Insight

Anti-Money Laundering Regulation: A Primer

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Executive Summary

- A 2018 Bank Policy Institute study found that participating banks spent $2.4 billion and employed 14,000 individuals specifically to meet anti-money laundering compliance requirements. Despite the high costs of compliance, only 4 percent of reports of suspicious activity sent to law enforcement have resulted in any follow-up.

- Perhaps as a result of this, both Houses of Congress have indicated that reforming anti-money laundering regulations will be a focus for 2019.

Context

On January 29, Senate Banking Committee Chairman Mike Crapo outlined the committee's agenda and priorities for the 116th Congress. Under the category of "National Security," the committee announced a commitment to "modernizing the decades-old anti-money laundering and beneficial ownership regime."

Also in January, House Financial Services Committee Ranking Member Patrick McHenry wrote to Deutsche Bank CEO Christian Sewing requesting information on the bank's internal processes relating to money laundering. This letter is in response to Deutsche's role in what is being called "the largest money-laundering scandal in European history." Danske Bank, the largest bank in Denmark, is currently under investigation in the United Kingdom, France, Denmark, and Estonia for allowing the transfer of some €200bn from legally suspicious sources of Russian and Baltic origins via its operations in Tallinn, Estonia. €200bn is of course roughly 10 times the size of Estonia's economy.

Money laundering represents a very real and present risk, and (at least in Europe) current regulatory and supervisory oversight mechanisms are not working as intended. With both the Senate and House indicating that this is a concern, there is a real chance that 2019 will involve meaningful anti-money laundering reform. All of which begs the question: what is the current state of anti-money laundering regulation in the United States, and why does it need to be changed?

Legislative History

First, perhaps, a definition. Money laundering is the process of making illegally-gained proceeds (i.e. "dirty money") appear legal (i.e. "clean"). Typically this is done by introducing dirty money back into the financial system and then unnecessarily *moving* the money – through a series of sales and purchases, perhaps – to disguise the original source of the money. Money laundering is a major international concern because of its role in illegal activity, most notably the financing of terrorism.

Each year, between $500 billion and $1 trillion of dirty money is laundered through the international financial

system. It is estimated that half of this laundered money is conducted through banks in the United States. Anti-money laundering regulation in the United States originates in the 1970 Bank Secrecy Act, but Congress significantly reinforced it after the 9/11 terrorist attacks. The USA Patriot Act of 2001 amended the Bank Secrecy Act, requiring all financial institutions to create and conduct anti-money laundering programs and also criminalizing the financing of terrorism.

Most pertinently, and unusually, the updated anti-money laundering provisions require financial institutions to self-report via a Suspicious Activity Report (SAR). Firms must file a SAR with the Financial Crimes Enforcement Network (FinCEN) following a suspected issue of money laundering. In other words, the law deputizes firms to prevent, identify, investigate, and report criminal activity.

Implications

In 2018 the Bank Policy Institute (BPI) undertook a wide-ranging study to better understand whether the bank resources devoted to anti-money laundering compliance in the United States were effectively providing law enforcement with useful data.

BPI found that:

- Survey participants are employing over 14,000 individuals, investing approximately $2.4 billion and utilizing as many as over 20 different IT systems per institution to assist them with Bank Secrecy Act /Anti-Money Laundering compliance;
- In 2017, survey participants reviewed approximately 16 million alerts, filed over 640,000 suspicious activity reports (SAR) and more than 5.2 million currency transaction reports (CTR); and
- Institutions that record data regarding law enforcement inquiries reported that a median of 4 percent of SARs and an average of 0.44 percent of CTRs warranted follow-up inquiries from law enforcement.

The cost of anti-money laundering compliance is high. Anecdotally, banks have noted that anti-money laundering compliance drives higher annual costs than compliance with the entirety of Dodd-Frank combined. The requirements incentivize firms to submit as many SARs as they can both to appear to be in compliance with anti-money laundering requirements and to do their best to avoid an actual money laundering incident. Despite (and perhaps in part because of) this effort BPI found that a median of only 4% of SARs are pursued by law enforcement. In 2016 the Heritage Foundation found that the total cost to the economy of anti-money laundering compliance was between $4.8 and $8 billion annually. Despite this, the system resulted in fewer than 700 convictions annually, meaning each conviction cost approximately $7 million.

Conclusion

SARs are a costly tool in the fight against money laundering, and the ongoing incidences of money laundering and fraud suggest they're not even effective. The current anti-money laundering framework relies on the ineffective SAR process, which has been outpaced by technological advancement and could be replaced by models that mine financial data. Compliance with anti-money laundering should be transferred from bank examiners to the Treasury Department, which has the statutory authority to examine banks but delegated it over 20 years ago to banking regulators, with a view to preventing fraud or money laundering rather than simply detecting instances ex-post facto. Refreshing U.S. anti-money laundering regulation would better protect national security and reduce an unnecessary burden on U.S. financial institutions.