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# STATEMENT OF
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# GENERAL GOVERNMENT DIVISION
# BEFORE THE
# PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
# COMMITTEE ON GOVERNMENTAL AFFAIRS
# UNITED STATES SENATE
# ON THE
# FEDERAL REGULATORY AGENCIES' EFFORTS TO ASSURE BANK SECRECY ACT COMPLIANCE

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to provide our preliminary results from the review you requested on March 19, 1985, on how various regulatory agencies assure compliance with the Currency and Foreign Transactions Reporting Act (also called the Bank Secrecy Act). This act and implementing regulations require various institutions--banks, credit unions, savings and loans, securities brokers, and others--to report currency transactions greater than $10,000. The act is a key tool in investigating and prosecuting drug traffickers and other criminals who depend on cash and its free movement.

The Department of the Treasury is responsibile for enforcing the Bank Secrecy Act. Treasury has delegated authority for assuring compliance by financial institutions to five depository institutions' regulatory agencies, the Securities and Exchange Commission (SEC) and the Internal Revenue Service (IRS). Although the regulatory agencies undertake examinations of their constituent financial institutions to assure compliance with the act, our preliminary results show that these agencies, as a group,

--place greater emphasis on mission-related objectives, and lesser emphasis on Bank Secrecy Act compliance when allocating examination resources, because they believe these resources are limited;

--do not have detailed Bank Secrecy examination procedures and apply those they do have inconsistently;

--do not sufficiently document the examination work performed, which makes it difficult to accurately assess how well examiners are performing compliance examinations; and

--tend, in some instances, to use examiners with lesser levels of experience and training to assess compliance with the act.

In addition, we found that the examination procedures used as a model by the five depository institutions' regulatory agencies could be strengthened. Furthermore, Treasury and all the agencies could better communicate and coordinate their Bank Secrecy-related activities with one another and thereby enhance the overall compliance effort.

We also found that the IRS, which has responsibility for examining such institutions as pawnbrokers, is experiencing difficulties in identifying other institutions they should review for compliance with the act. According to IRS officials, this is because the implementing regulations do not clearly define such institutions.

These results are similar to those in a report we issued in 1981.[1] At that time, we made some recommendations which were not accepted or implemented by these same agencies, but which we believe are still relevant.

Having said this, I should also note that Treasury and the regulatory agencies are proposing and implementing initiatives

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[1] Bank Secrecy Act Reporting Requirements Have Not Yet Met Expectations, Suggesting Need For Amendment. (GAO/GGD-81-80).

to improve their compliance with the act. I will describe these later in my statement. Since the initiatives are in the proposal stage or just beginning to be implemented, we did not fully evaluate them.

SCOPE OF REVIEW

As you requested, we reviewed the activities of the following seven agencies:

--the Federal Reserve System (FRS),

--the Office of the Comptroller of the Currency (OCC),

--the Federal Deposit Insurance Corporation (FDIC),

--the Federal Home Loan Bank Board (Bank Board),

--the National Credit Union Administration (NCUA),

--the Internal Revenue Service (IRS), and

--the Securities and Exchange Commission (SEC).

The first five agencies are members of the Federal Financial Institutions Examination Council (Council). This Council was created in 1979 to coordinate policies of the depository institution regulatory agencies.

We also discussed compliance procedures with officials of the National Association of Securities Dealers (NASD), the New York and American Stock Exchanges, and the Treasury Department.

We reviewed more than 1,400 examination files from a statistically valid sample of examinations conducted in calendar year 1984 by the seven regulatory agencies and discussed examination procedures with top-level officials and field examiners. We concentrated on 1984 because late in that year and in early 1985 revelations of currency transaction reporting

violations at several banks led to this subcommittee's March 11 hearings and to increased attention to the reporting problem.

Our study included institutions from eight states having a high potential for money laundering.

In evaluating the examination files, we looked for an indication such as use of a checklist that Bank Secrecy Act procedures were applied. We also looked for supporting workpapers describing the nature and extent of the work performed by the examiners. The presence or absence of supporting workpapers in any given examination does not conclusively prove that procedures were or were not applied. However, based on our discussions with some examiners, we adopted the premise that variations in the quality of evidence would indicate variations in the application of procedures.

Our staff has gathered a great deal of detailed information that we believe will be useful to the Subcommittee. Recognizing practical time limitations, my remarks today will highlight our preliminary findings, conclusions, and recommendations. These, however, are still being developed and will be included in our written report.

## FEDERAL FINANCIAL INSTITUTIONS' REGULATORS HAVE GIVEN A LOW PRIORITY TO BANK SECRECY ACT COMPLIANCE EXAMINATIONS

Because regulators see their primary roles as being preservers of the safety, soundness, and integrity of the financial system, and because they see examination resources as being relatively limited, they have given Bank Secrecy

examinations a relatively low priority. Federal regulators of depository institutions--the FRS, FDIC, OCC, Bank Board and NCUA--give greatest attention to monitoring for safety and soundness, especially given the increasing list of problem banks and savings institutions. The SEC's stated mission is to maintain the integrity of the financial marketplace and to protect the financial interests of investors in these markets. IRS' stated primary objective is enforcing compliance with the tax laws.

Along with these primary objectives, the regulatory agencies perform several types of compliance examinations at their constituent institutions, with Bank Secrecy Act compliance being but one of several.

During our review we found that:

--Only FRS's examiners routinely performed transaction testing, which, in our opinion, is key to assuring compliance.

--NCUA's examiners performed few Bank Secrecy Act examinations in 1984.

--Bank Board policies make performance of Bank Secrecy Act examinations optional at the examiner's discretion.

--OCC and FDIC examiners have not documented their examinations sufficiently, based on recognized standards, for their own management or any external evaluator to assess their performance.

--SEC uses a checklist, but has no detailed Bank Secrecy Act examination procedures.

Overall, the Federal Reserve Banks we evaluated generally performed the most comprehensive Bank Secrecy examinations in their member institutions.

EXAMINATION PROCEDURES APPLIED INCONSISTENTLY OR NOT APPLIED AT ALL AT DEPOSITORY INSTITUTIONS

In 1981, the Council developed model procedures for depository institutions' regulators to use in Bank Secrecy Act examinations. Unfortunately, most of the agencies apply the procedures inconsistently. Moreover, the NCUA does not use the Council's detailed procedures, and the Bank Board leaves the use of Bank Secrecy Act procedures up to the discretion of examiners.

The Council's procedures, which were developed in cooperation with the Treasury Department, consist of two modules:

--Module I is limited in scope and is designed to ascertain if a financial institution has adequate operating standards and internal audit procedures.

--Module II contains expanded, more detailed procedures that, for example, test specific teller transactions involving the deposit and withdrawal of cash.

Module II is used only if the examiner deems it necessary. However, if Module II is not used, the examiner is required to prepare a Module I summary explaining why.

During 1984, the period we reviewed, FRS, OCC, and FDIC officials required their examiners to use the Council's model procedures. Although some FRS offices consistently performed the basic Module I procedures, at the other FRS, FDIC, and OCC offices we visited, we found little evidence that these procedures were performed consistently or comprehensively. Moreover, in those instances where Modules I or II were used, we found that they were used inconsistently. For example, certain field offices of some bank regulators did not check currency shipments for the required 6-month period preceding the examination, while other offices of the same regulators did. Further, at some locations, we found that examiners reviewed banks' standard operating procedures, while at other locations we found no such evidence. As another example, we found that only 59 of the 702 examination reports we reviewed at these 3 agencies contained the required, written summaries explaining why Module II procedures were or were not performed.

The Bank Board adopted the Council's model procedures, but suspended the mandatory use of all examination procedures in 1982. Although the Bank Board advised its offices to consider the Council's procedures as the model to use if they performed Bank Secrecy Act examinations, it permitted its examiners to use them at their discretion. At the Bank Board, we found little evidence that examiners performed Module I procedures, and no evidence they performed Module II procedures.

Table I summarizes our findings on how consistently Module I procedures were applied as shown by the amount of evidence

contained in examination files.

Table I
Module I Procedures:
Extent of Performance
and Supporting Evidence
(percentage)

| (a) Agency | (b) Performed with full/some support | (c) Performed with no support | (d) No evidence of performance | (e) Not performed | (f) Not applicable/ Other | (g) Total |
|---|---|---|---|---|---|---|
| FRS | 14 | 30 | 22 | 1 | 33 | 100 |
| OCC | 11 | 27 | 39 | 2 | 21 | 100 |
| FDIC | 11 | 11 | 62 | 0 | 16 | 100 |
| FHLBB | 5 | 4 | 66 | 2 | 23 | 100 |

In looking at the figures in columns c and d, we found either no documentation supporting performance of the procedures or no evidence they were performed in 52 percent of the FRS' procedural worksteps, 66 percent of OCC's, 73 percent of FDIC's, and 70 percent of the Bank Board's. The absence of supporting documentation demonstrates two problems: first, contrary to the Council's intent, the procedures were not used consistently; second, the workpapers did not meet recognized documentation standards, and therefore, do not demonstrate the extent to which procedures were used, a point I will elaborate on later.

Also, note the absence of the NCUA from the table. In February 1981, the agency adopted procedures which were similar in concept to the Council's. However, in October 1982, in order to increase its safety and soundness examinations of credit

unions, NCUA revised its Bank Secrecy examination procedures and adopted a scaled-down version that permitted examiners to vary the scope of examinations according to the financial condition of the credit union being examined. Under the scaled-down procedures, NCUA examiners were not required to specifically address Bank Secrecy matters. Our review of a significant sample of NCUA's 1984 credit union examinations disclosed that in only 3 of the 300 examinations reviewed did we find instances where a basic procedural workstep was performed. According to NCUA officials, many credit unions do not handle large cash transactions. Therefore, application of these procedures may only apply at those credit unions where large cash transactions are likely.

We also found inconsistent application of Module II procedures among the agencies. Although the Council's procedures do not require the performance of expanded worksteps on all Bank Secrecy examinations, at some offices, there was no evidence that the Module II requirement to test-check teller transactions for a minimum of 5 days was being performed. This teller transaction testing is a procedural requirement to verify that all transactions greater than $10,000 have been reported. In other locations, Module II tests of teller transactions were performed in a relatively high percentage of examinations. The following table summarizes, out of the total number of examinations we reviewed, how often we found evidence that the examiners tested 5 days of teller transactions:

Table II
Number And Percent Of Total Examinations In Which
5 Days Of Teller Transactions
Were Reviewed

| Locations | OCC # | OCC % | FDIC # | FDIC % | FRS # | FRS % | FHLBB # | FHLBB % | NCUA # | NCUA % |
|---|---|---|---|---|---|---|---|---|---|---|
| MA/RI | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Illinois | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| NY/NJ | 0 | 0 | 2 | 4 | 21 | 55 | 0 | 0 | 0 | 0 |
| Florida | 4 | 11 | 4 | 14 | 24 | 48 | 0 | 0 | 0 | 0 |
| California | 2 | 4 | 14 | 32 | 8 | 38 | 0 | 0 | 0 | 0 |
| Texas | 4 | 8 | 1 | 2 | 5 | 10 | 0 | 0 | 0 | 0 |
| | 10 | 4% | 21 | 8% | 58 | 32% | 0 | 0 | 0 | 0 |

As you can see, except for the four underlined locations, the evidence indicates this test was rarely performed.

## SEC PROCEDURES LACK SUFFICIENT DETAIL

SEC examiners' procedures consist of a six-point checklist. Typically, the SEC examination checklists were filled in, but in most instances, we found little documentation to indicate the examinations' scopes. The Treasury Department official who is responsible for Bank Secrecy oversight believes SEC's checklist lacks sufficient detail and thus could result in inconsistent examinations. I should point out that many of the broker dealers SEC examines do not routinely handle cash, and for them, this portion of the examination is not applicable. However, we believe more detailed procedures are necessary for

those 700 or so institutions where cash transactions are probable.

## IRS' RESPONSIBILITIES ARE NOT WELL DEFINED

IRS has detailed review procedures and documented support for its examinations. However, according to IRS officials they have difficulty identifying those financial institutions they should review for compliance with the act.

IRS cannot easily define the institutions under its jurisdiction because the implementing regulations do not clearly define those institutions. Treasury delegates responsibility for national banks to the Comptroller of the Currency, savings and loans to the Federal Home Loan Bank, etc., and then in essence delegates responsibility to IRS for any remaining miscellaneous financial institutions. However, the enabling regulations do not specifically identify these miscellaneous institutions. Further, once the types of institutions are defined, IRS has difficulty identifying the specific financial institution or business it should monitor in a given geographical area. IRS must continuously compile listings of the businesses subject to its examination by having IRS agents research the yellow pages of telephone directories.

## EVIDENCE DOES NOT SUPPORT PERFORMANCE OF PROCEDURES

I made a point earlier of saying that, in many of the examinations reviewed, we could not determine to what extent

Bank Secrecy procedures were performed because examiners did not prepare appropriate supporting workpapers. Although there were check marks, tick marks, or short narrative statements in the examination reports signifying that the Bank Secrecy Act procedures were addressed, we found no complete workpapers to support the extent of work performed. For instance, of the 30 depository institution regulators' field offices we visited, only 4 had sufficiently documented the use of Module I Bank Secrecy Act procedures.

Without this documentation, any evaluation of the work done by examiners is hindered; thus a standard of performance and, ultimately, accountability, cannot be established. We have published a guide called, "Standards For Audit Of Governmental Organizations, Programs, Activities And Functions," which is used as a standard of performance for, among other things, reviews of compliance with laws and regulations. This guide states that workpapers should be complete and accurate, understandable, legible, and relevant to the objectives of the review.

## EXAMINATION PROCEDURES COULD BE STRENGTHENED

The Council's model procedures used by the OCC, FRS, FDIC and the Bank Board could be improved in two areas. Under the current procedures, an examiner is required to determine if Currency Transaction Reports and Reports of International Transportation of Currency or Monetary Instruments are properly completed and filed with IRS or the U.S. Customs Service,

respectively, within 15 days of the transaction. The examiner is to accomplish this by reviewing the institution's copies of the completed forms. However, the examiner is not assured that these reports were, in fact, filed by the institution and received either by the IRS or Customs. As we recommended in our 1981 report, the procedures could be improved by providing examiners with a record of forms received by IRS and Customs so that they could verify that the reports found in the institutions were actually filed. Regulatory agency officials and examiners we spoke to in this review agreed that this information would help detect filing violations.

Secondly, the procedures should include a review of transactions which occur at facilities such as cash control centers and foreign exchange units. As a recently publicized Bank Secrecy-related case demonstrated, not all reportable transactions occur through a teller's window. In this case, many of the unreported transactions were related to cash transfers received from foreign banks. Yet, as noted by the Federal Reserve Bank of New York, the Council's procedures require examiners to test only teller transactions. In May 1985, the Federal Reserve Bank of New York informed its examiners that Bank Secrecy Act procedures should include an analysis of currency flows at all currency-handling facilities to ensure coverage of all reportable transactions. To better assure that the required currency transactions are being reported, we believe the Council's verification procedures

should require examiners to review all cash transactions at currency-handling facilities.

## BANK SECRECY ACT COMPLIANCE MONITORING EFFORTS COULD BE IMPROVED

According to regulatory agency officials, Bank Secrecy Act monitoring could be improved if targeting information (such as intelligence and transaction data) and appropriate cash flow information were made available to them. Access to this type of data would enable regulators to direct their Bank Secrecy examinations at institutions with a high potential for violating the act. The Treasury Department, a focal point for intelligence data regarding financial institutions, should routinely share it with the regulatory agencies, to the extent permitted by law.

The FRS has current, nationwide data regarding depository institutions' cash transactions and flow. The FRS regards this information as being highly sensitive. However, it would be useful for targeting geographic areas and institutions where the potential for Bank Secrecy violations is high. Accordingly, while we don't propose routine release of such information to the regulators, we do believe that the FRS should provide this information on an exception basis--for example when it detects changes in cash flow patterns.

In 1981, we recommended that the regulators comprehensively examine, using the Council's procedures, a geographically dispersed, random sample of institutions scheduled for examinations. This approach is similar to IRS' tax audit

compliance approach, whereby the potential for being examined may be high enough to induce voluntary compliance by institutions. We still believe that, in addition to better targeting, use of a complete examination could enhance monitoring and enforcing compliance.

The regulatory officials had several objections to this approach back in 1981. For example, FDIC officials said that it would be inefficient, and that by using the Council's new procedures and currency flow data it could target resources. However, up to the period of our review, there was little evidence that the agencies had been performing the new procedures and routinely using currency flow data from the FRS to target institutions having unusual cash flow patterns.

In 1981, Bank Board officials said that this approach would be burdensome and that the Council's new procedures would improve its examinations. However, the Bank Board suspended mandatory use of those procedures in 1982.

## TRAINING AND EXPERIENCE

### Training

The majority of examiners we interviewed told us that they received their Bank Secrecy Act compliance training through self-study, informal lectures, and on-the-job training. Agency officials said that formal classroom training on this topic is very limited. Furthermore, the examiners told us that by virtue of their education and experience, they are adequately prepared to perform Bank Secrecy Act compliance examinations.

The seven agencies differ in the degree of formal Bank Secrecy Act training given to their examiners. For example:

- --Neither the NCUA nor the SEC offers formal Bank Secrecy training.
- --The Bank Board offers one classroom course which very briefly addresses (about 10 minutes) Bank Secrecy.
- --The OCC offers two courses that briefly address Bank Secrecy issues.
- --The FRS offers one course for new examiners which devotes 1 hour to Bank Secrecy and an advanced course which briefly describes this subject.
- --The FDIC devotes 1 hour to Bank Secrecy in a course for more senior examiners.
- --The IRS offers 2 hours of formal classroom training for excise tax examiners.

In order to supplement the formal training, OCC uses training teams that provide lectures covering Bank Secrecy issues. For its more experienced examiners, the FRS offers continuing education programs which address the Bank Secrecy Act. The other agencies provide Bank Secrecy Act seminars and on-the-job training.

We were unable to evaluate SEC's Bank Secrecy training. Two SEC officials told us that training for new examiners is provided by the NASD. To date, however, we have been unable to confirm this. NASD officials told us they rarely provide Bank Secrecy training to SEC's examiners, and when they do, it is

on an ad hoc basis. One NASD official estimated that in a typical year, two or three SEC examiners participate in NASD classes.

## Experience

The experience of examiners performing Bank Secrecy examinations varies widely. Some agencies delegate this part of an examination to junior examiners, because it is generally considered one of the less difficult examination segments. Other agencies make no distinction based on experience and assign that segment to the examiner who can most easily complete the work. When possible, the FDIC typically has its more senior examiners complete the Bank Secrecy examinations. The FDIC's compliance examinations are normally performed by a special core of examiners who have successfully completed the agency's Consumer Protection School.

## RECENT CHANGES

The Treasury Department and most regulatory agencies are considering improvements in their oversight of Bank Secrecy compliance. The proposals cover a variety of areas affecting the act's implementation. In addition to agency proposals, the Council is reevaluating its earlier interest in white collar crime training.

The Treasury Department is sponsoring a variety of efforts to improve the act's implementation. Treasury officials have organized an Interagency working group to modify existing Bank Secrecy Act examination procedures and develop new procedures where appropriate. The group includes representatives from the

seven agencies which are responsible for conducting these examinations. As a result of the group's first meeting in June 1985, representatives were instructed to review their examination procedures and submit written recommendations for improvements. When all responses are received, Treasury will reconvene the group to discuss their recommendations. Despite a July 1 deadline, only FDIC and NCUA had responded with recommendations as of October 1.

Mr. Chairman, this concludes my statement. I will be happy to discuss these recent changes in more detail and to respond to any questions from you or the other members of the Subcommittee.

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