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Banks - Europe

FAQ: Money laundering and economic sanction breaches remain costly threats

Between 2012 and 2018, European banks paid over \$16 billion in fines for facilitating money laundering,¹ trade sanction breaches and weaknesses in money laundering compliance controls. Most of these fines were imposed by US regulators, led by the Department of Justice (DoJ), which levied over 75% of fines during this period. European regulators are now imposing larger penalties than previously, as illustrated by the Dutch Public Prosecution Service's (DPPS) \$915 million fine against ING Groep N.V. (Baa1 stable) in September 2018.

Although most of these fines have been lower than the affected banks' annual pre-tax earnings, they remain costly for European banks, posing material financial, operational, and reputational risks.

In some cases, supervisors have offered banks deferred prosecutions in exchange for a period of additional regulatory oversight, during which they must improve their risk and governance frameworks. This usually entails sustained large-scale investment in their compliance and operations functions, which although credit positive, can create a drag on profitability. New regulations, such as the European Union's (EU) updated Anti-Money Laundering Directive (AMLD 5), are designed to reduce the likelihood of large financial penalties by encouraging banks to halt money laundering pre-emptively.

Nevertheless, various probes into potential money laundering and trade sanction breaches are currently under way. The DoJ and the US Securities and Exchange Commission (SEC) are both investigating Danske Bank (A2/A2 negative, baa1), which in October 2018 admitted to failures in the anti-money laundering (AML) controls of its Estonian branch between 2007 and 2015. Swedbank (Aa2/Aa2 stable, a3) is also under investigation for alleged weak AML controls, with multiple regulators undertaking investigations into its Baltic operations. Preliminary investigations are also ongoing at other Nordic banks, both internally and externally. In addition, Italy's central bank has identified shortcomings in the AML processes of ING Italy, the Italian subsidiary of ING Groep N.V., and has prohibited the bank from taking on new customers in Italy until further notice.

Recent regulatory investigations highlight the importance of Environmental, Social and Governance (ESG) considerations in banks' risk frameworks. Below we answer frequently asked questions regarding the impact of money laundering and economic sanctions on European banks.

What is money laundering?

Money laundering is the process whereby the proceeds of illegal activity are subsequently made to appear legitimate. The laundering process usually takes place in three phases. First "placement" whereby the "dirty" money is deposited into a bank account, second "layering," where money is transferred to offshore or shell company accounts, and third "integration/extraction," which routes the money back to different onshore bank accounts.

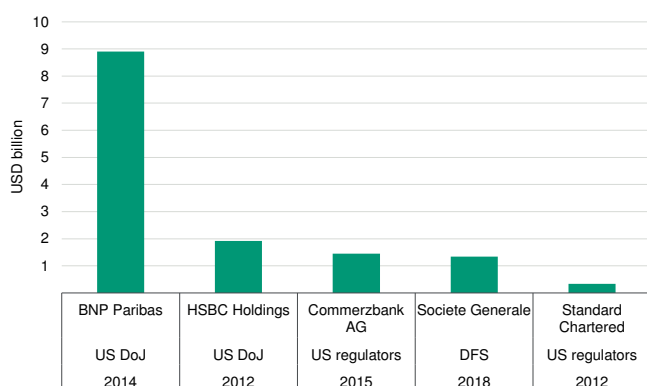
What are trade sanctions?

Sanctions and trade restrictions are placed on countries, companies and individuals to prevent or restrict businesses from trading with them. If businesses or banks trade with or for an entity that is subject to sanctions, they are likely to face penalties from regulators in the country that initiated the sanctions. They could also be prevented from trading within that country. Sanctions breaches are often categorized alongside money laundering, as they also rely on clandestine money transfers using structures such as shell companies and offshore accounts.

Which European banks have paid the largest money laundering fines and economic sanctions?

Exhibit 1

Five largest fines imposed on European banks for economic sanctions breaches (\$ billion)

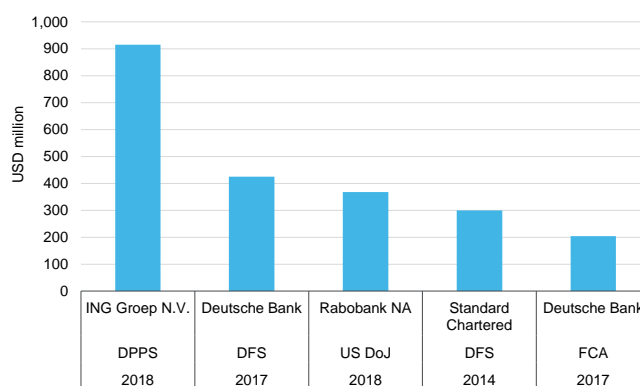


Acronyms: US DoJ - United States Department of Justice, DFS - New York's State Department of Financial Services, FCA - United Kingdom Financial Conduct Authority. Notes: HSBC Holdings was fined by the US DoJ for both economic sanctions and money laundering breaches. Commerzbank AG's fine in 2015 was a settlement with the US Department of Justice (DoJ), OFAC, DANY, Federal Reserve and New York's Department of Financial Services (DFS). Standard Chartered's fine in 2012 was a settlement with the DFS, OFAC, DANY, the DOJ and the Federal Reserve.

Source: Moody's Investors Service

Exhibit 2

Five largest fines imposed on European banks for money laundering breaches (\$ million)



Acronyms: DPPS - Dutch Public Prosecution Service

Source: Moody's Investors Service

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Below we list the five European banks that have paid money laundering and economic sanction fines in excess of \$900 million since 2012.

BNP Paribas (Aa3/Aa3 stable, baa1) – 2014 - \$8.9 billion

In 2014, BNPP agreed to forfeit \$8.9 billion after pleading guilty to illegally conducting financial transactions on behalf of Cuban, Iranian and Sudanese entities which were subject to US sanctions. The penalty was equivalent to the sum of the illegal transactions. To date, this is the largest penalty paid by a single bank in relation to money laundering or sanctions breaches. BNPP terminated the employment of a number of staff involved in the activities under investigation, and partially suspended US dollar clearing operations at its New York branch, where the misconduct was centered, for one year. The bank also extended monitoring procedures that had been put in place in 2013 for a further two years.

HSBC Holdings plc (A2 stable, a2) – 2012 - \$1.9 billion

In 2012, HSBC agreed to a settlement of \$1.9 billion and entered a deferred prosecution agreement (DPA) with the DoJ after it emerged that lapses in the controls of the bank's US operations had facilitated large-scale laundering of money originating in Mexico. A large proportion of the money laundered was connected to the Black Market Peso Exchange (BMPE), a complex system used to move large amounts of money generated from trafficking drugs in the US to countries outside the US. HSBC also violated US sanctions by conducting transactions on behalf of customers in Burma, Cuba, Iran, Libya, and Sudan. As part of the DPA, HSBC was required to enhance its internal compliance procedures and make structural changes across its global operations to prevent future lapses.

Commerzbank AG (A1/A1 stable, baa2) – 2015 - \$1.45 billion

Commerzbank agreed in 2015 to pay penalties totalling \$1.45 billion to five US agencies for facilitating financial transactions with countries on the US sanctions list, including Iran and Sudan, between 2002 and 2008. Commerzbank also entered into a deferred prosecution agreement with the US DoJ and the New York County District Attorney's Office for violations of governance practices in relation to money laundering between 2008 and 2013. The combined penalties included forfeited revenues of \$563 million, a \$79 million fine imposed by the DoJ, a \$258.6 million fine levied by the Treasury Department's Office of Foreign Assets Control (OFAC), which was satisfied by payments made to the DoJ, and a \$610 million fine levied by the New York State Department of Financial Services (DFS).

Société Générale (A1/A1 stable, baa2) – 2018 - \$1.3 billion

In 2018, various US regulators and agencies including the New York State Department of Financial Services (DFS) imposed a \$1.3 billion fine on Société Générale for conducting financial transactions with entities in countries subject to US sanctions and embargoes, including Cuba, Iran, Libya and Sudan. Société Générale also entered into a consent order with the DFS to fix identified deficiencies in the risk management and compliance programs of its New York branch.

ING Groep N.V. (Baa1 stable) – 2018 - \$0.9 billion

In 2018, ING Groep was fined \$915 million by the Dutch Public Prosecution Service (DPPS) for failing to detect money laundering, and for shortcomings in the execution of documentation, classification and review processes it had put in place related to customer due diligence (CDD) between 2010 and 2016. The penalty consisted of a fine of \$800 million, plus a further \$115 million representing underspend in the Netherlands on staffing for the implementation and execution of financial economic crime CDD policies and procedures during the period under investigation. After the start of the external investigation, ING also launched an internal investigation which identified risk failures at management level. This led to reductions in bonuses for senior executives, and in some cases to their suspension from duty. In the investigations no evidence or indications were found of employees having actively cooperated with clients to commit financial economic crime.

ING implemented initiatives to address shortcomings, including strengthening of 'know you customer' (KYC) and 'client activity monitoring'. This included centralising KYC data across divisions and introducing an engagement program to further enhance internal awareness. ING also cooperated with the US Securities and Exchange Commission (SEC). However, ING now expects no further action, given the remedial action and settlement agreed with the DPPS.

What is the typical time lag between the initial infringement and the payment of regulatory fines?

As shown in Exhibit 2, lengthy legal processes mean that European banks often pay regulatory fines over a decade after the initial breach. Assessing the impact on banks' capital and profitability is therefore difficult, as full litigation costs may not be realised for many years.

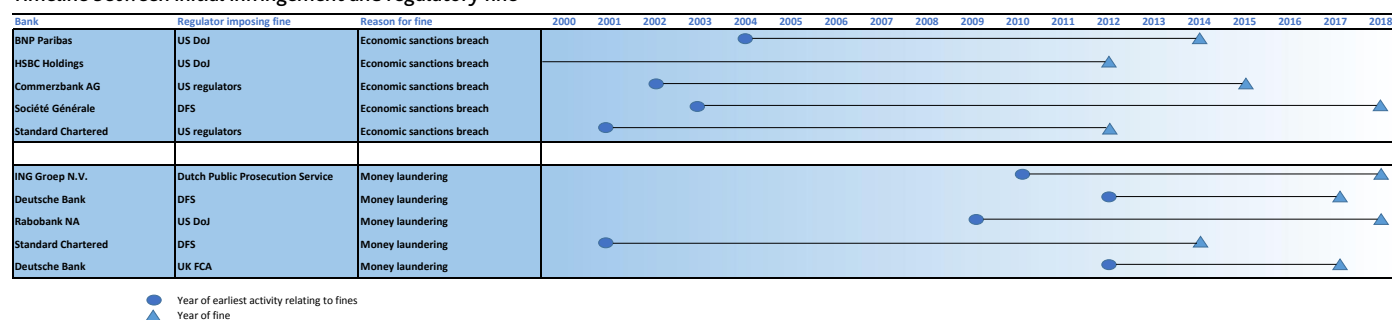
While banks have had to pay large one-off fines, they have also had to bear the ongoing expense of bringing their AML functions back into compliance. In most cases this requires sustained investment over many years, and is likely to cost more than the penalty imposed by the regulator.

It is important that banks implement a rigorous corporate governance structure, and continue to invest in their compliance functions, to ensure infringements are identified at an early stage. Infringements which are not detected by internal procedures are likely to lead to regulatory investigations, which can be lengthy. Adverse media coverage is also likely to negatively impact the franchise in the interim period.

Exhibit 3

Regulatory fines may not emerge until years after the initial infringement

Timeline between initial infringement and regulatory fine



Acronyms: (US DoJ) United States Department of Justice, (DFS) New York's Department of Financial Services, (FCA) United Kingdom Financial Conduct Authority. HSBC's economic sanctions activity dates back to the mid-1990s.

Source: Moody's Investor Service

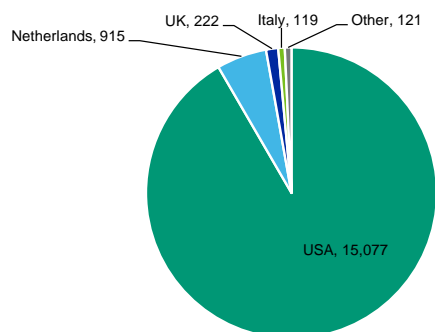
In some cases, regulators have offered banks deferred prosecution agreements under which the lenders receive an amnesty in return for accepting certain conditions. These include additional supervisory oversight over their risk activities for a specific period of time, structural changes to operations, and the deferral of compensation to senior executives.

Which regulators have been most active in levying fines for money laundering failures?

US regulators have imposed the majority of the money laundering-related penalties paid by European banks in recent years (see Exhibit 3). The US has been particularly active in pursuing overseas banks that do not comply with its AML and economic sanctions regulations, as well as those found to have conducted business with individuals, businesses or states subject to US sanctions.

Exhibit 4

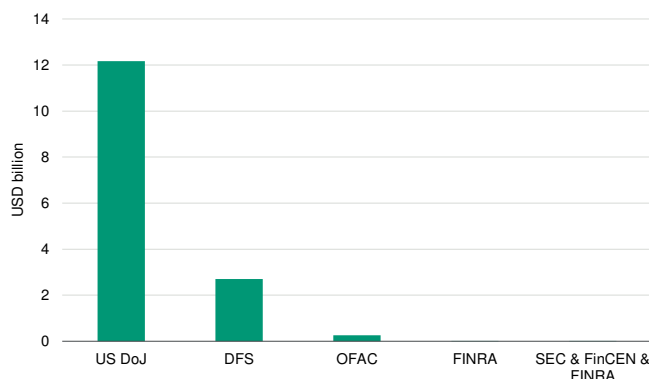
US regulators have imposed the majority of the economic sanctions breaches and AML penalties paid by European banks (\$ million)



Source: Moody's Investor Service

Exhibit 5

The US DoJ has imposed the vast majority of economic sanctions breaches and AML fines on European banks (\$ million)



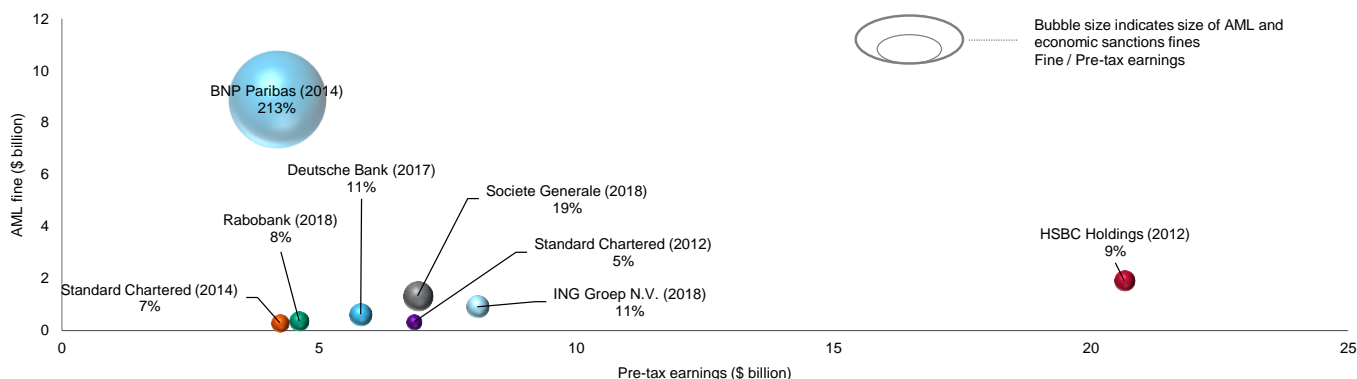
This graph gives a detailed breakdown of fines levied by US regulators. Standard Chartered fine in 2012 levied by multiple US regulators shown exclusively in the US DoJ total. This is due to being unable to clearly distinguish the amount of the fine, levied by each US agency.

Source: Moody's Investor Service

The US DoJ is responsible for the vast majority of the money laundering fines imposed on European banks (see Exhibit 4). Within Europe, the UK's Financial Conduct Authority (FCA) has been one of the most active regulatory bodies in investigating money laundering, although national supervisors across the region have imposed money laundering-related fines (Exhibit 5). The largest single penalty levied by a European regulator was the DPPS' \$915 million fine against ING in 2018. With the exception of BNP Paribas, European banks have been able to fully absorb fines levied by regulators from pre-tax earnings in the year of the fine (see Exhibit 5).

Exhibit 6

BNP Paribas has incurred the biggest fine as a share of pre-tax revenue to date
Largest AML and economic sanctions breaches fines paid by banks, % of pre-tax revenue in year of fine



Deutsche Bank total fine shown includes both the UK Financial Conduct Authority and US New York State Department fine. Commerzbank AG is not shown, as pre-tax earnings were negative in the year of fine.

Source: Moody's Investor Service

What are European regulators and banks doing to prevent money laundering?

On 19 June 2018, the European Union introduced its fifth Anti-Money Laundering Directive (AMLD 5), which member states must transpose into national law by January 2020. The new Directive extends its remit to include virtual currency platforms and tax related services. It also aims to improve centralised databases and enhance the powers of financial intelligence units (FIUs) to facilitate cooperation among national regulators and authorities. The directive is designed to prevent money laundering by eliminating loopholes at an earlier stage.

Under AMLD 5, the "central transparency register," a database containing bank account holder identity information, will be made available to the public for the first time, whereas previously only government agencies had access. AMLD 5 also improves on AMLD 4 by mandating FIUs and AML authorities to use national central bank account registers across all member states. The objective is to try and combat cross-border money laundering activities and provide a centralised database which can be accessed in a timely manner, so criminal activities can be disrupted at an earlier stage.

Updated criteria have also been developed to identify high risk countries, where systematic controls over all incoming and outgoing transactions are required. The objective is to manage known deficiencies in the treatment of AML and Counter Terrorism Financing in third countries, as listed by the European Commission. The new directive also limits the use of prepaid cards to a maximum transaction amount of €150 (formerly €250), if used in store, or €50 online.

The UK's FCA, which oversees Europe's biggest financial centre, has been monitoring the money laundering controls and governance of the banks it supervises every year since 2012 through its Systematic AML Programme (SAMPLP). This annual assessment considers what improvements banks need to make, and how these changes are being implemented.

Banks globally have come together to combat money laundering via the Wolfsberg Group, an association of thirteen G-SIB banks² dedicated to developing management guidance in the area of financial crime. The group focuses in particular on Know Your Customer (KYC) and AML issues, as well as counter terrorist financing policies.

Banks have made significant investments to improve their Know Your Customer (KYC) systems and processes, and are increasingly using artificial intelligence and machine learning to identify suspicious customer transactions. This is likely to continue, as money laundering becomes more sophisticated.

Banks have also embarked on a program of de-risking designed to avoid breaches that might incur legal and regulatory penalties. This has led to the closure of client accounts that might be linked to money laundering. The move also comes in response to increased capital requirements imposed by regulators for doing business with riskier clients.

AML deficiencies can be exacerbated by poor governance controls and lack of accountability by senior executives. Banks operate several layers of oversight, starting at the operating level, followed by a dedicated financial crime unit, which in turn reports into the main group risk board.

The board of directors is ultimately responsible for the prevention of money laundering, with implementation delegated to the CEO to manage day-to-day controls. Internal audit plays an important role in identifying and challenging flawed governance processes, and in highlighting warning signals. To prevent interference or bias, the internal audit function typically reports directly to the audit committee, not to management to prevent any interference or bias.

Is Danske Bank sufficiently capitalised to absorb the costs relating to money laundering investigations?

In 2018, Danske Bank A/S (A2/A2 negative, baa1) admitted to failures in the AML controls of its Estonian branch, leading to the departure of its CEO. Although Danske's Baltic operations accounted for only a small proportion of the overall group, the potential reputational risk to the bank's franchise is significant. Danske Bank has also seen its funding costs increase due to increased regulatory scrutiny and uncertainty around potential financial penalties.

The investigation and litigation process could last for several years. Given the varied nature of the potential penalties, it is difficult to assess the ultimate financial impact on Danske. However, the bank has increased its short to medium-term core equity tier one (CET1) ratio target to 16% from 14-15% previously. The increase came in response to the Danish FSA's decision that it needs to set aside a minimum of DKK 10 billion (USD 1.7 billion) in Pillar II capital to cover "heightened compliance and reputational risks". Danske has also cancelled its share buy-back programme. Danske expects that once it receives the potential fine(s) and/or settlement(s), it will be able to release most of the DKK 10 billion Pillar II requirement.

We have modelled Danske's ability to build up additional capital through retained profits to pay any potential financial penalty. We estimate the bank would be able to generate an additional c.5 percentage points of CET1 capital over three years, based on our forecasted net income. This assumes constant risk weights and minimal dividend payments.

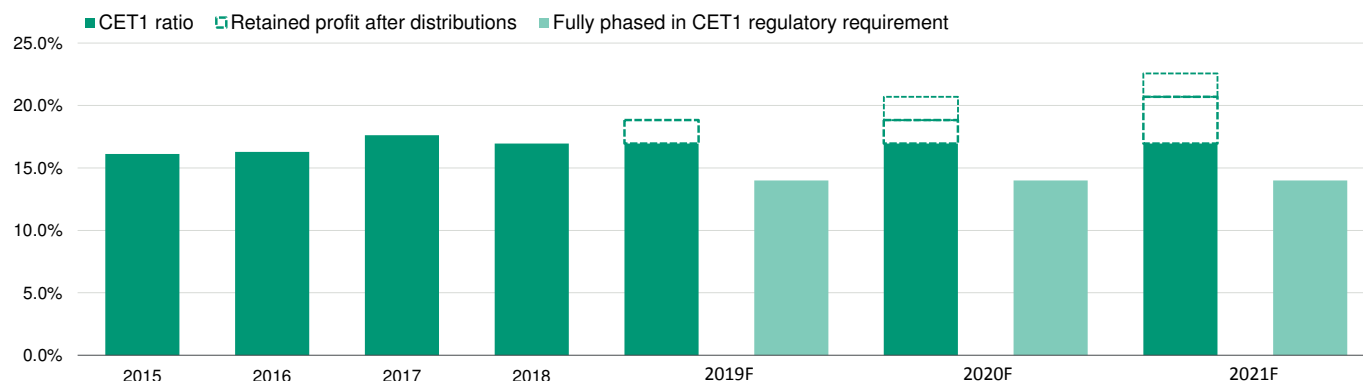
An additional c.5 percentage points of CET1 capital over three years would increase the existing buffer between Danske's end-2018 reported CET1 ratio of 17%, and its fully phased-in requirement of 14% (Exhibit 6). It would also provide a further buffer of c.5 percentage points to absorb any potential hit to total capital that may result from the regulatory investigations.

In this scenario, we believe Danske bank would be able to absorb a moderate initial fine, though it would remain exposed to the tail risk of regulators subsequently imposing a more severe penalty. Potential reputational damage from the ongoing investigation continues to pose further risks to Danske's franchise.

Exhibit 7

Danske Bank has scope to build up additional capital

Danske Bank's actual and illustrative CET1 ratios and regulatory requirement



We assume average consensus net income for 2019, 2020 and 2021.

Source: Company report and Moody's Investors Service

What is the likely credit impact of ongoing investigations into Swedbank and other European banks?

Since Danske Bank's admission of AML failures, Swedbank AB's (Aa2/Aa2 stable, a3) has also come under regulatory scrutiny in relation to potential AML breaches.

On 28 March, Swedbank's board of directors dismissed President and CEO Birgitte Bonnesen ahead of the bank's annual general meeting. Bonnesen's dismissal came one day after the Swedish Economic Crime Authority (SECA) expanded its investigation into allegations of unlawful disclosure of inside information regarding potential money laundering in the Baltics to include aggravated swindling, following a raid at Swedbank's Stockholm headquarters.

These developments are credit negative because they expose the bank to potential regulatory investigations, penalties and reputational damage. Although Swedbank, as one of the largest retail banks in Sweden and the Baltic countries, is highly capitalised and profitable, and thus resilient to market shocks, its heavy reliance on market funding renders the bank sensitive to shifts in investor sentiment.

The chain of events leading up to Bonnesen's dismissal dates back half a year, when she explained during the bank's third-quarter 2018 results presentation why Swedbank's Baltic operations are less exposed to money-laundering activities than Danske Bank A/S. Danske Bank is under investigation in several jurisdictions for apparent large-scale money laundering at the Estonian branch between 2007 and 2015. Bonnesen argued during the presentation that Swedbank's focus on local customers and its level of cross-border payments was in line with its balance sheet size in the market.

However, "Uppdrag Granskning," an investigative journalism program broadcast on Swedish television network Sveriges Television, aired three programs, the first on 20 February, that uncovered allegedly questionable transactions stemming from Swedbank's Baltic operations. A later episode further claimed that the bank had not answered exhaustively a request for information by the New York Department of Financial Services.

SECA on 27 February launched an investigation into Swedbank that initially probed whether the bank unlawfully disclosed inside information to the bank's 15 largest owners regarding revelations of potential money laundering ahead of the "Uppdrag Granskning" broadcast. The SECA expanded its investigation on 27 March to the more severe allegation of aggravated swindling, which refers to a claim that the bank knew more about the Baltic transactions than it had conveyed publicly, thereby spreading misleading information to the public and the market.

Swedbank has consistently stated that it takes its anti-money-laundering responsibilities seriously, and Bonnesen announced on 22 March that the bank had created a specialized Financial Crime Intelligence Unit focusing on criminal behaviour.

Other Scandinavian banks have also come under scrutiny from regulators, which have highlighted weaknesses in their AML functions, with investigations still ongoing.

Separately, Italy's central bank in March 2019 identified shortcomings in the AML processes of ING Italy, the Italian subsidiary of ING Groep N.V., following routine on-site inspections between October 2018 and January 2019. As a consequence, ING Italy is not permitted to on-board new customers until these shortcomings have been fixed.

In these cases, regulators have highlighted failings in internal governance controls, often because main operating entities have not maintained sufficient oversight of their subsidiaries' day-to-day operations. Weak internal audit functions have also failed to identify ongoing infringements, which may have been remediated if discovered at an earlier stage.

Endnotes

¹ We do not consider fines levied for tax avoidance.

² Globally Systemically Important Banks: Banco Santander, Bank of America, Barclays, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan Chase, MUFG Bank, Société Générale, Standard Chartered and UBS

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