

*Testimony of*

**Megan Davis Hodge**

*On Behalf of the*

**American Bankers Association**

*Before the*

Subcommittee on Oversight and Investigations

Committee on Financial Services

United States House of Representatives

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Chairman Watt and Members of the subcommittee, I am Megan Davis Hodge, Director of Anti-Money Laundering and BSA Officer for RBC Centura Bank, headquartered in Raleigh, North Carolina appearing today on behalf of the American Bankers Association (ABA). ABA, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

ABA and its members have long been steadfast partners with law enforcement and regulators in the mission to protect the integrity of the American banking system against the threat of serious illegal financial activity, money laundering and terrorism financing. From the Board room through senior executives and compliance professionals to tellers and other transaction personnel, the banking industry strives to deter, detect and defend against those who would undermine our financial system.

While vigilance is high to combat threats against our financial and economic system, the issue before us today is how to use the resources available to all parties in the most effective way to increase our success.

This hearing, Mr. Chairman, is extremely timely and important. ABA appreciates this opportunity to address how banks, regulators and law enforcement can improve the Suspicious Activity Report (SAR) process and make Bank Secrecy Act (BSA) compliance requirements more responsive to the challenges we all face in combating money laundering, terrorism financing and serious financial crime. This mission is too important to squander our resources on ineffective reporting programs. We need to give priority to the efforts that achieve the greatest benefit and eliminate those obligations that produce relatively little or no benefit.

The general themes of my testimony are:

- Standards for suspicious activity reporting should be fine-tuned to assure it encourages and enables effective reporting and better balances burden with benefit.
- Antiquated reporting obligations should be eliminated as they have a low degree of usefulness in combating financial crime and divert resources away from newer, more effective methods.
- Finding cost-effective solutions to minimize the direct and opportunity costs of BSA data reporting is critical. The cost is significant and rising for all banks. For small community banks, resource challenges in implementing new software, dedicating staff to review outputs, and managing the documentation and reporting requirements of anti-money laundering programs are becoming severe.

Under these themes, we recommend the following:

- Uniform Examination Procedures provide a solid foundation for consistent supervision, but refinements are needed, such as allowing SARs to be shared within an enterprise-wide BSA compliance program.
- Through training and consistent application, assure that examiners abide by the Interagency Exam Procedures, which will reduce banks' very real concerns about being second-guessed by the examiners and reduce marginal or "defensive" SAR filings.
- Better communicate law enforcement priorities, results and limits, through more realistic threshold requirements for SAR filing that conform with law enforcement prosecutorial standards; distribution of SARs to specialized teams that can detect patterns and more effectively pursue such crimes as identity theft and mortgage fraud; establishment of a rule that stops filing after the second SAR if law enforcement has not indicated a specific interest in that customer's continuing activity; and instituting tracking by the Financial Crime Enforcement Network (FinCEN) and the Justice Department of outcomes associated with the use of SARs.
- Update the archaic currency transaction report (CTR) system by eliminating CTRs on seasoned customers, which would, in turn, make the SAR process much more effective and efficient.
- Reconsider the IRS approach to investigating structuring SARs and develop a communication strategy to better educate bank customers about BSA data reporting in order to discourage idiosyncratic structuring behavior without jeopardizing the confidentiality in SAR filings.

The remainder of my statement will detail these themes and recommendations.

### **Uniform Examination Procedures are a Solid Foundation for Consistent Supervision**

At ABA's prior appearance before this subcommittee in May 2005, we emphasized that the banking agencies needed to reach agreement on how the financial services industry would be examined for compliance under the USA PATRIOT Act and the other anti-money laundering (AML) requirements. Under the auspices of the congressionally authorized Bank Secrecy Act Advisory Group (BSAAG), bank representatives were able to provide suggestions to agency staff during their drafting process. Bankers were seeking useful guidance for developing compliance programs that would meet supervisory expectations and also respect management's risk-based judgments about tailoring controls to each bank's unique operations. We believe the willingness of the agencies to engage with the private sector resulted in procedures that better anticipated the needs of bankers.

We are pleased to note that the final interagency procedures were released on June 30, 2005. FinCEN, the federal banking agencies and ABA (together with other bank trade associations), coordinated extensive outreach efforts to both examiners and bankers to introduce the Interagency Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual to the industry.

However, there are still areas where our bankers have suggested improvements in the procedures. One important disconnect between the goal of effective reporting and the manual's guidance is in the area of sharing SARs among sister affiliates within an enterprise-wide BSA compliance program. On the one hand, the manual states that "banking organizations should not share SARs with such affiliates." Yet on the other hand, enterprise-wide risk management is encouraged by the Interagency Exam Procedures – and the most natural option to effectuate such a program includes the freedom to share SARs across sister affiliates within the organization in a secure manner. Although the BSAAG Subcommittee on SARs and the ABA have recommended guidance that approves such sharing, FinCEN and the agencies have not yet updated their policy statements despite pledging over a year ago to do so. Thus, today, we continue to labor under the counterproductive constraint in the manual that banking organizations should not share SARs with sister affiliates. Such sharing not only allows banks to take their own prudent actions against suspicious activity across the enterprise, but it also increases the likelihood of better and more complete information – within a fuller context – to be shared with law enforcement services.

Of course, as with any new procedures, implementation is the real test of their success. At this time, ABA sees the glass half-full in that regard. In particular, how the exam procedures are applied to bank SAR processes and how agencies administer SAR utilization are issues that will have significant impact on the burden banks bear, and the benefit government derives, from suspicious activity reporting going forward.

### **The SAR Process is Burdensome and Leads to Unwarranted Reporting**

In the words of the Interagency Exam Procedures, "suspicious activity reporting forms the cornerstone of the BSA reporting system." Perhaps reflecting its place as the cornerstone of BSA compliance, the section of the Interagency Exam Procedures on SARs is 17 pages—the longest section in the more than 300-page manual. Yet even this is an underestimation; most of the rest of the manual is guidance on how to detect and mitigate a range of potential financial crime risks

across the spectrum of bank operations and products, demonstrating that the entire volume sets forth expectations that engage every corner of the bank in the task of reporting suspicious activity.

No matter what their size, banks have an ongoing obligation to monitor their customers' transactions and banking behavior in order to detect suspicious activity. To undertake this duty, an institution must start by assessing and understanding the money laundering and terrorist financing risk of its customers and the products they use in order to build a transactional profile that facilitates identification of anomalies and unusual patterns. Detection may be triggered by the personal observation of a teller or other customer service personnel—or it may occur as a result of a manual or automated back-office review of transaction records. Once a transaction, or series of transactions, is flagged for unusual behavior, an investigation is conducted into the details of the suspect behavior. After this detailed review, a SAR is filed if the bank has reason to believe that the customer's activity meets the reporting requirements. Compliance with filing deadlines, transaction threshold levels and report narrative requirements are observed throughout the process. Extensive records are generated and maintained as part of the process to support the SAR or even the decision *not* to file a SAR.

Informing senior management about the bank's SAR experience takes place on an ongoing basis and the independent audit function ensures that the overall SAR process is sound and completed in a timely manner. As with other AML/BSA obligations, employee training, risk-reassessment, documentation and retention are layered on top of the linear monitoring and filing process.

Yet this brief summary does not do justice to explaining what it really takes to comply with SAR procedures, nor does it fully convey the expense and opportunity cost incurred in the process. Even those adopting automated technology solutions face both information technology costs and considerable manual investigatory effort. Although systems are put in place for account and customer monitoring, they require manual intervention to investigate each alert that is produced on a daily basis, which can amount to hundreds if not thousands of transactions flagged. Additionally, institutions must document the automated monitoring process from end to end, from developing the daily data feed that goes into the specialized detection software to training staff on how to handle the output. Resource allocations do not stop once these systems are implemented. In addition to continued training, institutions must monitor the alert outputs and continuously adjust their filters and scenarios to reflect current or new patterns of activity, new services and products, changes in their customer base, and evolution in typical customer transactions. A clearly documented process must be followed to justify each and every change made in the system, including a rationale detailing the change to enable examiners to understand how and why modifications in monitoring levels were made. That is to say, in addition to monitoring financial activities, banks have to report on their monitoring of their monitoring.

In light of the implementation of "intelligent" software solutions, financial institutions have also had to cope with the ever rising expectations set by their examiners. As software vendors compete for the market and enhance their tools to have unique analytic capabilities, examiners are taking note of this development and doing a comparative analysis of the potential monitoring standards institutions can utilize as opposed to the basic regulatory requirements. This cycle generates escalating demands on small community banks that face resource challenges in implementing new software, dedicating staff to review outputs and managing the documentation and reporting requirements. In addition, large banks have learned from experience that while electronic monitoring solutions have utility, they have limits and do not warrant adoption just because they exist.

What has this complex and expensive undertaking produced? In the first decade since suspicious activity reporting obligations were expanded following the Annunzio-Wylie Anti-money Laundering Act, the number of SARs filed by depository institutions has grown from 81,197 in 1997 to 567,080 in 2006, a **seven-fold increase**. As these numbers continue to rise, the question looms ever larger: Are they a measure of success or excess? Can this possibly reflect an epidemic of illicit activity eating away at the integrity of American banking? We think not. Rather, we believe that this state of reporting overdrive can be largely attributed to the following factors:

- First, regulatory pressures promote “defensive filing” that inflates SAR volume out of proportion to the risk represented by the underlying conduct.
- Second, in the absence of constructive feedback from law enforcement, banks identify a broad and evolving array of fraud and other potentially serious criminal activities that expand the SAR universe independent of the likelihood of prosecutorial pursuit or value.

Let me explore with you what might explain these points and what can be done to improve SAR process efficiencies.

### **Agencies Can Reduce Defensive SARs by Assuring Examiners Follow Exam Standards**

During ABA’s testimony in May 2005, we expressed substantial concern that regulatory scrutiny of SAR filings and the civil penalties assessed against banks for SAR deficiencies had caused many institutions to file SARs as a purely defensive tactic (the “when in doubt, file” syndrome) to stave off unwarranted criticism or second-guessing of an institution’s suspicious activity determinations. If a SAR is filed, the bank cannot be criticized for not filing. This is a significant problem because defensive filing overloads the system with marginal reports and wastes bank staff time in filing technically correct, but substantively useless, information. It also wastes law enforcement time and resources in processing and evaluating these surplus SARs. In a world of SARs, more is not better; unfortunately, the current system succeeds only in extracting more.

Every ABA member bank wants to eliminate defensive filings and have the satisfaction of knowing that its anti-money laundering efforts are making a difference in thwarting crime and terrorism. However, ABA members continue to comment that unwarranted substitution of examiner judgment for their own bank’s well-considered risk assessment is the reason for these defensive filings. We believe that much of the solution to this serious problem resides in eliminating fear of supervisory second-guessing by making sure examiners respect the bank’s risk assessment and abide by the review standards established in the Interagency Exam Procedures. These procedures focus on effective programs, not quantitative outputs. The procedures state:

The decision to file a SAR is an inherently subjective judgment. Examiners should focus on whether the bank has an effective SAR decision-making process, not individual SAR decisions. Examiners may review individual SAR decisions as a means to test the effectiveness of the SAR monitoring, reporting, and decision-making process. In those instances where the bank has an established SAR decision-making process, has followed existing policies, procedures, and processes, and has determined not to file a SAR, the

bank should not be criticized for the failure to file a SAR unless the failure is significant or accompanied by evidence of bad faith.<sup>1</sup>

We believe this standard is sound and that the banking agencies intend to abide by it. The challenge for our regulators is to assure that examiner judgment is trained and applied in a way that supports this standard and honors the risk-based approach endorsed by the manual. ABA believes that this does not require legislation, but can be addressed through Congress's oversight powers. We support holding the agencies accountable for monitoring and correcting deficiencies in how examiners apply this standard. We believe that codifying this standard places would be unnecessary and could actually impose regulatory rigidity where risk-based flexibility is preferred. Moreover, it would not improve upon what has already been succinctly stated by the agencies themselves. As long as any criminal prosecution of SAR filing deficiencies is subject to existing Justice Department guidance involving consultation with the banking regulators, banks should feel more secure about making the judgments called for in filing quality SARs.

Another practice could be adopted by the agencies to help the industry assure better examiner analysis of the SAR process—especially when conducting reviews of individual SAR decisions. Although examiners receive bank specific reports about an institution's SAR filings in preparation for an exam, they refuse to share those reports with the subject bank at the exam. We have members who report they have spent extensive time and effort responding to examiner inquiries that in the end turned out to have been based on inaccuracies in the reports the examiner had received from his agency. We believe that if examiners shared these reports from the beginning, we could eliminate inaccuracies rather than engage in wasteful searches predicated on erroneous information. After all, the compliance exam is not supposed to be a report-by-report "gotcha." Rather, exam transaction testing is intended to evaluate overall program quality.

I would like to now turn to the second point dealing with the real law enforcement value of SARs.

### **Better Communicate Law Enforcement Priorities, Results and Limits**

Substantial bank resources and many SAR filings apply to financial crimes that cause banks and their customers to suffer significant losses. Crimes such as fake check and wire scams, credit and debit card fraud, mortgage fraud, identity theft, and computer intrusion are being reported and contribute to a rising trend in SAR filings. Still, compliance professionals realize that not every SAR will yield an active law enforcement case or even become a corroborating lead in such a case. This is due to several factors. One significant factor is that the thresholds for filing SARs are far below the operative thresholds used to guide prosecutorial discretion. After all, law enforcement does not have unlimited resources. Banks do not have unlimited resources either, and we would rather not flood the system with filings that are not going to be acted on. ABA has several suggestions to address this:

- FinCEN should review the threshold requirements for SAR filing and recommend more realistic levels that are likely to conform to law enforcement prosecutorial standards.

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<sup>1</sup> FFIEC Bank Secrecy Act/Anti-Money Laundering Examination Manual, July 2006, page 66.

- FinCEN and the Justice Department should better leverage law enforcement task forces so that SARs involving lower dollar threshold transactions are directed by type to specialized teams that can detect patterns and more effectively pursue such crimes as identity theft and mortgage fraud.
- A standard should be established that, when it comes to reporting on *repeat* activity, a bank can stop filing after the second SAR if law enforcement has not indicated a specific interest in the particular activity of that customer.

ABA appreciates the feedback received by the FinCEN publication, *SAR Activity Review*, and believes that it should continue. We do, however, believe that describing the value of SAR reporting must go beyond the anecdotal stories in the *Review*. In light of the enormous efforts banks expend for BSA compliance, we believe that a more probative report can be produced to enable better comparison of the burden and the benefit of the SAR process. In particular, we believe ***FinCEN and the Justice Department should institute tracking of outcomes associated with the use of SARs so that aggregated data better reflects law enforcement results*** such as cases initiated, indictments obtained, arrests, convictions and recoveries that are derived from SARs. This type of information is reported for the 314(a) process instituted under the USA PATRIOT Act and has been a great source of information to the industry.

The ABA would like to see the 314(a) data report format serve as a model for expanded reporting on outcomes of suspicious activity reporting. While the number of SAR filings and the number of indictments are not necessarily directly connected, it is interesting that between 2002 and 2005 Justice Department money laundering cases, indictments and recoveries fell while the number of SARs increased dramatically.<sup>2</sup> Only with more specific tracking of SAR use and case results can industry and government make more informed judgments about how to balance the burden and benefit of the SAR process and improve the focus of resources on activities that produce genuine results.

### **Updating the Archaic CTR System Will Go a Long Way to Improve the SAR Process**

Another way of ensuring that government and industry resources are used effectively in the area of financial crime detection is to remove unnecessary data collections.

As ABA has testified on numerous prior occasions, ***we believe that the time has come to dramatically address this reporting excess by eliminating cash transaction report (CTR) filings for transactions conducted by seasoned business customers.*** ABA recognizes your strong leadership, Mr. Chairman, in pursuing such an initiative. We gratefully acknowledge your efforts along with those of your colleagues on this subcommittee and in a bi-partisan effort across the entire House that resulted in the passing of H.R. 323, the “Seasoned Customer Exemption Act of 2007” by voice vote. Enactment of this legislation could be the most significant step in years to improve the effectiveness of our anti-money laundering efforts. As any athlete knows, you improve performance when you eliminate wasted movements. Streamlining our BSA efforts will allow us to improve results.

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<sup>2</sup> 2007 National Money Laundering Strategy, "FBI money laundering-related statistics, FY2002 - FY2005", Appendix B, Table F-2, Page 89.

The conspicuous consumption of bank resources for unnecessary CTRs hardly needs restating, but we note that the continued growth in CTRs last year alone prompted FinCEN to move its estimated number of filings to over 15 million per annum. Even at FinCEN's conservative estimate of around 25 minutes per report for filing and recordkeeping, it means that financial institutions as a whole devote around 6.28 million staff hours of work to handling CTRs in a single year. Based on a small sample conducted by ABA, three-quarters of bank filings were for business customers who had been with the bank for over a year. That equates to industry spending over 4.5 million staff hours filing notices on well-established, routine business customer transactions!

The two million report increase from 13 to 15 million represents the addition of more than 400 new employees throughout the banking industry dedicated to CTR reporting in one year alone! In other words, more staff were hired by industry for the increase in CTR filings than are currently employed by FinCEN. This upward trend is only likely to continue and demand more and more staff to report on more and more transactions, further burying the real needles of money laundering under an exponentially growing mound of the hay of legitimate business transactions by law abiding people recorded at great expense and ever-increasing opportunity cost.

Changing the mindset about mandating the collection of routine cash data would have the following benefits:

- The vast majority of the 15 or so million CTRs filed annually would stop, thus saving many hours a year in filling out forms;
- Wasteful SARs would decline. Rather than filing specious structuring reports, banks could focus their energies on detecting suspicious handling of currency regardless of artificial thresholds;
- Bank systems and resources could be redirected from CTR monitoring to supporting further improvement in suspicious activity reporting;
- Regulatory criticism of technical mistakes with CTR filings would cease;
- Costs incurred due to the overly complex CTR exemption process would be reduced; and,
- Law enforcement could redirect resources to better evaluation and follow-up of higher-value SARs.

Simply put, eliminating CTRs on seasoned customers is probably the single most effective step toward making the SAR process much more meaningful and efficient.

### **Protecting Confidentiality of SARs is Vital**

Before concluding, it is important to note that for the SAR process to work properly, the safe harbor that Congress has bestowed must be vigorously defended. Only by keeping a SAR confidential and observing the prohibition against advising the subjects of SARs that they have

been reported by the bank for suspicious activity, can we insure the safety of our bank employees and assure that the information provided will be handled securely.

Bank employees that have regular contact with customers play an indispensable role in the SAR process. This is especially true under the current system when reporting structuring behavior, i.e., when an individual seeks to conduct or structure cash transactions to be below the CTR reporting threshold. Structuring is often a matter that tellers observe in handling a customer's cash transactions. Yet recent activity by the IRS's Criminal Investigations Division (CID) has jeopardized the safe harbor protection in the process of "investigating" a structuring SAR.

ABA members in several communities around the country tell us that IRS agents and other law enforcement representatives have been literally knocking on doors at people's homes and asserting that they have information that the person is structuring their bank transactions. At the conclusion of these visits, the agent gets the individual to sign an acknowledgement so that future prosecution of the person is simplified. In other cases, letters from Supervisory Special Agents from the IRS-CID have been arriving in the mail and stating, "I have reason to believe that you, or others on your behalf, may have conducted financial transactions that appear to be in violation of the Bank Secrecy Act." Since most people do their banking at one institution, it is immediately obvious which bank has reported them to the government. In many situations, customers going through this experience confront bank employees and demand to know who reported them. Employees and managers are schooled not to confirm SAR reporting, and so the tension in these confrontations can quickly escalate. At the least, this situation is awkward and embarrassing; in other situations, it could lead to disruptive or even more dangerous behavior.

Unfortunately, under current CTR standards, structuring is often inferred from conduct rather than any hard evidence of money laundering. Therefore, individuals are reported who have absolutely no connection to otherwise illicit activity—especially not to any financial crime that threatens the banking system or our national security. Most structuring SARs are filed based on technical requirements rather than any concern that a serious criminal enterprise is underway. Yet approaching individuals based on SARs for which agents do not obtain (from the bank or other sources) any indicia of serious money laundering or terrorism financing often results in effectively identifying the bank's SAR filing. This identification needlessly threatens banking relationships and consumes law enforcement resources that could surely be better applied to cases of greater importance to the fight against terrorism financing or organized crime.

ABA urges IRS-CID and those with similar programs to reconsider their approach to investigating structuring SARs. We believe that FinCEN and the bank regulators should work with law enforcement to devise best practices that would better honor the letter and spirit of the SAR safe harbor and make superior use of investigative resources. To the extent that the IRS-CID approach has an "education" value for the individual confronted, we believe that by compromising the SAR safe harbor, it comes at too high a price. ABA and its members are prepared to work with the IRS, FinCEN, the banking regulators, and other interested parties in developing a communication strategy that will better educate bank customers about the BSA data reporting process and more effectively discourage idiosyncratic structuring behavior without jeopardizing SAR confidentiality.

## **Conclusion**

Entering the second decade of expanded SAR filing, it is time to apply the lessons learned about all forms of BSA data reporting to improve the process, to give priority to the reports that have the highest value to law enforcement, and to eliminate the burden on banks for those reports that do not contribute such value. In this way, all parties can apply their scarce resources more effectively to the important mission of combating terrorism financing, money laundering and serious financial crime that can threaten our national security and the integrity of the American banking system.

ABA has always had a strong commitment to BSA compliance and has devoted considerable resources to informing and educating banks on compliance requirements. ABA provides valuable support to the frontline efforts of our bankers. For example, ABA produces a bi-monthly electronic newsletter on money laundering and terrorist financing issues, offers online training on BSA compliance, and has a standing committee of more than 80 bankers who have AML responsibilities within their institutions that help us inform our policy positions and improve our outreach efforts. This year, ABA will once again hold our annual conference with the American Bar Association on money laundering enforcement that is approaching its 20th anniversary, and which has educated thousands of people who are enlisted in this important effort. We will continue to apply our resources, as well as our analysis and our advocacy efforts, to the task of helping to build a financial crime deterrence, detection and enforcement program that sheds outdated obligations in favor of more efficient methods.

Thank you for your attention to these issues. I would be happy to answer any questions.