

# ANALYSIS: U.S. regulatory action looms for CommBank as AML failures deepen

Sep 04 2017 Nathan Lynch and Ajay Shamdasani

The revelation that Commonwealth Bank of Australia (CBA) had non-existent or minimal transaction monitoring controls in its New York and Houston branches has made it inevitable U.S. regulators will take action, financial crime experts said. The Financial Crimes Enforcement Network (FinCEN) is already involved in the case and has been seeking information on whether any of the money laundering transactions that began with CBA's flawed intelligent deposit machines involved U.S. dollars.



Local banking sources said the threat of U.S. enforcement action was viewed as the "worst-case scenario" when banks conduct stress tests on their anti-money laundering and counter-terrorism financing (AML/CTF) risks. They said local bank boards had underestimated the threat posed by Australian Transaction Reports and Analysis Centre (AUSTRAC) but were acutely aware of the U.S. penalties for AML/CTF or sanctions breaches.

U.S. lawyers said the announcement of a formal investigation, a precursor to enforcement action, was now only a matter of time. They said CBA was responding to information requests from a number of agencies, including FinCEN, the financial intelligence unit in the Department of Treasury. U.S. money laundering or terrorism financing investigations can cut across a matrix of organisations with differing mandates and enforcement agendas, including the Office of the Comptroller of Currency (OCC) and the New York State Department of Financial Services.

Edward Wilson Jr, partner at Venable in Washington, D.C., said FinCEN was already involved. AUSTRAC would have informed FinCEN of this investigation via the U.S.-Australia memorandum of understanding (MoU), the Egmont Group, or through the Asia/Pacific Group on Money Laundering, of which the United States is a member.

"CBA has U.S. branches and deals in U.S. dollars. For both reasons, CBA will be required to comply with American AML laws," Wilson said.

Wilson said while CBA may not be required to inform the U.S. Federal Reserve System of its problems in Australia, its U.S. counsel "would certainly encourage it."

Bill Majcher, a former U.S.-based AML undercover investigator, said the Australian bank would be unprepared for the ferocity of U.S. investigators and prosecutors.

"There will be powerful enforcement people in the U.S. who will be righteously indignant at what will be perceived to be a rogue bank. The pain that will be felt by all CBA shareholders if any number of class action lawsuits were to be launched in the U.S. will be nothing short of mind staggering," Majcher said.

"There is zero doubt in my mind that CBA will face enforcement action in the U.S. based on the past and current actions of CBA. The awareness of the IDMs and transaction monitoring failures are significant in themselves. The greater issue is the appearance of catastrophic failures in terms of the governance culture at CBA from the very top down," he said.

### **Chasing the connection to corruption**

Malaysian and Hong Kong regulators are already examining whether any breaches have occurred under their laws. As such, CommBank could face a probe that builds upon existing work those agencies are doing on the 1MDB corruption scandal.

"Given the involvement of Malaysia and Hong Kong, both of which were involved in 1MDB, FinCEN will also be looking for 'hooks' to that investigation and to trying to track money from that investigation," Wilson said.

The transaction monitoring problems at CBA have come to light following scrutiny of its anti-money laundering controls for smart ATMs in Australia. The oversights affected the bank's New York branch, which holds a U.S. banking licence and is regulated by the OCC. The branch is also supervised by the Federal Reserve Bank of New York and must report financial intelligence to FinCEN.

A bank spokesman said CBA was communicating with overseas regulators but the bank had not been informed CBA of any formal investigations or legal action at this point. The OCC and FinCEN did not reply to requests for comment on Friday.

An Australian financial crime investigator, speaking on condition of anonymity, said the discovery process that is taking place at CBA is creating major headaches. The more the bank looks, the more reportable problems it finds, he said. It is also common in major internal investigations to unearth problems that need to be reported to other regulators.

"For now, it all depends on how much information is brought out through discovery and the regulators' investigations. The bank is in serious trouble because there are internal reports talking about these things from several years ago," he said.

### **Sanctions concerns**

Sven Stumbauer, anti-money laundering and sanctions practice leader at AlixPartners in Miami, said the discovery of

problems with CBA's transaction monitoring would raise red flags at the Office of Foreign Assets Control (OFAC) about its sanctions compliance. It was common for U.S. regulators to look for sanctions breaches where serious AML deficiencies are identified and that process was likely to have started.

"FinCEN and other U.S. regulatory bodies may review the robustness of Commonwealth Bank of Australia's (CBA) anti-money laundering (AML) and OFAC internal controls," he said.

"Given that CBA has U.S. operations in New York City and Houston, the bank's primary regulators may specifically look at AML controls and transactions processed through U.S. branches to determine if any violations occurred."

OFAC has a "zero tolerance" approach to sanctions breaches, Majcher said. Unlike AML, where a risk-based approach and compliance controls can be a defence, there was no such leeway with sanctions breaches.

"I expect many stones will be unearthed at CBA and it would not surprise me in the least to learn that as individuals close to CBA get in the cross hairs of aggressive U.S. prosecutors, they will roll over on every sin they can think of to get the spotlight off themselves," Majcher said.

"U.S. prosecutors play this game very well. With a conviction rate that exceeds 90 percent in the U.S. Federal Court, they carry a very big stick."

### **Gaps in controls**

After the problems emerged with CBA's smart ATMs in 2015 the bank ordered a review of Anti-Money Laundering and Counter-Terrorism Financing (AML/CTF) compliance across its institutional and markets divisions. The bank discovered it lacked automated transaction monitoring (TM) in debt capital markets, leasing, institutional lending in Australia and across Singapore, Hong Kong, Shanghai, Tokyo, London and New York. The bank would need to spend A\$6 million to address the problem, an internal report said.

On September 1, Commonwealth Bank acknowledged that an internal report had found problems with its transaction monitoring but said it was a "working document" — part of a continuing "program of action". The bank was trying to set out a process to automate tasks undertaken manually.

"A combination of automated and manual monitoring is common practice across the industry," the bank said.

Financial crime experts said it would be highly unusual for a major bank to conduct large portions of its work using manual transaction monitoring. Some parts of a major bank use manual transaction monitoring but these are only in isolated business lines, such correspondent banking, private banking, leasing or remittances.

CommBank uses SAS for its transaction monitoring which runs on top of the organisation's SAP-based core banking system. CBA was the first big four bank to move away from a mainframe-based core banking system, which is believed to have caused problems with its transaction monitoring.

"The lion's share of transactions and also overseas transactions, unless they're really small, would have automated monitoring. What appears to be the issue for CBA is that it may have thought transactions were being automatically monitored — like the IDMs — but the transactions were not linked to the monitoring solution," a senior AML official said, on condition of anonymity.

Many banks have faced challenges in this area but identified the problems with a complete "end-to-end" mapping of the IT systems that feed into the TM software. Banks run various legacy systems so it is difficult for the AML team to know whether all parts of the business are feeding into the monitoring platform.

"You might think everything is being monitored but until you follow a transaction through, you can't be sure," the source said.

Suggestions CBA was "manually" monitoring its overseas transactions have been met with similar incredulity among bank analysts, who are calling on the bank to be more transparent with investors.

Brian Johnson, banking analyst at CLSA, said this transparency was critical given the potential size of any U.S. fines. CBA's claims it had "manual" transaction monitoring in place were unconvincing, he said.

"To say that you were doing something manually, but not to have done it all, sounds implausible," he said.

"This report is clear evidence that CBA's dispute with AUSTRAC dispute goes well beyond the simple 'coding error' rhetoric."

### **Potential for "huge fines"**

The biggest risk for CBA now is that a number of U.S. regulators and prosecutors will all launch separate enforcement actions, as has happened with multiple agencies in Australia.

Australian bank boards fear U.S. sanctions and AML/CTF regulators more than anything on the domestic front, AML sources said. Banks are required to conduct stress testing and scenario analysis to determine their ability to withstand an operational risk crisis. At one major Australian bank a recent stress test used a hypothetical scenario where they were fined A\$10 million by AUSTRAC for AML/CTF breaches; the worst-case scenario for fines from U.S. regulators was A\$1 billion.

Johnson said Pakistan's Habib Bank faces a \$630 million fine from the New York State Department of Financial Services for

a branch that was generating just \$20 million annually. "These fines in the U.S. can be punitive," he said.

Another penalty available to U.S. regulators is to place conditions on a bank's access to U.S. dollar clearing.

U.S. lawyers said it was unlikely regulators would accept the "manual monitoring" claim, especially if the problems were not self-reported to the regulator back in February when they came to light.

### **Internal discovery**

The best course of action now for CBA would be to disclose everything to the U.S. regulators, sources said. Self-identified and reported issues often receive leniency in the United States compared with issues that regulators uncovered. CBA would know this and was likely to be undertaking a comprehensive internal review as result, Stumbauer said.

Majcher, who is now chief executive of risk consultancy EMIDR in Hong Kong, said U.S. regulators would want to know whether the bank's failed cash machine policy had compromised the U.S.-dollar banking system. They would be unimpressed by the Australian bank's "coding errors" defence and would want explanations for the collective failure of technology, oversight and the auditing systems. FinCEN and the Department of Justice (DoJ) would seek any connection to 1MDB, as there was already a major investigation underway, he said.

As a former Canadian AML undercover investigator, Majcher said foreign banks were often surprised at how much regulatory reach and enforcement appetite the U.S. agencies had in cases such as these.

The questions American regulators and prosecutors would ask include:

- Did any of the transactions linked to money laundering or terrorism financing involve U.S. dollars?
  
- Has this affected CBA's correspondent banking relationships?
  
- Did any of these unreported money flows entering the global banking systems eventually lead to funding a terrorist event where a U.S. citizen was injured or killed?
  
- Did any of the money fund a criminal action that created U.S. victims?

- Did U.S. reporting banks or U.S. citizens fail to properly identify and take action against faulty AML procedures for interactions involving CBA?
  
- Did any U.S. citizens, assisted by CBA, avoid Foreign Account Tax Compliance Act-related reporting by illegally laundering cash proceeds via CBA?

"The U.S. can use any number of mechanisms, including initiating an open-ended criminal investigation, as they can articulate 'reasonable suspicion' that some of the funds involved may have come from Americans engaged in tax evasion, funds may have been used to commit crimes against America and Americans," Majcher said.

"When it comes to financial crime, the greatest advocate to protect Canadian citizens was the U.S. government and justice system. Perhaps Australia might find out the same to be true with CBA," he said.

(Additional reporting by Brett Wolf in St Louis)

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