Dirty Money: How Banks Influence Financial Crime

(by Janet Gao, Joseph Pacelli, Jan Schneemeier, Yufeng Wu)

Isha Agarwal

UBC Sauder

CICF, July 2021

Research Question

- Do banks facilitate financial crime by not reporting suspicious activities?

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U.S. NEWS MARCH 17, 2010 / 8:23 AM / UPDATED 11 YEARS AGO

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JPMorgan and Deutsche Bank Named in Money Laundering Report

Bank shares slide following a report that says financial institutions defied money laundering crackdowns.

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- **Very important contribution**: ample anecdotal evidence but no systematic analysis

Methodology and Results

- Stylized model: banks choose optimal stringency of their reporting policy
  - lax reporting could imply higher expected fines from the regulator but could boost revenue by attracting risky customers
- Empirical analysis: effect of banks' risk taking incentives on SAR volume
  - county and state-year fixed effects
  - structural estimation
  - causality using the shale gas expansion experiment
  - various robustness tests to rule out alternative explanations
- Main finding: a fall in bank profitability (aggregated at the county level) is associated with a higher volume of county-level SARs.
- Mechanism: **low profits** $\Longrightarrow$ more risk taking $\Longrightarrow$ lax reporting policy $\Longrightarrow$ attracts criminals $\Longrightarrow$ **higher SAR reporting volume**
- Very hard research question. Major effort to bring in different data and methodologies to provide evidence of the mechanism

Mechanism: Bank profitability and customer mix

- Mechanism: low profits $\implies$ more risk taking $\implies$ adopt lax reporting policy $\implies$ attracts criminals $\implies$ higher SAR reporting volume
- Since banks privately file SARs to the regulator, criminals do not directly observe how a bank's reporting policy changes with its profits
- Criminals perhaps have a prior belief about each bank's reporting policy that's based on long-term reputation of the bank in facilitating criminal transactions. For example, Deutsche Bank
- Hidden link: adopt lax reporting policy $\implies$ inspection by the regulator $\implies$ unreported suspicious activity gets detected $\implies$ bank fined $\implies$ media coverage $\implies$ criminals update their prior beliefs $\implies$ higher SAR reporting volume

Mechanism: Bank profitability and customer mix

Is it possible to provide more evidence on how the results depend on the strength of these intermediate channels?

Suggestions:

1. Can use data on AML violations and see if a fall in profits leads to more AML violations
2. Event study analysis: look at media coverage of well-known AML violations and other instances of misconduct and see how SAR volume changes after the media covers the incident.
3. To disentangle the effect of short-term changes in reporting strategy vs long term reputation effect, can check how the results are different for banks that have been involved in AML scandals in the past compared to banks that have a relatively clean history
4. Can also test how the probability of an audit would affect the transmission of lax reporting policy to more risky customers. Even if the reporting policy is lax and the bank is never caught, criminals may not approach such a bank if they ex ante perceive this bank to be safe

Mechanism: Bank profitability and risk taking

- low profits $\implies$ more risk taking $\implies$ adopt lax reporting policy
- How does the expected risk and reward of different financial crimes affect banks' risk taking strategy and their reporting policy?
- How low do the profits have to be for banks to engage in risky activities such as money laundering?
- In other words, are there banks for which the strategic disclosure effect might matter more? If so, which characteristics in the cross-section of banks and illegal activities would lead this effect to dominate?

Mechanism: Bank profitability and risk taking

- Banks file SARs on various activities including check clearance, identity theft, mortgage fraud etc.
- Expected fine from lax reporting of money laundering related activities may well exceed the fines on lax reporting of fraudulent check transaction
- Is it possible to use data on SAR volume for different types of activities to see how aggressively profitability affects reporting strategy depending on different risk and reward of these different activities?

Other Minor Comments

- Exogenous pool of safe borrowers. Exit of safe customers in response to lax reporting policy?
- Detection of AML fraud has a negative effect on bank equity returns. Do banks incorporate this cost while thinking about optimal reporting policy?

Conclusion

- The paper makes a very important contribution by taking a first pass at looking at banks' role in facilitating financial crime
- Highly policy-relevant
- Provides many avenues for future research on this topic