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Banks Flee Risk of Illicit Finance, with Unintended Consequences

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In the past decade, the international financial system has become an important battleground for the U.S. government in its efforts to confront threats to national security. Alongside traditional responses, policymakers have increasingly sought to harness U.S. economic power to compel private sector action against a range of illicit actors.

These efforts have been effective. Robust sanctions and anti-money-laundering programs have enhanced the integrity of the financial system and advanced national security interests. Rogue regimes have been isolated, terrorist organizations disrupted and drug cartels weakened by these initiatives.

However, these activities are also having unintended consequences that threaten to undermine their purpose. Specifically, a flight from risk by global banks – fueled by a fear of illicit finance compliance failure – is creating a vacuum that may be filled by less transparent and accountable institutions. This would undermine the integrity of the global financial system and our national security.

The use of financial policy to confront security threats increased in the aftermath of 9/11. Among other lessons, the events of that day demonstrated the strategic importance of the global financial system to those with illicit objectives. Within three years the U.S. had established an Office of Terrorism and Financial Intelligence in the Treasury Department that would oversee a dramatic shift in the use of sanctions and financial measures in the interests of national security.

As part of these efforts, the Treasury spearheaded a global initiative to isolate Iran from the international financial system. Guided by intelligence relating to Iranian abuse of the financial system, U.S. officials met directly with senior banking executives in dozens of countries and encouraged them to drop their controversial Iran business or risk regulatory consequences. Many banks, insurance companies and multinational corporations curtailed their exposure accordingly.

However, the cooperative tone that helped isolate Iran soon grew more confrontational. The first cracks appeared in 2009 when an investigation revealed Lloyds Bank had willfully circumvented U.S. sanctions on Iran and Sudan, resulting in a $350 million penalty. Lloyds proved to be the tip of the iceberg and penalties have since been levied against a range of institutions caught up in U.S. sanctions violations or for failed AML controls, including a number of U.S. banking heavyweights.

In the worst of these cases, bank officials have ignored sanctions or looked the other way as criminal proceeds were laundered. In others, inadequate compliance programs have been to blame. Either way, the results have been the same. And faced with severe penalties, a confrontational regulatory environment, and complex political terrain, many of the world's leading institutions have been "derisking," choosing to exit the jurisdictions and lines of business that carry the greatest risks.

From a commercial perspective, this is understandable. With annual profits measured in the billions, profit lines measured in the millions are not compelling for a bank if the regulatory risks have grown too complex to manage. From a U.S. policy perspective, the consequences are a matter for concern.

By virtue of their size and sophistication, the world's biggest banks are more equipped than most to manage risk in markets with elevated levels of illicit financial activity. When these institutions exit a jurisdiction or line of business, they create a vacuum that is likely to be filled by institutions less sensitive to, or less capable of managing, the risks involved.

For instance, in 2010 Wachovia received a $160 million penalty for compliance failures that saw drug-money laundered through exchange houses in Mexico. As a result, Wachovia terminated relationships with all exchange houses worldwide. Barclays, another exchange house service provider, has also reduced its exposure to the sector. However, in many parts of the world, exchange houses remain the most competitive and responsible providers of remittance services for low-paid workers. Their activities will continue, with or without these banking giants.

Similarly, JPMorgan Chase has stopped offering clearing services to 500 foreign banks and halted new business with its foreign correspondent partners. Credit Suisse and Barclays wealth management divisions are withdrawing from dozens of markets due to the cost of anti-money laundering programs, while HSBC has reportedly ceased a range of activities in Asia and Latin America while attempting to leave Iraq.

The withdrawal of these institutions will make life harder for those charged with disrupting individuals and organizations engaged in illicit finance. As global banks withdraw, risk management will shift from the hands of the best-resourced institutions that offer regulators important visibility to others that are potentially less regulated, less transparent and less accountable.

To halt this trend, thought must be given to incentivizing established institutions to invest in managing sophisticated risk types. If Washington and London wish to preserve their global economic and financial leverage, a renewed spirit of cooperation is needed between government and the private sector to reduce the illicit finance knowledge gap and the fear it appears to have created. Effective cooperation between banks and regulators must promote confidence, in addition to caution; good faith efforts to control complex risks should be recognized; and the economic benefits of leading financial institutions operating globally deserves renewed attention.

Financial institutions should be encouraged to move compliance to comprehension, where forward-looking policies can enable the sophisticated understanding and confident management of dynamic illicit finance risk. At stake is nothing less than the integrity of the financial system, the global economic growth it supports, and our national security.

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