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Risk Management and Regulatory Failures at Riggs Bank and UBS: Lessons Learned
Before the Subcommittee on Oversight and Investigations, Committee on Financial
Services, U.S. House of Representatives**

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Introduction

Chairwoman Kelly, Representative Gutierrez and members of the Subcommittee, I am pleased to be here this morning to discuss certain recent events relating to the Federal Reserve's Extended Custodial Inventory ("ECI") program. With me from the Federal Reserve Board are Katherine Wheatley, Assistant General Counsel, and Michael Lambert, Financial Services Cash Manager. Today, I will focus on the Federal Reserve Bank of New York's ("New York Fed") responses to the deceptive conduct of one of the former operators of an ECI facility, namely UBS, a Swiss banking organization. UBS operated an ECI site in Zurich, Switzerland, until late October of 2003 when the New York Fed terminated its contract with UBS for serious breaches. More recently, the Federal Reserve assessed a \$100 million civil money penalty against UBS for its deceptive conduct both in connection with its performance under the ECI contract, and with respect to the investigation into that performance.

My remarks today will cover four topics. First, I will provide some background regarding the ECI program. Second, I will review the chronology surrounding our discovery that UBS had violated its ECI Agreement with the Federal Reserve Bank of New York by engaging in U.S. dollar ("USD") banknote transactions with countries subject to sanctions by the U.S. Department of the Treasury's Office of Foreign Assets Control ("OFAC"), and, moreover, that certain former officers and employees of UBS had intentionally deceived the New York Fed in order to conceal

those transactions. Third, I will explain the rationale behind our decision to assess a civil money penalty in the amount of \$100 million and will distinguish this punitive action from the earlier action for breach of contract and the remedial action of the Swiss supervisor, the Swiss Federal Banking Commission (referred to as the “EBK”). Fourth, I will discuss the steps the New York Fed has taken with respect to its remaining ECI operators so as to improve the controls relating to OFAC compliance.

Background on the ECI Program

Let me now describe the ECI program. The ECI program serves as a means to facilitate the international distribution of U.S. banknotes, permit the repatriation of old design banknotes, promote the recirculation of fit new-design currency, and strengthen U.S. information gathering capabilities on the international use of U.S. currency and sources of U.S. banknote counterfeiting abroad. ECI facilities function as overseas cash depots operated by private-sector commercial banks. These banks hold currency for the New York Fed on a custodial basis.

It is estimated that as much as two-thirds of the value of all Federal Reserve Notes now in circulation, or more than \$400 billion of the \$680 billion now in circulation, is held abroad. While many financial institutions trade U.S. dollars in the foreign exchange markets, no more than thirty institutions worldwide participate in the wholesale buying and selling of physical USD banknotes. Wholesale banknote dealers purchase approximately 90 percent of the U.S. banknotes that are exported to international markets from the New York Fed.

Working with the U.S. Department of the Treasury, the Federal Reserve introduced the ECI program as a pilot in 1996 to aid in the introduction of the \$100 new

currency design note, and in recognition that an assured supply of U.S. currency abroad would help to alleviate any uncertainty that might have been associated with a new design. The pilot program succeeded in ensuring the orderly introduction of the new design banknotes by providing ready supplies of such notes, particularly in the European and former Soviet Union markets.

After supporting the successful introduction of the new design \$100 banknote in 1996, the primary purpose of the ECI program shifted to enhancing the international banknote distribution system. Currently, there are a total of eight ECI facilities in five cities that are operated by five banks: American Express Bank (London), Bank of America (Hong Kong, Zurich), HSBC Bank USA (London, Frankfurt, Hong Kong), Royal Bank of Scotland (London), and United Overseas Bank (Singapore).

The New York Fed manages the ECI program and provides management oversight and monitoring of it. We coordinate the shipment and receipt of currency between our offices and the ECIs. All banknotes contained within an ECI vault and while being transported between the New York Fed and an ECI vault, remain on the books of the New York Fed. When banknotes are withdrawn from the ECI vault to fill a banknote order from a third party, or for an ECI operator's use, the ECI operator's account at the New York Fed is debited accordingly. When banknotes are deposited into the ECI vault and augment the New York Fed inventory, the operator's account at the New York Fed will be credited.

The relationship between ECI operators and the New York Fed is governed by an ECI Agreement and a Manual of Procedures for the ECI Program ("Manual of Procedures"). From the start of the ECI program, the ECI Agreement has

specifically prohibited ECI operators from engaging in transactions with OFAC sanctioned countries. In addition, since the beginning of the program, the ECI Agreement and the Manual of Procedures have required ECI operators to provide the New York Fed with monthly reports showing all countries that engaged in U.S. dollar transactions with the operator during the preceding month and the volume of those transactions.

The ECI program facilitates the international distribution of U.S. currency by maintaining sufficient inventory of Federal Reserve notes in strategically located international distribution centers. The ECIs also are a key part of the Federal Reserve's and Treasury's efforts to distribute currency to the major global financial markets during times of crises. In the wake of the September 11th attacks, when air transportation was seriously disrupted, having U.S. currency already positioned at the ECI facilities enabled the Federal Reserve to satisfy heightened international demand for U.S. currency in the major financial markets without any interruption of service.

In addition to its role in international currency distribution, the ECI program is critical to ensuring the quality of U.S. currency abroad. ECIs are required to sort currency purchased from market participants both by currency design (old and new) and into fit and unfit notes. These requirements ensure that old design and unfit notes are removed from circulation in a timely fashion. ECIs are also responsible for authenticating banknotes purchased in the market. The ECIs detect counterfeit notes as they circulate in significant offshore money markets, and quickly report information on the geographic sources of these counterfeit notes to the Secret Service.

Finally, the information provided by the ECIs to the New York Fed regarding country level flows of payments, and receipts of U.S. dollars is important to the Federal Reserve, the Treasury, and the United States Secret Service because it provides a valuable tool for estimating stocks and flows of U.S. currency abroad, particularly for countries about which little information was available previously. Before the ECI program, the United States had little or no access to this mission-critical information about overseas counterfeiting and currency flows that is now required by the ECI Agreements.

The Chronology

I will now turn to the chronology of events surrounding the discovery that UBS had engaged in ECI transactions with OFAC-sanctioned countries and had concealed those transactions from the New York Fed.

On April 20, 2003, the Sunday New York Times reported that U.S. armed forces had discovered, in Baghdad, approximately \$650 million in United States currency. According to the article, the wrapping on the currency indicated that it originated, in part, from the New York Fed. Upon reading this article, I sent an e-mail directing staff at the New York Fed to attempt to determine how currency bearing the mark of the Federal Reserve Bank of New York might have traveled from our offices to Baghdad. Around the same date, staff from the Board of Governors of the Federal Reserve System (“Board of Governors”) in Washington were contacted by the Treasury Department and asked to assist in tracing the same currency. Also at this time, staff at the New York Fed and other Reserve Banks received telephone calls from agents of the U.S. Customs Service seeking information regarding the discovered banknotes.

Within days, the New York Fed received serial numbers for a small sample of the banknotes found in Iraq. By April 24, 2003, our cash staff in East Rutherford, N.J., had determined, using serial number records, that the sampled notes were part of twenty-four shipments that had been sent from our offices to three of our ECI facilities: HSBC in London, Bank of America in Zurich and UBS in Zurich. Over the next few weeks, we received additional serial numbers from other samples of the discovered currency as well as serial numbers from samples of an additional \$112 million that was discovered in Iraq shortly after the initial hoard. We successfully traced those serial numbers to the same three ECI facilities, as well as to HSBC's ECI facilities in Frankfurt and London; to the Royal Bank of Scotland's ECI facility in London; to a number of commercial banks in the United States and abroad; and to several foreign central banks.

In an effort to follow the currency trail further, in early May of 2003, we contacted each of the ECI operators, and one of the commercial banks that had done a large volume of relevant currency purchases, and asked them to provide us with information regarding the counterparties to whom they sold the identified banknotes. By the end of May, we had received responses from HSBC and Bank of America that included, for HSBC, specific counterparty information, and for Bank of America, more general country information, for the relevant shipments. No transactions with Iraq or any other OFAC-sanctioned countries were contained in these responses. Our investigative efforts to follow the trail of the currency discovered in Iraq are continuing.

UBS responded to our inquiry by advising that it did not track serial numbers for its banknote sales. In the alternative, UBS agreed to provide information

regarding shipments of currency from the ECI that corresponded closely to the dates on which the notes found in Iraq had been shipped from the New York Fed's New Jersey office to the UBS ECI. UBS also informed the New York Fed that Swiss law considerations precluded the sharing of specific counterparty names. Accordingly, only country destinations could be provided. On June 25, 2003, UBS provided a report to one of our cash officers, who was in Zurich for a periodic site inspection. The report purported to list the relevant shipments by date and included the countries to which the banknotes were sold and the amounts in each shipment. While no transactions with Iraq were identified, included in this report were entries representing eight shipments of banknotes to Iran. Of course, we had not expected such a disclosure as currency transactions with Iran were expressly prohibited by the ECI Agreement.

Upon learning that UBS had sold banknotes to Iran, we asked UBS to explain how these Iranian transactions could have occurred in view of the clear contractual prohibition in the ECI Agreement against shipping currency to countries that are the subject of regulations issued by OFAC. We also inquired as to why these transactions had not appeared on the monthly dollar transaction reports that UBS was required to provide to the New York Fed pursuant to the ECI Agreement. UBS responded that the transactions with Iran were done by mistake. Further, with respect to our specific questions directed at the false monthly reports, UBS banknote personnel provided a facially plausible, but false, explanation. The explanation was that the reports were the result of an innocent mistake and not an intentional deception.

In early July of 2003, New York Fed management concluded that the transactions by our ECI operator, UBS, with Iran constituted a material event that needed

to be reported. Consequently, on July 11, 2003, I sent a memorandum reciting the facts known then to the New York Fed's board of directors, which, under Section 4 of the Federal Reserve Act, exercises "supervision and control" of the Bank management. In addition, the New York Fed disclosed what we knew to senior staff at OFAC, the Board of Governors, and the Department of the Treasury. The UBS situation was discussed with the New York Fed's board of directors at its meeting on July 17, 2003. The directors concurred in the management recommendation to more fully understand the facts by involving UBS's home country supervisor, the EBK, and when the facts were fully understood, to make a decision with respect to contract termination.

On July 22, 2003, I met with representatives of the EBK in Switzerland to discuss how to move forward with an inquiry. I explained to the representatives that, to avoid termination of its ECI contract, UBS would have to provide the New York Fed with reassurance as to its compliance. I emphasized that the New York Fed could not tolerate a repeat violation. I also told the EBK that I was not satisfied with the explanation proffered by UBS concerning the monthly reports. It was agreed that the New York Fed would draft questions regarding UBS's compliance with OFAC regulations in the operation of the ECI and that Ernst and Young ("E&Y"), UBS's outside auditor, would review the operation and prepare responses to our questions.

In late July of 2003, E&Y began its review of UBS's ECI operation. During the course of this review, which concluded in October of 2003, E&Y learned that in addition to the transactions with Iran, UBS had also engaged in banknote purchase transactions with Cuba, another country on the OFAC list, and that the banknotes had been deposited into the ECI. E&Y also learned that, in preparing the monthly dollar

transaction reports, personnel in UBS's banknotes operation had concealed the Cuban transactions from the New York Fed. E&Y informed senior UBS personnel of its findings and encouraged UBS to disclose the information to the EBK and to the New York Fed.

In mid-October, UBS disclosed to the EBK that, in addition to the transactions with Iran, it had engaged in USD banknote transactions with Cuba that involved the ECI. The EBK advised UBS to disclose the transactions to the New York Fed. Late on Friday, October 24, 2003, representatives of UBS met with me at the New York Fed. They told me that UBS had engaged in transactions not only with Iran, but also with Cuba, and with Libya, yet another country on the OFAC list. On Tuesday, October 28, 2003, the New York Fed terminated its ECI Agreement with UBS for breach of Articles 8 and 9 of the Agreement which dealt with, respectively, UBS's monthly reporting obligations and its OFAC compliance obligations. Within a week of the termination, UBS disclosed that it had also engaged in transactions with Yugoslavia (the Republics of Serbia and Montenegro) during the time that Yugoslavia was subject to OFAC sanctions. New York Fed management promptly informed the New York Fed board of directors of the decision to terminate for breach, and the reasons for the decision.

After terminating the contract for breach, the New York Fed needed UBS's continuing cooperation in the investigation of the facts regarding the breach *and* the false reports. Senior management of UBS did cooperate with us in these specific matters. Further, we received extraordinary assistance from our supervisory colleagues at the EBK.

Following the termination of the ECI Agreement, UBS appointed an investigative steering committee and retained two respected law firms to conduct a full investigation into the operation of the Zurich ECI. The internal and external auditors of UBS were asked to assist. The EBK agreed to allow UBS to share the results of this investigation with the New York Fed on a confidential basis.

Over the next six months, the investigative team interviewed forty-eight UBS employees, many on multiple occasions, and reviewed several thousand documents, including e-mails. On December 3, 2003, the first report from the investigation was provided to the New York Fed. Between delivery of the first report and April of 2004, I, and other New York Fed officers met with representatives of UBS on three occasions and had many telephone conversations in which we reviewed the status of the investigation and requested that more work be done on specific issues. During this same time period, the UBS investigative team also provided us with numerous supplemental responses, documents, and updated chronologies. True to its commitment during the summer of 2003, the EBK enabled UBS to make full disclosure of the investigative results, and also enabled the New York Fed to interview members of the E&Y team that had reviewed UBS's ECI operations. On April 16, 2004, UBS provided the New York Fed with its final supplement to the December report.

The investigation confirmed that UBS engaged in USD banknote transactions, through the ECI, directly with four OFAC sanctioned countries: Cuba, Libya, Iran, and the former Yugoslavia, but not directly with Iraq. UBS consistently engaged in these transactions from the inception of the ECI program, notwithstanding the fact that the UBS personnel involved clearly understood that the ECI Agreement

prohibited such transactions. Moreover, UBS personnel took affirmative steps to conceal these transactions from the New York Fed, including, but not limited to, falsifying the monthly U.S. dollar transaction reports that it was contractually obligated to submit. UBS personnel continued their efforts to conceal these transactions even after the investigation was underway. The banknote personnel of UBS also affirmatively misled the EBK.

In early May of 2004, the New York Fed engaged the EBK in discussions regarding the appropriate supervisory response to UBS's conduct. Our goal was for the EBK to take remedial action in its capacity as UBS's home country supervisor, and for the Federal Reserve to take punitive action against UBS for its deceptive conduct with respect to an important U.S. program--our sanction regime. On May 10, 2004, the EBK publicly reprimanded UBS for the failures in internal control that permitted both the breach of contract and the deception. The EBK's decision acknowledged that UBS planned to discontinue its banknote trading business, and forbade UBS from restarting this business without the EBK's consent. Simultaneous with the EBK's announcement of its supervisory decision, the Federal Reserve announced the assessment of a \$100 million civil money penalty against UBS.

The Civil Money Penalty Assessment

I now turn to my third topic and focus on the amount of the civil money penalty assessed by the Federal Reserve against UBS. At the outset, let me emphasize that the civil money penalty is directed at deception and the violation of U.S. laws relating to deception. The remedy for breach of contract was contract termination, and that occurred more than six months ago.

The Federal Reserve's statutory authority to assess a civil money penalty is expressly set out in Section 8(i) of the Federal Deposit Insurance Act ("FDI Act"). When the Federal Reserve determines that a financial institution has violated the law, as UBS did here, and that such a violation justifies the assessment of a civil money penalty, we look first to Section 8(i) to determine the range of the penalty that might be imposed. The statute carefully lays out a three-tiered approach to assessment. The tiers focus on both the likelihood that the violation will cause financial harm to the institution and on the degree of willfulness demonstrated by the institution in committing the violation. The greater the likelihood of harm and the more deliberate the act, the higher the maximum penalty.

UBS's conduct here constituted a tier two violation. Section 8(i)(2)(B) of the FDI Act provides that any depository institution that violates any law, which violation is part of a pattern of misconduct, shall pay a civil money penalty of not more than \$25,000 for each day during which such violation continues. This formula, applied to UBS's multiple violations of law, permitted the Federal Reserve to assess a civil money penalty of \$100 million.

While UBS is a \$1 trillion institution, and has abundant financial resources, banknote trading was a very small piece of UBS's overall business. For the years 1999-2003, UBS's banknote trading business for all currencies with all countries had aggregate net profit of approximately \$87 million. From 1996 through 2003, UBS earned net profit of slightly less than \$5 million from its banknote transactions with countries subject to OFAC sanctions. Thus, the \$100 million civil money represents a

penalty that is approximately twenty times the amount of the net profit that UBS derived from its wrongful conduct.

Clearly, however, we recognized the severity of UBS's actions. UBS had deceived us over an eight-year period in several different ways. In assessing the civil money penalty, however, we were mindful that the assessment should not be made in a vacuum. In 1992, the Board of Governors assessed a \$200 million penalty against BCCI; and the \$100 million civil money penalty assessed against UBS is equal to the next-highest penalty the Federal Reserve has ever assessed against an institutional respondent. Last year, in conjunction with a criminal disposition by the U.S. Department of Justice, the Federal Reserve assessed Credit Lyonnais a \$100 million civil money penalty. While no two cases are alike, Credit Lyonnais engaged in a similar pattern of deliberate and repeated false statements to the Federal Reserve in connection with its secret acquisition of the Executive Life Insurance Company.

In considering whether the amount of the civil money penalty was sufficiently large, it is not enough to look only at the size of UBS's balance sheet and net profit. It is important to keep in mind that UBS is a Swiss institution with its own banking supervisor, the EBK, which has no authority to impose money penalties. A Swiss governmental reprimand to the largest bank in Switzerland is, to our knowledge, unprecedented in Swiss history. The EBK took that action, in no small measure, to demonstrate that it would not tolerate deception any more than we would. We gave special consideration to the EBK's views also because, as senior Treasury officials have noted in testimony before Congress, the EBK has demonstrated exceptional cooperation

in matters relating to the global fight against terrorist financing. As a bank supervisor active in that fight, the Federal Reserve appreciates the value of global cooperation.

In short, the \$100 million civil money penalty that we assessed against UBS was appropriate. It was in proportion to the revenues UBS derived from its unlawful actions. It was in line with the Federal Reserve's history of civil money penalties. And, it was appropriate because we were able to act together with the EBK to craft supervisory action that is both punitive and remedial.

2004 Enhancement of ECI OFAC Compliance Requirements

Turning to my final point, I will describe the actions taken by the New York Fed in the wake of the discovery of UBS's deceit. These actions are aimed at ensuring that our ECI operators will not conduct ECI transactions directly with OFAC-sanctioned countries. Thus, through our ECI contracts, we are able to extend the reach of the OFAC sanctions to foreign jurisdictions. It is important to keep in mind, however, that the U.S. sanctions regime cannot be applied extraterritorially without limitation.

Immediately following the discovery that UBS had engaged in transactions with Iran, in July 2003, we directed inquiries toward each of the five banks with which we continue to maintain an ECI relationship. The banks responded by detailing for us the procedures each had in place to ensure their contractual compliance with the OFAC regulations and various Anti-Money Laundering ("AML") statutes and regulations. These responses gave us sufficient confidence to carry us through for the period necessary until we could amend our contracts to strengthen the OFAC and AML compliance provisions.

In the fall of 2003, the New York Fed began a process of amending all of the ECI Agreements and the accompanying Manual of Procedures to strengthen the compliance requirements supporting the OFAC sanctions programs. Each revised Agreement establishes the ECI operators' general responsibilities for OFAC compliance, while the new Manual of Procedures enumerates in detail minimum specific responsibilities. The new contracts and Manual of Procedures were all executed and became fully effective in February 2004.

In revising the ECI Agreements, two major changes were made to the OFAC Compliance Section. First, language was added to expressly provide that the ECI bank "agrees that ECI Banknote Activity is subject to the jurisdiction of the U.S. Department of Treasury's Office of Foreign Assets Control." Second, the Agreement was amended to include an acknowledgement from the operating bank that, with respect to banknote transactions, it must comply with the provisions of the U.S. Trading with the Enemy Act, the International Emergency Economic Powers Act, the Antiterrorism and Effective Death Penalty Act, and "any other similar asset control laws, to the extent that they are implemented by OFAC regulations."

Perhaps the most significant changes, however, relate to new audit requirements for the ECIs. A new section was added to the ECI Agreement requiring an annual audit of the operating bank's AML and OFAC compliance programs by a public accounting firm, hired at the ECI operator's expense. The ECI Agreement also provides that a management representative must attest that the ECI operator is complying with the contract. Then, in a Sarbanes-Oxley inspired provision, the contract requires that the public accounting firm must attest to the management assertion, and specifically, whether

the assertion is fairly stated. The contract also provides that the public accounting firm will render an opinion on whether the monthly reports that the ECI bank has provided to the New York Fed are accurate. The New York Fed is currently in the process of working with the public accounting firms concerning implementation of this requirement.

The Manual of Procedures was also expanded and now requires ECI operators to:

1. Establish a system of internal controls to ensure compliance with all OFAC regulations. Internal controls should be specific to all aspects of ECI Banknote Activity from account opening through the initiation and settlement of all transactions;
2. Perform and document a comprehensive OFAC risk assessment of all aspects of ECI activities, including any transactions that are processed through the ECI for another institution;
3. Designate a compliance officer responsible for monitoring compliance with all OFAC laws and regulations, and an officer responsible for overseeing any funds blocked as a result of any OFAC law or regulation;
4. Implement an audit program that will provide for independent testing of all aspects of the OFAC compliance program and for an annual comprehensive audit of each line of business relating to the ECI activities;
5. Provide appropriate OFAC compliance training for all employees in each line of business relating to ECI activities;
6. Maintain the most current OFAC List of prohibited countries, entities, and individuals;
7. Retain all OFAC-related records for a period of not less than five years; and
8. Require the OFAC compliance officer to develop a program to screen customers and transactions for OFAC compliance. The screening program shall, at a minimum:

- a) Ensure that all new customers are compared to the OFAC list and formally approved for activity before any transaction is initiated with the customer;
- b) Specify what information in the account is being compared, *e.g.*, accountholder, signatories, powers of attorney, beneficiaries, and/or beneficial owners;
- c) Require that, whenever OFAC updates the OFAC List, a review shall immediately be performed of existing customers and of all electronic files used to maintain customer information;
- d) Require periodic testing to ensure that existing customers and any electronic customer information files are effectively tested for OFAC compliance;
- e) Require that all ECI activities be compared to the OFAC list and monitored for prohibited activity;
- f) Implement an escalation program to ensure that any potential matches of customers or transactions be reported immediately to the OFAC compliance officer for review and disposition;
- g) Implement effective controls to identify transactions that match an OFAC-sanctioned individual or entity;
- h) Require that any identified transactions be reported to OFAC in accordance with OFAC regulations and to the New York Fed personnel identified in the ECI Agreement; and
- i) Require that a history file of any customers or transactions initially identified as potential matches but subsequently approved by the OFAC compliance officer, be maintained under record retention policies for review by internal audit.

The changes to the Agreement and the expanded seventeen-point procedural program have strengthened ECI program internal controls, established

operational responsibility for compliance, and specified internal and external audit requirements. Moreover, each ECI operator's policies and procedures directed at OFAC compliance will be reviewed by a team from the New York Fed and OFAC. The first of these reviews is currently being planned.

I should note that, following the announcement of the assessment of the \$100 million civil money penalty against UBS, we again directed inquiries to our ECI operators to learn their reactions to the Federal Reserve's action. All of the ECI operators viewed the penalty as significant and understood that it reflected the importance the New York Fed places on both strict compliance with the OFAC requirements of the ECI Agreement and the Manual of Procedures, and on the integrity of its ECI operators.

Conclusion

The ECI program serves an important U.S. function by ensuring that we supply USD banknotes to the global market in an efficient manner, and that the quality of, and confidence in, our currency is maintained at a high level. UBS' egregious conduct should not overshadow the ECI program's benefits. In terminating the UBS ECI contract, in assessing a \$100 million civil money penalty against UBS for its deceptive conduct as a former ECI operator, and in working with the EBK to craft a coordinated regulatory response, the Federal Reserve acted decisively and properly to send a message about the importance it places on OFAC compliance. The remedial measures that we have put into place underscore the Federal Reserve's commitment to ensuring that all of our ECI operators will comply with U.S. sanctions in their ECI transactions.

Thank you for your attention, and I look forward to answering any questions you may have.