MONEY LAUNDERING: THE GLOBAL THREAT TO THE INTEGRITY OF FINANCIAL SYSTEMS

Rachel Manney

Abstract

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This article describes recent money laundering related events at large U.S. financial institutions and the legislative and regulatory changes to the U.S. money laundering regime that have been proposed as a response. The law that attempts to suppress that problem and its current limitations will then be described, in addition to potentially problematic amendments that have recently been proposed. U.S. policy makers face complex and potentially controversial choices in this area as they attempt to monitor and control global capital flows into the U.S.
MONEY LAUNDERING
The Global Threat to the Integrity of Financial Systems

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What is Money Laundering?

Money laundering is the exchange or factoring of the proceeds of criminal acts to disguise their origins.¹ One common example of money laundering is the movement of profits from drug trafficking, prostitution, corruption and other criminal activities through a series of bank or brokerage accounts to make them appear to be proceeds of legitimate business activity. This process is of critical importance, as it enables those perpetrating the criminal activities to enjoy these profits without revealing their sources, thereby making detection of the criminal activity less likely.

By its very nature, money laundering occurs outside of the normal range of economic statistics. Nevertheless, as with other aspects of underground economic activity, rough estimates have been put forward to give some sense of scale to the problem. The International Monetary Fund (IMF) has stated that the aggregate amount of money laundered in the world could be somewhere between two and five percent of the world’s gross domestic product.² Using 1997 statistics, these percentages indicate that money laundering ranged between US Dollar (USD) 590 billion and USD 1.5 trillion.³ The lower figure is roughly equivalent to the value of the total output of Spain’s economy.

How is money laundered? Initially, the launderer breaks up large amounts of cash into less conspicuous smaller sums, (usually co-mingles the smaller sums with funds from legitimate operations), and then either deposits the combined amount directly into a bank account, or purchases a series of monetary instruments (checks, money orders, etc., paid in US dollars). If the launderer purchases monetary instruments, he then deposits them into accounts at another, generally foreign, bank location. The monetary instruments are
issued in US dollars and payable from the foreign banks’ correspondent accounts at US banks. After the funds have entered the financial system, the second or layering stage takes place. In this phase, the launderer engages in a series of conversions or movements of the funds to distance them from their source. He may buy and sell a series of investment instruments, or simply wire the funds through a series of accounts at various banks across the globe. This phase of the money laundering process is called “layering.” This use of widely scattered accounts for laundering is especially prevalent in those jurisdictions that do not cooperate in anti-money laundering investigations. In some instances, the launderer might disguise the transfers as payments for goods or services, giving them a legitimate appearance. Having successfully processed his criminal profits through the first two phases of the money laundering process, the launderer then moves them to the third stage, integration, in which the funds re-enter the legitimate economy.

Money Laundering Activity in the U.S.

The U.S. has had a serious money-laundering problem for more than thirty years, and this problem is growing very rapidly. Although the amount of money illegally laundered in the U.S. is inherently difficult to estimate, the most commonly cited figure, at least until recently, was $250 billion annually.

A large majority of off-shore money laundering in the U.S. has historically been driven by the large-scale production and export to the U.S. of cocoa leaf and cocaine by organized drug cartels located in Bolivia, Peru, Mexico, and, particularly, Columbia. The effect of this drug trade on the health of U.S. society has been a source of enormous popular and political concern for many years. However, until the late 1990’s, U.S. policy makers did not appreciate the threat money laundering posed to the integrity of U.S. businesses and financial institutions.

Three recent events have concentrated the attention of Congress, Treasury, and law enforcement on the threat to the integrity of U.S. financial institutions posed by money laundering. The first of these was Operation Casablanca. Casablanca, was an elaborate, drug sting operation commenced in 1994. U.S. DEA and Customs agents infiltrated and exposed major money laundering operations of the Cali and Jaurez drug cartels and exposed their links to seven major Mexican, Argentinean and Venezuelan banks. Each of the banks and more than 150 individuals eventually were indicted. The US Customs Service, with the help of undercover agents, arrested 22 high-ranking and mid-level bankers from 12 of Mexico’s 19 largest banking institutions and seized $35 million dollars, 2 tons of cocaine and four tons of marijuana. However, in 1998, the Mexican government protested to the U.S. because they were not informed of the long undercover investigation, and the investigation ceased.

The second event was the U.S. Justice Department’s 1996 investigation into Citibank’s alleged laundering of $100 million of illegal income by Raul Salinas de Gortari, the brother of the former Mexican President, Carlos Salinas de Gortari.
The third wake-up call for U.S. law enforcement authorities involved The Bank of New York (BONY) and Russia. Two BONY employees and certain of the bank’s Russian participated in siphoning US$7 billion out of Russia and into three BONY accounts.

When the BONY story first hit the press in August of 1999, it proved compelling. The scandal contained an extraordinary array of themes and subplots that intersects with American fears and anxieties over what is happening in, and our relationship with, Russia. Among these are American’s increasing anxieties concerning the emerging menace of Russian organized crime, massive theft of U.S. aid, naivete of U.S. and IMF officials in managing both aid and larger policies toward Russia, and possible corruption of even the most venerable U.S. financial institutions.

The defendants ultimately pleaded guilty to: laundering money to promote criminal activity and defraud the Russian Government; conducting unlicensed banking operations; establishing an unauthorized branch of a foreign bank; operating an illegal money transfer business; bribing a bank employee; receiving illegal payments as a bank employee and laundering those payments abroad; tax evasion; and fraudulently obtaining visas for hundreds of Russians to enter the United States.9

The magnitude of such sums being transferred through major U.S. money-center banks, even if merely “flight” capital not subject to U.S. laws, stunned U.S. authorities. There were several reasons for this. First, the BONY scandal highlighted the increased risks posed by non-drug money laundering to the integrity of major U.S. financial institutions. Second, the allegations and convictions in the BONY case indicated that despite recently tightened federal bank reporting regulations requiring banks know whom they are doing business with, where funds they accept come from, and report all large or suspicious transactions were less than effective. Finally, and most importantly, the investigation into money laundering at BONY, as well as unrelated investigations of Russian money laundering at the BankBoston Corp. and Citigroup, posed major, controversial questions concerning the scope and effectiveness of U.S. money laundering law itself.

U.S. Anti-Money Laundering Legislation

The two most important laws governing money laundering in the U.S. are the Bank Secrecy Act, (BSA)10 which imposes extensive record keeping and reporting requirements on financial institutions in order to supply law enforcement with evidence of financial transactions. The second is the Money Laundering Control Act of 198611 which precludes circumvention of the BSA requirements by creating criminal liability for individuals who conduct monetary transactions knowing, or having reason to know, that the proceeds involved were obtained from unlawful activity.

The BSA requires financial institutions to file Currency Transaction Reports (CTRs) with the U.S. Treasury reporting deposits, withdrawals, and exchanges of more that $10,000 of currency. These reporting requirements, as well as the obligations to implement Know Your Customer (KYC) guidelines, have grown substantially over the last few years and the banking industry has consistently opposed them as unduly burdensome, expensive,
and ineffective. The events at Citibank, BankBoston Corp, and BONY support, at least to some extent, the last of these criticisms.

The BONY scandal encouraged bank regulators to re-issue in amended form the proposed regulations, imposing stricter KYC rules on banks. In April 1999, those proposed regulations were withdrawn, due to firm bank opposition. Another major initiative to control money laundering into the U.S. was underway even before the BONY investigation began. As a part of International Crime Control Strategy issued by President Clinton in May of 1998, U.S. law enforcement, diplomatic and intelligence agencies were ordered to intensify their efforts against international organized crime including money laundering. Pursuant to the initiative, the Departments of State, Justice, Treasury, and the FBI created permanent interagency working groups to coordinate operations against international crime by. In addition, the Department of Justice and the FBI have substantially increased the number of law enforcement personnel overseas. The FBI currently has more than 35 overseas offices and is considering opening new ones.

However, the most important new money laundering enforcement initiatives under consideration recently have been the Foreign Money Laundering Deterrence and Anticorruption Act (H.R. 2896), introduced in both the House and Senate in the fall of 1999 and the International Counter-Money Laundering and Foreign Anticorruption Act of 2000 (H.R. 3886), introduced in both the House and Senate in March of 2000. This legislation, supported by the Justice Department, would significantly expand the underlying crimes covered by and the effective reach of international jurisdiction pursuant to 18 U.S.C. 1956 and 1957, as well as bank’s monitoring and reporting obligations under the BSA. H.R. 2896 attempts to address one of the largest impediments in prosecuting the BONY case and many foreign organized crime money laundering cases in U.S. courts. To prove a charge of money laundering under federal law, prosecutors must allege and prove beyond a reasonable doubt that the Specified Unlawful Activities (SUAs) listed in the money laundering statutes, 18 U.S.C. 1956 and 1957, gave rise to illegal proceeds. The money laundering statute lists dozens of federal crimes that can serve as the predicate SUA for prosecuting organized crime activity in the U.S. However, only a very limited number of offenses committed outside U.S. borders, including narcotics trafficking, murder, kidnapping, robbery, extortion, fraud against a bank, and destruction of property explosives currently qualify as SUAs under the statute.

The proposed amendment of the money laundering statute would add to the list of applicable SUAs any crime of violence, fraud (or scheme to defraud) committed against a foreign government or governmental entity, bribery of a public official, or misappropriation, theft or embezzlement of public funds by or for the benefit of a public official, misuse of IMF funds and computer fraud. Although H.R. 2896 certainly will make federal prosecutions of off-shore money laundering in the U.S. much easier, it poses several problems and is likely to engender opposition from U.S. business and banking groups, international banks, and those concerned about the amendment’s potential for promoting conflict with foreign jurisdictions and foreign sovereigns.
Foreign businesses, banks, and governments have, not surprisingly, expressed concern over the prospect of having U.S. money laundering laws extended to the non-U.S. offices of international banks and businesses for alleged offenses outside the U.S. that do not involve their U.S. offices. American banks have opposed the legislation for two reasons. First, they have argued that the current law was more than sufficient to prosecute the limited money laundering found in the BONY case. American banks have argued that prosecutions of money laundering, per se, were not be brought in the BONY case due to Russian authorities inability or unwillingness to investigate those under suspicion in Russia, not the limited scope of the U.S. statute. Second, they oppose any measure that tends to increase the risk or cost of international banks’ selection and use of U.S. financial markets and infrastructure for transactions. Increases in such costs or risks to foreign capital and banks will divert business from the U.S.

In late 1999, the Clinton administration took steps to abandon H.R. 2896 after some 300,000 U.S. citizens opposed the legislation via email, and the American Civil Liberties Union stated that the bill would give a blank check to bank regulators to demand for international transactions the same kind of information they demanded under the BSA.  

The International Counter-Money Laundering and Foreign Anticorruption Act of 2000 (H.R. 3886), introduced in both the House and Senate in March of 2000, would give the U.S. Justice Department (IRS, Customs Service, Secret Service) the power to make new requirements on financial institutions; prohibit whole classes of international transactions; prohibit international transactions with certain financial institutions and prohibit international transactions with certain countries, each at their discretion. Once again, non-governmental industry and citizens groups are speaking out against this legislation, contending that the U.S. government’s charge of securing the rights of life, liberty and the pursuit of happiness, as stated in the U.S. Declaration of Independence and the rights of life, liberty and property, as stated in the U.S. Constitution, are not best served by this legislation.

In a speech delivered in May, 2001 Lori Richards, Director, Office of Compliance Inspections and Examinations, of the U.S. Securities and Exchange Commission (SEC), announced that, the SEC staff would be after conducting a new examination initiative designed to focus attention on money laundering compliance by broker-dealers. The initiative seeks to accomplish two goals. First, to ensure that all firms in the securities industry institute policies and procedures to combat money laundering. Second, the SEC hopes to give notice to those firms who already have anti-money laundering programs to ensure that they are top-notch and are being implemented effectively. The SEC expects that a firm would have written policies and procedures that contain the basic elements of the firm’s anti-money laundering program.

The SEC also suggested best practices which would include the firm conducting a risk assessment of its own business and customers in order to develop an overall strategy appropriate for its business. Additionally, the broker-dealer's money laundering policy should contain appropriate parameters and methods of monitoring so that suspicious customer activity can be detected and appropriate action can be taken.
Initiatives Taking Place Abroad

In response to mounting concern over money laundering, the Financial Action Task Force on Money Laundering (FATF) was established by the G-7 Summit that was held in Paris in 1989. Recognizing the threat posed to the banking system, financial institutions and taxing authorities, the G-7 Heads of State or Government and President of the European Commission convened the Task Force from the G-7 member States, the European Commission, and eight other countries.

The Task Force was given the responsibility of examining money laundering techniques and trends, reviewing actions that had already been taken at national or international levels, and setting out measures that still needed to be taken to combat money laundering. In April 1990, less than one year after its creation, the FATF issued a report containing a set of Forty Recommendations, which provides the blueprint used to fight against money laundering.

The FATF monitors members' progress in implementing anti-money laundering measures, reviews money laundering techniques and counter-measures, and promotes the adoption and implementation of anti-money laundering measures globally. In performing these activities, the FATF collaborates with other international bodies involved in combating money laundering.

The FATF does not have a tightly defined constitution or an unlimited life span. The Task Force conducts regular reviews of its mission every five years. The FATF has been in existence since 1989, and it has been agreed that it should continue its work until 2004. It will only continue to exist and to perform its function after this date provided the member governments agree that this is necessary.

The Forty Recommendations of the FATF outline a framework for anti-money laundering efforts and are designed for universal application. They attempt to provide a complete set of counter-measures against money laundering, covering the criminal justice system and law enforcement, the financial system and its regulation, and international cooperation.

The Forty Recommendations have been endorsed or adopted by many international bodies. The Recommendations are neither complex nor difficult to implement, and the FATF purports that they do not compromise the freedom to engage in legitimate transactions or threaten economic development. Initially developed in 1990, the Recommendations were revised in 1996 to account for changes in money laundering trends and to anticipate potential future threats. The FATF has also elaborated various interpretative notes, designed to clarify the application of specific Recommendations and to provide additional guidance.

Some of the obligations contained in the Recommendations were incorporated into H.R. 2896 and 3886. These obligations include:
identifying as criminal activity the laundering of the proceeds of serious crimes and the enactment of laws to seize and confiscate the proceeds of crime;
• requiring financial institutions to identify all clients, including any beneficial owners of property, and to keep appropriate records;
• requiring financial institutions to report suspicious transactions to the appropriate national authorities, and to implement a comprehensive range of internal control measures;
• adequate systems for the control and supervision of financial institutions;
• the need to enter into international treaties or agreements and to pass national legislation which will allow countries to provide prompt and effective international cooperation at all levels.

Some of these obligations are those points which Libertarians and privacy advocates in the U.S. have disagreed with. The opponents of such obligations argue that financial institutions should not take on a policing role, and that reporting requirements allow governments too much arbitrary power to examine private sector transactions in which no probable cause exists to believe that a crime has taken place.

In 2000-2001, the FATF is concentrating on two major initiatives, while continuing with the program followed in previous years. FATF’s first initiative was a review of the Forty Recommendations and Interpretative Notes. The review is expected to continue into 2001-2002.

The second initiative, which began in 1999-2000, identified jurisdictions with serious deficiencies in their anti-money laundering regimes. This initiative is designed to encourage the implementation of comprehensive and effective anti-money laundering measures in large financial centers. An initial report in June 2000 identified 15 jurisdictions as non-cooperative in the fight against money laundering. The FATF pursued a non-cooperative countries and territories initiative during 2000-2001. It monitored previously identified weaknesses and considered countermeasures for jurisdictions maintained their detrimental rules and practices. It also reviewed the anti-money laundering policies in an additional number of jurisdictions. In mid-2001, the FATF issued a new list of jurisdictions having serious deficiencies in their anti-money laundering procedures. Most importantly, Russia and the Philippines were given 90 days to improve their practices or face economic sanctions. This decision could have serious impact on the international banking system. Also significant was the removal of the Cayman Islands from the list of jurisdictions with deficient anti-money laundering laws.

Other Regional and International Anti-Money Laundering Initiatives

Several regional or international bodies such as the APG (Asia/Pacific Group on Money Laundering), CRATF (Caribbean Financial Action Task Force), the PC-R-EV Committee of the Council of Europe (a committee of experts on the evaluation of anti-money laundering measures) and the OGBS (Offshore Group of Banking Supervisors), either exclusively or as part of their work, perform similar tasks for their members as the FATF does for its own membership.
The FATF views these groups as part of their strategy to ensure that all countries in the world implement effective counter-measures against money laundering. Thus the CFATF, the Council of Europe PC-R-EV and OGBS carry out mutual evaluations for their members, which assess the progress they have made in implementing anti-money laundering measures. In the same vein, APG, CFATF and the Council of Europe PC-R-EV also review regional money laundering trends.

Recent News Reports of Anti-Money Laundering Initiatives

In April 2000, a meeting of financial regulators of thirty-six offshore banking centers, hosted in the Cayman Islands by the United Nations, produced a set of standards aimed at stopping money laundering. The agreement came after the multi-national FATF threatened to publish a blacklist of countries believed to be turning a blind eye to money laundering.

After two days of negotiations, the representatives agreed to a wide-ranging set of standards designed to deny criminal organizations access to the world's financial markets. Among the new measures is a better flow of information between the centers, the tightening of systems to report suspicious transactions and improved enforcement of money laundering laws.

Some of the smaller countries represented at the conference released statements welcoming the initiative. But those countries also welcomed the chance to avoid possible loss of business, which accompanies the threat of highly damaging blacklists.\(^{17}\)

In October 2000 eleven of the world’s largest banks met in Wolfsberg, Switzerland to confer on battling money laundering schemes. They adopted guidelines known as the Wolfsberg Anti-Money Laundering Principles. The guidelines require potential private-banking clients to document the origin of their wealth, and clients will be able to open an account only once a screening is completed. The screening includes identifying the beneficial owner of any numbered or third party originated accounts.

The eleven guidelines, which put the onus on private banking departments, call for banks to train employees to recognize money laundering and examine suspicious activity, such as large cash flows or money transfers that aren’t used for the purpose which the accounts were originally created.\(^{18}\)

In a report of the Democratic staff of the Senate investigations subcommittee released in February of 2001, four of the nation's six largest banks, including JP Morgan Chase, Citigroup's Citibank, First Union and Bank of America, were identified as having lax money laundering policies. The report blamed correspondent banking, a legitimate practice that allows foreign banks to establish US accounts, permitting them access to the US domestic banking network. In a correspondent banking relationship, one bank provides another with services which include current account related services, like payments services and collections; credit related activities, like granting of credit lines for money market, foreign exchange market and derivatives trading; securities related services, like custody, registrar and transfer agencies, paying agencies, depositories; trade
finance related activities and information services. The correspondent banking departments have increasingly assumed relationship management functions, which encompasses the credit function, especially assessing the counterparty risk potential for all types of interbank credit and settlement risks. The banks, according to the report, have operated these accounts in an atmosphere of complacency, with lax due diligence, weak controls and inadequate responses to troubling information.

The report also says that the US correspondent banking system provides a significant gateway for rogue foreign banks and their criminal clients to carry on money laundering and other criminal activity in the US. The Senate document follows a report issued in January, 2001 by the FATF, which issued a progress report on the efforts of 15 countries it had threatened with sanctions for making money laundering easy. In issuing its report, the FATF said seven countries had made substantial progress in countering money-laundering schemes, among them Israel and the Bahamas.

A Technological Solution?

In September 1999 Banco Itau S.A., the second largest bank in Brazil, licensed an Internet based risk management system from ACI Worldwide to monitor and control fraud involving laundering. The system, PRISM seeks to identify subtle patterns of fraudulent behavior by comparing individual card and account usage with known patterns of fraud. Transactions are monitored in near real-time or batch environments; when a suspicious transaction is found, the transaction is flagged for action. The software will monitor “universal accounts” – accounts that tie together the various bank accounts to which individuals and businesses have access.

Conclusion

Regulators worldwide, but particularly in the US, will continue to focus on money laundering and the effectiveness of procedures adopted by financial institutions. US registered investment advisers and broker-dealers would be wise to carefully review their procedures and ensure that all employees understand their importance and operation.
5. Vincent Boland, Earnings from Organized Crime reach $1,000 billion, Financial Times, Feb. 14, 1997 estimating the U.S. accounted for approximately a quarter of the total figure.
7. AP, 1/16/00 and US Department of the Treasury, the Office of Public Affairs, “US Customs Service Takes Down Major Drug Traffickers, Corrupt Banks and Bankers in Largest Drug Money Laundering Case Ever”.
16. www.oecd.org
17. Peter Greste, BBC News, 4/1/00.
18. www.wolfsberg-principals.com
19. BBC, 2/5/01.

It is important to distinguish money laundering from tax avoidance on proceeds from legal activities. An abnormally high tax regime often gives rise to a gray (or black) economy. Common examples of the latter type of activity include: understating value of import contracts (to avoid customs duties and import VAT payments); use of foreign trade contracts to disguise purely domestic transactions; avoiding mandatory conversion of hard currency receipts; and tax evasion generally.
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