

Testimony of
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COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

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INTRODUCTION

Good morning Chairman Shelby and ranking member Sarbanes. I am Diana Taylor, Superintendent of Banks for the State of New York and a member of the board of directors for the Conference of State Bank Supervisors.

Thank you for holding this hearing on an issue that is of great interest to those of us who oversee the financial services industry at the state level, and who are very concerned about the sometimes conflicting priorities of regulation, law enforcement, and the ability of necessary businesses to operate. This has become a very serious concern as issues of financial crimes, especially money laundering, figure so prominently today.

Seven months ago, this committee brought the issue of compliance with the Bank Secrecy Act and anti money-laundering provisions of the law (BSA/AML) in the Money Services Businesses (MSBs) to the nation's attention with its initial oversight hearing. I testified at that hearing and I thank you for this opportunity to continue the discussion.

WHO WE ARE

The New York State Banking Department is the regulator for more than 3,400 financial institutions and financial service firms in New York State. This number includes state-chartered banking institutions, the vast majority of U.S. offices of international banking institutions, all of New York State's money transmitters, check cashers, mortgage brokers, mortgage bankers and budget planners. The aggregate assets of the companies and institutions supervised by the Banking Department are nearly \$2 trillion.

Relevant to today's hearing, the Department is responsible for licensing, supervising, examining and regulating the check cashing and money transmitting businesses which operate in New York State.

We currently license 213 check cashers with 964 locations, employing 4,000 people. In 2003, in New York State alone, licensed check cashers cashed more than 36.4 million checks with an aggregate face value of some \$14.9 billion.

Nationwide, according to the trade group representing check cashers, this sector comprises some 11,000 neighborhood locations, which cash upwards of 180 million checks annually with an aggregate face value of more than \$55 billion.

Beyond the check cashers, there are 72 licensed money transmitters operating in New York through approximately 28,000 agents in New York State, employing more than 63,000 people. In 2004, these licensed money transmitters processed more than 90 million travelers checks, money orders, official checks issued on behalf of banks and remittances with an aggregate face value of over \$101 billion in New York alone.

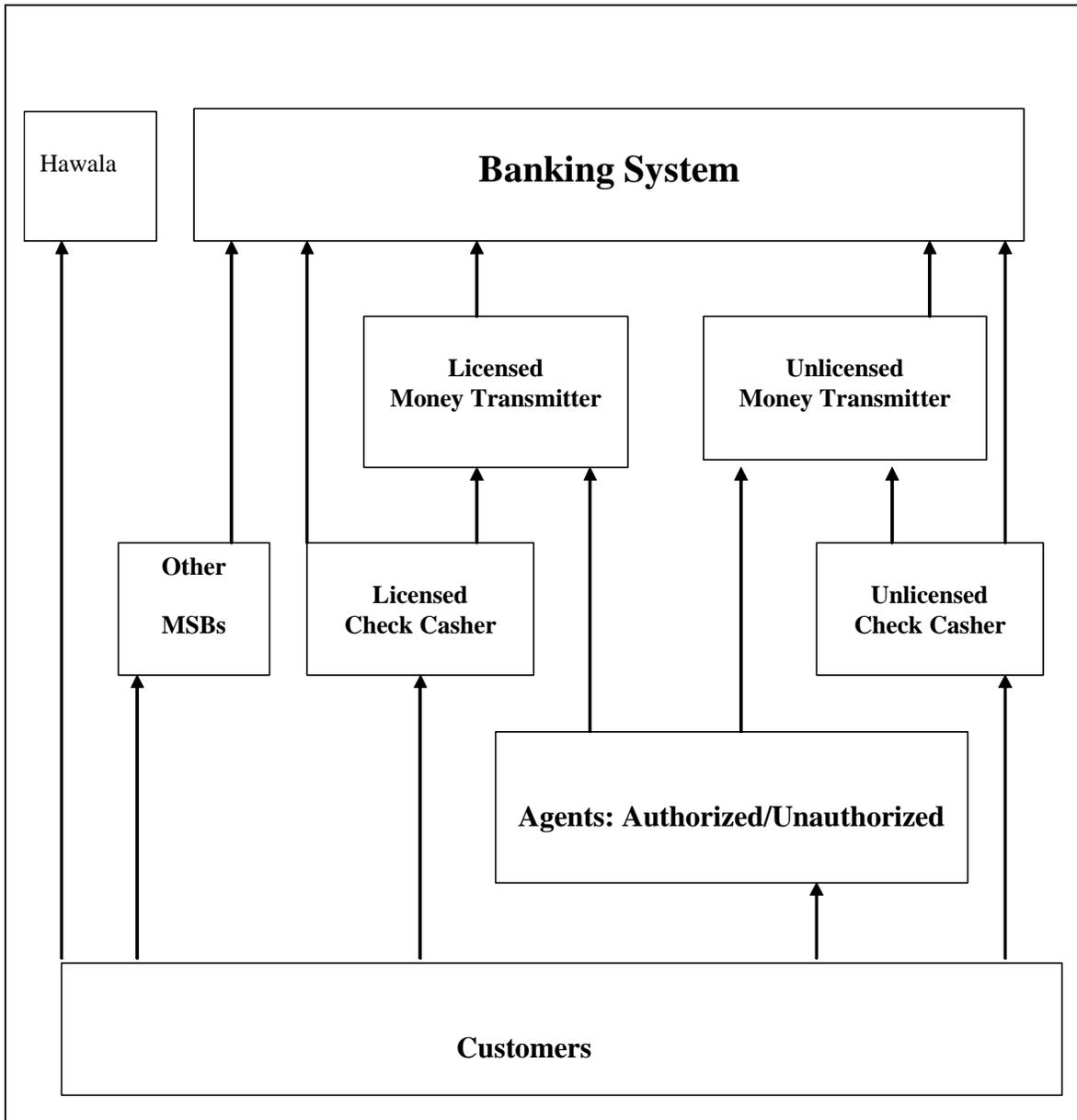
These figures represent just one state. I don't have comparable nationwide figures, but a quick extrapolation would indicate that check cashers and money transmitters constitute a very large presence which serves a very large market. Check cashers and money transmitters need banks to conduct their business. This is how they move money. Thus, the banks become portals into our financial system. It goes without saying that the scope of the task of overseeing this large and growing sector of the financial services industry is enormous.

MSBs fill a real need by providing financial services in areas where there are very few if any bank branches. These are typically very low income areas. MSBs exist in immigrant and minority communities where people have varying levels of comfort with the banking system for a broad range of reasons, from cultural to educational to personal preference. MSBs provide an alternative to banks – they are easy to access, and they are convenient in terms of cost, proximity to their markets and hours of operation. In addition, an MSB location may provide a wide variety of other services. One might ask why banks are not providing these services, but that is outside the scope of today's discussion.

We need to keep this industry viable. There are thousands of people for whom check cashers and money transmitters are the sole means of access to their cash, and the sole means of moving that cash. Many are immigrants who make use of this system to send money back to families and loved ones in their countries of origin. A significant portion of the economies of many third world countries are dependent upon these resources.

THE MSB INDUSTRY

The following chart diagrams how the MSB industry interfaces with the banks and with its customers.



As with any financial service business, MSBs have particular risk factors, or vulnerabilities. One of the goals of law, regulation, and compliance systems is to reduce those factors as much as possible, while at the same time allowing legitimate business to be conducted.

The first vulnerability to consider with MSBs is the customer base. We have to acknowledge that there will always be those who are looking for ways to exploit MSBs, and indeed the financial system, for the purpose of laundering funds and other illegal activities. Second, legitimate customers and businesses are vulnerable to the practices of unlicensed or unregistered MSBs, or unauthorized agents as may be applicable, where they are not afforded the same level of consumer protection as with a licensed MSB.

Third, licensed MSBs are open to reputational risk or guilt by association as a result of the activities of those unlicensed MSBs.

REGULATION AND SUPERVISION OF MSBs — NEW YORK STATE'S TOP-DOWN APPROACH

State regulators are a very important component in the effort to reduce the risks and vulnerabilities of this industry. Many states are actively involved in ensuring compliance with BSA/AML requirements. At least 45 states are now reviewing financial institutions for BSA compliance. A growing number of states are also examining for BSA in money services businesses.

In New York, we are empowered to enforce the provisions of the USA Patriot and Bank Secrecy Acts through our supervisory powers over MSBs. We are in the process of significantly enhancing our ability to carry out our responsibility to ensure that MSBs are sound, that they are obeying the law and that customers are protected.

We hope that by strengthening our regulation and examination processes and personnel, banks will develop a sufficient level of confidence that New York State licensed MSBs are operated in a safe and sound — and legitimate — manner.

In general terms, we look at safety and soundness of all institutions we regulate — banks and non-banks — with an eye to the preservation of our monetary system as a whole, as well as providing consumer protection.

For MSBs in particular, our licensing criteria include, but are not limited to, character and fitness standards; safety and soundness standards as may be

evidenced by net worth, liquidity and bonding requirements; and compliance, inclusive of BSA/AML standards, e.g. policies and procedures which are in place and being followed effectively, and a designated compliance officer experienced in the field.

For us, BSA/AML standards are pertinent from the moment an applicant seeks permission to open a money service business in New York State. We require, among other information, an Anti-Money Laundering Compliance Manual, and an affidavit indicating compliance with the USA Patriot Act, inclusive of the four requirements for an effective anti-money laundering compliance program:

- First, policies, procedures and internal controls designed to ensure compliance with BSA/AML requirements;
- Second, a compliance officer responsible for day-to-day compliance with the BSA/AML and a compliance program;
- Third, education and/or training of appropriate personnel; and
- Fourth, an independent review to monitor and maintain an adequate program.

At a minimum, the first three points must be in place prior to our issuing a license. This allows the Department to assess the BSA/AML knowledge base of the applicant and ensure — from the very beginning — that the compliance program is adequate.

The subsequent examination process allows the Department to test the implementation of the compliance program presented during the application process.

The core BSA/AML examination program that we use for both banks and MSBs is the same as that used for banks by the Federal agencies. Although a standardized examination program is available, it is a flexible format that may be tailored to the risk profile of a given licensee. In addition, all sources of information available are used to determine a licensee risk profile, e.g. Cash Transaction Reports and Suspicious Activity Reports filed with FinCEN. In the field, transaction testing is performed using a variety of sampling techniques.

Supervision of Licensed MSBs

There are many similarities in how we look at banks and at MSBs as businesses. Because they differ in that MSBs are not depository institutions, we have come up with a slightly different protocol. While we (along with the Federal Reserve Board) use the CAMELS system for banks, we have developed an assessment protocol known as FILMS for MSBs.

- F - is for Financial Condition. Our examiners look at balance sheets, levels of permissible investment, level and quality of capital, the quality and quantity of earnings, trends and stability and they analyze liquidity, profitability and leverage.
- I - is for Internal Controls and Auditing. How effective are the MSB's controls and overall internal control environment?
- L - is for Legal and Regulatory Compliance. This is critical – how good is the business at adhering to applicable state and federal laws and regulations? How effective is compliance and can management spot and correct any compliance issues or gaps? Is the BSA/AML program effective or deficient?
- M - is for Management. Examiners look at the overall performance and the licensee's ability to identify, measure and monitor risks. Succession plans are also important as is responsiveness to recommendations by auditors and supervisors.
- S - is for Systems and Technology. An important part of the exam, particularly for money transmitters, is the IT audit, testing the management, development and support of information systems.

LAW ENFORCEMENT – BOTTOM-UP APPROACH

We have found that law enforcement agencies and their bottom-up approach dovetails very well with our top-down method of regulation and supervision of the MSB industry. Law enforcement can identify information at the street level in terms of the type of suspicious activity, including hawalas, or patterns of activity that may be flowing through both licensees or unlicensed entities. Partnering with law enforcement for information sharing and coordination provides a solid basis to identify inappropriate or unlicensed activity and assists in targeting where this activity might be taking place.

In New York State we have formed a very successful in partnership with law enforcement and we have been effective in shutting down unlicensed MSBs, and licensed MSBs who may be conducting illegal activities. For example, most recently, on March 24, 2005, through the cooperative effort of the Department and the FDIC, the Manhattan District Attorney announced the indictment of an unlicensed money transmitter known as Vietnam Service, Inc. and its owners on charges of moving almost \$25 million to Vietnam in the last three years.

THE CHALLENGE

BSA/AML concerns have overshadowed the MSB industry to the point where very few banks will do business with them. This does not necessarily mean these businesses will disappear — the demand for their services is very strong. It does mean that they will have to find alternative means to move money. This result

would defeat the intent of the law. Imagine the crisis this would engender: planes and trucks loaded with cash traversing borders. Following the money under circumstances such as these would be made even more difficult.

One of New York's largest banks, which has historically represented the majority of the market for MSBs, sent discontinuance letters to two dozen wire transfer businesses just last month, citing compliance burdens associated with servicing these firms. These businesses, and others, have come to us asking us to intervene. They have been experiencing profound difficulty in interesting any other banks in working with them. We are very worried that many of these transmitters may have no alternative but to shut down their businesses, leaving thousands of legitimate customers in the lurch.

This problem of banks being reluctant to open accounts for MSBs stems in large part from their concerns over the lack of regulatory and supervisory guidance in the area of BSA/AML which creates uncertainty in the market. There has been a history of deferred prosecutorial agreements and very large penalties being extracted from institutions for what is arguably not criminal behavior. In addition, regulators have told them this is a high risk area of business. Many banks have decided the cost of setting up the compliance systems and uncertainty about their own role with regard to regulation. Moreover, the fear of monetary penalties and loss of reputation at best and the fear of prosecution by law enforcement agencies at worst is just not worth it.

THE SOLUTIONS, NEXT STEPS

Now that these problems have been recognized, and defined, there are several steps that should be taken to resolve these issues. Each one of these elements is important. They range from clarification of the law, to working together co-operatively, to making sure examiners are trained appropriately and the industry is educated as to what is required, to the need more uniformity of standards across the country.

Guidance:

First and most important, FinCEN and the federal banking supervisors recently announced that guidance on BSA/AML compliance would be issued soon. This is very welcome news and promises a strong step in the direction of providing more clarity to the banks as to their BSA/AML requirements with respect to MSB customers. This guidance will assist banks in determining the measures they should undertake. One very important issue that was made clear is that banks are not expected to become or act as MSB regulators.

One issue that I hope to see clarified in the forthcoming guidance has to do with the OCC pre-emption of state depository and lending laws. Under the current OCC rules, operating subsidiaries of nationally chartered banks, including MSBs, may ignore any state licensing or other regulatory requirement. I think it is important under these circumstances that a means be crafted to establish national standards regarding these entities, along with a very clear understanding of who is responsible for what in this area.

Coordination Among Regulatory Agencies:

I am so pleased to report that since that initial hearing last September we have all made significant progress toward a plan to achieve a coordinated approach through communications. I especially want to thank this committee for recognizing that the state regulators are an important part of the solution. Over the last few months, the Conference of State Bank Supervisors (CSBS) has worked diligently with all of the states, our federal bank regulatory counterparts, FinCEN and the IRS to produce two model Memoranda Of Understanding (MOUs) setting forth procedures for the exchange of certain BSA information between the States and FinCEN and the IRS, respectively. In addition, these efforts resulted in the creation of a model side letter agreement between the states and the federal banking agencies to facilitate sharing by the state and federal banking regulators of jointly held BSA examination material with FinCEN and the IRS.

In return, the states will receive analytical tools from FinCEN that will maximize resources and highlight areas and businesses with higher risk for money laundering. The agreement with the IRS will allow for examination-sharing to reduce duplicative efforts and establish an ongoing working relationship.

This is an unprecedented co-operative agreement. We have all recognized that no one of us can be effective in this area without the others. Each one of us has resources needed by the others to do their jobs effectively.

Both FinCEN and the IRS have been exceptionally cooperative in outreach efforts to answer all state questions about the agreements, and as a regulator who is keenly concerned about the MSBs enjoying a viable and visible future, I am deeply grateful for this.

Throughout the process of developing these agreements, CSBS has worked with other organizations of state MSB regulators, including the Money Transmitters Regulatory Association (MTRA). The information-sharing agreement templates are designed to be signed by any state regulator with jurisdiction over those entities that fall within the purview of BSA/AML issues.

In March, the CSBS Board of Directors endorsed the information-sharing agreements and strongly urged all state banking departments to join as signatories on the MOUs. CSBS is distributing the information sharing agreements to the state banking departments.

On behalf of New York, I have signed the MOUs with the IRS and FinCEN. Our goal is to obtain signatures from all 50 states to cement this relationship with both FinCEN and the IRS. Not only will these agreements provide additional information to the regulators, the more information FinCEN receives and is able to analyze, the better the guidance from state and federal regulators will be.

These MOUs highlight the recognition by FinCEN and the IRS of the vital role that states play in BSA/AML supervision and enforcement for both banks and MSBs. These MOUs provide the mechanism for increased communication and enforcement, leading to more effective compliance for banks and MSBs. Also, importantly, the MOUs provide for the sharing of training and examination and other program materials, addressing resource issues at both the state and federal levels.

Coordination with Law Enforcement:

Addressing the banks' fear of prosecution is a challenge. Some prosecutors seem to be of the opinion that all instances of criminal behavior can be and should be prevented. I am in absolute agreement that criminal behavior, especially in the area of BSA/AML issues is serious, and must be punished appropriately. However, there is no system in the world that is going to catch every single case immediately, if ever. This is not to say we should not try, but we must be realistic about it or we will render inoperable a system which has served us all very well. Regulatory matters such as BSA/AML compliance failures are being criminalized and weaknesses, deficiencies and mistakes are being prosecuted in ways which I think are counterproductive.

I believe it is more constructive for us to work with banks, in a supervisory mode, to build strong compliance with BSA/AML. The powerful supervisory tools of administrative action and enforcement sanctions can be used toward this end.

But, in order to do this, we as regulators, the banks and the users of the financial system need to know what the rules are, which is why FinCEN's guidance is so critical.

Our supervisory and regulatory powers can be very helpful to law enforcement in weeding out and prosecuting violators of the law. It is we the regulators who can require these entities to have effective BSA/AML compliance programs in place; it is we the regulators who examine and detect non-compliance with BSA/AML;

issue enforcement actions to correct and penalize violations; and it is we the regulators who oversee compliance with corrective actions. It is law enforcement that prosecutes criminal behavior when regulators are ignored, or not doing their jobs.

I strongly believe that if MSBs are in compliance with BSA/AML as interpreted by FinCEN, that this should be a sufficient compliance standard for the banks, their regulators and criminal law enforcement authorities. I do not believe that banks or their principal management should be subject to criminal prosecution if the appropriate regulator has determined the compliance standards of the banks are sufficient under the law and I believe that criminal prosecution should only extend to a bank or any bank personnel that is knowingly violating BSA/AML standards for criminal purposes.

The real lesson of this discussion is that to have a real and lasting effect on illegal activity in this area, it is essential that the agencies involved in the regulatory, investigative and enforcement frameworks for MSB's proactively cooperate with each other. To that end, we have formed a working group in New York State which includes representatives from State and Federal Homeland Security, the NYS Department of Criminal Justice Services, the New York County District Attorney's office, the FBI, IRS, ICE, and the NYPD. As a designated High Intensity Financial Crime Area, (HIFCA) we have a template for this level of co-operation. No one agency can combat this illegal activity on its own.

Examiner Training

Another part of the solution is rigorous examiner training. Because MSBs are not banks, they require a different examiner perspective than the one used in bank examination. Certain organizations, such as the MTRA, do offer industry-specific examination training. This could be useful for states with a less specific protocol than New York's. In my testimony last fall, I suggested that the Federal Government might play a roll in funding training for State bank examiners to ensure a uniformly high level of competence.

Continuous BSA/AML training programs for the general examination staff is essential. We take advantage of external training resources when available but we also have developed our own training programs in-house that are based upon our regulatory and supervisory requirements, industry best practices and real life examination experiences. In addition, we have specialists for internal controls, BSA/AML compliance and systems technology. Special training is needed in each of these areas.

In developing a national standard, it is key that these training opportunities and resources can be effectively shared among the states. This may be accomplished

by sharing training programs and examination manuals that may be available for MSBs. Hands-on examination experience can be obtained through joint or coordinated examinations as evidenced through the efforts of the MTRA. In addition, the CSBS is currently working on plans for a BSA examiner 'boot camp' training program that will be offered nationwide later this year. Federal assistance in these areas would be very valuable.

Industry Education

Education must not be restricted to the regulators. Both the MSB and banking industries need to be thoroughly knowledgeable concerning BSA regulatory and supervisory standards.

I firmly believe that it is the regulator's job to ensure that the entities – all the entities – under its purview fully understand what is expected of them through the exam process and in day-to-day behavior. This is, for many people, where we experience the disconnect, or mis-connection, between law enforcement and regulators. Our job is to help banks and MSBs understand what the law is, what the regulations do, and ensure they have the systems set up to comply, which will help avoid prosecution which can harm the reputation of an entire industry and close down a business.

We continue to work with the MSB industry to "raise the bar" of supervisory standards and communicate those standards and our supervisory expectations. The banking industry must be informed of our standards for MSBs and what they should expect from their MSB customers in terms of compliance, e.g. licensing, FinCEN registration and compliance programs. Something as simple as the requirement by banks that any MSB opening an account prove that they are licensed and registered would go a long way. This question has not always been asked.

We are planning a conference to take place at the end of this quarter to which we will invite both MSB and banking industry participants to discuss the regulation and supervision of MSBs. This conference will include regulators as well as representatives of law enforcement who will explain how they view the industry and will give us all an idea of what they consider to be behavior that could be subject to criminal prosecution.

The Need for More Consistency Nationwide

I've described my Department's approach to MSB supervision and mentioned a need to push for national consistency in our approach to monitoring the MSBs and their relationship to the banking industry. As you may know, across the country, supervision and regulation of this industry as a whole remains uneven.

On the bright side, this is an area that the state regulators collectively have worked on and will continue to work on by sharing best practices either on a one-on-one state-to-state basis or through organizations such as the MTRA.

To ensure that both banks and MSBs know what is expected of them we need to create more than a rulebook – we need a uniform supervisory system, we need all states to adopt stringent safety and soundness requirements if they have not already done so. We are working through CSBS and other organizations of state regulators of MSBs to make that happen.

CONCLUSION

There are serious regulatory challenges posed by the MSBs. These companies deliver services that are necessary for many legitimate customers, most of whom are low income, immigrant populations. We must devise a system that allows them to operate while at the same time assuring that our laws and regulations are obeyed. We have made a great start toward reaching this goal through a clearer understanding of the law, through co-operation by and among all the regulatory agencies involved, and through all of our co-operation with law enforcement and vice versa. But we still have a long way to go.

Thank you again, Mr. Chairman for allowing me to share the New York view of where we are, what the challenges are and what we need to do about them. In holding this hearing, you have performed a valuable service for us all.