information, training programs, and compliance audits. We also evaluate BSA officer competence, the BSA program structure, and the bank's audit program, including the independence and competence of the audit staff. While examining for overall BSA compliance, examiners typically focus on suspicious activity monitoring and reporting systems and the effectiveness of the bank's customer due diligence program.

Additional and more detailed procedures are conducted if control weaknesses or concerns are encountered during the general procedures phase of the examination. These supplemental procedures include:

- transaction testing to ascertain the level of risk in the particular business area (*e.g.*, private banking, payable upon proper identification programs (PUPID), nonresident alien accounts, international brokered deposits, foreign correspondent banking, and pouch activity) and to determine whether the bank is complying with its policies and procedures, including SAR and CTR filing requirements;
- evaluation of the risks in a particular business line or in specific accounts and a determination as to whether the bank is adequately managing the risks;
- a selection of bank records to determine that its recordkeeping processes are in compliance with the BSA.

For community banks (generally total assets under $5 billion), examiners determine the examination scope based on the risks facing the institution. For low-risk banks, examiners evaluate changes to the bank's operations and review the bank's BSA/AML compliance program. For banks with higher risk characteristics and weak controls, additional procedures are performed, including review of a sample of high-risk accounts and additional procedures set

forth above. Examiners also perform periodic monitoring procedures between examinations and conduct follow-up activities when significant issues are identified.

Use of CTR and SAR Data in the Examination Process

All banks are required by regulation to report suspected crimes and suspicious transactions that involve potential money laundering or violate the BSA. In April 1996, the OCC, together with the other federal banking agencies, and FinCEN, unveiled the SAR system, SAR form, and database. This system provides law enforcement and regulatory agencies online access to the entire SAR database. Based upon the information in the SARs, law enforcement agencies may then, in turn, initiate investigations and, if appropriate, take action against violators. By using a universal SAR form, consolidating filings in a single location, and permitting electronic filing, the system greatly improves the reporting process and makes it more useful to law enforcement and to the regulatory agencies. As of December 2003, banks and regulatory agencies had filed over 1.3 million SARs, with national banks by far the biggest filers. Nearly 50% of these SARs were for suspected BSA/money laundering violations.

The OCC also uses the SAR database as a means of identifying high-risk banks and high-risk areas within banks. Year-to-year trend information on the number of SARs and CTRs filed is used to identify banks with unusually low or high filing activity. This is one factor used by the OCC to identify high-risk banks. Examiners also review SARs and CTRs to identify accounts to include in the examination sample. Accounts where there have been repetitive SAR filings or accounts with significant cash activity in a high-risk business or inconsistent with the type of business might be accounts selected for the sample.

V. RIGGS BANK ENFORCEMENT ACTIONS

As previously mentioned, the OCC and FinCEN recently assessed a $25 million CMP against Riggs Bank N.A. for violations of the BSA and its implementing regulations, and for failing to comply with the requirements of an OCC C&D order that was signed by the bank in July 2003. Also, in a separate C&D action dated May 13, 2004 to supplement the C&D we had issued in July 2003, the OCC directed the bank to take a number of steps to correct deficiencies in its internal controls, particularly in the BSA/AML area. Among other requirements in this separate action, the OCC directed the bank to:

- Ensure competent management. Within 30 days, the board of directors must determine whether management or staff changes are needed and whether management skills require improvement.
- Develop a plan to evaluate the accuracy and completeness of the bank's books and records, and develop a methodology for determining that information required by the BSA is appropriately documented, filed and maintained.
- Adopt and implement comprehensive written policies for internal controls applicable to the bank's account relationships and related staffing, including the Embassy and International Private Banking Group. Among other requirements, the policies must mandate background checks of all relationship managers at least every three years and

must prohibit any employee from having signature authority, ownership or custodial powers for any customer account.

- Develop and implement a policy that permits dividend payments only when the bank is in compliance with applicable law and upon written notice to the OCC.
- Adopt and implement an internal audit program sufficient to detect irregularities in the bank's operation, determine its level of compliance with applicable laws and regulations and provide for testing to support audit findings, among other requirements.

These actions were based on a finding that the bank had failed to implement an effective AML program. As a result, the bank did not detect or investigate suspicious transactions and had not filed SARs as required under the law. The bank also did not collect or maintain sufficient information about its foreign bank customers. In particular, the OCC found a number of problems with the bank's account relationship with foreign governments, including Saudi Arabia and Equatorial Guinea. Riggs failed to properly monitor, and report as suspicious, transactions involving tens of million of dollars in cash withdrawals, international drafts that were returned to the bank, and numerous sequentially-numbered cashier's checks. The OCC will continue to closely monitor the corrective action that the bank takes in response to the Order and we are prepared to take additional actions if necessary.

These actions are the most recent of a series of escalating supervisory and enforcement reactions to ongoing deficiencies in Riggs BSA/AML compliance program. Since this matter involves an open bank and open investigations, there are limitations on what can be said without disclosing confidential supervisory information and potentially compromising future criminal, civil and administrative actions. With that caveat, we have tried to set out below a summary of our supervision of this institution in the BSA/AML area, dating back to 1997.

The OCC first identified deficiencies in Riggs' procedures several years ago. Beginning in the late 1990's we recognized the need for improved processes at Riggs and for improvements in the training in, and awareness of, the BSA's requirements and in the controls over their BSA processes. Prior to 9/11, the OCC visited the bank at least once a year and sometimes more often to either examine or review the Bank's BSA/AML compliance program.

Over this timeframe OCC examiners consistently found that Riggs' BSA compliance program was either "satisfactory" or "generally adequate," meaning that it met the minimum requirements of the BSA, but we nonetheless continued to identify weaknesses and areas of its program that needed improvement in light of the business conducted by the bank. We addressed these weaknesses using various informal, supervisory actions. Generally, this involved bringing the problems to the attention of bank management and the board and securing their commitment to take corrective action.

During this period, it was clear that the bank's compliance program needed improvement but we determined that the program weaknesses did not rise to the level of a violation of our regulation or pervasive supervisory concern. The OCC identified problems with the bank's internal audit coverage in this area, its internal monitoring processes, and its staff training on the BSA and customer due diligence requirements. Repeatedly, management took actions to address specific OCC concerns but, as is now clear, the corrective actions being taken often were not sufficient to

achieve the intended results. The bank was continually taking steps to respond to OCC criticisms, but failed to take action on its own to improve its overall compliance program, especially with regard to high-risk areas. Due to the lack of an effective and proactive management team, additional weaknesses and deficiencies were continually identified by the OCC over this time period, but bank follow-up on these weaknesses ultimately proved to be ineffective and the problems continued longer than they should have.

As various changes occurred in the regulatory expectations for banks relative to BSA compliance and related issues over this period of time, our scrutiny of the bank was adjusted accordingly. For example, when the Financial Action Task Force and FinCEN identified "uncooperative" countries, we conducted an examination at Riggs that specifically focused on account relationships with those countries and determined that the bank did not have extensive transaction activity with any of the countries on the list. In addition, Treasury issued its guidance on "politically exposed persons" in January 2001, and, as a result, the OCC's focus on the risks associated with the Riggs' embassy banking business began to increase and our supervisory activities were heightened accordingly. However, at that time, the Kingdom of Saudi Arabia was not viewed as a country that posed heightened risk of money laundering or terrorist financing, and Equatorial Guinea had just begun to reap the financial benefits of the discovery of large oil reserves in the mid-1990s.

After 9/11, the OCC escalated its supervisory efforts to bring Riggs' compliance program to a level commensurate with the risks that were undertaken by the bank and we believed that we were beginning to see some progress in this regard. In fact, the bank was beginning the process of a major computer system conversion that would address many of the shortcomings in the existing information systems that the bank was relying on. Unfortunately, bank management had to adjust the timeline repeatedly. This caused significant delays in the implementation date, pushing it from the original target of year-end 2002 to September 2003. Thus, the bank was not able to fulfill many of the commitments that it made to the OCC to correct our concerns pertaining to their BSA compliance program. Also, as previously mentioned, the OCC conducted a series of anti-terrorist financing reviews at our large or high-risk banks, including Riggs, in 2002. As a result of these reviews and other internal assessments, plus published accounts of suspicious money transfers involving Saudi Embassy accounts, our concerns regarding Riggs BSA/AML compliance were heightened. Thus, we commenced another examination of Riggs in January of 2003.

The focus of the January 2003 examination was on Riggs' Embassy banking business, and, in particular, the accounts related to the Embassy of Saudi Arabia. Due to its Washington D.C. location, its extensive retail branch network, and its expertise in private banking, Riggs found embassy banking to be particularly attractive and had developed a market niche. In fact, at one time, 95% of all foreign embassies in the U.S., and 50% of the embassies in London conducted their banking business with Riggs. The OCC's examination lasted for approximately five months and involved experts in the BSA/AML area. The findings from the January 2003 examination formed the basis for the July 2003 C&D order entered into with the bank. The OCC also identified violations of the BSA that were referred to FinCEN.

During the course of the 2003 examination, the OCC cooperated extensively with investigations by law enforcement into certain suspicious transactions involving the Saudi Embassy relationship. These transactions involved tens of millions of dollars in cash withdrawals from accounts related to the Embassy of Saudi Arabia; dozens of sequentially-numbered international drafts that totaled millions of dollars that were drawn from accounts related to officials of Saudi Arabia, and that were returned to the bank; and dozens of sequentially-numbered cashier's checks that were drawn from accounts related to officials of Saudi Arabia made payable to the account holder. There was regular contact with the FBI investigators throughout this examination. We provided the FBI with voluminous amounts of documents and information on the suspicious transactions, including information concerning transactions at the bank that the FBI previously was not aware of. The OCC also hosted a meeting with the FBI to discuss these documents and findings. Throughout this process we provided the FBI with important expertise on both general banking matters, and on some of the complex financial transactions and products that were identified.

The July 2003 C&D order directed the bank to take a number of steps to correct deficiencies in its internal controls in the BSA/AML area and to strongly consider staffing changes. Among other requirements in this action, the OCC directed the bank to:

- Hire an independent, external management consultant to conduct a study of the Bank's compliance with the BSA, including, training, SAR monitoring, and correcting deficiencies and conduct a risk assessment for compliance with the BSA throughout the bank.
- Evaluate the responsibilities and competence of management. In particular, the consultant's report to the board of directors must address, among other things, the responsibilities and competence of the bank's BSA officer, and the capabilities and competence of the supporting staff in this area. Within 90 days, the board of directors must determine whether any changes are needed regarding the bank's BSA officer and staff;
- Adopt and implement detailed policies and procedures (including account opening and monitoring procedures) to provide for BSA compliance and for the appropriate identification and monitoring of high risk transactions;
- Ensure effective BSA audit procedures and expansion of these procedures. Within 90 days the board of directors must review and evaluate the level of service and ability of the audit function for BSA matters provided by any auditor; and
- Ensure bank adherence to a comprehensive training program for all appropriate operational and supervisory personnel to ensure their awareness and their responsibility for compliance with the BSA.

The OCC began its next examination of the bank's BSA compliance in October 2003. The purpose of this examination was to assess compliance with the C&D order and the PATRIOT Act, and to review accounts related to the Embassy of Equatorial Guinea. It was clear from this examination that the bank had made progress in complying with the order and in improving its AML program. Another notable accomplishment was the successful implementation of the long planned system upgrade that significantly improved the information available to bank staff and management to monitor account activity and identify suspicious activity. Notwithstanding, there

were significant areas of noncompliance noted by our examination. The examiners found that, as with the Saudi Embassy accounts, the bank lacked sufficient policies, procedures and controls to identify suspicious transactions concerning the bank's relationship with Equatorial Guinea. These transactions involved millions of dollars deposited in a private investment company owned by an official of the country of Equatorial Guinea; hundreds of thousands of dollars transferred from an account of the country of Equatorial Guinea to the personal account of a government official of the country; and over a million dollars transferred from an account of the country of Equatorial Guinea to a private investment company owned by the bank's relationship manager. The findings from this examination, as well as previous examination findings, formed the basis for the OCC's recent CMP and C&D actions.

In retrospect, as we review our BSA/AML compliance supervision of Riggs during this period, we should have been more aggressive in our insistence on remedial steps at an earlier time. We also should have done more extensive probing and transaction testing of accounts. Our own BSA examination procedures called for transactional reviews in the case of high-risk accounts, such as those at issue here, yet until recently, that was not done at Riggs in the Saudi Embassy and the Equatorial Guinea accounts. Clearly, the types of strong formal enforcement action that we ultimately took should have been taken sooner. This is not a case where the deficiencies in the bank's systems and controls were not recognized, nor was there an absence of OCC supervisory attention to those deficiencies. But we failed to sufficiently probe the transactions occurring in the bank's high-risk accounts and we gave the bank too much time, based on its apparent efforts to fix its own problems, before we demanded specific solutions, by specific dates, pursuant to formal enforcement actions. As described below, we have reevaluated our BSA/AML supervision processes in light of this experience and we will be implementing changes to improve how we conduct supervision in this area. The Comptroller has also directed that our Quality Management division undertake an internal review of our supervision of Riggs. These steps are outlined more fully below.

Improvements Undertaken to Improve BSA/AML Supervision

While we believe our overall supervisory approach to BSA/AML compliance has been rigorous and is working well, we are committed to ongoing evaluation of our approaches to BSA/AML compliance and to appropriate revisions to our approach in light of technological developments, and the increasing sophistication of money launderers and terrorist financers, as well as to address aspects of the process where shortcomings were evidenced in the Riggs situation. Recent and current initiatives include the following:

- As previously mentioned, together with the other federal banking agencies, we recently developed revised examination procedures for several key sections of the PATRIOT Act and we expect to be issuing a revised version of our BSA Handbook by the end of the year.

- We plan to develop our own database of national bank-filed SARs with enhanced search and reporting capabilities for use in spotting operational risk including in the BSA/AML area. This database will be compatible with the OCC's supervisory databases and will enable us to: (1) generate specialized reports merging SAR data with our existing

supervisory data, (2) sort SAR information by bank asset size and line of business, and (3) provide enhanced word and other search capabilities.

- We are developing and will implement nationwide, a new risk assessment process to better identify high-risk banks. This system uses standardized data on products, services, customers, and geographies to generate reports that we will use to identify potential outliers, assist in the allocation of examiner resources, and target our examination scopes (e.g., particular products or business lines).

- We are exploring with FinCEN and the other agencies better ways to use BSA information in our examination process, so that we can better pinpoint risks and secure corrective action. Upon completion of FinCEN's BSA Direct initiative (currently under development), the OCC will have direct access, as opposed to dial-in access, to the SAR database. We expect that this direct access system will allow us to make better and more effective use of FinCEN's SAR database.

- We are also exploring how we can systematically capture BSA/AML criticisms in examination reports so that we can track situations where no follow-up formal action has been taken.

- Our Committee on Bank Supervision also has sent an alert to remind and reinforce for OCC examination staff the need to recognize accounts and transactions that appear to be anomalous or suspicious or that have other characteristics that should cause them to be considered high-risk in nature, and to conduct additional transaction testing and investigation in such situations.

In addition, specifically with regard to Riggs, the Comptroller has directed our Quality Management Division to immediately commence a review and evaluation of our BSA/AML supervision of Riggs. This review will include an assessment of whether we took appropriate and timely actions to address any shortcomings found in the bank's processes and in its responses to matters noted by the examiners, and the extent and effectiveness of our coordination and interaction with other regulators and with law enforcement. The Comptroller has also asked for recommendations for improvements to our BSA/AML supervision and our enforcement policy with regard to BSA/AML violations.

Conclusion

The OCC is committed to preventing national banks from being used, wittingly or unwittingly, to engage in money laundering, terrorist financing or other illicit activities. We stand ready to work with Congress, the other financial institution regulatory agencies, the law enforcement agencies, and the banking industry to continue to develop and implement a coordinated and comprehensive response to the threat posed to the nation's financial system by money laundering and terrorist financing.

BANK SECRECY ACT: OCC Examination Coverage of Trust And Private Banking Services

OIG-02-016 November 29, 2001

Office of Inspector General

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The Department of the Treasury

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Abbreviations

BSA	Bank Secrecy Act
CTR	Currency Transaction Report
FATF	Financial Action Task Force
FCB	Foreign Correspondent Banking
HIDTA	High Intensity Drug Trafficking Area
OCC	Office of the Comptroller of the Currency

Contents

Abbreviations continued

OIG	Office of Inspector General
SAR	Suspicious Activity Report
SMS	Supervisory Monitoring System

OIG

Audit Report

The Department of the Treasury
Office of Inspector General

November 29, 2001

John D. Hawke, Jr.
Comptroller
Office of the Comptroller of the Currency

The Office of the Comptroller of the Currency (OCC) is responsible for ensuring that the financial institutions under its supervision comply with the Bank Secrecy Act (BSA). In recent years, trust and private banking services have become an increasingly important component of the BSA and have provided the banking industry an increased stream of revenue.

This is the third in a series of Office of Inspector General (OIG) audits covering BSA examinations conducted by OCC. Our earlier audits focused on bank wide BSA controls at domestic and foreign banks. The overall objective of this audit was to evaluate OCC's examination coverage and supervision of trust and private banking services under the BSA. To conduct our audit, we visited OCC headquarters and field offices, reviewed examination files and interviewed responsible officials and examiners. Our audit covered a sample of BSA examinations completed between March 1996 to June 2000. A detailed description of the objectives, scope and methodology is presented in Appendix 1.

Results in Brief

We believe that OCC has taken many important steps to improve BSA examinations. For example, OCC recently revised the agency's BSA examination handbooks and created a Deputy Comptroller position to supervise among other things BSA work performed by compliance examiners. OCC also issued guidance

which requires each supervisory office to be responsible for planning, staffing and coordinating BSA and anti-money laundering examinations of bank asset management services. We believe these and other changes will provide OCC with a more focused approach to performing BSA examinations. However, as discussed below, we found that greater OCC attention is warranted in the trust and private banking areas.

First, trust and private banking services were not always included as a part of a bank's overall BSA examination. Specifically, 17.6 percent of the trust examinations reviewed (6 of 34) did not show evidence of BSA examination coverage. Similarly, BSA examinations at 60 percent of the banks offering private banking services (12 of 20) did not cover the private banking services. The examinations identified that OCC management were not always closely monitoring the results of BSA examinations. (see page 10).

Second, 32 percent (9 of 28) of the examinations performing BSA reviews did not fully comply with OCC BSA examination guidelines. We identified examinations where the wrong examination handbook had been followed, and instances where examiners did not perform the applicable examination procedures. This is similar to findings identified in our prior BSA audit report issued in January 2000. However, our prior report covered bank wide BSA reviews and did not specifically examine trust and private banking services. (see page 17).

Third, some of the BSA examinations lacked sufficient testing of high-risk transactions commonly associated with money laundering or lacked review and evaluation of critical BSA reports that banks are required to file. Specifically, examiners did not always test wire transfers, transactions with foreign correspondent banks, currency transaction reports or suspicious activity reports. For example, in both trust and compliance examinations where transaction testing was performed, examiners reviewed these areas generally less than 40 percent of the time. (see page 20).

Fourth, we believe the BSA examination procedures contained in OCC's newly revised handbooks could be improved through a few enhancements, clarifications and reassessment. For example,

during our audit examiners were using the older BSA handbook that contained 12 mandatory procedures, the revised BSA handbook contains over 45 mandatory procedures. Similarly, the Community Bank handbook grew from 18 to over 30 mandatory procedures. In our opinion, the number of new mandatory procedures may be too rigid in light of the varying degrees of compliance risk at different banks and OCC's own strategic plan, which calls for using risk-focused examination procedures. (see page 23).

Accordingly, we make several recommendations in the report. We believe OCC could improve its supervision and BSA examinations of trust and private banking services by (1) requiring coverage in all BSA examinations, (2) improving the monitoring process used in management oversight, (3) completing all mandatory examination procedures, (4) ensuring that examiners use the correct examination handbook, (5) ensuring that examiners complete testing of high risk areas, (6) reassessing whether the new BSA examination procedures should be mandatory or optional, and (7) reassessing whether the same examination sampling methodology contained in the large bank handbook should be used in the Community Bank handbook. Our recommendations take into account OCC's risk focused examination approach.

OCC concurred with our reported findings and recommendations and has committed to undertake various management actions in response to the report. For the full text of OCC's response to our draft report see Appendix 4. Under separate correspondence, OCC has committed to take corrective action within 90 days after issuance of the final report.

Background

Trust and private banking services are growing increasingly important to the banking industry as a source of revenue. However, there is growing worldwide concern that these services may be conduits for criminal money laundering. The BSA was enacted as one means to stem such activity. OCC is actively conducting bank wide BSA examinations that focus on the effectiveness of bank internal controls to detect and prevent money-laundering activity.

Trust Services

Trust services involve a fiduciary relationship in which the trustee, such as a bank, holds and/or manages property for their clients and any beneficiaries. Trust accounts are generally set up to achieve long term goals in accordance with a trust agreement and offer privacy and confidentiality to their bank customers.

As of September 30, 2000, there were 907 OCC regulated National Banks with trust charters whose aggregate trust assets exceeded $3 trillion.

Although typical trust activity may not result in the large, quick movement of funds as with private banking activity, trust activity can involve all of the high-risk circumstances conducive to money laundering. In October 2000, 11 of the world's largest banks agreed to a set of global anti-money laundering guidelines for international private banks including those offering trusts.

In February 2001, the Financial Action Task Force (FATF) on Money Laundering, an international policy coordination group, issued a report on money laundering methods[1]. Trusts were identified as vehicles that were easy to establish but difficult to monitor. Most governments have no registration requirement or central registry. In fact, trusts may be formed with the intention of taking advantage of strict privacy or secrecy rules in order to conceal the identify of the true owner or beneficiary of the trust assets. For these reasons, trust accounts are viewed as potential vehicles that criminals can use to launder money. The FATF also noted that trusts have also been used as a layering technique to disguise illicit proceeds of criminal activity and create the impression of legitimacy.

Private Banking

In contrast to the tangible nature of bank trust services, private banking generally refers to arrangements or relationships between a bank and select clients rather than to specific products or services. Private banking services are tailored for high net worth individuals

[1] Financial Action Task Force on Money Laundering, *Report on Money Laundering Typologies 2000-2001*, February 1, 2001 FATF-XII.

and include personalized services such as money management, financial advice and investment services. Private banking activities are generally conducted through relationship managers who provide the client the expertise to utilize the various services the bank offers.

In essence, there is no industry wide reporting of private banking assets or private banking accounts. Unlike trust charters, OCC does not issue a separate charter to those institutions offering private banking and the banking industry has no standard definition for private banking services. Thus, we were unable to identify the total number of OCC regulated banks that offer private banking or to estimate the value of the assets covered by private banking arrangements. However, a 1999 Washington Post article estimated that private banking units manage $15.5 trillion worldwide.

Confidentiality is an attractive and important feature of private banking arrangements. Private banking is thought to be particularly sensitive to money laundering because large sums of money are managed through these confidential private banking arrangements. For example, a study found that private banking customers have, on average, a minimum investment account of $300,000, and a net worth of $2.3 million[2].

Law enforcement and bank regulators have expressed concern about offshore private banking activities and their potential to be a banking "soft spot" for money laundering[3]. Some private banking customers are known to reside in countries identified as high-risk areas for drug trafficking and money laundering. Concerns about private banking activities have also been raised in Congress. For example, in November 1999, the Senate Permanent Subcommittee on Investigations heard testimony that criminals were using certain private banking services in attempts to launder money. Recently, Congress investigated high profile money laundering cases involving private banking customers using offshore accounts or

[2] *Information on Private Banking and Its Vulnerability to Money Laundering,* GAO/GGD-98-19R, Oct. 30, 1997.
[3] *Money Laundering: Regulatory Oversight of Offshore Private Banking Activities,* GAO/GGD-98-154, June 29, 1998.

transactions to facilitate the movement of illicit funds through the banking system.

Money Laundering and the Bank Secrecy Act

Money laundering is the means by which criminals transform their illicit proceeds into legitimate appearing assets. This in turn allows them to continue to operate and expand their criminal enterprises. Money laundering worldwide is estimated to exceed $500 billion a year, and more than 170 crimes are identified in the federal money laundering statutes.

Congress enacted The Currency and Foreign Transactions Reporting Act[4], also known as the BSA, to prevent banks and other financial institutions from acting as intermediaries for the transfer or deposit of money derived from criminal activity. Congress delegated to the Secretary of the Treasury the authority for administering the BSA regulations. The implementing regulation, 31 CFR Part 103, requires financial institutions to file certain currency and suspicious activity reports and to maintain certain records for possible use in criminal, tax and regulatory proceedings. These BSA record keeping and reporting requirements provide a paper trail to help law enforcement agencies investigate money laundering activities.

The OCC and other bank regulatory agencies are responsible for monitoring financial institutions' BSA compliance through their examination and supervision activities. A primary regulation for OCC is 12 CFR § 21.21, which was issued to ensure that all national banks establish and maintain procedures reasonably designed to ensure and monitor compliance with the BSA and 31 CFR Part 103. Banks are expected to have a written BSA compliance program with at a minimum, a system of internal controls to ensure compliance, testing for compliance, coordination and monitoring of day-to-day compliance and personnel training.

OCC BSA Examinations

Generally compliance examiners, who are specifically trained in the BSA, reviewed and evaluated bank wide controls including those

[4] Title 31 USC Sections 5311-5330 and 12 USC Sections 1818(s), 1829(b), and 1951-1959.

covering private banking, while trust examiners reviewed specific trust accounts for compliance and unusual activity. Depending on asset size, and other factors such as a risk assessment of each bank, BSA examinations are generally completed every 12 to 36 months.

OCC examiners conduct BSA examinations of trust and private banking units based on procedures in 3 handbooks: Community Bank Consumer Compliance (updated November 2000), Bank Secrecy Act (updated September 2000), and the Community Bank Fiduciary Activities Supervision handbook (dated September 1998).

During our review separate exams were not required at banks offering trust and private banking services, although it's likely that trust exams were performed at a different time than the commercial BSA exam and by different examiners.

During our review period, BSA examinations for banks with total commercial assets over $1 billion primarily focused on a bank's internal controls over its bank-wide operations. Also included are optional tests of bank transactions such as testing whether BSA reporting forms were fully and accurately completed. Community bank examination procedures can be used for banks with commercial assets up to $1 billion. These examinations rely heavily on transactional testing to assess BSA compliance.

Findings and Recommendations

Finding 1 Trust and Private Banking Services Were Not Always Covered In A BSA Examination

We could find no evidence that trust and private banking services were being covered as a part of a bank's BSA examination for some of the 34 sampled banks. OCC BSA examination guidelines require examiners to cover "specialty areas" such as trust and private banking services in all BSA large bank examinations. However, no such requirement exists in the community bank handbook because of the banks smaller size and they may not have specialty areas.

No Evidence of Trust BSA Examination Coverage At Some Banks

To determine whether there had been BSA examination coverage of either trust or private banking services, we reviewed the latest trust and compliance examinations completed at our sample of 34 banks. We looked for instances where BSA examination documentation indicated trust and/or private banking services were covered during the bank's BSA examination process. Where examination work was not clearly documented, we asked responsible examiners about the extent of such work completed in either area.

We found no evidence of BSA examination coverage of trust services at six (17.6%) of the 34 sampled banks. Based on various factors reflecting BSA compliance risk, we considered 4 of the 6 to be of moderate risk and 2 low risk. (See appendix 2 for our risk assessment ratings). The trust assets managed by these 6 banks ranged from about $660 million to over $30 billion.

Table 1 below shows a breakout across three asset size categories of the sampled banks.

Table 1
Evidence of Trust Examination Coverage

Sampled Banks Asset Size	Trust Banks in Sample	No Evidence of Trust Coverage
Over $1 Billion In Trust Assets	24	5 (20.8 %)
$250 Million to $1 Billion In Trust Assets	9	1 (11.1%)
Under $250 Million In Trust Assets	1	0 (0.0%)
Totals	34	6 (17.6%)

Source: OIG Analysis of OCC examination records

Table 1 identifies the number of banks based on trust assets because this review focused on BSA coverage of trust services. Prior OIG BSA audits identified banks based on commercial assets.

The applicable OCC guidance for BSA trust examinations during our review period was the BSA handbook (dated September 1996) and the Community Bank Consumer Compliance handbook (dated August 1995). In OCC BSA examinations, the use of one handbook or the other is generally dependent on the amount of commercial assets rather than trust assets managed by a bank. The number of banks in our sample based on commercial assets included 12 banks over $1 billion, 11 between $250 million to $1 billion and 11 banks under $250 million.

For banks with over $1 billion in commercial assets, OCC policy stipulates that examiners are to use procedures from the BSA handbook. These procedures are commonly called the large bank procedures. For banks with total assets of less than $250 million with no regional or multinational affiliation examiners are required to use the Community Bank handbook. For banks with commercial assets between $250 million to $1 billion the examiners can use either handbook depending on the bank's structure and examiner judgment.

According to the BSA large bank handbook, the examination scope requires examiners performing BSA examinations to ensure coverage for all banking units of the bank being examined. This includes specialty areas such as trust, private banking, correspondent banking, currency operations, credit card, international and discount brokerage. The Community Bank handbook does not specifically require examination coverage of trust services even though there is the potential money laundering risk associated with trust services.

Aside from the BSA handbooks, we identified other factors suggesting that BSA examination coverage was warranted.

- One bank with a moderate risk of money laundering had not received BSA trust coverage in either of its 2 most recent trust examinations. This covered a span of almost five years.

- The six banks with no evidence of trust coverage contained over $67 billion in trust assets.

The absence of BSA examination coverage was similarly noted in two internal OCC quality assurance reviews in year 2000. The Central District's community bank quality assurance program review found 8 (53 percent) of the reviewed examinations failed to contain any evidence that the bank BSA review included the trust department. The Southwestern District's quality assurance review found 4 (40 percent) of the Asset Management (trust) examinations did not evaluate compliance with the BSA. The quality assurance report opined that this was a systemic deficiency.

Private Banking Examination Coverage Also Lacking

We also found the absence of BSA coverage for many of the banks' private banking activities. As shown in Table 2, we found this for 12 (60%) of the 20 banks offering private banking services.

Table 2
Evidence of Private Banking Examination Coverage

Sampled Banks	Sampled Banks With Private Banking	No Evidence Of Private Banking Coverage
Over $1 Billion In Commercial Assets*	14	7 (50%)
Under $1 Billion In Commercial Assets*	6	5 (83.3%)
Totals	20	12 (60%)

* Commercial asset size includes regional or multinational affiliation
Source: OIG Analysis of OCC examination records

As with our review of trust services, we found this condition by reviewing the examination workpapers and interviewing responsible examiners. Appendix 3 summarizes the BSA coverage for private banking services for the sampled banks.

Weaknesses In Examination Process

Based on our review of examination workpapers, discussions with examiners, and a review of OCC's supervisory monitoring system, we believe that several factors contributed to the observed gaps in

BSA examination coverage of trust and private banking services. These included handbook guidance, which do not specifically require coverage of trust and private banking services, and OCC's supervisory monitoring system's limited informational capacity to monitor BSA examination coverage.

OCC handbook guidance does not specifically require detailed BSA examination procedures be applied to either specialty area. For example, the large bank handbook only requires that examiners review bank wide policies that address all business units. It does not require examiners to specifically cover trust or private banking and does not require mandatory transactional testing in these areas. The Community Bank handbook examination requirements do not require examiners to cover specialty areas because the banks are smaller and less likely to offer trust and private banking services.

Given the widely acknowledged risk of money laundering with regard to trust and private banking services, we believe OCC could enhance its supervision of bank BSA compliance for both services by covering these areas in the banks' risk analysis. Examination coverage in these areas should be mandatory unless the examiner's risk assessment documents why coverage is not warranted. As we were told by some OCC officials, BSA compliance risks are affected by various factors such as the effectiveness of internal and/or external audits, the nature and extent of trust and private banking services provided, and the presence of bank BSA policies and procedures. Expanded clarification on how these various factors are to be assessed and documented could provide not only examiner flexibility but also BSA coverage.

We also inquired about OCC's examination monitoring system to determine how supervisors and/or managers monitor BSA examinations to ensure sufficient coverage, and whether they were aware of the lack of BSA coverage we found. We found that another contributing factor to the gap in BSA examination coverage may be the informational limitations of OCC's examination monitoring system.

For supervision and monitoring purposes, the results of BSA examinations are recorded into OCC's Supervisory Monitoring System (SMS). This is an automated system used to record and

communicate narrative and statistical information on institutions of supervisory interest. During our review, SMS was the primary monitoring system that OCC management used to track examinations. However, in March 2001, OCC initiated a new monitoring system called Examiner View.

The new monitoring system is an integrated system used by most examiners to plan and record the results of supervisory activities, including workpaper documentation. OCC personnel told us Examiner View can query information at all but the largest banks that OCC supervises. Unlike Examiner View, the older SMS is unable to query and track specialty areas of BSA examinations. If managers wanted to follow up on work completed in trust or private banking they would need to read the narrative for the entire compliance examination and then possibly call the examiner who completed the work to identify what was specifically completed.

SMS also does not have the capability to automatically search examination records and generate reports to management alerting them that required BSA coverage was lacking. We believe these SMS system limitations did not allow managers to readily oversee or monitor BSA examinations to ensure required trust and private banking services were covered and examination procedures were fully implemented. However, the new Examiner View monitoring system should be more effective given its ability to query and track all specialty areas of most BSA examinations.

OCC officials do not believe that mandatory examination coverage for trust and private banking services is needed in all BSA examinations. However, they agreed these services should be reviewed and included in the bank risk analysis. The officials also believe that the frequency of examination coverage for trust and private banking should depend on the level of risk relative to BSA compliance and money laundering.

Recommendations

1. The Comptroller of the Currency should establish mandatory BSA examination coverage for trust and private banking services in all BSA examinations in the absence of a documented risk assessment to the contrary.

OCC Management Comment

OCC concurred that in some cases, their examination teams could have expanded the scope of BSA examinations to include trust and private banking services. To address future examination coverage of trust and private banking services, OCC emphasized they would hold ongoing discussions with the examination staff on the need to perform and document risk assessments for each institution. OCC also plans to place a notice on their internal website to communicate to examiners the results and concerns of this audit.

2. The Comptroller of the Currency needs to improve the examination monitoring process used by management to ensure adequate oversight of BSA examinations covering trust and private banking services.

OCC Management Comment

OCC concurred and stated they would communicate to managers the need to periodically monitor and identify, through Examiner View, examinations where examination procedures were performed on high-risk areas such as private banking and trust. OCC also stated that internal targeted quality assurance reviews of private banking and trust services would be conducted in 2002.

OIG Comment

We believe the management actions planned by OCC, if properly implemented, address the intent and conditions of recommendations 1 & 2. Furthermore, OCC plans to take the corrective actions within 90 days after issuance of this report.

Finding 2 Trust BSA Examinations Did Not Always Comply With OCC Examination Policy

When BSA examinations covered trust services, examiners did not always follow OCC's applicable BSA handbook guidelines.

Examiners did not always use the appropriate set of examination procedures or the complete set of procedures.

Trust Examinations Were Not Always Complete

OCC's BSA examinations covered trust services at 28 of the 34 sampled banks. We found that the examination files generally identified and documented the work completed in an understandable manner and we were able to evaluate the actual work performed. But we found that in 9 (32.1%) instances the examination was incomplete because either none or only some of the mandatory procedures had been completed. During our review, OCC's BSA handbooks required 12 mandatory procedures for the large banks and 18 mandatory procedures for the community banks.

Table 3 shows the nature and extent of incomplete trust examinations.

Table 3
Nature of Incomplete Trust Examinations

	Banks Receiving BSA Trust Exams	None of the Mandatory Procedures Were Completed	Mandatory Procedures Were Only Partially Completed	Examinations Properly Following OCC Guidelines
Totals	28	2 (7.1%)	7 (25%)	19 (67.8%)

Source: OIG Analysis of OCC examination records.

Similar findings were identified in an OCC Community Bank quality assurance follow-up review for the Western District in March 2000. The quality assurance review found that 6 of 16 (37.5%) examinations did not utilize the 12 mandatory steps for large bank examinations. The quality assurance review states in part that "confusion exists among examiners as to what is required to be performed for BSA".

Contrary to OCC policy, examination workpapers usually did not adequately document why applicable large or community bank examination procedures were not completed. We asked OCC examiners to explain the omission of any required handbook procedures. Examiners cited various reasons such as: (1) the

examiner did not believe the step was mandatory in all examinations, (2) the examiner-in-charge waived the step, (3) the procedures were completed in earlier examinations with no identified problems, and (4) the BSA large bank procedures do not apply to banks having limited trust powers. When we inquired, one OCC policy official told us that these were not valid explanations for not documenting why a required BSA examination procedure was not performed.

Examination Guidance Needs Clarification

In reviewing the BSA examinations, we found that examiners did not always use the correct BSA handbook in completing the examinations. The Community Bank handbook with 18 mandatory procedures can be used for banks with assets up to $1 billion and must be used for banks with total assets under $250 million with no regional or multinational affiliation. For banks over $1 billion, examiners are to use the large bank handbook with 12 mandatory procedures.

The Community Bank handbook does not specifically define what is to be included in determining asset size. The large bank handbook does not mention asset size. Neither handbook specifies whether the term bank assets is to be applied based on the bank's commercial assets, the trust department's managed or held assets, or some combination of these, or whether off-balance sheet assets are included. Another handbook offering guidance on handbook selection is the Overview handbook. However, even this handbook does not give the examiner a definition of which type of asset to use. We found that examiners had interpreted the asset size guidance differently.

For example, in one case the trust and compliance examiners used different handbooks. The compliance examiners followed the community bank procedures because the commercial assets were under $250 million and the trust examiners used the large bank procedures because the trust assets were over $1 billion. In another examination, we found that the trust examiners used community bank procedures though the bank was affiliated with other banks having commercial assets over $1 billion.

Incomplete BSA Examinations Previously Reported By OIG

In a prior January 2000 OIG audit report[5] we noted that OCC had not performed a complete BSA examination for 38 of the 82 examinations we reviewed. Those examinations generally occurred in 1996 and 1997 and were based on bank wide BSA examinations, not specifically trust and private banking.

Our current audit of trust and private banking services suggest that OCC has not fully implemented corrective action regarding incomplete BSA examinations and this has become a lingering weakness. In responding to our prior audit, OCC agreed to (1) emphasize, through ongoing discussions with the examining staff, the need to perform all of the required examination procedures and (2) monitor examiner compliance through their quality assurance program beginning in 2000.

Recent OCC quality assurance reviews have identified improving conditions relating to BSA examinations. However, corrective actions are still needed to ensure that BSA examiners follow and complete all applicable mandatory examination handbook procedures.

Recommendations

3. The Comptroller of the Currency needs to ensure that all required BSA examination procedures are completed when covering trust and private banking services. If examiners determine that a required procedure is not needed, the work papers should be annotated documenting the exceptions consistent with OCC's working paper policies.

   OCC Management Comment

   OCC concurred and stated they would communicate to examiners the need to perform all required examination procedures, as well as the results and concerns raised in this report.

[5] *Office of the Comptroller of the Currency Bank Secrecy Act Examinations Did Not Always Meet Requirements*, OIG 00-027, January 3, 2000.

OIG Comment

Our audit found that OCC had previously communicated to examiners the need to perform all required examination procedures and that this communication was not always followed. However in their response to this report, OCC also agreed to increase oversight and monitoring by managers through Examiner View. We believe that along with the implementation of Examiner View, OCC's planned corrective actions address the recommendation and underlying conditions.

4. To better ensure that examiners use the correct examination handbook, the Comptroller of the Currency should clarify examination guidance as to what is to be specifically included in determining total assets. In addition, consideration should be given to covering this clarifying language in any associated BSA examination training.

OCC Management Comments

OCC concurred and stated they would communicate to examiners the definition of total assets and provide guidance on using the appropriate examination procedures for community and large banks. OCC also stated they planned to expand the training modules for BSA to provide guidance on using the appropriate examination procedures for community and large banks.

OIG Comment

We believe OCC's planned corrective actions adequately address the recommendation.

Finding 3 Certain High-Risk BSA Areas Are Seldom Tested

Examiners did not always test certain high-risk transactions commonly associated with money laundering or evaluate available BSA reports that banks are required to file. These high-risk areas were foreign correspondent banking and wire transfers; the reports

were the currency transaction reports and suspicious activity reports.

Testing these high-risk areas could provide a more reliable assessment of a bank's BSA controls and could disclose situations that indicate potential money laundering. Testing normally involves reviewing a sample of trust or private banking customer transactions. OCC's prior BSA handbooks did not require transactional testing for trust or private banking services regardless of bank size or risk. In our sample, we believe that over 80 percent of the banks reviewed were moderate to low risk.

Fourteen of the banks in our sample maintained correspondent accounts with foreign banks to facilitate the transfer of customer funds between countries. Foreign correspondent accounts may face increased risk for money laundering due to the activities and services they provide, particularly if they are located in a secrecy haven.

Money launderers may use wire transfers to quickly move funds through multiple accounts and banks making it difficult to trace their origin. Criminals can also use wires to move money out of the country through a bank account in a country where laws are designed to facilitate secrecy.

Large currency transactions are also subject to special bank reporting as a means for law enforcement to detect potential money laundering. Examiners can also review the Currency Transaction Reports (CTR) as a means of detecting potential money laundering and test bank compliance with the reporting requirement.

Similarly, banks are required to file Suspicious Activity Reports (SAR) for any suspicious transaction relating to a possible violation of law, including money laundering. As with CTRs, SARs also provide law enforcement an audit trail for investigative purposes.

Table 4 below shows the frequency these high-risk areas were tested and/or available reports were evaluated for our sampled banks.

Table 4			
Testing of High Risk Transactions			
Transactions Applicable to Business Unit	**Banks Offering Service**	**Instances Where Transactions Tested**	**Rate Of Coverage as a Percent**
Trust Services (28 banks)			
Foreign Correspondent Banking	12	1	8.3 %
Wire Transfers	26	13	50 %
Large Cash Transactions	21	7	33 %
Suspicious Activity Reports	28	3	10.7 %
Private Banking Services (8 banks)			
Foreign Correspondent Banking	7	0	0 %
Wire Transfers	8	4	50 %
Large Cash Transactions	8	3	37.5 %
Suspicious Activity Reports	8	2	25 %

Source: OIG Analysis of OCC examination records

Table 4 excludes the 6 banks where there was no BSA examination coverage of trust services, as well as the 12 banks where the BSA examination did not cover private banking.

We believe that transactional testing in high-risk areas is a reliable means of assessing BSA program compliance. Transactional testing in these areas also provides examiners some assurance that bank wide internal controls are working as intended.

OCC officials at the exit conference agreed that testing of high-risk areas is important in BSA examinations. However, they believe that mandatory transactional testing for the noted high-risk areas is not necessary in all situations. OCC officials also noted that the new BSA handbooks contain examination procedures that include a review of CTRs, SARs, and foreign correspondence accounts in high-risk banks in order to draw a sample for testing compliance. The sample size of the high-risk areas is to be based on the overall risk profile of the bank.

Recommendation

5. The Comptroller of the Currency should ensure that examiners complete transactional testing of high-risk BSA areas in trust

and private banking unless the documented bank risk assessment deems it unnecessary.

OCC Management Comments

OCC concurred and stated they would convey to examination staff the need to perform transactional testing procedures, using the recently issued BSA/AML examination procedures, on areas identified in the risk assessment as high-risk.

OIG Comment

We believe OCC's planned corrective actions will address the recommendation and underlying conditions if properly implemented.

Finding 4 Opportunities To Improve BSA Handbook Guidance

In late 2000, OCC revised its BSA examination handbook procedures for both large and community banks. We reviewed the new handbooks to see whether the new procedures would address the examination weaknesses we noted in this audit. We identified 2 areas where there appears to be an opportunity to further enhance the BSA examination handbooks.

First, the new BSA handbook now has over 45 mandatory procedures while the new Community Bank handbook has over 30 mandatory BSA procedures. We believe these mandatory procedures may not always be warranted because the risk of BSA compliance and a given bank's exposure to money laundering varies across banks. For example, the type of bank internal controls likely vary from very elaborate sophisticated systems to minimal published policies that might be reviewed based on available staffing. Examination efficiencies may accrue by affording examiners greater discretion in applying the mandatory procedures to the specific risk of a given bank.

Second, the Community Bank handbook recommends a sample size of only 5 accounts or transactions for testing purposes. We believe this number may be too small to provide a reliable basis for

an examiner's conclusions. We believe that OCC examiners could improve transactional testing effectiveness by basing the sample size selection on the bank's risk profile similar to that used in OCC's large bank handbook. The primary advantage is that the large bank handbook links the sample size to risk and not an arbitrary number. Furthermore, the large bank handbook sampling provides sufficient flexibility to use a small sample size should conditions and risk warrant a smaller sample.

OCC officials at the exit conference stated they believed this finding was somewhat inconsistent in that findings 1 through 3 identify lack of examination effort while this finding suggests OCC may be expending too much effort. We believe this inconsistency is one of context. Our prior observations took into account the risk of each sampled bank. The purpose of our report recommendations is to ensure coverage for trust and private banking services unless the documented risk assessment deems it unnecessary. Furthermore OCC's strategic plan calls for using risk focused examination resources based on need and risk while the new BSA handbooks mandate the same minimum coverage for every bank regardless of need and risk.

OCC officials also stated they realize the new number of mandatory BSA procedures is higher than those in the older handbooks but reasonable because the procedures cover many basic preliminary steps. The officials noted a review could be conducted to consider scaling back the procedures should it become apparent that the increased numbers of mandatory procedures were burdensome or impractical.

Further, OCC officials believed the recommended sample size of 5 for transactional testing in the Community Bank handbook is reasonable because community banks are usually small, have fewer transactions than large banks and offer fewer services to their customers.

Recommendations

6. The Comptroller of the Currency should reassess whether making the new examination procedures optional rather than mandatory would provide examiners greater flexibility in aligning examination procedures with the bank's BSA compliance risk.

This would not be contrary to OCC's Strategic Plan calling for risk focused examination procedures. Furthermore, if the procedures are made optional, OCC must ensure that the basis for not completing an examination procedure is adequately annotated in the working papers in line with OCC's working paper documentation policies.

OCC Management Comments

OCC concurred and stated during 2002, they will reevaluate the effectiveness of the new procedures and revise the procedures as warranted. During this review, they will also consider a number of factors, including feedback from the examination staff, examination results, review findings, and examination efficiency measures.

7. The Comptroller of the Currency should reassess whether the large bank sampling methodology for BSA transactional testing should be used for community banks to replace the current arbitrary sample size of 5 currently used. The large bank sampling approach should provide sufficient sampling flexibility for smaller samples given the focus on risk.

OCC Management Comments

OCC concurred and stated they will closely evaluate appropriate changes to the community bank examination approach, including sampling methods, in the context of risk-based supervision.

OIG Comment

We believe that OCC's planned corrective actions address the intent of recommendations 6 & 7. It should also be noted that OCC's planned internal targeted quality assurance reviews of both private banking and trust for 2002 should provide added insights from which to further assess the OIG's recommendations.

* * * * * *

We would like to extend our appreciation to OCC for the cooperation and courtesies extended to our staff during the audit. If you have any questions, please contact me at (415) 977-8810 ext. 222 or John A. Richards, Audit Manager, at (415) 977-8810 ext. 225. Major contributors to the report are listed in Appendix 5.

/S/
Benny W. Lee
Regional Inspector General for Audit

Appendix 1
Objectives, Scope, and Methodology

The objective of the audit was to evaluate OCC's BSA examination coverage over trust and private banking services. Specifically, we sought to determine if BSA examination procedures were adequate to ensure that national banks had sufficient controls and procedures to comply with the BSA, and prevent and detect money laundering through trust and private banking activities. We also sought to determine if examiners were complying with OCC examination guidelines and if additional examination procedures or supervision were needed.

We visited OCC Headquarters in Washington, D.C., and 7 OCC district or field offices located in Charlotte, North Carolina, Dallas, Texas, Glendale and San Francisco, California, Miami, Florida, New York City, New York, and Pittsburgh, Pennsylvania. At OCC headquarters, we obtained BSA guidance provided to field examiners, including specific examination procedures to be used in conducting all BSA examinations. At each field location visited, we reviewed and discussed bank examination strategies and BSA policies and procedures with managers and examiners.

Additionally, we reviewed a judgmentally selected sample of 34 recent BSA examinations completed on national banks holding trust charters. Our sample included 5 banks that were supervised by OCC's large bank supervision group, 7 other banks with commercial assets over $1 billion and 22 banks with commercial assets under $1 billion. Twenty of the 34 banks in our sample offered private banking services. The examinations we reviewed were completed between March 1996 and June 2000. OCC Headquarters personnel in the compliance and policy groups helped us to identify banks that would be generally representative of banks with trust powers. Accordingly, most banks selected offered a wide range of trust services, such as estate planning and administration, retirement accounts, and investment services. Further, many of the 34 banks were located in High Intensity Drug Trafficking Areas (HIDTA) as designated by the Office of National Drug Control Policy.

The 34 banks with trust charters had assets ranging from about $124.7 million to $694.6 billion. These banks held a total of over $2 trillion in trust assets. OCC does not issue a separate charter to those banks offering private banking and therefore was unable to provide us the number of banks offering private banking services or the estimated asset size of private banking accounts.

Our sample also contained two of the twenty banks surveyed for correspondent banking by the Minority Members of the Permanent Subcommittee on Investigations[6].

With many of the sampled banks located in HIDTA areas we expected each trust examination to have full compliance with OCC BSA guidelines and complete minimal trust BSA work at each bank regardless of risk. Further, as the bank risk increased for potential money laundering activities we looked to see if the number of BSA examination procedures and work performed increased proportionately.

To help us assess the adequacy of BSA examinations, we developed a risk profile of each bank in our sample. We used the profiles to evaluate institutional risk including the risk of the bank violating BSA regulations, or the bank's clients using their trust or private banking accounts to launder money. Factors we considered in developing the risk profile included:

- the products and services offered to trust and private banking customers;
- the typical trust or private banking client having an account with the institution;
- the number of clients who were non-resident aliens, especially those residing in bank secrecy havens, or countries known to be heavily involved in drug trafficking;
- whether trust or private banking accounts included high risk business entities, such as check cashing or currency exchange facilities;
- whether the bank had off-shore accounts, foreign branches, and foreign correspondent banking relationships (especially with banks located in bank secrecy havens, or countries known to be heavily involved in drug trafficking);
- identifying the level of cash transactions processed by the bank; and
- Identifying the bank's procedures for controlling and monitoring transactions initiated by trust administrators and private bankers.

We obtained information for the risk profiles from OCC's Supervisory Monitoring System printouts, BSA examination workpaper files, interviews with OCC examiners-in-charge and portfolio managers and background information from the bank's web site. Further, we primarily ranked the institutions as high, moderate or low risk according to the type of services and products offered, type of clientele served and locations of business operations worldwide. We identified and evaluated OCC's

[6] *Correspondent Banking: A Gateway For Money Laundering*, S.Prt. 107-1 February 5, 2001, Minority Staff Report.

examination procedures based on our bank profile and activities that pose the highest risk for money laundering.

Finally, we also reviewed OCC's Policies and Procedures Manual 5400-8, dated February 4, 1997 to identify minimum examiner documentation standards. Our review evaluated all OCC examination work contained in workpaper files that directly focused on trust and private banking services. Our opinions are based on documentation found in the examination workpaper files and through discussions held with knowledgeable OCC examiners for each institution reviewed.

We conducted our fieldwork between July 2000 and June 2001 in accordance with generally accepted government auditing standards.

Appendix 2
Summary Of Trust Examination Coverage

Sample Bank No.	OIG Assigned BSA Risk Rating	Did Examiners Apply Correct Handbook Procedures?	Extent Mandatory BSA Procedures Completed	Evidence of Trust Coverage?
01	HIGH	YES	ALL	YES
02	LOW	NO	NONE	NO
03	LOW	NO	NONE	NO
04	HIGH	YES	ALL	YES
05	MODERATE	YES	SOME	YES
06	MODERATE	YES	ALL	NO
07	MODERATE	YES	ALL	YES
08	LOW	YES	ALL	YES
09	MODERATE	YES	SOME	YES
10	MODERATE	NO	NONE	NO
11	MODERATE	YES	SOME	YES
12	MODERATE	YES	ALL	YES
13	LOW	NO	NONE	YES
14	LOW	YES	ALL	YES
15	HIGH	YES	ALL	YES
16	HIGH	YES	ALL	YES
17	MODERATE	YES	ALL	YES
18	MODERATE	YES	ALL	YES
19	LOW	YES	ALL	YES
20	MODERATE	YES	ALL	YES
21	MODERATE	YES	ALL	YES
22	MODERATE	YES	ALL	YES
23	MODERATE	YES	SOME	NO
24	MODERATE	NO	NONE	YES
25	MODERATE	YES	ALL	YES
26	MODERATE	YES	SOME	YES
27	MODERATE	YES	ALL	NO
28	MODERATE	YES	SOME	YES
29	LOW	YES	ALL	YES
30	MODERATE	YES	ALL	YES
31	MODERATE	YES	SOME	YES
32	MODERATE	YES	ALL	YES
33	HIGH	YES	ALL	YES
34	HIGH	YES	SOME	YES
			21 All	
		29 YES	8 some	28 YES
		5 NO	5 None	6 NO

Appendix 3
Summary Of Private Banking Examination Coverage

Sample Bank No.	OCC District	Bank Offers Private Banking Services	Size of Bank Based On Commercial Assets*	Evidence of Private Banking Coverage
01	NE	YES	LARGE	YES
02	NE	N/A		
03	NE	YES	COMM./LARGE	NO
04	NE	YES	COMM./LARGE	YES
05	NE	N/A		
06	NE	N/A		
07	NE	N/A		
08	W	N/A		
09	W	YES	LARGE	NO
10	W	YES	LARGE	NO
11	W	YES	LARGE	YES
12	W	YES	LARGE	NO
13	W	N/A		
14	W	N/A		
15	W	YES	COMM./LARGE	NO
16	SE	YES	LARGE	YES
17	SE	YES	LARGE	YES
18	SE	YES	LARGE	NO
19	SE	N/A		
20	SE	YES	COMMUNITY	NO
21	SE	N/A		
22	SE	N/A		
23	SE	YES	LARGE	NO
24	SE	YES	COMMUNITY	NO
25	SW	YES	LARGE	YES
26	SW	N/A		
27	SW	YES	LARGE	NO
28	SW	YES	LARGE	NO
29	SW	N/A		
30	SW	N/A		
31	SW	N/A		
32	SW	YES	COMM./LARGE	NO
33	SW	YES	LARGE	YES
34	W	YES	LARGE	YES
			14 LARGE	
			2 COMMUNITY	8 YES
		20 YES	4 COMM./LARGE	12 NO

*Large: over $1 billion, Comm./Large: from $250 million to $1 billion, Community: under $250 million.

Appendix 4
Management Comments

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Benny W. Lee, Regional Inspector General for Audit

From: John D. Hawke, Jr., Comptroller of the Currency

Date: November 9, 2001

Subject: Draft Audit Report -- BSA Examination Coverage of Trust and Private Banking Services

We have reviewed your draft audit report titled *Bank Secrecy Act: OCC Examination Coverage of Trust and Private Banking Services*. We welcome the opportunity to respond to your findings and recommendations.

The OIG report represents a review of 34 Bank Secrecy Act (BSA) examinations of national banks holding trust charters that were conducted by the OCC between 1996 and 2000. We are pleased with the OIG's finding that BSA examination files generally identified and documented the work completed in an understandable manner.

Your report contains recommendations to address the audit exceptions and to revise our examination approach for BSA examinations. As detailed below, we will take steps to address your findings and recommendations.

Examination Coverage and Scope

Your report states that not all of the sampled BSA examinations included:

- Coverage of trust and private banking services;
- Testing in certain high-risk situations, and
- Performance of all mandatory procedures.

We concur that, in some cases, the examination team could have expanded the scope of their BSA examinations to cover all required procedures, trust activities, private banking services, or other high-risk situations. Also, it should be noted that the appropriate scope of review should be risk-based. The foundation of the OCC's risk-based philosophy is that all banks must have risk management systems in place to identify, measure, control and monitor risks. These systems should be commensurate with the size and complexity of, and risks assumed by, the institution. As noted in your report, examiners should include coverage of high-risk situations unless the risk assessment deems it unnecessary. We rely on the examiner's judgment to determine if the scope of the review should be expanded beyond the minimum procedures to ensure quality supervision.

Appendix 4
Management Comments

In response to the OIG's findings regarding examination coverage and scope, the OCC will take the following actions:

- Communicate to examiners the results and concerns identified by the OIG by placing a notice on our internal website.
- Emphasize, through ongoing discussions with the examination staff, the need to: 1) perform and document risk assessments for each institution, 2) perform all required examination procedures, and 3) perform transactional testing procedures, using the recently issued BSA/AML examination procedures, on areas identified in the risk assessment as high-risk.
- Communicate to managers the need to periodically monitor and identify, through Examiner View, examinations where examination procedures were performed on high-risk areas such as private banking and trust.
- Communicate to examiners the definition of total assets and provide guidance on using the appropriate examination procedures for community and large banks.
- Request that internal targeted quality assurance reviews of private banking and trust be conducted during 2002.
- Expand training modules for BSA to provide guidance on using the appropriate examination procedures for community and large banks.

Examination Approach

Your report recommends that we reassess the mandatory nature of our examination procedures and reassess the sampling methodology used in community bank examinations. As you know, the OCC recently updated and published its BSA/anti-money laundering (AML) examination procedures for both community and large banks. During 2002, we will reevaluate the effectiveness of the new procedures and revise the procedures as warranted. During this review, we will consider a number of factors, including feedback from the examination staff, examination results, review findings, and examination efficiency measures. Also, we will closely evaluate appropriate changes to the community bank examination approach, including sampling methods, in the context of risk-based supervision.

We are committed to ensuring that our supervisory efforts with respect to the Bank Secrecy Act and anti-money laundering activities are comprehensive and effective. We believe we have demonstrated that commitment through our expanded examination programs. While we feel we have made significant progress in this area in the past few years, we will continue to address identified shortcomings and strengthen our policies and practices.

Technical corrections and editorial suggestions were provided to your auditors separately. We appreciate the opportunity to review and comment on the report.

Appendix 5
Major Contributors to this Report

Western Region

John A. Richards – Audit Manager
John E. Carnahan – Auditor-in-Charge
Jack S. Gilley – Auditor
Gale H. Dwyer – Auditor

Appendix 6
Report Distribution

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