Bloomberg BNA

Banking Daily Bulletin™

Bank Supervision

This is the first part of a two-part article discussing the ''de-risking'' practice of some banks, in which they choose to exit categories of business activity that are high risk for money laundering or terrorist financing. Part I describes the context of de-risking, as well as the perspectives of government and private-sector stakeholders.

BNA INSIGHTS: When Banks Act as Rational Economic Units Rather Than Law Enforcement Deputies

BY ROBERT M. AXELROD

Global and national banks have attracted attention in recent years by announcing plans to cease servicing categories of clients or business in response to heightened money laundering risks. While not a lock-step phenomenon, these instances of de-risking have raised concerns about the possible marginalization of some market segments.

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In particular, the U.S. and U.K. governments, as well as the Financial Action Task Force (FATF), have criticized this phenomenon.[1] Some have distinguished the

[1] Thomas J. Curry, Comptroller of the Currency, Remarks before Association of Certified Anti-Money Laundering Specialists (March 17, 2014), transcript available at http://www.occ.gov/news-issuances/speeches/2014/pub-speech-2014-39.pdf; FinCEN Statement on Providing Banking to Money Services Businesses. (Nov. 10, 2014) (hereafter, (''FinCEN Statement'') at http://www.fincen.gov/news_room/nr/html/20141110.html; FATF Clarified Risk Based Approach: Case by Case, Not Wholesale De-risking (Oct. 23, 2014) (hereafter, ''FATF Statement'') at http://www.fatf-gafi.org/documents/news/rba-and-de-risking.html; De-risking – Banks' Management of Anti-Money Laundering Risk – FCA Expectations (April 27, 2015) (hereafter, ''FCA Expectations'') at

 ISSN 0000-0000

decision to cease service to a particular customer because of risks that can't be managed (''good'' de-risking) from the decision to cease service to a whole category.[2] There is even the suggestion that the disfavored sort of de-risking will be met with greater examination scrutiny, because of the potential for discrimination, harm or illegal arrangement among banks.[3]

This article offers two explanations for why an ostensibly simple economic decision about customer coverage implicates such complex issues that divide the private and public sectors. First, the view of banks as the deputies of law enforcement presumes a corporate motivation that may not be as prominent to banks as it is to law enforcement. Second, as discussed in Part II of this article, if, as rational economic units who may not relish the role of deputy, banks total up the costs of dealing with risky parts of the Money Laundering/ Terrorist Financing (ML/TF) legal and regulatory environment, what may appear to be an overreaction of de-risking a product category could actually be a logical result.

The Uncertain Value of Being a Deputy.

One of the hallmarks of the current global approach to ML/TF prevention is the recruitment of financial institutions, including banks, to gather information about customers and transactions in order to recognize and report suspicious activity to the government. This recruitment functionally deputizes these institutions. In many jurisdictions, the failure of financial institutions[4] to carry out this role is not only a regulatory but a criminal event. The failure to file such reports has been a factor in the levying of very substantial fines. Accordingly, verifying the presence of a robust process to recognize and report suspicious activity is a key feature of the regulatory examination process.

From time to time, enforcement actions have centered on the failure to gather information and/or to identify suspicious activity by high-risk customers, such as Politically Exposed Persons (PEPs), potential tax evaders, Ponzi schemers, money services businesses and large-volume bank note transactors. However, even though the legal and regulatory requirements functionally effect a recruitment of banks as deputies, there is no regulation or law that actually declares banks to be deputies, nor is there any explicit requirement[5] that they assist law enforcement, other than in those ways set out in specific written obligations, such as reporting suspicious activity or identifying the presence on their books of certain customers.[6]

In this context, it is interesting to look at the work of the FATF. As an association of 34 member countries, the FATF sets policies to reduce ML/TF activity globally, and suggests requirements for its members. Not surprisingly, it sees banks as the projection of some of these requirements. The FATF counsels a risk-based approach, but the approach is in some ways particular to government. For example, it is concerned with ''financial inclusion'' of underserved customer groups, because they may end up fueling the operation of underground (and unregulated) financial institutions that cater to the criminal element.

Similarly, the FATF is concerned that if banks do not serve high-risk segments of customers, those customers' transactions will then be more opaque in the unregulated financial markets.[7] FATF's views here neatly anticipate the tension between the private and public sector on de-risking — how large an interest should banks have in taking additional company risk to make the government's goal of identifying criminal activity easier? The private and public sectors have different priorities on the value of a bank serving as deputy.

From the perspective of a deputy law enforcement group (including the regulatory role for banks to recognize and report suspicious activity, such as potential crimes), banks should be particularly eager to embrace high-risk customers. Where else would there be a greater likelihood of finding the tells of illicit activity, the denizens of criminal enterprises and the movement of corrupt and other illicit funds? Just as law enforcement officials will preferentially want to review suspicious activity reports from areas most likely to be associated with crime, banks would want to have those transaction streams in their own sights as well.

Following the same reasoning, the last thing a bank fulfilling a deputy role would want to do would be to exit the high-risk customer groups such as border businesses, marijuana sellers, money services businesses or embassies. However, in light of the fact that regulators have criticized (and penalized) particular banks' handling of high-risk customers, and in light of banks' ob-

https://www.fca.org.uk/about/what/enforcing/money-laundering/de-risking.

[2] David Cohen, Treasury Under Secretary for Terrorism and Financial Intelligence, Remarks at ABA/ABA Money Laundering Enforcement Conference (Nov. 10, 2014) (Hereafter, ''Remarks of David Cohen'') at http://www.treasury.gov/press-center/press-releases/Pages/jl2692.aspx.

[3] FCA Expectations: ''While the decision to accept or maintain a business relationship is ultimately a commercial one for the bank, we think that there should be relatively few cases where it is necessary to decline business relationships solely because of anti-money laundering requirements. *As a result, we now consider during our AML work whether firms' de-risking strategies give rise to consumer protection and/or competition issues*.'' (*Emphasis Added*). See also FinCEN Statement: ''FinCEN and its regulatory colleagues will continue to monitor trends with respect to the provision of banking services to MSBs *and are committed to taking steps to address the wholesale de-banking of an important part of the financial system*.'' (*Emphasis Added*).

[4] While this discussion applies to all financial institutions, de-risking has particularly been prominent with banks, and this discussion will be nominally limited to banks.

[5] The political ramifications of such a requirement, which would be akin to establishing a common carrier status for banks, would be significant, and do not appear to have been raised in the de-risking context. While in some countries banks are explicitly governmental, many Western countries generally treat banks as businesses, albeit regulated, that make their own decisions based on their customers, shareholders, revenues and other factors common to almost all businesses as market participants.

[6] See, e.g., USA PATRIOT Act Sections 314a, 352 and 356.

[7] ''The more attractive the underground economy is for legitimate transactions, the more available that market is for illicit transactions.'' FATF Guidance on Anti-Money Laundering Terrorist Financing Measures and Financial Inclusion (June, 2011) at pp. 14-15 at http://www.fatf-gafi.org/media/fatf/content/images/AML%20CFT%20measures%20and%20financial%20inclusion.pdf. See also, FinCEN Statement: ''Refusing financial services to an entire segment of the industry can lead to an overall reduction in financial sector transparency that is critical to making the sector resistant to the efforts of illicit actors. This is particularly important with MSB remittance operations.''

   ISSN 0000-0000

ligation not to facilitate ML/TF and have illicit funds flow through them, banks are also drawn to control the risk that such customers will embroil them in criminal activity or regulatory criticism.

As with the decision to accept or to attempt to control any risk, a rational economic actor will weigh the costs and the benefits in determining a course of action around a high ML/TF risk product or market segment. There are several choices banks can make in deciding to accept the risk of a particular customer class. We can insert businesses near the high-crime Mexico-U.S. border, money services business, or virtually any high-risk group for this purpose:

- ignore the risk and reap the revenues, though some nominal controls will be imposed;
- impose controls whose costs are reasonably smaller than the exposure likely from the perceived risk, but which reasonably protect against failure, and live with the modest chance that the controls will fail, but continue the business;
- segregate[8] the high-risk group into the part where economically viable controls appear not to be available — the chance of failure will be great and the revenues relatively small — from the part where controls will be both effective for compliance and economically rational. Service only the economically viable, and charge proportionately to the cost of the tailored controls;
- just throw out the entire group and be done with the fine distinctions, which are always inexact, anyway.

If banks have a high priority on serving as deputies, but nonetheless have a healthy disinclination to experience the movement of illicit funds through their books, they should be inclined to select the third choice. That is in fact what government officials have repeatedly suggested. For example, while recognizing the high-risk aspects of embassy accounts, the Federal Financial Institutions Examination Council[9] manual suggests that banks parse the various different kinds of banking services associated with embassies and essentially accept the risk they can control, implicitly rejecting an all-or-none approach.

Similarly, when some banks responded to guidance regarding third-party payment providers that potentially were taking unfair advantage of consumers by eliminating banking coverage, and to the Department of Justice's Operation Choke Point, the regulatory response was to pare down the examples given in guidance and encourage banks to pick among such clients on a risk basis.[10]

On the other hand, if the role of deputy is simply a recognition of the specific functions imposed by particular laws and regulations, rather than a role willingly assumed by banks, the choice process should be very different. It should look at the costs of having suspect categories of business, and the distributed costs of enforcement when controls fail. With those factors, the fourth choice gains significant appeal.

Regulators have not been obtuse to bank perspectives, and, indeed, if not especially indulgent, they have shown a keen sense of the tension between serving systemic goals of transparency and inclusion, and avoiding the risk of regulatory infraction.[11] The open-ended quality of this issue should now be considered in light of computing enforcement costs, and that is the focus of Part II of this article.

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[8] In theory, there could be enough categories that this occurred on a customer-by-customer basis, but, as a practical matter, one would expect more frequently for two or more groups of customers or market segments to be created in this regard.

[9] Bank Secrecy Act/ Anti-Money Laundering Examination Manual (2014) at p. 297.

[10] See guidance instances from the Federal Deposit Insurance Corporation: FDIC Clarifying Supervisory Approach to Institutions Establishing Account *Relationships with Third-Party Payment Processors, FIL-41-2014 (July 28, 2014)* at FIL-41-2014 - PDF and Statement on Providing Banking Services (Feb. 12, 2015) (Hereafter referred to as ''FIL-5-2015'') at FIL-5-2015 - PDF.

[11] ''All this is to say that a risk-based approach is not black and white. A key aspect of FinCEN's mission is to collect reporting from financial institutions and get this information into the hands of our law enforcement and regulatory partners. The only way we can do our job is if businesses actually have bank accounts and their transactions are monitored and reported to FinCEN, as appropriate. This is critical to what we do, because of the indisputable value the BSA reporting provides to investigations. And for those of you who are not sure that the value BSA reporting provides to investigations is indisputable, hold that thought, because I will be returning to that topic in a moment. While we need financial institutions to provide us with transparency, we also ask financial institutions to help us keep dirty money from contaminating not only their institutions, but our financial system as a whole. I can appreciate that these two messages are at odds with each other, but we need to find a balance between the two; a balance where we receive valuable BSA reporting, but where a financial institution also feels it has effectively managed its risk in making decisions about maintaining a relationship with its customers.'' Remarks of Jennifer Shasky Calvery, FinCEN Director, at Mid-Atlantic AML Conference (Aug. 12, 2014), at p. 4 at http://www.fincen.gov/news_room/speech/pdf/20140812.pdf. See also Remarks of David Cohen: '' 'De-risking' is the antithesis of an appropriate risk-based approach. . . . Put another way, ''de-risking'' occurs when a financial institution terminates or restricts business relationships simply to avoid perceived regulatory risk, not in response to an assessment of the actual risk of illicit activity. Now, perceived regulatory risk and actual illicit finance risk usually overlap —– one key purpose of regulatory supervision and enforcement is to ensure that regulated institutions appropriately address actual illicit finance risk. I know there are concerns that there may be a gap between regulatory risk and illicit finance risk, and that the BSA's risk-based regime has, in practice, become a zero-tolerance regulatory regime.''