Effectiveness of US anti-money laundering regulations and HSBC case study

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Abstract

Purpose – This paper aims to provide a macro analysis of the USA's anti-money laundering (AML) legislation. In examining the context and consequences of these regulations, a general determination can be made on the effectiveness of the current US AML legislation. The major AML regulations in the USA are covered under the Bank Secrecy Act, USA Patriot Act and the Office of Foreign Assets Control. It is difficult to determine what constitutes as implementation and maintenance of effective AML Compliance Programs because US federal AML requirements remain largely dynamic. This paper will provide some context to why certain major AML regulations were established as well as the reasoning behind their implementation. This paper will then attempt to determine the effectiveness of current AML regulations, particularly on the banking sector, by looking at several cases of alleged failure to maintain effective AML Compliance Programs. An examination will be conducted on HSBC's $1.9 billion settlement in 2012 to the US government, as HSBC failed to establish a reasonable AML program according to the US Department of Justice press releases.

Design/methodology/approach – A brief description of major US AML regulations pertaining to the 2012 HSBC case is first made. Also, a look into the frequency of suspicious activity report (SAR) filings as well as initiated money laundering investigations is made. The paper critically analyzes the Financial Action Task Force (FATF)'s evaluation of US AML regulations.

Findings – It is evident that the FATF held an accurate evaluation of US AML regulations being both very comprehensive and severely enforced. The main criticism is with the implementation of these regulations driving adverse economic and social effects. Financial institutions fear being charged with not having a proper AML program; this causes banks to be more inclined to inflate SARs as well as engage in financial exclusion. It is difficult to prevent these adverse effects, as they directly result from having strict and comprehensive AML legislation, which is necessary to prevent and detect money being laundered.

Practical implications – A determination as to whether US AML regulations need strengthening or is too strict in that it causes adverse effects.

Originality/value – A macro analysis of America's AML legislation is severely needed. Many papers on the issue lack a thorough description of the large-scale socio-economic effects of the AML programs of American financial institutions.

Keywords USA, Regulations, Anti-money laundering

Paper type Research paper

Introduction

The major US anti-money laundering (AML) regulations are covered under the *Bank Secrecy Act*, *USA Patriot Act*, *Money Laundering Control Act* and *Money Laundering Suppression Act*. In examining the governing bodies responsible for handling these regulations, a general determination can be made on the state of

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modern AML regulations. This paper looks into financial sector's reactions and criticisms to these regulations, including a mutual evaluation of US AML regulations outlined by the *Financial Action Task Force (FATF)*. Finally, we present a case study on *HSBC*'s $1.92 billion settlement in 2012 to the US government, as the bank allegedly failed to establish a reasonable AML program according to the *US Department of Justice* press releases (The United States Department of Justice, 2012b). With this information, a conclusion is drawn on the effectiveness of current US AML regulations.

The major US AML regulations

The *Bank Secrecy Act* of 1970 required financial institutions to file currency transaction reports, suspicious activity reports (SARs) and maintain recordkeeping requirements. A currency transaction report must be sent to *Financial Crimes Enforcement Network (FinCEN)* if a bank handles any transaction in currency of more than $10,000, including withdrawals, deposits, payments and exchange of currency. SARs are confidential reports that must be sent to *FinCEN* if any employee of a financial institution comes across a transaction that seems to be related to terror financing, money laundering, financial fraud or any other type of illegal financial activity. The *Annunzio-Wylie Anti-Money Laundering Act* of 1992 further incentivized banks to file SARs by making it illegal to disclose when a SAR has been filed and by giving financial institutions protection from civil liability when filing the report. A financial institution must also keep documentation of any purchase or sales of monetary instruments valued between $3,000 to 10,000. The precise required retention period of these documents vary depending on the state, but the information must be kept for at least five years (FinCEN, 2015b).

The 2001 *USA Patriot Act* was conceived in reaction to the 9/11 terrorist attacks. Title III of the *Patriot Act* is responsible for the abatement of money laundering and financial terrorism mainly through the identification of correspondent bank account owners (Section 312, 326), encouraging information sharing between the government and financial institutions (Section 314), prohibiting the use of certain types of bank accounts (Section 313), adding penalties for non-compliance (Section 329, 315) and encouraging financial institutions to report suspicious accounts to the government (Section 324) (FinCEN, 2015b). Furthermore, Section 352 requires financial institutions to establish AML programs. These programs must include the designation of an internal compliance officer, a continuous employee-training program on AML regulations, implementation of an independent audit function and the implementation of internal money laundering detection procedures, including a "Know Your Customer" due diligence program that identifies the source of assets of prospective clients. It is to be noted that before 2001, most financial institutions already had similar AML programs in place under the *Bank Secrecy Act* regulations. Section 352 of the *Patriot Act* served mostly to readjust and further standardize existing AML programs (Wilkes and Lemmo, 2012).

The *Money Laundering Control Act* of 1986 made money laundering a criminal offense with maximum penalties of 20 years jail time and $500,000 in fines for each offense. It also required financial institutions to set up AML programs outlined in the *Bank Secrecy Act* and banned the structuring of monetary transactions to evade reporting requirements. The 1994 *Money Laundering Suppression Act* required money services businesses to be registered and keep records of its agents. The 1998 *Money Laundering and Financial Crimes Strategy Act* called for the designation of certain geographical or institutional areas as high risk for crimes relating to money laundering, these areas became known as *High-Risk Money Laundering and Related Financial Crimes Areas* (HIFCA). *The Office of Foreign Assets Control* administers the *Specially Designated Nationals* list, which is a list of sanctioned organizations and individuals with whom US citizens are prohibited to do business with (Haggerty *et al.*, 2010).

For an institution or individual to be found guilty of aiding and abetting money being laundered, prosecutors must show that there had been reckless disregard, deliberate ignorance or collective knowledge of it happening. To assess appropriate money laundering penalties, the Secretary of the Treasury delegate research and recommendation tasks to *FinCEN* as well as other self-regulatory organizations like *Financial Industry Regulatory Authority* or the *Securities and Exchange Commission*. On top of that, state regulators can also assess their own civil penalties too. The *Asset Forfeiture and Money Laundering Section* of the *US Department of Justice* can bring civil, criminal, as well as forfeiture actions after the assessment. *FinCEN* is the US regulator for AML regulations. Other major federal banking regulators that help enforce AML legislation are the *Federal Reserve Bureau*, the *Office of the Comptroller of the Currency*, the *National Credit Union Administration*, the *Federal Deposit Insurance Corporation* and the *Office of Thrift Supervision* (Haggerty *et al.*, 2010, pp. 13-15).

Regulation reactions and criticisms

In 2004, the *Intelligence Reform and Terrorism Prevention Act* amended the *Bank Secrecy Act* to require specific financial institutions, as determined by the Secretary of the Treasury, to report cross-border fund transfers. The Secretary of the Treasury is given discretion in deciding which institutions are required to report cross-border transfers if he/she deems that it is reasonably necessary in combating money laundering and terror financing (Haggerty *et al.*, 2010). Also with the 1998 *Money Laundering and Financial Crimes Strategy Act*, the Secretary of the Treasury or the Attorney General can designate HIFCAs to concentrate AML enforcement on (Wilkes and Lemmo, 2012). The issue with regulations like these is that what constitutes as "reasonably necessary" or "high-risk areas" is up to interpretation; these regulations can facilitate abuse of power, especially if ruling is up to the discretion of one individual.

Although *FinCEN* had purported that the volume of SAR filings is not necessarily an indicator of the quality of an AML program, financial institutions can still be held liable for not filing a SAR if it is determined by regulatory organizations that they should have (FinCEN, 2015a). Since the signing of the *Patriot Act*, guidelines for proper AML protocols have become stricter and penalties for failing to meet the protocols have become harsher. Financial institutions are incentivized to file SARs as a safeguard even if their internal investigations find nothing wrong about an initially suspicious-looking transaction.

In Table I, we see that the amount of SAR filings from depository institutions for money laundering increased consistently from 155,468 in 2003 to 501,324 in 2012. To determine if this increase is due to better AML practices from ongoing AML training or if this increase is due to banks being overcautious and inflating their SAR filings under heightened scrutiny from regulators post-9/11, we must compare the data to Table II. From looking at the available *Internal Revenue Service, Criminal Investigation (IRS-CI)*

Table I.
Suspicious activity report form TD F 90-22.47 (suspicious activity report filings by characterization of suspicious activity)

Suspicious activity	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Bank Secrecy Act/structuring/money laundering	155,468	214,797	303,318	302,818	347,398	382,338	376,718	411,676	475,320	501,324
Terrorist financing	495	987	958	736	687	506	545	711	612	543

Notes: Exhibit 5: number of suspicious activity report filings by characterization of suspicious activity*, January 1, 2003, through December 31, 2012
Source: The SAR Activity Review–By the Numbers (2013)

statistics shown in Table II, we see that there seems to be no clear trend in US money laundering investigations initiated from 2010 onward. This indicates that banks are, in fact, inflating their SAR filings. The statistics show that the dramatic increase of SAR filings over recent years has not resulted in increased money laundering investigations initiated, though we must also take under consideration that there may be other factors in effect like investigative budget constraints.

In Table I, we can also see SAR filings for terrorist financing spike in 2004 and then decrease again; this is largely due to newly implemented regulations from the 2004 *Intelligence Reform and Terrorism Prevention Act*. It is evident that there has been mounting political pressure in recent years for regulators to reinforce stricter AML measures. However, this does not necessarily mean that AML regulations are becoming more effective. As banks are pressured to inflate their SAR filings over fear of regulators viewing them as not complying with the *Bank Secrecy Act*, it becomes harder for *FinCEN* to sift through the reports to find cases of legitimate financial crime.

US AML regulations and enforcement can have far-reaching socio-economic effects. For example, in 2013, a year after the US government imposed a $1.92 billion fine on *HSBC* for failing to meet proper AML protocols, *Barclays* decided to terminate banking services for over 250 money transfer companies in fear of getting money laundering charges as well. This act threatened Somalia's economy, which depended solely on money services businesses for remittances from the UK (prolonged civil strife had left Somalia without a formal banking sector). In 2014, FATF addressed the issue of AML legislation potentially driving financial exclusion and illicit markets. FATF President Roger Wilkins concluded, in a statement, that regulatory action had been more effective than "resolutions, standard setting, and guidance notes", and financial institutions often face harsher risks when de-banking in most areas than from regulatory action. Roger Wilkins claimed that de-banking often causes reputational, commercial and business risk that are "bigger long-term risks" than staying in those regions and attempting to fix AML programs (Financial Action Task Force, 2014).

According to the 2006 FATF mutual evaluation of US AML standards, the USA has "a comprehensive legal and institutional framework for investigating and prosecuting money laundering and terrorist financing offenses" (Financial Action Task Force, 2006). The USA also has an effective regulatory framework in monitoring AML compliance and applies harsh financial penalties to perpetrators that do not comply. However, customer identification requirements could be strengthened and AML measures should also apply to more non-financial businesses. The FATF's biggest issue with US AML measures is that information on beneficial owners are hardly adequate, accurate or delivered in a timely manner (Financial Action Task Force, 2006).

Money laundering investigations	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
Investigations initiated	1597	1762	1663	1596	1312

Source: IRS (2014)

Table II. Money laundering investigations initiated in the USA

Case study: HSBC

In 2012, *HSBC* entered into a deferred prosecution agreement to forfeit $1.256 billion, agreed to pay $665 million in civil penalties and settled $375 million with the Office of Foreign Assets Control (OFAC) to the Department of Justice (DOJ) for violating AML regulations. As a part of the agreement, if *HSBC* failed to pay or strengthen its internal controls until 2017, the DOJ will pursue a criminal indictment. The DOJ charged *HSBC* with four counts of breaching US AML regulations (The United States Department of Justice, 2012a, pp. 9-13). According to the "USA against *HSBC Bank USA, N.A.* and *HSBC Holdings PLC*" (The United States Department of Justice, 2012a) court case documents, *HSBC* failed to maintain an effective AML program, failed to conduct due diligence on corresponding bank accounts belonging to foreign persons, violated the *International Emergency Powers Act* and violated the *Trading with the Enemy Act*. Specifically, it was alleged that *HSBC* knowingly and willfully did not maintain due diligence or "Know your Customer" information, did not monitor wire transfers from "medium-risk" countries and did not provide adequate staffing for its AML programs in violation of the Bank Secrecy Act, Title 31, Sections 5,318 (h,i) and 5,322 (b,d). *HSBC* also intentionally facilitated transfers to sanctioned entities in Iran, Libya, Burma and Sudan in violation of the *International Emergency Powers Act* and facilitated transfers to sanctioned entities in Cuba in violation of the *Trading with the Enemy Act*.

The DOJ press release stated that from at least 2006 to 2009, *HSBC Bank USA* rated Mexico as "standard" risk, the lowest AML risk rating it can give. During this time, *HSBC Mexico* processed over $670 million in wire transfers and $9.4 billion in purchases of physical US currency, all of which went unmonitored by *HSBC USA*. As a direct result, *HSBC Mexico* became the preferred financial institution for Mexican drug traffickers to launder money. The ICE Homeland Security Investigation's El Dorado Task Force found multiple *HSBC Mexico* bank accounts tied to the Black Market Peso Exchange. Drug traffickers were depositing hundreds of thousands of dollars in US currency into these *HSBC* accounts every day to move the proceeds of drug sales out of America. $881 million in illicit proceeds were laundered in these accounts, including money from the Sinaloa and Norte del Valle drug cartels (The United States Department of Justice, 2012b).

As for processing payments to sanctioned entities, *HSBC Group* affiliates added notes including "care sanctioned country" and "do not mention Iran" to cover payments attempting to pass the bank's filters. From 2001 onward, *HSBC Bank USA* repeatedly contacted *HSBC Group* about the use of cover payments preventing them from confirming whether the payments met OFAC regulations, but senior compliance officers largely ignored the issue. Richard Weber, Chief of the IRS-CI, claimed that in ignoring concerns like these, *HSBC* becomes a "conduit to money laundering" (The United States Department of Justice, 2012b).

The DOJ found that *HSBC Bank USA, N.A.* and *HSBC Holdings PLC* did not meet required US AML regulations; however, that fact does not make any determination on the effectiveness of the regulations. We must examine whether a bank could have detected or prevented money being laundered if they had more stringently followed US AML procedures. If an international bank had a more comprehensive due diligence program, "Know your Customer" program, a better compliance staff and enforces responsible AML standards on its relevant subsidiaries, we can reasonably conclude that it would be more likely that its subsidiaries abroad could have prevented individuals with criminal proceeds from opening bank accounts with them and proactively stopped money laundering at the placement stage. Additionally, current US AML legislation would have also called for the designation of a higher level of risk to specific developing countries, which would have resulted in transfers being monitored and an increase of money laundering detection in the layering and integration stages.

The question of whether an international bank should be guilty of being complicit to money laundering for oversight or deliberately having a lax AML program is a complex one. Should there be a criminal element to a bank's actions solely because investigators found hard evidence of money being laundered through the institution's accounts or should the criminal element stem solely from deliberately failing to meet AML legislation? There is a subtle difference between these two ideas that can be illustrated with two additional questions: if a bank had a lax AML program but has no one laundering money through them, would that bank be charged? Conversely, if a bank had proper AML procedures but there was evidence of money laundering going through them, would that bank still be charged? If a bank has a lax AML program, as long as there is no evidence of money being laundered through the bank, penalties should only be civil (Haggerty *et al.*, 2010, pp. 13-15). There seems to be consideration of criminal charges against *HSBC* by the DOJ because the ICE Homeland Security Investigation's Eldorado Task Force found evidence of money being laundered through *HSBC Mexico* accounts, not strictly because the DOJ found *HSBC*'s AML procedures to be deficient, although separating the two is difficult because they are causally related (The United States Department of Justice, 2012b). A bank with relatively poor AML procedures will most likely see an increase of money being laundered through them if this information is known to the underground economy. Additionally, if it is well known that a bank has relatively rigorous AML procedures, criminal organizations with illegal proceeds will try to avoid laundering money through them.

As a result of how AML legislation is structured combined with the complexity of the finance sector, determination of an effective AML program is in part subjective, or more accurately, dependent on whether there actually is money laundering. AML regulations most open to interpretation are the implementation of internal money laundering detection procedures and "Know your Customer" requirements in AML programs. This is because the amount of due diligence required on a potential client to reduce asymmetric information is based on the risk assessment of that client. Although there are many standardized methods banks use to determine the risk of a client, initial risk assessment is still ultimately subjective (PwC, 2013). Similarly, although SARs are not supposed to be filed based on extraneous factors, like a person's ethnicity, legislation like the designation of HIFCAs influences the initial assessment of a client's risk to be at least partly subjective.

If someone has laundered money through a bank, the immediate implication is that the bank has improper AML protocols. As, in practice, it is impossible to eradicate all instances of money laundering, it seems that after implementing strict AML measures, banks must then rely on luck that no one gets away with money laundering through them. In short, banks can implement AML procedures, and the result would be that the bank would better detect money laundering; however, no matter how strictly a bank adheres to US AML regulations, if there is an instance of money being laundered through them, that is enough reason for the bank to be held liable.

Conclusion

From looking at *HSBC*'s court case, we conclude that following US AML regulations will result in better detection and prevention of money laundering. However, we also saw that US AML regulations and the complex banking sector is conjointly structured in such a way that prosecutors can find a bank liable just from the fact that there is an instance of someone laundering money through them. Whether the bank has a strict AML program or a lax program seems to only affect the assessment of penalties.

It is evident that the *FATF* held an accurate evaluation of US AML regulations, being both very comprehensive and severely enforced. The main criticism is with the implementation of these regulations driving adverse economic and social effects. Financial institutions fear being charged with not having a proper AML program; this causes banks to be more inclined to inflate SARs as well as engage in financial exclusion. It is difficult to prevent these adverse effects, as they directly result from having strict and comprehensive AML legislation, which is necessary to prevent and detect money being laundered.

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