

Understanding the Wash Cycle

by Paul W. Bauer and Rhoda Ullmann

“Follow the money.”

—“Deep Throat,” Bob Woodward’s informant, in *All the President’s Men*

Although the phrase “money laundering” did not even appear in print until the Watergate scandal,¹ criminal investigators have long adhered to Deep Throat’s sound advice. While not officially outlawed until 1986, money laundering—or failure to do it well—has figured in many prominent cases. Two of the century’s most notorious criminals were undone by failure to cover their financial tracks. Al Capone was finally convicted of tax evasion, not racketeering, and Bruno Richard Hauptmann, who kidnapped Charles Lindbergh’s son in 1932, was caught because he failed to launder the ransom money successfully.² And, as we saw last year, when concerns arose about funds that may have been obtained illegally in Russia possibly entering the U.S. banking system, the problem of dirty money has not gone away.

Because criminals have a strong incentive to disguise their activities, the amount laundered is not known precisely, but the International Monetary Fund has estimated that the annual total is equivalent to around 3 to 5 percent of the world’s output. Alternatively, the Group of Seven (G7) nations’ Financial Action Task Force puts the figure at \$300 billion to \$500 billion worldwide. More than \$2 trillion courses daily through the U.S. economy alone, so law enforcement is necessarily a needle-in-a-haystack effort.³ This *Economic Commentary* describes the money laundering process, examines the motivation behind the evolving statutes, and explains the Federal Reserve System’s supporting role in enforcing them.

■ Wash-Cycle Basics

Money laundering involves three steps, which sometimes overlap: placement, layering, and integration. During the placement stage, the form of the funds must be converted to hide their illicit origins. For example, the proceeds of the illegal drug trade are mostly small-denomination bills, bulkier and heavier than the drugs themselves. Converting these bills to larger denominations, cashier’s checks, or other negotiable monetary instruments is often accomplished using cash-intensive businesses (like restaurants, hotels, vending-machine companies, casinos, and car washes) as fronts.

In the layering stage, the launderer tries to obscure further the trail linking the funds with the criminal activity by conducting layers of complex financial transactions. For example, sophisticated criminals with large sums to launder set up shell companies in countries known either for strong bank-secrecy laws or for lax enforcement of money laundering statutes. The tainted funds are then transferred among these shells until they appear clean.

These transactions must be disguised to blend in with the trillions of dollars of legitimate transactions that occur every day. Variations of “loan-backs” and “double invoicing” are common techniques. With a loan-back, the criminal puts the funds in an offshore entity which he secretly controls and then “loans” them back to himself. This technique works because it is hard to determine who actually controls offshore accounts in some nations. In double invoicing—a scam for moving funds into or out of a country—an offshore entity keeps the proverbial two sets of books. To move “clean” funds into the

Money laundering has gone on since the first crime was committed for profit, but it has been explicitly illegal only since 1986. Interest in this topic soars whenever a major “laundromat” is uncovered. This *Economic Commentary* describes the money laundering process, summarizes the evolving statutes, and describes the Federal Reserve’s role in assisting in their enforcement.

United States, a U.S. entity overcharges for some good or service. To move funds out (say to avoid taxes), the U.S. entity is overcharged.

Other layering techniques involve buying big-ticket items—securities, cars, planes, travel tickets—which are often registered in a friend’s name to further distance the criminal from the funds. Casinos are sometimes used because they readily take cash. Once converted into chips, the funds appear to be winnings, redeemable by a check drawn on the casino’s bank.

The integration stage is the big payoff for the criminal. At this stage, he moves the funds into mainstream economic activities—typically business investments, real estate, or luxury goods purchases.

■ Key U.S. Legislation

Law enforcement agencies are fond of money laundering legislation because it may be more effective than a direct attack on criminal activity. In the illicit drug trade, for example, profit rates can reach 1,000 percent—tempting enough to ensure that a steady supply of criminals will replace those carted off to jail.

However, if its rewards can be reduced through legislation and enforcement, then so can its appeal.

The foundation of U.S. money laundering laws is the Bank Secrecy Act (BSA) of 1970, which does not criminalize the activity but does require financial institutions to create and preserve a “paper trail” for various types of transactions. The BSA has been challenged repeatedly. Some criticize the compliance costs it imposes. Others claim it infringes on Fourth Amendment protection against unreasonable search and seizure and Fifth Amendment guarantees against self-incrimination. Although it has been upheld repeatedly, the BSA remains controversial in some quarters. In one case that went all the way to the Supreme Court, the forceful dissenting opinion written by Justice Douglas said, “I am not yet ready to agree that America is so possessed with evil that we must level all constitutional barriers to give our civil authorities the tools to catch criminals.”⁴

As the drug trade grew, Congress became increasingly concerned with money laundering and moved to outlaw it in 1984 by making BSA violations predicate acts under the Racketeer Influenced and Corrupt Organizations Act. Finally, the Money Laundering Act (1986) made money laundering a federal crime. It added three new offenses to the criminal code: knowingly helping to launder money from criminal activity, knowingly engaging in a transaction of more than \$10,000 involving property from criminal activity, and structuring transactions to avoid BSA reporting requirements.⁵ This last element targeted “smurfs,” people hired by launderers to make multiple deposits or purchases of cashiers’ checks in amounts just under the \$10,000 threshold.

This legislation has been amended several times. The Anti-Drug Abuse Act (1988) significantly increased the penalties, required strict identification and record-keeping for cash purchases of certain monetary instruments.⁶ In addition, the legislation permitted the Treasury to force financial institutions to file additional geographically targeted currency transaction reports. The Secretary of the Treasury can issue an order requiring financial institutions in a specific geographic area to file currency transaction reports for less than the \$10,000 threshold. The act also directed the Treasury to negotiate bilateral international agreements for recording

large transactions of U.S. currency and sharing this information.

The Annunzio–Wylie Anti–Money Laundering Act (1992) enlarged the BSA’s definition of “financial transactions,” added a conspiracy provision, and outlawed the operation of “illegal money transmitting businesses.” Annunzio–Wylie is best known for establishing of the “death penalty,” which provides that if a bank is convicted of money laundering, the appropriate federal bank supervisor must begin a proceeding to either terminate its charter or revoke its insurance, depending on the bank’s primary supervisor. Annunzio–Wylie also created the BSA Advisory Group (of which the Federal Reserve is a founding member) to suggest methods for increasing the effectiveness and efficiency of the Treasury’s antilaundrying programs.

The Money Laundering Suppression Act (1994) tinkered with the law’s conspiracy and structuring provisions, while the Terrorism Prevention Act (1996) added terrorist crimes as predicate acts to money laundering violations, and the Health Insurance Portability and Accountability Act (1996) made “federal health care offenses” predicate acts as well.

Criminal penalties include prison terms as long as 20 years and fines up to \$500,000 or twice the value of the monetary instruments involved, whichever is greater. On top of the criminal penalties, violators may face civil penalties up to the value of the property, funds, or monetary interests involved in a transaction. Congress intended these punishments to be harsh. Before the Money Laundering Act (1986), defendants had to be prosecuted under other statutes related to the underlying unlawful activities that had induced the money laundering (such as tax evasion, conspiracy, BSA, bribery, and fraud). Generally, these statutes have far less severe penalties.

But from a monetary perspective, life for accused violators gets really nasty when the forfeiture laws kick in. Forfeiture is intended to prevent criminals from keeping either the fruits of their crimes or the tools used to commit them. Under the Civil Asset Forfeiture Reform Act of 2000, the government must now clear a slightly higher hurdle to seize and forfeit assets. To seize assets, it must show probable cause that the property is from criminal activity. To win civil forfeiture,

it must prove its case by a preponderance of the evidence, and to win criminal forfeiture, it must prove its case beyond a reasonable doubt. Forfeited assets may be shared with all law enforcement agencies involved in obtaining a conviction, a policy that has been particularly effective in obtaining cooperation from some foreign law-enforcement agencies.

Legally, money laundering is defined as any attempt to engage in a monetary transaction that involves criminally derived property. To convict, prosecutors must show that the defendant engaged in financial transactions or international transportation that involved funds from a “specified unlawful activity.” The list of such activities is extremely long and includes bribery, counterfeiting, drug trafficking, espionage, extortion, fraud, murder, kidnapping, racketeering, and certain banking practices.

■ The Paper Trail

Prosecutors consider the paper trail mandated by the BSA and its amendments to be a crucial tool in the investigation and prosecution of money laundering offenses. They use five kinds of reports to track financial transactions:

Currency transaction report. Filed when a financial institution receives or dispenses more than \$10,000 in currency, it reports the name and address of the person who presents the transaction and the identity, account number, and Social Security number of anyone for whom a transaction is made.⁷

Suspicious activity report. Filed when any bank employee has reason to suspect a person of money laundering, regardless of the transaction size.

IRS Form 8300. Filed by any person involved in a business that receives cash payments in exchange for goods or services exceeding \$10,000 in a single transaction or a series of related ones.

Currency and monetary instruments report. Filed by anyone entering or leaving the country with currency or monetary instruments in excess of \$10,000. Carrying more than this amount is perfectly legal, but failure to file the report can lead to fines, up to five years in prison, or forfeiture.

Foreign bank account form. Filed by anyone controlling more than \$10,000 in a foreign account during the year.

All these reports help investigators “follow the money.” The Financial Crimes Enforcement Network (FinCEN), which was created by Treasury order in 1990 to give law enforcement agencies analytical support, is now charged with maintaining these reports as well. On occasion, the reporting requirements have been adjusted so that useful information is gathered without generating a flood of unnecessary reports.

By filing these forms, financial institutions aid law enforcement authorities in the fight against money laundering. The forms also impose real costs on these institutions and on legitimate customers. FinCEN estimated that reporting and record-keeping costs associated with BSA compliance in 1999 totaled \$109 million,⁸ which does not include the costs of training and monitoring personnel, modifying computer programs to enable compliance, or inconveniencing legitimate customers. There is also concern that a disproportionate share of these costs may fall on smaller institutions.⁹

In addition, the forms’ effectiveness has been questioned. Former Federal Reserve Governor Larry Lindsey observed that between 1987 and 1996, banks filed 77 million currency transaction reports; these led to only 3,000 money laundering cases, in which 7,300 defendants were charged but only 580 were convicted.¹⁰ To be fair, in addition to 580 guilty *verdicts*, the Department of Justice obtained 2,295 guilty *pleas*, for a 40 percent sentencing rate. Bank regulators and law enforcement representatives defend the BSA applications, countering that currency transaction reports were never designed to generate prosecutions, and the Federal Reserve Board continues to support them.

■ The Global Spin Cycle

In the evolving global financial system, funds can be zapped from one country to another, making international cooperation even more important in combating money laundering. In 1989, the G7 nations established a Financial Action Task Force (FATF) to develop antilaunching strategies. The next year, the task force drafted its “Forty Recommendations,” which require member countries to assist each other in money laundering investigations, avoid enacting secrecy laws that hamper such investigations, criminalize money laundering, and report suspicious transactions.

Although the task force involves the major financial centers in North America, Europe, and Asia, many countries are not yet FATF participants. In June 2000, the task force released a list of 15 countries with “serious systemic problems.”¹¹ In July, finance ministers from the G7 nations followed up with a plan to persuade these countries to cooperate by threatening to cut off their access to the international banking system—as well as International Monetary Fund and World Bank loans—unless they combat money laundering more aggressively. In addition, private financial institutions in G7 countries will be warned that transactions with target countries will draw intense scrutiny.

■ The Federal Reserve’s Role

Although the Federal Reserve is not a law enforcement agency, it works actively to deter the use of financial institutions for laundering.¹² The Fed’s activities include conducting BSA exams, developing antilaunching guidelines, and providing expertise to U.S. law enforcement officers and various foreign central banks and government agencies. Financial organizations and their employees are considered the strongest defense against money laundering, and the Federal Reserve emphasizes the banks’ importance in establishing controls to protect themselves and their customers from illicit activities. In every examination the Fed supervises, it verifies the bank’s BSA compliance. Any indication of deficiencies, such as inadequate internal controls or training, results in a second-stage examination that is even more rigorous.

The Federal Reserve has been promoting the concept of “enhanced due diligence.”¹³ Under this policy, banks that have experienced problems will be required to enter agreements to ensure future compliance. These agreements are designed to reasonably ensure the identification and timely, accurate, and complete reporting of known or suspected criminal activity against or involving the bank to law enforcement and supervisory authorities.

■ Future Considerations

Two developments warrant close monitoring. First, Internet-based payment systems are being developed to facilitate electronic transactions. Some of these systems seek to give users as much anonymity as currency provides.

The speed of electronic transfers, combined with the anonymity of cash, would appeal strongly to launderers. While this is a potential law-enforcement concern, today’s e-money lacks the large volume of legitimate transactions essential to provide cover for criminal ones. Moreover, launderers are not drawn to most current electronic purse schemes, in which balance limits are low and transactions can be audited.

Second, proposed legislation would grant the Treasury sweeping new powers to fight money laundering, the centerpiece being an ability to ban financial transactions between offshore financial centers and U.S. banks or brokerage houses. The Treasury now has no power to prevent U.S. financial entities from transacting business in countries that allegedly tolerate money laundering, short of asking Congress to declare emergency sanctions against nations deemed security threats. The Treasury issues advisories warning banks against money from foreign institutions that repeatedly violate accepted standards, but these advisories lack the force of law.

■ Conclusion

Over the last 30 years, lawmakers have enacted a broad array of domestic legislation, striving to forge the enforcement tools they need to combat launderers’ ingenious and continuously evolving techniques for circumventing the previous piece of legislation. As a bank regulator, the Federal Reserve has an important supporting role in the struggle against money laundering. Because launderers’ operations are global, the recent increase in international cooperation is a promising development. Of course, in our zeal to catch criminals, we must weigh the benefits of legislation and regulation against the costs they impose on financial institutions and their customers.

■ Footnotes

1. *Oxford English Dictionary*.
2. For more details, see George Waller, *Kidnap: The Story of the Lindbergh Case*. New York: Dial Press, 1961.
3. “Dirty Money Goes Digital,” *Business Week*, September 20, 1999.
4. See Thurston Clarke and John J. Tigue, Jr., *Dirty Money: Swiss Banks, the Mafia, Money Laundering, and White Collar Crime*. New York: Simon and Schuster, 1975, p. 79.
5. In this context, “knowingly” applies to a person who is willfully blind to a questionable situation.

6. Most of the requirements related to keeping records of cash purchases of monetary instruments have been repealed.
7. Currency transaction reports need not be filed for every large cash transaction. Banks can exempt certain customers from this obligation, thereby reducing the number of CTR filings.
8. FinCEN response to a request from U.S. Representative Ronald Paul's office, May 19, 2000.
9. Testimony of U.S. Representative Ronald Paul before the Commercial and Administrative Law Subcommittee of the House Judiciary Committee, U.S. House of Representatives, March 4, 1999.
10. "Should Money Laundering Be a Crime?" Cato Institute Debate no. 5, December 1997.
11. The countries cited were the Bahamas, Cayman Islands, Cook Islands, Dominica, Israel, Lebanon, Liechtenstein, Marshall Islands, Nauru, Niue, Panama, Philippines, Russia, St. Kitts and Nevis, and St. Vincent and the Grenadines.

12. More complete details on the Federal Reserve's positions on these issues can be found in the testimony of its officials before various congressional committees. See in particular the statements of Richard A. Small before the Senate Permanent Subcommittee of the Investigations Committee on Governmental Affairs, November 10, 1999, and before the House General Oversight and Investigations Subcommittee and the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Banking and Financial Services, April 20, 1999. Also see statements by Edward W. Kelley, Jr., before the House Committee on Banking and Financial Services, February 28, 1996, and by Herbert A. Biern before the House Committee on Banking and Financial Services, June 11, 1998.
13. Enhanced due diligence is illustrated in several recent enforcement actions taken by the Board. The enhanced due diligence agreement between the Bank of New York, the Federal Reserve, and the New York State Banking Department can be found at <http://www.federalreserve.gov/boarddocs/press/Enforcement/2000/20000208/attachment.pdf>.

Paul W. Bauer is an economic advisor at the Federal Reserve Bank of Cleveland, and Rhoda Ullmann is a research assistant at the Bank.

The views stated here are those of the authors and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

Economic Commentary is published by the Research Department of the Federal Reserve Bank of Cleveland. To receive copies or to be placed on the mailing list, e-mail your request to 4d.subscriptions@clev.frb.org or fax it to 216-579-3050. Economic Commentary is also available at the Cleveland Fed's site on the World Wide Web: www.clev.frb.org/research, where glossaries of terms are provided.

We invite comments, questions, and suggestions. E-mail us at editor@clev.frb.org.

**Federal Reserve Bank of Cleveland
Research Department
P.O. Box 6387
Cleveland, OH 44101**

Return Service Requested:
Please send corrected mailing label to the above address.

Material may be reprinted if the source is credited. Please send copies of reprinted material to the editor.

**PRSR STD
U.S. Postage Paid
Cleveland, OH
Permit No. 385**