Global Finance Journal 22 (2011) 19–31

Contents lists available at ScienceDirect

Global Finance Journal

journal homepage: www.elsevier.com/locate/gfj

Enforcement of the USA Patriot Act's anti-money laundering provisions: Have regulators followed a risk-based approach?

Burak Dolar [a,*], William F. Shughart II [b]

[a] Department of Business Administration, Augustana College, United States
[b] Department of Economics, University of Mississippi, United States

ARTICLE INFO

Article history:
Received 19 October 2009
Accepted 24 August 2010
Available online 20 May 2011

JEL classification:
D72
D78
H23

Keywords:
USA Patriot Act
High-risk money laundering and related financial crime areas
Anti-money laundering
Commercial banks
Heterogeneous-firm model of regulation

ABSTRACT

In this paper, we test whether or not banking regulators have followed a risk-based approach in the enforcement of the USA Patriot Act's anti-money laundering (AML) provisions. In order to do so, we compare the financial performances of banking institutions operating branches inside and outside the boundaries of counties in the State of California designated as "high-risk money laundering and related financial crime areas". Our results indicate that regulatory enforcement under the Patriot Act cannot be explained on the basis of financial institutions' relative risks of being targeted by money launderers.

1. Introduction

Money laundering is defined as the "process by which one conceals the existence, illegal source, or illegal application of income and then disguises or converts that income to make it appear legitimate" (United Nations International Drug Control Program, 1997). Money laundering poses a significant threat to the integrity and sound functioning of any financial system. One contaminated by funds generated by criminal activity loses its credibility and compromises its profitability insofar as it becomes more difficult to attract and maintain legitimate depositor accounts. According to International Money Fund estimates, the

* Corresponding author at: Department of Business Administration, Augustana College, 639 38th Street, Rock Island, IL 61201, United States. Tel.: +1 309 794 8946; fax: +1 309 794 7625.
E-mail address: brockdolar@augustana.edu (B. Dolar).

1044-0283/$ – see front matter
doi:10.1016/j.gfj.2011.05.002

volume of money laundered internationally ranges between $1245 billion and $3113 billion annually, sums representing from 2% to 5% of world GDP based on 2008 Central Intelligence Agency data.[1] The United States experiences the highest level of money laundering activity of any single country. It is estimated that half of the world's money laundering activity takes place in the US financial system as a whole, with almost half of it laundered through US banks (Charles, 2004).

The history of US anti-money laundering (AML) legislation starts with the passage of the 1970 Bank Secrecy Act (BSA), which was enacted in response to then-growing concerns about the vulnerability of financial institutions to organized criminal enterprises, especially those engaged in narcotics trafficking. Worries regarding the mounting volume, scope, and complexity of money laundering activity led, in the 1980s and 1990s, to the passage of another six AML regulations. The terrorist attacks of September 11, 2001, and the USA Patriot Act of 2001, the legislative response to those attacks, triggered dramatic changes in the fight against money laundering in the United States as well as the rest of the world.

Title III of the Patriot Act, also known as the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001, strengthened existing AML regulations significantly. The 2001 law expanded the focus of money laundering to include terrorist financing, enlarged the number of financial and non-financial institutions subject to AML measures, and introduced new requirements that not only are national but international in their scope and application.

Commercial banks face the most stringent requirements under 2001's AML mandates (Mandell, 2003). The Patriot Act has imposed considerable compliance costs on the entire banking industry, which are the direct and most visible effects of the law. Equally important, but less discernible "indirect effects" of the Patriot Act may arise from uneven enforcement of the new AML rules. In this study, we seek evidence of compliance-cost asymmetries resulting from the enforcement of the Patriot Act's AML provisions and test whether or not such asymmetries can be explained by differences in financial institutions' exposures to money-laundering risk.[2] In order to do so, we examine the effects of the Patriot Act on a number of performance indicators (i.e., return on assets, total assets per employee, and the ratio of non-interest expenses to net income) of commercial banks, savings and loan associations, and savings banks (the latter two are also called "thrifts") operating in the State of California.

We use a dataset derived from banking institutions in California because the designation of "high-risk money laundering and related financial crime areas" (HIFCAs) there supplies the basis for a natural experiment. Comparing the performances of banks operating branches in California's HIFCA counties, where AML enforcement is expected to be more stringent due to greater perceived money-laundering risks, with those operating branches in non-HIFCA counties, enables us to test whether regulatory agencies have followed a risk-based approach in designing and supervising the Patriot Act's regulatory controls. The HIFCAs were first conceived in The Money Laundering and Financial Crimes Strategy Act of, 1998, which called for the designation of "high-risk areas" in which money laundering and related financial crimes were thought to be likely. One of the main objectives of the HIFCA designations is to concentrate AML law enforcement resources in regions at greatest risk (US Department of the Treasury and US Department of Justice, 2000). The State of California is home to two HIFCAs. The National Money Laundering Strategy for 2000 designated seven counties in the Southern California District as areas at high-risk to money laundering and related financial crimes. The following year's AML strategy created the Northern California District, which includes another 14 counties.

Our empirical results do not lend support to the hypothesis of a risk-based approach to regulation. The asymmetrical compliance-cost burdens associated with the enforcement of the Patriot Act's AML provisions cannot be explained on the basis of the differential money-laundering risks posed by financial institutions located in the two California HIFCAs. Interestingly, holding other factors constant, we find that the financial performances of institutions identified as being more vulnerable to money laundering have improved in the post-Patriot Act period relative to the institutions considered less vulnerable.

[1] By way of comparison, the combined GDPs of Canada and India, the world's 11th and 12th largest economies, respectively, amounted to $2801 billion in 2008 (Central Intelligence Agency, 2009).

[2] According to Bartel & Thomas (1985), enforcement asymmetries exist when regulations are enforced more stringently on a subset of firms in an industry.