The Hazards of Enforcing Guidance

*By John F. Cooney**

The federal Anti-Money Laundering program presents a fascinating case study of the unintended consequences that can arise when an agency attempts to enforce compliance standards that were established by informal guidance, rather than through a rule promulgated under the APA.

The agencies that supervise depository institutions implemented the AML laws in the same manner that they conduct safety and soundness regulation, by adopting rules of sweeping generality and then elaborating the actual standards with which institutions must comply in detailed guidance and examination manuals. Whatever its success in traditional bank regulation, this approach created substantial problems when the agencies sought to enforce the AML guidance after the 9/11 attacks.

The government failed to anticipate how banks would respond to the combination of ambiguities in the guidance and aggressive civil and criminal enforcement. Many institutions quickly changed their behavior in response to the threats presented by the enforcement regime. Their reaction impaired the overall effectiveness of the AML program, and the government was forced to back pedal. To persuade banks to reverse their changes in behavior, the six principal regulatory agencies were forced to negotiate and publish a joint 300-page long guidance document that set forth in minute detail the standards upon which future enforcement actions would be premised.

This experience demonstrates the programmatic risks of attempting to base a complicated regulatory scheme on informal guidance and the possible consequences if government officials underestimate the industry's need for certainty in the face of regulatory risks presented by an enforcement program.

Creation of the AML Program

The Bank Secrecy Act of 1970 required financial institutions to file reports on large-scale currency transactions, to provide law enforcement with an after-the-fact tool to prosecute money laundering connected to drug trafficking. The BSA vested Treasury with responsibility for overall policy formulation but provided for implementation through the corps of examiners maintained by the five financial supervisory agencies (the Federal Reserve, the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corp., and the National Credit Union Administration).

The agencies incorporated the AML requirements into their existing safety and soundness-based compliance programs, which generally require institutions to identify the risks they face and to focus their prevention programs on the greatest risks. In safety and soundness regulation, the agencies rely heavily on informal guidance and even less formal manuals for field examiners. Large banks appreciate the flexibility provided by this informal approach; small banks tend to prefer the certainty provided by precise standards. Few banks, however, have found it in their self-interest to file an APA challenge to a "requirement" imposed through guidance. A safety and soundness regulator possesses vast, and largely unreviewable, discretion. The agency has multiple ways to persuade the bank that it would be wise to comply with the agency's wishes, regardless of the format in which the obligation was articulated.

By the mid-1990s, advances in computer technology allowed the supervisory agencies to refocus the AML program on the systematic detection of money transfers associated with major financial crimes. The new system was built on two pillars: (1) a Customer Identification Program, which makes banks responsible for understanding the identity, business, and expected activities of their customers, thereby establishing a baseline against which actual transactions could be compared to identify anomalies that might warrant investigation; and (2) a requirement that banks file Suspicious Activity Reports (SARs), to notify supervisory and law enforcement agencies of potential illegal activity. FinCEN, the Office in Treasury responsible for administering the AML program, and the five supervisory agencies undertook a multi-year effort to promulgate common rules that would impose these requirements. Progress was slow, however, due to difficulty in breaking these broad concepts down into concrete provisions. The process had not been completed by September 2001.

Adoption of the USA Patriot Act

Title III of the USA Patriot Act (Pub. L. No. 107-56), adopted in the immediate aftermath of the 9/11 attacks, changed the AML program in fundamental ways. First, Congress added the goal of preventing terrorist financing to the purposes of the BSA. To comply, financial institutions had to make significant investments, especially in new technology and training, to develop the capacity for real-time detection and reporting of potentially suspicious transactions. Second, the supervisory agencies were required to expand the scope of their rules (e.g., greater coverage of correspondent banking and wire transfers) and were given tight deadlines for adoption of a large number of significant rules (notably the long delayed Customer Identification Program rule).

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The new rules followed a risk-based approach. They directed banks to conduct internal reviews of the products and services they offered, their customer base, and the geographic regions in which they operated; identify the risks presented; make an explicit determination that they could address the risks with their personnel and technology; and focus their prevention and audit resources on the greatest risks. Each supervisory agency expanded upon the rules by issuing separate implementing guidance and adopted detailed examination procedures that were applied on an institution-by-institution basis through the periodic examination process.

Aggressive Enforcement

In 2004, FinCEN and the supervisory agencies undertook a series of BSA enforcement actions based on the "requirements" established by the guidance. Formal enforcement actions involved coordinated application of the Cease and Desist power of the bank regulator and the overlapping authorities of FinCEN and the regulator to impose Civil Money Penalties. Enforcement focused on international correspondent banking, money transfers through Money Service Businesses (non-depository institutions that cash checks and make wire transfers), and banks in southern Florida. Further, prompted by their superiors, the field examination staffs took informal enforcement actions for AML violations against an unprecedented number of institutions.

Banks were hopeful that, as in other risk-based areas such as credit risk, they would be allowed to exercise informed judgment about the size of various AML risks and the best means of managing them; and that they would not be found to have violated the BSA if an isolated customer engaged in a suspicious transaction, as long as the overall program was sound. The general perception within the industry, however, was that whatever the agencies stated at a policy level, the examination staffs disregarded the risk-based approach and followed a "zero tolerance" approach, under which enforcement action would be taken if any suspicious transaction occurred and was not reported, even in low-risk areas.

The Department of Justice complicated the situation by bringing two major criminal prosecutions against banks for AML violations: (1) a deferred prosecution agreement with AmSouth, which resulted in a $50 million Civil Money Penalty; and (2) a guilty plea by Riggs Bank to violation of the BSA in its Embassy Banking operations, which resulted in a criminal fine of $16 million, a $27 million Civil Money Penalty, and ultimately in the demise of the bank as an independent institution.

The Market Reacts

Banks do two things: they collect deposits and assess risks. Faced with the threat of aggressive enforcement of ambiguous and informal compliance standards, many banks concluded that they did not want to bear the apparent regulatory risks presented by certain products and certain types of customers, and therefore exited those market segments.

Embassy Banking. When Riggs was forced to close accounts for foreign Embassies, other banks refused to pick up those relationships, due to the perceived regulatory risks in those accounts and the enhanced degree of regulatory scrutiny that would accompany opening these relatively small accounts. The inability of foreign governments to obtain banking services led to complaints to the State Department, which in turn pressed Treasury and the Federal Reserve to issue public statements assuring banks that it was permissible under the BSA for them to maintain Embassy accounts.

Money Service Businesses. Many banks decided to close their MSB accounts, due to the intense scrutiny that field examiners gave these relationships. Their withdrawal from the market created a substantial risk that many money transmitters would be driven out of the formal banking system and would be forced to go underground. This response threatened to compromise the overall federal effort to police a part of the financial industry that is particularly susceptible to money laundering. Senior federal officials repeatedly attempted to reassure banks that it was permissible to maintain MSB accounts, as long as the risk could be managed properly. Many banks, however, feared the punitive reactions of their examiners more than they trusted policy statements from Washington, and continued to close MSB accounts.

SAR Overreporting. Many banks responded to the AmSouth and Riggs prosecutions by deciding to file a SAR on any anomalous transaction, regardless of its significance. In light of examiner pressure to enforce the reporting requirements, many banks concluded that the cost/benefit ratio was weighted in favor of filing a SAR, an inexpensive ministerial act, rather than attempting to exercise subjective judgment as to whether a transaction actually was suspicious and important. As a result, SAR filings in 2004-2005 reached unprecedented levels. Senior federal officials complained repeatedly that this wave of defensive filings significantly changed the signal-to-noise ratio, and was impeding the ability of law enforcement and intelligence agencies to identify the small number of filings that actually warranted investigation.

Public Criticism of Justice. Mirroring industry complaints, Federal and State supervisory agencies publicly criticized Justice for *de facto* criminalizing regulatory violations by being overly zealous in bringing prosecutions for AML violations. In response, Attorney General Gonzales rescinded the delegation of authority that previously had allowed individual U.S. Attorneys to bring the criminal charge involved in AmSouth and Riggs, failure to file a SAR, without prior authorization from Washington. Justice thereby centralized policy control of criminal prosecutions to permit system-wide calibration of the enforcement threats faced by banks.

In response to the industry reaction, senior government officials initiated a public campaign to persuade financial institutions that they misperceived the risks of AML enforcement and should stop acting in ways that threatened to

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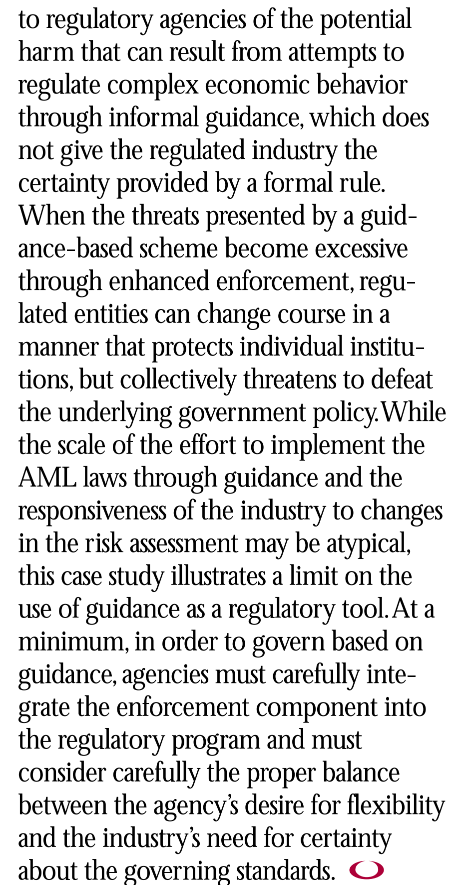
undermine the effectiveness of the BSA program. Those efforts largely failed. Banks objected that: (1) individual institutions did not have sufficient notice of the actual standards to which they would be held and were unwilling to expose themselves to the risk of enforcement actions; and (2) administration of the AML program was producing competitive inequalities among industry segments, because examiners in various agencies implemented the few rules that existed in different ways.

Damage Control by the Government

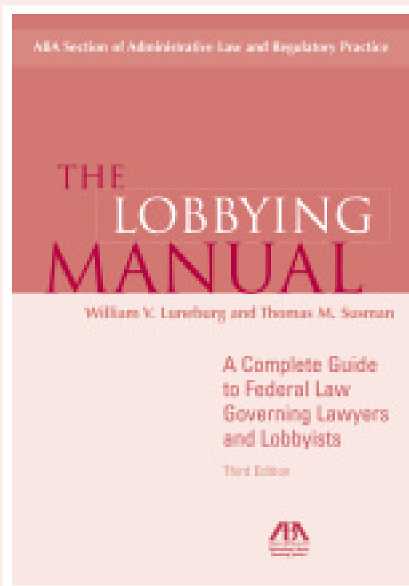
The unintended consequences resulting from AML enforcement forced the government to respond comprehensively to industry concerns. The agencies addressed complaints of excessive reliance upon, and inconsistent application of, guidance by issuing more guidance. FinCEN and the five supervisory agencies undertook a complicated and time-consuming effort to negotiate common guidance. The resulting BSA AML Examination Manual, made avail able on June 30, 2005, exceeds 300 pages. It sets forth in great detail the standards to be applied by field examination staffs in all industry segments. The Manual also conveys an implicit commitment that future enforcement efforts will adhere to the "requirements" it establishes.

It is too soon to tell if this unprecedented joint guidance will affect the banks' risk calculus and will satisfy a sufficient number of institutions that it is safe to reverse the defensive policies that, taken collectively, harmed the overall effectiveness of the AML program. The outcome depends in large measure on whether future civil and criminal enforcement actions respect the implicit commitment in the Examination Manual not to penalize a bank for the exercise of informed judgment, and whether field examiners can resist the temptation to sanction good faith disagreements about risk assessments.

The broad lesson that can be drawn from the AML experience is a warning



to regulatory agencies of the potential harm that can result from attempts to regulate complex economic behavior through informal guidance, which does not give the regulated industry the certainty provided by a formal rule. When the threats presented by a guidance-based scheme become excessive through enhanced enforcement, regulated entities can change course in a manner that protects individual institutions, but collectively threatens to defeat the underlying government policy. While the scale of the effort to implement the AML laws through guidance and the responsiveness of the industry to changes in the risk assessment may be atypical, this case study illustrates a limit on the use of guidance as a regulatory tool. At a minimum, in order to govern based on guidance, agencies must carefully integrate the enforcement component into the regulatory program and must consider carefully the proper balance between the agency's desire for flexibility and the industry's need for certainty about the governing standards.



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