

**A new wave of money
laundering investigations
their impact on European banks
and the Danske Bank case**

Action Institute

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What a CEO's suicide might mean for the European banking sector

On Monday September 23th, Aivar Rehe, former CEO of Danske Bank in Estonia, was reported missing by his family, and was later found dead near his house in Tallinn, most likely after having committed suicide. Though Estonian prosecutors confirmed that he was not implicated in their ongoing investigations of Danske's money-laundering scandal, Mr. Rehe felt responsible for what happened during the decade he ran the unit.

Only a couple of days later, it was revealed that German prosecutors are looking into Deutsche Bank's role in the same case, since the Frankfurt-based financial institution used to clear dollars for Danske's Estonian branch until 2015.

Almost simultaneously, ABN Amro disclosed that it is also under investigation, for insufficient due diligence and monitoring of clients in other instances of money laundering and financing of terrorism.

Such a collection of events in a short timeframe signals that the last week of September, opened by the tragedy of the loss of a human life, could become a sad metaphor, the canary in the coal mine for a renewed and serious source of concerns in the European banking sector.

European banks have surely grown stronger over the past decade, with vastly improved equity buffers and asset quality, but they are still plagued with a chronically inadequate profitability, caused by multiple factors, including a low interest rate environment, a relatively flat yield curve, the slowdown of economic growth, a still underused physical branch network, and increasing competition from challenger and digital players. For these reasons, while European stocks are broadly flat over the past year, bank shares are down by around 25% on average.

A new wave of money laundering investigations

Now a new wave of money-laundering investigations has the potential to generate further trouble on the horizon. The quantum of the impact is uncertain, but might be large, both in terms of the number of institutions possibly involved, and because it will not only be confined to the direct cost of fines.

Danske Bank alone has set aside almost USD 1.5bn for future fines, and the Estonian FSA (EFSA) also forced it to liquidate its still profitable Estonian operations, in what clearly amounts to forgone revenue, even though the business involved with money laundering had already been abandoned in 2015. Moreover, banks will need to increase the size of their compliance and regulatory functions – which drives costs up and profitability down – so as to avoid future issues: for example, ABN has recently promised to spend an additional EUR 220m, and, during the past five years, already tripled its staff dedicated to the prevention of financial crime. Losses related to reputational damage are more difficult to quantify, but the observation of share performance can be a helpful guide: Danske's shares are down by c. 60% since early 2018, and ABN's lost 12% in a single day – obviously, we should deduct the expected costs mentioned above (fines, additional compliance investments) from these figures, in order to gauge the amount markets associate purely to reputational damage, but the numbers would still look sizeable. Finally, the Deutsche Bank investigation could open a further frontier, as never in the past a correspondent bank was held responsible for KYC failings of an originating bank: if such a precedent were set, the number of at-risk institutions might multiply, and investors might eventually trade many bank stocks at a discount.

In the meantime, lawmakers and regulators have increased their focus on fighting money laundering. Only 1% of illicit money flows are actually caught, and the complexity of criminal schemes has risen over the past decade: the use of cryptocurrencies, mirror trades in derivatives markets, and sophisticated shell-company arrangements have caused

law enforcement to fall way behind, and – at the same time - have served as a necessary wake-up call.

On the one hand, cooperation between the public and private sector is needed, and is in fact improving, with banks and regulators working together to change current processes to detect money laundering. The transition to more automated checks, with the widespread use of artificial intelligence (AI), is surely one of the main bets to achieve higher effectiveness. In this context, the banks that prove to be bolder in implementing new strategies and systems will probably face more leniency in case of breaches. Such a phenomenon does not bode well for smaller banks, and calls for further consolidation in the industry, given that larger structures can better use economies of scale to absorb significant AI and compliance investments.

On the other hand, regulation is destined to be more stringent. Earlier this year, the European Commission centralised anti-money laundering (AML) powers at the European Banking Authority (EBA), even though the EBA's mandate is still quite narrow, and limited to make sure that national authorities “effectively and consistently supervise the risks of money laundering and that they co-operate and share information”.

From the legislative perspective, the 6th EU Anti-Money Laundering Directive (6AMLD) was approved by the European parliament last November, and will need to be transposed into national law by each member state by December 3rd 2020. The following are among the most relevant amendments of the 6AMLD:

- A unified list of twenty-two predicate offences for money laundering, which must be criminalised across the EU and include cybercrime
- New criminal offences, such as aiding, abetting, attempting and inciting to commit money laundering

A new wave of money laundering investigations

- Criminal liability extended to legal persons (e.g., companies) and to certain employees (e.g., decision makers), if they commit the offence, or for lack of proper supervision
- Increased minimum prison sentence for money laundering offences, from one to four years, and various types of punishment for legal persons, including compulsory winding-up
- Six offences will need to be criminalised across the EU, even if such conduct is lawful in a given jurisdiction. These include corruption, terrorism, and participation in an organized criminal group and racketeering.

That said, though AML directives require that all EU countries comply with some basic requirements, there is still no single rule book across Europe, and such lack of harmonization makes it difficult for a single authority, like the EBA or potentially an entirely new body, to combat money laundering in the most effective way.

Danske Bank's Estonian scandal: what went wrong

We have seen that much pressure has piled onto banks, regulators, and policymakers alike to prevent money laundering and to keep up with the criminals' increasingly sophisticated schemes, and how – albeit surely necessary – such renewed focus will likely damage the profitability of the banking sector in several ways, by driving up costs. While it is impossible to predict where and when the next scandal will emerge, it is obviously possible for banks to try and limit the probability of it happening, and we have observed how private-public cooperation and increased investments in AI can be sensible options.

A new wave of money laundering investigations

As Cicero suggested, it should also be noted that “*historia est magistra vitae*” (“history is life’s teacher”), and, in the case of AML, learning from past experience will be crucial. The largest money laundering scheme in Europe could therefore prove to be a valuable, albeit painful, lesson: the rest of this essay will present a summary of what went wrong at Danske Bank in the nine years to 2015.

It all started when Danske Bank, the largest Danish financial institution, completed its acquisition of the Finnish-based Sampo Bank in February 2007. Such acquisition included Estonian subsidiary Sampo Pank, which, in 2008, became a branch of Danske.

Between 2007 and 2015, the Estonian branch had c. 15,000 non-resident customers, mostly corporate entities coming from ninety different countries, the main ones being Russia, the UK and the British Virgin Islands. C. 10,000 of the non-resident customers were part of a “Non-Resident Portfolio” (NRP), that was managed by a separate group of employees. To put this into perspective, Danske’s market share in the segment was extraordinarily high: by the end of 2013 such NRP represented 44% of non-resident deposits in Estonia, and 9% in the whole Baltic region. As a percentage of the total customers of Danske’s Estonian branch, the NRP represented a mere 2% to 4%, depending on the year, but generated a disproportionate part of its profits before credit losses, from c. 50% between 2007 and 2010, to c. 95% or more between 2012 and 2014.

The NRP showed uncharacteristically high levels of activity, including deposits, payments and other transactions in different currencies, and securities trading: there were 7.5 million payments from 2007 to 2015, excluding internal transfers between customers, and the total flows amounted to the astounding sum of c. EUR 200bn, most of which in euros and US dollars. It later turned out that the vast majority of such flows were related to money laundering: this included the infamous “Russian Laundromat”, a scheme that typically involved UK-registered “Company A” pretending to grant a loan to UK-registered

“Company B”, with Russian companies, fronted by Moldovans, acting as guarantors; “Company B” would later fail to pay back the loan, the debt would be authenticated by Moldovan judges, and – thanks to this – the Russian companies could transfer money to banks in Moldova, from which it was sent to Danske’s Estonian branch and other institutions within the EU.

In hindsight, most of those customers should have been easily considered suspicious for a number of reasons, including clients with shared addresses, with large differences between revenues and payment activities, with suspicious counterparts in other financial institutions, or associated with money laundering in the public domain. It took major deficiencies in controls and governance to allow Danske’s Estonian branch to be used for such extensive criminal activities for so many years.

Firstly, the IT platform of the Estonian branch was not integrated with that of the broader Group: a project to that end was conceived in 2008, but later abandoned since it was considered too expensive and too burdensome. Because of this, also AML procedures (customer systems, risk monitoring, etc.) were different, and the Group did not have full visibility on Estonian activities. The latter fact was exacerbated by that branch’s widespread use of documents, including client information, in the Estonian or Russian languages.

Secondly, there were demonstrable failures in all three lines of defence: the business unit, risk, compliance and AML functions, and Group Internal Audit all neglected some of their basic due-diligence, monitoring, and reporting duties. As an example, ongoing monitoring was supposed to be performed manually by account managers, responsible for so many clients that it was humanly impossible for them to properly fulfil their role. Also, over forty employees and agents of the Estonian branch even appear to have colluded with NRP customers.

A new wave of money laundering investigations

These failings are clearly shown in the below table, taken from Danske's presentation during their September 19th 2018 press conference¹:

Obligations	AML failings re Non-Resident Portfolio at the Estonian branch
Due diligence	<ul style="list-style-type: none">▪ Lacking knowledge of customers▪ Lacking identification of (ultimate) beneficial owners and "controlling interests"▪ Customers included so-called intermediaries, which were unregulated and represented unknown end-customers
Monitoring	<ul style="list-style-type: none">▪ Insufficient attention to customer activities▪ Lacking identification of the source and origin of funds▪ No screening of customers against lists of politically exposed persons▪ No screening of incoming payments against sanctions or terror lists▪ In general, no automatic screening of incoming payments
Reporting	<ul style="list-style-type: none">▪ Lack of response to suspicious customers and transactions

Thirdly, a number of warning signs were not taken seriously for several years, starting in 2007, after Danske's acquisition of Sampo Bank, when the EFSA issued a critical assessment of the Estonian branch.

During the same year, the Danish FSA (DFSA) also informed Danske about a letter it received from the Russian Central Bank, suggesting "tax and custom payments evasion" and "criminal activity in its pure form".

¹ Source: <https://danskebank.com/-/media/danske-bank-com/file-cloud/2018/9/presentation-from-the-press-conference-about-the-findings-of-the-estonia-investigations.pdf>

A new wave of money laundering investigations

Though, no proper analysis of the NRP was conducted, partly due to the fact that most internal presentations contained minimal information about that segment of customers, partly because the high ROE generated by the Estonian branch (402% in 2013, compared to 7% for the bank as a whole) probably helped conceal AML problems. Moreover, a follow-up investigation by the EFSA in 2009 showed less concern, and reports by Group Compliance to the Executive Board and Board of Directors did not flag any particular alarms until 2014, similarly to those by Group Internal Audit from 2011 to 2013.

Other opportunities to scrutinise the NRP came in 2013, when a corresponding bank clearing USD trades out of the Estonian branch decided to end the relationship due to money laundering risks, and, at the end of the same year, when a whistleblower suggested that Danske was knowingly dealing with criminals in Estonia.

Following this, Group Internal Audit did actually report the inadequacy of AML procedures and the need to take action on the NRP, but those findings were not communicated to authorities. Also, the measures taken in 2014 proved to be insufficient, and so did the investigation of the whistleblower's claims: even though a new internal policy required the Estonian branch's customers to have legitimate reasons for doing business in the Baltics, the majority of customers within the NRP was retained.

The run-off of the NRP was only completed in the second half of 2015, with a few accounts closed in early 2016, after an extremely critical report by the EFSA in December 2014, and more terminations of correspondent banking relationships.

With mounting pressure from the media as well as from the still ongoing criminal investigations in Denmark, the US, France and Estonia, Danske finally restructured its Estonian branch, with a new management, stronger independence of local control functions, and fully integrated IT systems, and the objective to serve only subsidiaries of

A new wave of money laundering investigations

Nordic and international clients. As also noted in the first part of this essay, such actions did not prevent the EFSA to request the liquidation of the branch in February this year.

At the same time, Danish prosecutors have already charged ten people, including Danske's former CEO Thomas Borgen and former CFO, and chair of the DFSA, Henrik Ramlau-Hansen, both accused of failure to prevent certain transactions.

Meanwhile, Danske, whose share price has collapsed, is facing fines that could potentially reach billions of dollars.

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