

Introduction

Riggs Bank used to be one of the most prestigious in the nation, and a venerable institution in Washington, holding the bank accounts of both Jefferson Davis and Abraham Lincoln. A famously local bank, it was nevertheless had a strong international banking arm due to its unique placement and strong networks with the Embassy community. The bank was essentially unremarkable until 2004, when it collapsed under the weight of a series of money laundering scandals. First regulators discovered that Riggs had been laundering money belonging to General Augusto Pinochet of Chile (who himself was wanted for criminal offenses in several nations). Then it appeared that Riggs laundered money for Equatorial Guinea, a regime described by the US Department of State as being “one of the most corrupt on Earth.” Finally, a series of misappropriations came to light, including the misuse of the Riggs company jet and lavish parties paid for by Riggs customers (the vast majority of whom were average Washington-area residents. A planned merger with PNC Bank was sped up, and an institution ingrained in Washington culture was swiftly dispatched.

In the wake of the money laundering affair scandal, Federal officials called for increased regulation of banks and stricter standards regarding doing business for international clients. Calls came from Congress and Federal regulators to update the Bank Secrecy Act as well as the recently-passed PATRIOT Act “to prevent Riggs from happening again” (O'Brien, 2004). But the problem with Riggs was not that anti-money laundering (AML) regulations were not strict enough. But clearly, there is no evidence to suggest that the crisis at Riggs was or is endemic to the banking system as a whole.

In the following, I will articulate the main problems faced by Riggs and show that, while there is no evidence to suggest that the corruption at Riggs is endemic to the entire banking sector. However, this does not mean that the Riggs affair does not signal some serious challenges facing banks. In particular I argue that the internal culture of banks and structure of the market create a gulf between illegal/unethical behavior and the way a bank prefers to operate. The majority of my analysis will articulate these challenges and present some solutions that may alleviate these pressures.

History of the Riggs Affair

Riggs' involvement with the Pinochet regime first appeared in company documents in a 3 November 1994 memorandum reporting on a official bank trip to Chile, the purpose being to thank the Chilean military for reinstating its business relationship with Riggs (O'Hara, 2004a). The Chilean government maintained its foreign accounts in Canada after the US Treasury Department began aggressively monitoring Chilean bank accounts following the assassination of Orlando Letelier, a Chilean diplomat. Investigators concluded that the assassination was ordered by Pinochet's regime, and in response Chilean nationals moved their assets out of the country.

The 1994 memorandum outlined the growth potential for Riggs in Chile. After twenty years of often bloody revolution, Chile was emerging from its status as an international controversy. Its strong market orientation and previous relationship with Riggs made it an attractive prospect for the bank, which had felt heavy losses as bank deregulation promoted new financial providers to enter the Washington area home mortgage market (O'Hara, 2005).

The memorandum coincided with a time when many banks struggled to meet retail customer demands. After the entry of new financial institutions into the retail banking sector, the partial failure of reaping cost savings by replacing branches with Automatic Teller Machines, and the fallout from bank deregulation policies in the 1980s, the concept of "customer relationship building" was in vogue in the retail banking sector (Durkin, 1999). The key feature of this technique involved engaging the customer in a personal way in hopes of selling them a broad range of bank services.

Viewed in this context, the admonitions that Riggs should "aggressively court" the business the Chilean government makes sense. From 1994 to 2002, Riggs officials made seven trips to Chile to deepen the evolving business relationship. Joseph. A. Allbitron, the bank's chairman and a staple of Washington's black-tie circuit, led the Riggs delegation on four of the seven occasions and met with Pinochet in 1996 and 1997.

The method by which Riggs laundered Chile's money involved creating bank accounts using false names for Pinochet and other senior leaders and setting up a series of shell trusts into which Chilean officials could deposit illicit money. One such account, The Ashburton Trust (an account

based in The Bahamas), facilitated over US \$15 million in transactions over a three year period (O'Hara, 2004a). During a routine examination by the Office of the Comptroller of the Currency in 2000, a bank examiner inquired as to the holder of the account, the Bank delayed its response. In 2002, the OCC demanded to know the identity of the trustee; faced with more serious investigations, Riggs disclosed that it was Pinochet.

The Riggs examiner at the time, R. Ashley Lee, counseled the government to not pursue action against the bank (he would later work for Riggs) three times beginning in 1999. Moreover, a Senate investigation into the Riggs affair shows that he specifically counseled the other bank examiners supervising the Riggs investigation not include information about Pinochet's accounts in the OCC electronic database (O'Hara, 2005b). Nevertheless, the government began a serious investigation into Riggs' accounts, culminating in a 2004 Senate Banking Subcommittee Report chaired by Senator Carl Levin (D-MI) and uncovering an illegal relationship not just with a number of Chilean officials but also with leaders of Equatorial Guinea. Holding accounts by nationals of these countries constituted a violation of the Banking and Securities Act.

In the end, Riggs was bought by PNC Bank in a protracted negotiation and ordered to pay US \$35 million in fines. Charges against Allbitron and other Riggs officials are pending.

Policy Ineffectiveness

The effectiveness of the Bank Secrecy Act (1970) was its provision to “deputize banks” to alert Federal officials when they suspected that lawbreaking was taking place. Banks were required to file a Suspicious Activity Report when they believed that a customer was attempting to violate the letter (or often) the spirit of the BSA. One key problem with this task is that it is difficult if not impossible to determine if a customer was trying to hide illegal money from examining spending patterns. While banks have repeatedly attempted to increase the rate at which they catch customers who break the law, many bank officials (SRC Insights, Fall 2006) “remain skeptical that their programs are effective.”

Moreover, many bank officials argue that the relationship between the bank examiner and the banking officers have deteriorated. Says one such officer: ““We've moved back to the days when you

didn't dare discuss issues with your 'in charge' examiner because it will appear in their next exam report. The examiners seem more concerned about justifying their positions by finding things, even if they have to manufacture them, than measuring the bank's compliance level" (SRC Insights, Fall Quarter 2005).

After the terrorist attacks on September 11, 2001 the pressure on banks to "do their share" increased, and the passage of the USA PATRIOT act was designed to "improve reporting [and AML] compliance" (USA PATRIOT ACT, Sec. 330). In particular, banks were required to create an AML program and appoint an AML officer responsible for its oversight. Additionally, Section 313 prohibits shell accounts, Section 312 requires bank officials to identify account holders of a correspondent account, and Section 315 redefines money laundering to include any activity that is used in order to commit a crime of violence (USA PATRIOT Act, 2001).

By some metrics, the period immediately following September 11 saw higher compliance by banks. The number of SARs filed by banks increased by nearly 20% between September 2001 and October 2001, and the numbers continued to increase (SAR Review: Trends, Tips, and Issues, 2002). But it is arguable that enforcement of laws was not becoming more strict; simply that banks were over-eager to report suspicion where none realistically existed. And soon, familiar grumblings by bank officials reappeared: A survey by [cite here] found that 40% of surveyed bank officials were indifferent to the post-9/11 money laundering laws; only 27% supported them. Those that opposed the program complained that government directives were vague, the relationship between the government and the bank was adversarial, and that the programs took up too much time and were ineffective.

It is in this environment that Riggs was able to commit its crimes. Clearly, Riggs violated many essential laws of both the BSA and the PATRIOT Act, and it is unclear how increased or different regulations would have altered Riggs' behavior. While it may be true that increased regulation of the banking sector is necessary (indeed, the evidence presented above suggests that a different approach to the banker-government relationship should govern new regulations), Riggs violated laws on already on the books, and if the laws themselves were more expansive, Riggs would have simply violated those

laws too.

True, Riggs broke the law because the internal structure of the bank was corrupt – a corruption encouraged from the Allbitron on down. But that was not the only factor governing Riggs' behavior. Indeed, the market structure of the retail bank led Riggs down a path that enabled its crimes to take place.

External Market Structure

A US Treasury Report assessed changes to the retail banking sector: “Since 1980, the US banking industry has experienced a sustained and unprecedented level of merger activity that has substantially affected the banking structure” (Rhoades, 2000). After a series of laws passed in the wake of the monetary crises of the 1970s and 1980s and a set of serious technology changes, many banks found themselves unable to compete against a growing array of non-bank financial services providers. Smaller banks especially found their customers dwindling as growing national banks began to enter local markets around the county. With smaller banks' retail balance sheets deteriorating, many local banks turned to home mortgage lending and other financial services, believing that they would have a comparative advantage against large, national conglomerates (Ibid.).

But in the Northeast and Mid-Atlantic, this venture would also soon become difficult. Cynthia Angel (2005) reports that home construction (and therefore, home mortgages) increased rapidly during the 1980s. Resulting from a number of factors, including rapid growth of the economy and a general change in the population, banks simply lent money to customers who were not good credit risks. When the Cold War ended and a brisk recession gripped the Northeast and Mid-Atlantic, many of these loans proved unrecoverable. In Washington DC, the bust of the housing market was particularly severe (Ibid.), and banks operating primarily in this market lost significant profits.

It is in this environment that Riggs found itself during the spring and autumn of 1994. Faced with paying back large capital investments left over from the 1970s and 1980s, and the recent contraction of the home mortgage sector, expanding Riggs international operation seemed like a logical and necessary choice. This does not excuse Riggs' actions, it simply provides the context for the decisions that bank officials made.

Internal Bank Culture

Joseph Allbitron famously remarked at a Riggs Board meeting in 2000 that Riggs “would take anyone's business and it wasn't the bank's job to base its relationship on a client's politics” (O'Hara, 2005). Fellow Board Member and Joseph Allbitron's wife Barbara Allbitron questioned why the Pinochet accounts needed to be closed (O'Brien, 2004) after learning from regulators that Pinochet was under investigation for a variety of human rights abuses. This culture of decision-making clearly filtered down to Carol Thompson, the bank executive in charge of the Latin American embassy and private client business for Riggs. A 2003 survey of bank managers uncovered widespread fears of expressing one's own views, and intense fear of upsetting Allbitron or his surrogates (which included Thompson). One survey (conducted after the Riggs affair became public) respondent wrote: “The bank knew that other people would think what we were doing was wrong, but we disagreed with them...so we hid [the Pinochet money].” To this date, Riggs has offered no public apology of its actions – and given its importance in Washington, DC, such a failure to account displays a serious cultural failure at the bank (O'Hara, 2005).

Jeffrey A. Sommerfield, the associate dean of management at Yale Business School, writes that there was “...a deeper set of issues in these [Riggs'] breakdowns. People know right from wrong. There is often a group-think mentality where the notions of diffusion of responsibility sets in” (Ibid.). This mentality profoundly affected Riggs, and amplified by its market position, is the efficient cause behind the company's actions.

Confined to Riggs?

The challenge, then, is to account for how much of Riggs actions can be explained by its internal culture, and how much can be explained through the structure of the market. Norm Coleman, the Minnesota Republican and former chairman of the investigative subcommittee tasked with the Riggs report, argued that Riggs' leaders were to primarily blame: “Freedom always implies a corresponding responsibility to respect the rules that society imposes on the market...Top officials did not always justify their freedom from aggressive oversight with a willingness to respect and implement their social duties” (O'Brien, 2004). Certainly, Riggs and particularly Allbitron is responsible for

creating a culture where laundering the money of a dictator known to be wanted on human rights and genocide charges was not questioned. And yet, one must wonder if the structure of the Washington market would not have been so competitive and the relationships with bank examiners so combative that the Riggs scandal would have been so pervasive.

Mark Durkin writes of the change in bank management during the mid 1990s in order to increase market share. He urges banks to embrace the concept of “relationship banking” (Durkin, 1999). Recognizing that there are few consumer relationships so intimate than a bank and its client, relationship banking was predicated on creating a life-long connection with a client, and selling a set of financial services to that client primarily through that connection. This marketing strategy, argues Durkin, would slow the losses in profits accrued over the past two decades, create a more secure customer base that would not easily switch to a competitor, and allow for specialization and the development of new, profitable services.

However, Durkin notes the serious challenges embedded in the concept of relationship banking. For both banks and consumers know that the consumer is in demand and can therefore structure the terms of the relationship. Thus there is a structural pressure to meet customer needs, regardless of what those needs may be. Durkin surveyed managers and bank employees and found that this pressure to serve the customer “at any cost” was higher in longer-tenured employees than for recently-hired ones (Ibid.). However since relationship banking implies a greater decision making latitude for front line employees, more recently hired employees felt less sense of direction and asked for more guidance in executing their actions.

This survey helps to explain Riggs behavior more clearly. A bank facing intense competitive pressure embraces the idea of relationship banking, not just for its average customers, but especially for its high-end customers. At some point in dealing with the Pinochet account, bank employees either knew or perceived that the client was attempting to launder money. But an internal culture of silence, reinforced by the hypercompetitive external market structure prevented the Pinochet accounts from being frozen.

There is insufficient evidence to judge whether the external market structure similarly affects

other banks in the industry. Indeed, since we have seen no other major bank failure other than Riggs, we must conclude that the efficient cause of the money laundering was Riggs' internal culture, not external pressure. However, by uncovering Riggs actions, it is plain to see that there are problems both in the way that bank examiners relate to banks, and in the way that the retail banking sector is structured.

Recommendations

There are steps that the Government can take to ameliorate the situation. Primarily, these include:

- **More clearly specifying the kinds of AML compliance programs expected of banks.** One generalized comment made by banks is that they want to comply with the law, but they have no guidance from Treasury or FinCen on what would compose an effective AML program. Federal Regulators, on the other hand, have an interest in remaining vague: for then if they need to they can more easily “find” violations. These dual interests mean that banks do just enough to skirt the requirements of the law, and Federal Regulators are forced to play “gotcha” auditing. A more clear set of guidelines on AML compliance would improve this situation.
- **Recognize the market pressures facing banks.** For two decades, the cost of much of key financial innovations (ATMs, credit card transactions, the growth of alternative accounts) have been born by banks. This, combined with intense local and now global competitive firms, has forced banks to seek profit wherever they can. Government regulators must be cognizant of their administered banks' position, and develop tools to ease the market pressures so that banks can develop the appropriate programs to meet compliance standards.
- **Relaunch the Bank-Regulator relationship.** Beginning with the Bank Secrecy Act of 1970, bank examiners and bank officers have worked together to stop money laundering. At times this relationship has been contentious, but other times it has been harmonious. When the parties work together it is far more likely that the partnership will be more effective than when the parties are at odds. The government should take the lead in improving this relationship since it

has supervisory power over the banks.

- **Re-examine the market structure of banks, especially mergers.** Banks are locked into heavy competition in no small part because of the merger laws passed during the 1980s and 1990s. The government should reexamine this intuition, and decide if the competitive market should be cushioned a bit to ease the pressure on banks.

Evidence from the Riggs case also finds ample opportunities for banks to improve their operations. These include:

- **Creating a culture of responsibility among employees.** Durkin finds a significant gulf between different classes of employees in meeting client needs, and evidence from Riggs shows how a corrupt culture at the top of the organization can easily filter down to less senior staff. It is essential that banks train their employees and secure a commitment from them to follow the letter and spirit of the law, even if that means refusing transactions from profitable clients.
- **More objective relationship banking.** Banks are arguably the closest service-provider to individuals throughout their lives. With a few clicks, a bank can learn more about a consumer than even a close family member or friend will ever know. This creates an incentive to look the other way when customers may be engaging in illegal behaviors but are nevertheless profitable clients. Banks must safeguard their relationship with the consumer, but be willing to terminate it if clear evidence of lawbreaking appears.
- **Develop a more sound business plan.** Small banks especially have moved from one industry fad to another, and they have mostly suffered for it. When the bank itself has no apparent direction, bank employees and executives are less secure in their operations and create a more instable environment. Instead of jumping from one sector to another, banks should decide on a sound business plan which will realistically generate revenue and then stick to it.

The above recommendations will solve most, but not all, of the challenges afflicting banks. For real progress to be made, more serious changes will be need to happen on all parties.

The Riggs scandal is not endemic to the banking industry, but it is illustrative of its challenges.

While it is unlikely that we will see another bank fail so spectacularly, should the competitive environment faced by banks grow more severe, the incentives for individual banks to cheat will undoubtedly rise.

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