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Money Laundering: Regulatory or Political Capture?

Danske Bank has recently been accused of having laundered more than 200 billion Euros through its Estonian branch. The size of the scandal has reinvigorated the discussion over lax enforcement by regulators and poor bank compliance with anti-money laundering laws. In this brief, we concisely review some recent cases of poor regulatory and political behaviour with respect to these matters, focusing in particular on the UK, whose financial system seems to have become a main hub for this type of financial misconduct.

A widespread phenomenon

The size of the recent money laundering scandal at Danske Bank, involving more than 200 billion Euros, has surprised many. Money laundering is a widespread issue in an increasingly complex world where financial transactions are many and instantaneous, while oversight slow and limited (Radu 2016). According to the United Nations Office on Drugs and Crime, an estimated $800 – $2 trillion is laundered every year (United Nations Office on Drugs and Crime). The source of laundered money is often from corruption, crime and drug cartels (as with the HSBC scandal, see below). Attempts to blow the whistle on these illegal transactions have gotten several people killed, especially in Russia (The Daily Beast, October 2018).

Malta's Pilatus bank recently had its license revoked by the European Central Bank after its chairman was charged with money laundering (Reuters, October 2018). The investigative reporter Daphne Caruana Galizia was killed in a car bomb in October of 2017 in Malta (The Guardian, October 2017). She was leading the Panama Papers investigation into corruption in the country and had accused Pilatus bank of processing corrupt payments (The Guardian, November 2018). In Sweden, some banks have recently been criticized for insufficient actions against money laundering. Experts at the regulator recommended extensive sanctions, but upper management stopped them (Svenska Dagbladet, December 2018). In November, Deutsche Bank's headquarters in Frankfurt were raided by prosecutors in a money laundering investigation (BBC, November 2018).

Back to Danske Bank. Its Estonian branch was recently accused of having laundered money, amounting to over 200 billion Euros of suspicious transfers (Financial Times, November 2018). In 2011 the Estonian branch accounted for 0.5% of Danske Bank's assets, while generating 12% of its total profits before taxes. In 2013, 99% of the profits in the branch came from non-residents. Many of the non-resident customers are believed to be from Russia and other ex-soviet states (Forbes, September 2018). The alleged money laundering came to light due to the whistleblower Howard Wilkinson, who headed Danske Bank's market trading unit in the Baltics from 2007 to 2014. Surprisingly, his anger over these transactions was not primarily aimed at top management in Copenhagen, or failure of rank and file employees to follow protocol in customer acquisition, but against the UK, who he claimed is "the worst of all" when it comes to combating money laundering (Financial Times, November 2018). In fact, the UK institutions seem to have been at the very heart of the scandal (ibid):

> "Mr Wilkinson's emails to Danske executives in 2013 and 2014 highlighted how UK entities were "the preferred vehicle for non-resident clients" at the heart of the scandal."

In an address to European Union Lawmakers, he said (Reuters, November 2018):

> "The role of the United Kingdom is an absolute disgrace. Limited liability partnerships and Scottish liability partnerships have been abused for absolutely years".

Regulatory or political capture?

The increasingly central role that the UK appears to be playing as a hub for financial crime is perhaps not new or surprising. The UK has indeed come to be widely recognized as one - though certainly not the only - main hub for these illegal transactions (see e.g. Radu 2016, p.15). The UK's National Crime Agency estimates 93 billion GBP of tainted money is flowing into Britain annually (Financial Times, September 2018).

And according to the classic theory of regulatory capture (Stigler, 1970), it is to be expected that a large, wealthy and highly concentrated sector such as the UK financial industry, will be able to capture regulatory institutions and lead them to act more in its favour than in that of the (national or international) community. However, besides being a concentrated source of special interests, the financial sector also represents a large share of the UK economy. It could be the case, therefore, that the capture goes all the way up to the political system and the government (as in Becker 1983, and Laffont, 1996). So, is it the alleged crime-friendly environment in the UK financial system linked more to problems of regulatory capture, or to deeper political capture?

Already in 2004 there were worrying signs of possibly deep political capture. At the time, Paul Moore, a senior risk manager at Halifax Bank of Scotland (HBOS), raised concerns about the bank's risk taking and was subsequently fired by the executive James Crosby. Crosby then proceeded to become Deputy Chairman at the Financial Services Authority (FSA). HBOS then collapsed during the financial crisis of 2008 and merged with Lloyds bank, leading to one of the most concentrated banking systems in the world (the top 5 banks have 85% of the UK banking market). Many took this to substantiate Moore's claim that the bank had been taking excessive risks. During Prime Minister's question time in the House of Commons, David Cameron commented on then Prime Minister Gordon Brown's decision to appoint Crosby to the FSA:

> "Sir James Crosby, the man who ran HBOS and whom the Prime Minister singled out to regulate our banks and to advise our Government, has resigned over allegations that he sacked the whistleblower who knew that his bank was taking unacceptable risks." (cited in Dewing and Russell 2016, p.165)

A suggestive episode directly involving politicians and money laundering is the case of HSBC, with headquarters in London. HSBC avoided criminal prosecution in the US and entered into a deferred prosecution agreement with the DOJ in 2012 (Department of Justice, December 2012). HSBC was found to have violated U.S. Anti-Money Laundering and Sanctions Laws by laundering billions of dollars linked to Mexican drug cartels, groups in Iran and Syria, and groups linked to terrorism. While HSBC apparently had systems to flag suspicious transactions, employees were told to disregard red flags (Garrett 2014, p.201). The case led to a 2016 House Committee report entitled "too big to jail" that was extensively used against the Democrats by the Trump presidential campaign (Committee on Financial Services, 2016).

The report states that on the 10th of September 2012 UK Chancellor George Osborne (the UK's chief financial minister) wrote a letter to Federal Reserve Chairman Ben Bernanke (with a copy transmitted to then Treasury Secretary Timothy Geithner). In the letter, Chancellor Osborne insinuated that the U.S. was unfairly targeting UK banks by seeking settlements that were higher than comparable settlements with U.S. banks. He also worried about what criminal sanctions against HSBC would imply for financial stability. Criminal charges could also lead to a revoked license, making the bank unable to do business in the US (Financial Times, July 2016). HSBC was eventually ordered to pay a 1.9 billion dollar fine, while another whistleblower claims that the money laundering still went on (Huffington Post, August 2013).

The FSA also appeared much more concerned about criminal sanctions against HSBC than with money laundering for the bloodiest drug cartel in history (estimated to be responsible for several tenths of thousands of murders). In fact, the house committee report states that "The FSA's Involvement in the U.S. Government's HSBC Investigations and Enforcement Actions Appears to Have Hampered the U.S. Government's Investigations and Influenced DOJ's Decision Not to Prosecute HSBC" (p.24).

Things have not improved more recently. In 2013 the FSA was split up into the Financial Conduct Authority and the Prudential Regulation Authority (FCA & PRA). In 2014 the FCA & PRA came out with a note requested by the British parliament on whether financial incentives for whistleblowers should be introduced in the UK. These financial incentives, or reward programs, are used extensively in the US in tax, procurement, and securities. The FCA & PRA came out strongly against rewards in their seven-page note, yet do not cite a single piece of evidence (PRA and FCA, 2014). Most importantly, the note contains important factual misstatements about available evidence on their effectiveness that were easy to check at the time of the report (Nyreröd & Spagnolo 2017, National Whistleblower Center 2018). Nor was the note amended when one of us repeatedly communicated the mistakes to the agencies. This suggests persistent and deep regulatory capture. Consistent with this interpretation is the sanctioning behavior of UK regulators.

A blatant recent example is the ridiculous fine against CEO of Barclays Bank Jes Staley. He ordered his security team to unveil the identity of an uncomfortable whistleblower, going so far as to request video footage of the person who bought the postage for the letter. Yet, the FCA & PRA decided to just fine him £642 000 – a small fraction of his pay package that year (Reuters, May 2018). When Moore was asked about the fine he replied that "it is a very clear sign to whistleblowers not to bother" (Reuters, April 2018).

Conclusion

Is this regulatory capture, or political capture? The impressive list of consistent cases of regulatory slack and of political complacency suggests both, at least in the case of the UK. But the problem of regulatory capture in the case of financial crimes goes way beyond the somewhat extreme case of the UK. In all jurisdictions financial misbehavior has recently only led to settlements between regulators and the infringing financial institution, with settlement payments way too low to generate (financial stability concerns, and) deterrence effects. Banking regulators appear mainly concerned about banks' health and profitability, so that large financial institutions have not only become too big to fail, but also too big to jail, and now even too big to fine, at least to the appropriate extent (Spagnolo 2015). All this even though the financial crime has been that actively supporting through money laundering criminal organizations that killed tenths of thousands of innocent people.

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