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This is the second part of a two part article on de-risking. Part I set out the context of bank de-risking, and the bank/government divergent views about bank decisions to exit business segments that are high risk for money laundering or terrorist financing. Part II discusses an approach to calculating the risks for a bank in the current enforcement environment, and some potential solutions to divergent views regarding the costs and benefits of ongoing high-risk business.

BNA INSIGHTS: How Banks Decide to De-Risk

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One aspect of the dissonance between banks and the government regarding de-risking is the different approaches to enforcing for flawed controls. From the government's perspective, truly egregious conduct[1] justifies large enforcement actions that involve billions of

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[1] See FATF Statement: ''Recent supervisory and enforcement actions have raised the consciousness of banks and their boards about these issues. However, it is important to put into context that these were extremely egregious cases involving banks who deliberately broke the law, in some cases for more than a decade, and had significant fundamental AML/CFT failings. 'De-risking' should never be an excuse for a bank to avoid implementing a risk based approach, in line with the FATF standards. The *FATF Recommendations* only require financial institutions to terminate customer relationships, on a case-by-case basis, where the money laundering and terrorist financing risks cannot be mitigated.'' FATF does not discuss

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dollars and deferred prosecution agreements, if not the imposition of personal liability. The conduct at issue may involve systematically removing jurisdictional information from funds transfer messages, or setting up offshore companies to shield the identity of would-be tax evaders or those hiding corrupt funds. Since no one would argue that such behavior is part of a corporate mission for the servicing of high-risk customers, why is there an appetite to completely abandon some of the high-risk customers?

From the bank perspective, however, the banking industry's money laundering/terrorist financing (ML/TF) enforcement history has created its own calculus of risks. This history has made banks far more bearish than the simple fear of being punished for truly egregious behavior would imply. Thus, while government officials have hinted that occasional ''technical'' lapses in controls regarding high-risk aspects of business may be tolerated,[2] the banking industry may not view such assurances as credible or as useful as the government might hope.

The stakes are even higher than the large fines in headlines. Enforcement actions have included limitations on business as well as inchoate reputational risk. In addition to enforcement penalties, banks can anticipate shareholder disapproval or private litigation from the putative victims of criminal activity associated with the enforcement action.

High-risk customers provide a prominent target for banking examiners. Managing and responding to banking examinations has become a remarkably complex and resource rich effort for banks, as many banks have a number of regulators (such as, in the U.S. the Office of the Comptroller of the Currency, the Federal Reserve Board and the Consumer Financial Protection Bureau as well as state regulators) regarding banking and other regulators regarding associated businesses owned by a bank (such as the Securities and Exchange Commission and Financial Industry Regulatory Authority).

High-risk products often attract sustained attention from examiners and internal auditors to assess how risky both the specific product and the institution may be and how much overall scrutiny the institution deserves. High-risk products thus magnify the banks' regulatory burden, even if their controls are perfect and no problematic activity is discovered.

the economic consequences of a ''cannot'' standard. http://www.fatf-gafi.org/documents/news/rba-and-de-risking.html.

[2] ''FinCEN recognizes that, as a practical matter, it is not possible for a bank to detect and report all potentially illicit transactions that flow through an institution.'' (FinCEN Statement). The FDIC's recent statement here is also useful: ''The FDIC is aware that some institutions may be hesitant to provide certain types of banking services due to concerns that they will be unable to comply with the associated requirements of the Bank Secrecy Act (BSA). The FDIC and the other federal banking agencies recognize that as a practical matter, it is not possible for a financial institution to detect and report all potentially illicit transactions that flow through an institution. *Isolated or technical violations, which are limited instances of noncompliance with the BSA that occur within an otherwise adequate system of policies, procedures, and processes, generally do not prompt serious regulatory concern or reflect negatively on management's supervision or commitment to BSA compliance.*'' FIL-5-2-2015. (Footnote Omitted)(*Emphasis Added*).

Personal liability has become a popular issue with the press and legislators, and some recent actions have caused significant concerns amongst persons who are charged with evaluating the adequacy of controls or overseeing the control process, such as compliance personnel. Because large enforcement actions have frequently involved high-risk products, they may be seen as lightning rods for future enforcement actions. As a result, bank personnel and directors may conclude it is in their personal interest to avoid such products at all costs.

The focus on personal liability has extended to compliance officers, business leaders and boards of directors, even absent their direct involvement in illicit activity, because their roles have been seen as requiring that they ensure compliance or accuracy in one way or another. Indeed, as has been observed, one analog of de-risking is the growing disinclination of persons to serve as accountable compliance officers.[3]

Ironically, this will be particularly likely within institutions with the greatest needs which, consequently, are most in need of capable compliance personnel. Because enforcement actions are almost invariably the product of settlements rather than trials or hearings, there is little opportunity for prior cases to provide insights about precisely what behavior makes individuals vulnerable or resistant to enforcement. Thus, the reaction to the actions tends to be categorical, as in de-risking, rather than refined.

Bank compliance is a highly complicated and global enterprise that has become increasingly challenging. Greater size of banking activity has led, recently, to greater capital and other regulation. In that context, it has become increasingly attractive to jettison a difficult activity that is not essential to the bank's business model or highly profitable. Infrastructure has become a more significant and more unwieldy part of banking requirements, particularly for the large institutions that ordinarily provide such broad coverage to various market segments. De-risking is one way to simplify infrastructure.

Controls short of de-risking for high-risk clients are never going to be absolutely effective, anyway. The only absolutely effective control is not to engage in the business. Approaching greater comfort requires increasingly disruptive and expensive forms of control. Where significant revenues are not possible, that sort of effort is less attractive. Private banking is a high-profit (if high-risk) line of business for many banks, and has seen little de-risking. But other banking activities generally do not have the same revenue potential, either per client or as an aggregate segment of business.

Enforcement against banks has, for various reasons, entered what might be called the bonus round. In other words, misbehavior that might ordinarily give rise to two units of punishment might now invoke 10. This is telling for a bank with a significant ML/TF enforcement event in its history, which is, unfortunately, all too common in the last 15 years for many major banks. The government itself has identified the phenomenon of banks overreacting to prosecutorial zeal by abandoning a market segment, particularly regarding Operation

[3] Julia Black and David Kershaw, ''Criminalising Bank Managers,'' Law and Financial Markets Project Briefing, London School of Economics and Political Science (2013).

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Choke Point.[4] One should not be surprised if banks react to the worst-case scenarios they observe in calibrating their sensitivities to enforcement. This is particularly true in light of the fact that numerous state and federal governmental entities have enforcement power, but may have divergent expectations of banks and take divergent views of the scope of regulations and the severity of response to any particular violation. Different entities may also react differently to the publicity that may attend a given violation.

While one might not be sympathetic to banks, given the enforcement issues recently presented for fixing interest rates, falsifying records, evading sanctions regarding terrorist countries and individuals, evading taxes and the like, as well as the perceived (by some) blameworthy role of the banking industry in the 2008 global financial crisis, the reality is that each next enforcement action occurs within an industry that is already suspect, and thus the penalties are likely to be harsher than if the underlying conduct were evaluated in a vacuum. The difficulty banks have in predicting the extent of potential enforcement costs would be consistent with the decision to de-risk rather than to simply build into the pricing for particular products or market services the increased costs of greater controls.

This notion that the enforcement action costs are difficult to measure is exacerbated by the realization that the egregious behavior spawning enforcement actions has often occurred within large banks that may not collectively think of themselves nor are thought of as criminal enterprises. Indeed, the issues resulting in enforcement actions often resulted from the activities by affiliates or branches in distant locations. Similar issues may arise in these same institutions in the future even though most, if not virtually all, of these banks' personnel work hard to avoid wrongdoing. That was true for the last 15 years, too, and didn't prevent some egregious conduct from occurring.

The prosecution of Arthur Andersen, and its reaction, reflects these concerns. Though conviction was reversed in an appeal after the company stopped operating, it stands for the proposition that a corporation may incur crippling penalties due to the problematic actions of relatively few individuals. From a bank's perspective, the rational thing to do may be to stay away from those areas that are toxic, such as high-risk clients, so that when what may be some inevitable misbehavior occurs, the penalties are not thereby magnified.

Solutions

Like many complicated problems, this one does not have a single solution. Governments are unlikely to solve de-risking by nationalizing banks to make them into true government agents. Nor have governments set clear and explicit limits on enforcement consequences to rationally invite banks into taking more risk with designated high-risk categories. However, some things have worked very well. When there were no government identification numbers in the U.S. for migrant workers, and banks couldn't readily comply with Customer Identification Program requirements, the Mexican government issued matricula cards that effectively resolved the government identification requirement issue.

Similarly, there is now great reluctance to bank marijuana sellers in states that have decriminalized this activity, because it is still a U.S. federal crime, even though federal agencies appreciate the benefits of these state-legitimate organizations being banked rather than remaining as cash businesses vulnerable to money laundering. Legislation pending in Congress[5] that would significantly decriminalize medical marijuana provides a safe harbor for banks handling proceeds of otherwise legal activity.

At the end of the day, there is a still a conflict between the social value of a truly inclusive (and information rich for anti-money laundering) banking system, and the heavy enforcement consequences of violations. To be fair, banks also value (economically) being part of a complete financial market, and we presume they have not already taken that economy into account in making their decisions. Just as some specialties of medicine may become relatively unavailable in states with very high malpractice awards and malpractice insurance premiums, one cannot expect banks to put their future on the line in the name of patriotism. Attractive though it may seem, it is not a market phenomenon, and they are primarily creatures of the markets, notwithstanding their good works and general constructive efforts from time to time. A more realistic approach may be for each side to gather the best that it can with compromises on a case-by-case basis.

Conclusion

The actual deterrent effect upon banks of the ML/TF enforcement environment appears to be greater than is useful, because, by the analysis of law enforcement itself, it threatens to push more transactional activity into areas where it cannot be seen by law enforcement. Aggressive enforcement may also work a financial hardship, as well as stifle the servicing of emerging kinds of clients, such as those that handle marijuana sales.

The issue is not simply whether banks are sufficiently motivated to refrain from illegal activity, but rather whether they are now overly motivated to avoid potential enforcement situations. It does not appear that banks have been irrational in taking the de-risking positions they have, and thus further government explana-

[4] The Department of Justice's Operation Choke Point Hearing before the Subcommittee on Oversight and Investigations (July 15, 2014) at p. 4 et seq. http://financialservices.house.gov/uploadedfiles/113-90.pdf:

"'Operation Choke Point'' takes a new approach to banking supervision. If you don't like a given industry, bend your authorities and force that industry out of the financial services space, making it impossible for it to survive. How does it work? DOJ staff who conceived of ''Operation Choke Point'' summed it up in a November 5, 2012, memo to Mr. Delery [of the Department of Justice]: 'Banks are sensitive to the risk of civil and/or criminal liability and regulatory action.' In other words, DOJ can intimidate banks into doing what it wants by threatening them with subpoenas including with the regulators. Since last August, I have met with some of our regulators and even one of the witnesses on today's panel. In each of those meetings, the regulators agreed that casting a wide net and targeting legal industries is inappropriate. But despite that sentiment, 'Operation Choke Point' continues.'' Statement of Rep. Blaine Luetkemeyer (R-Mo.). (Explanation Supplied).

[5] See Senators Introduce Bill to End Federal Curbs on Medical Marijuana (March 11, 2015). http://www.forbes.com/sites/davidkroll/2015/03/11/is-congress-planning-to-legalize-marijuana/.

tions and dialogue are unlikely to change their behavior. This is not a happening based on incomplete information or on misunderstanding. Regulation forcing coverage contrary to a banker's economically rational view seems equally unlikely, particularly where there appears to be no inherently bad motive or invidious discrimination taking place.

Progress may require designating specific limits on personal and corporate liability that are in keeping with the government's value regarding compliance, including the consequences of harsher enforcement activity. If banks are economically rational actors, one cannot expect them to conduct their activity while writing a blank check with regard to flaws they have historically been unable to completely avoid. On the other hand, if governmental agencies consider that the current enforcement regime already strikes the correct balance, and already affords as much specificity as is prudent, we should all be prepared to live with ongoing derisking, except where real fixes to the rational concerns banks have, such as particular legislation around marijuana sellers, can be implemented.

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