

GAO

Report to the Chairman, Subcommittee  
on General Oversight and Investigations,  
Committee on Banking and Financial  
Services, House of Representatives

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June 1998

# MONEY LAUNDERING

## Regulatory Oversight of Offshore Private Banking Activities



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**General Government Division**

B-279710

June 29, 1998

The Honorable Spencer Bachus  
Chairman, Subcommittee on General Oversight  
and Investigations  
Committee on Banking and Financial Services  
House of Representatives

Dear Mr. Chairman:

This report responds to your August 26, 1997, request that we review U.S. regulatory oversight of private banking activities involving offshore jurisdictions. You expressed concern that high profile money laundering cases have generally involved the use of offshore accounts or transactions to facilitate the movement of illicit funds through the banking system. Law enforcement and bank regulatory officials have also raised concerns about offshore private banking activities and their potential to be the private banking "soft spot" for money laundering. To assist with your continuing deliberations on money laundering, you asked that we review the regulatory oversight of offshore private banking activities and that we specifically address the following areas:

- regulatory oversight procedures to ensure that offshore private banking activities are covered by banks' anti-money-laundering efforts,
- deficiencies identified by banking regulators regarding offshore private banking activities and corrective actions taken by banks,
- barriers hindering regulatory oversight of offshore private banking activities and efforts to overcome them, and
- banking industry views regarding regulatory access to documentation pertaining to offshore private banking activities.

To address these areas, we reviewed examination manuals, relevant agency documents, and examination reports that addressed banks' anti-money-laundering efforts relative to their private banking activities. We also interviewed U.S. regulators; conducted a limited survey of banks; and spoke with officials from key offshore jurisdictions, international bank supervisory groups, and international anti-money-laundering task forces.

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## Background

Private banking has been broadly defined as financial and related services provided to wealthy clients.<sup>1</sup> Such products and services may include deposit-taking, lending, mutual funds investing, personal trust and estate administration, funds transfer services, and establishing payable through accounts<sup>2</sup> or offshore trusts. For purposes of this review, we defined offshore private banking as including (1) private banking activities carried out by domestic and foreign banks operating in the United States that involve financial secrecy jurisdictions,<sup>3</sup> including the establishment of accounts for offshore entities, such as private investment companies (PIC)<sup>4</sup> and offshore trusts; and (2) private banking activities conducted by foreign branches of U.S. banks located in these jurisdictions. Offshore entities that maintain private banking accounts provide customers with a high degree of confidentiality and anonymity while offering such other benefits as tax advantages, limited legal liability, and ease of transfer. Sometimes documentation identifying the beneficial owners<sup>5</sup> of offshore entities and their U.S. private banking accounts is maintained in the offshore jurisdiction rather than in the United States. Although banking regulators believe that offshore private banking activities are generally used for legitimate reasons, there is some concern that they may also serve to camouflage money laundering and other illegal acts.

The government's reliance on financial institutions as the first line of defense against money laundering activities has increased with the adoption of enhanced suspicious activity reporting rules for banks issued jointly by Treasury's Financial Crimes Enforcement Network and the federal depository institution regulators.<sup>6</sup> The revised rules, which became effective April 1, 1996, require a bank to file a suspicious activity report

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<sup>1</sup>See *Private Banking: Information on Private Banking and Its Vulnerability to Money Laundering* (GAO/GGD-98-19R, Oct. 30, 1997).

<sup>2</sup>Payable through accounts are transaction deposit accounts through which U.S. banking entities extend check-writing privileges to clients of a foreign bank.

<sup>3</sup>The Internal Revenue Service defines financial secrecy jurisdictions as jurisdictions having a low or zero rate of tax, a certain level of banking or commercial secrecy, and relatively simple requirements for licensing and regulating banks and other business entities. Examples of such jurisdictions include the Cayman Islands and the Channel Islands. In this report, we use the term "offshore jurisdictions" to refer to financial secrecy jurisdictions.

<sup>4</sup>Private investment companies are "shell" companies incorporated in financial secrecy jurisdictions that are formed to hold client assets. Such offshore entities are formed to maintain clients' confidentiality and for various tax- or trust-related reasons.

<sup>5</sup>The beneficial owner is the individual or group that controls the account.

<sup>6</sup>The federal depository institution regulators involved were the banking regulators—Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation—and the Office of Thrift Supervision, and the National Credit Union Administration.

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pertaining to money laundering when a transaction at or above \$5,000 (1) involves funds derived from illegal activities or efforts to disguise the nature of such funds, (2) is intended to evade the Bank Secrecy Act (BSA) requirements, or (3) is not a normally expected transaction for a particular customer and appears to have no lawful business purpose.<sup>7</sup>

Federal banking regulators consider “know your customer” (KYC) policies one of the most important components of an institution’s measures for understanding with whom it is doing business, recognizing unusual transactions, and detecting illegal or suspicious activities. These policies are intended to enable the institution to identify account owners and to recognize the kinds of transactions that a particular customer is likely to engage in. Although such policies are not currently required by regulation or statute, federal banking regulators expect institutions to incorporate KYC policies in their operations, and they have developed examination procedures for determining whether institutions have implemented such policies and related procedures. Federal banking regulators are currently in the process of developing a joint regulation and accompanying guidance intended to formally require banks to establish KYC policies.

The Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation are responsible for reviewing banks’ anti-money-laundering efforts, including their KYC policies and procedures. The Federal Reserve and OCC have primary responsibility for examining and supervising the overseas branches of U.S. banks to ascertain the adequacy of their anti-money-laundering efforts.<sup>8</sup> During the past 2 years, the Federal Reserve and OCC have focused attention on banks’ private banking activities in an attempt to ensure that they are not used for money laundering and are not a potential source of reputational or legal risk<sup>9</sup> to banks. In 1996, the Federal Reserve Bank of New York (FRBNY) undertook a focused review of banks’ private banking activities in its district that included coverage of related offshore activities as well as a review of banks’ anti-money-laundering programs and KYC policies. This initiative reflected a heightened supervisory interest in the

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<sup>7</sup>Banks are also required to file suspicious activity reports for other types of suspicious activities such as insider abuse.

<sup>8</sup>The Federal Deposit Insurance Corporation does not routinely conduct overseas examinations, as the foreign offices of banks under its direct supervision primarily comprise offshore shell branches or otherwise represent relatively small operations in terms of their asset size.

<sup>9</sup>Reputational risk is the potential that negative publicity regarding a bank’s business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions. Legal risk is the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a bank.

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area arising from the growing market for private banking, banks' increased reliance on private banking as a source of income, and a related increase in competition. Because of the concentration of private banking activities in the New York district and its focused efforts in the area, FRBNY assumed a key role within the Federal Reserve for the oversight of private banking activities. FRBNY, on behalf of the Federal Reserve Board, recently issued a paper on sound practices for private banking activities.<sup>10</sup> At the time of our review, the Federal Reserve Board was also in the process of issuing a private banking examination manual and coordinating training for Federal Reserve examiners in the area of private banking.

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## Results in Brief

Federal banking regulators may review banks' efforts to prevent or detect money laundering in their offshore private banking activities during compliance or BSA examinations; safety and soundness examinations; or, more recently, during targeted examinations of their private banking activities. In these examinations, regulators focus on the bank's compliance program, KYC policies, and internal controls. They instruct their examiners to ensure that the bank's compliance program, and particularly its KYC policies, extend to its private banking activities. To guard against offshore entities that maintain U.S. private banking accounts from being used for money laundering or other illicit purposes, examiners are to look for specific KYC procedures that enable banks to identify and profile the beneficial owners of private banking accounts. For private banking activities conducted by branches of U.S. banks located in offshore jurisdictions, examiners rely primarily on the bank's internal audits to verify that KYC policies are being implemented in offshore branches where they may be precluded from conducting on-site examinations.

Our review of bank examination reports prepared under FRBNY's private banking initiative showed that the most common deficiency relating to offshore private banking was a lack of documentation on the beneficial owners of PICS and other offshore entities that maintain U.S. accounts. FRBNY and OCC examiners noted other deficiencies during their respective examinations, such as inadequate client profiles and weak management information systems, that may make it difficult for banks to monitor client activity for unusual or suspicious activity. The bank examinations we reviewed, along with discussions with examiners and bank officials, indicated that most banks had started to take corrective actions to address deficiencies related to offshore private banking activities, but further

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<sup>10</sup>Guidance on Sound Risk Management Practices Governing Private Banking Activities, July 1997, prepared by FRBNY on behalf of the Board of Governors of the Federal Reserve System.

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improvements were needed. For example, during follow-up examinations, examiners found that although banks had started to make progress on improving client profiles, some of the banks' client profiles were still inadequate; and other banks were not updating the profiles for their clients in a timely manner.

Secrecy laws that restrict access to banking information or that prohibit on-site examinations of U.S. bank branches in offshore jurisdictions represent key barriers to U.S. oversight of offshore private banking activities. The nine offshore jurisdictions we identified for review have secrecy laws that protect the privacy of individual account owners, and five of them impose criminal sanctions for breaches of privacy. Moreover, federal banking regulators' attempts to work around restrictions associated with these secrecy laws are sometimes hampered. For example, federal banking regulators' reliance on internal audits to determine how KYC policies are applied to U.S. banks' offshore branches is sometimes hindered by weaknesses in audit coverage of the KYC area. Regulators also lacked access to audit workpapers pertaining to branches in certain offshore jurisdictions and documents containing information on individual customers. We also found that all nine offshore jurisdictions selected for review were engaged in some type of anti-money-laundering activities. Their activities ranged from participating in international task forces aimed at combatting money laundering to requiring banks to report suspicious activity. Although the efforts of individual jurisdictions may contribute to the international fight against money laundering, it is too early to ascertain their impact on money laundering or the extent to which the offshore jurisdictions' secrecy laws will continue to represent barriers to U.S. and other foreign regulators.

We surveyed officials from 15 banks that were asked by FRBNY to provide documentation on the beneficial owners of PICS and other offshore entities that maintained U.S. accounts. We found that the officials had a number of concerns. One common concern related to perceived inconsistencies within and among federal banking regulators regarding requests for access to beneficial owner documentation. Bank officials also expressed concerns regarding the compromising of customer confidentiality, potentially violating offshore secrecy laws, and potentially losing business to other financial institutions not subject to the same documentation requirements. In spite of these concerns, most officials indicated that their banks changed how they maintain documentation on offshore private banking activities in response to FRBNY's request for beneficial owner documentation.

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## Scope and Methodology

To determine how regulators oversee offshore private banking activities, we reviewed BSA examination manuals and other agency documents pertaining to the oversight of private banking and offshore banking activities. We also reviewed information on examination methodology in examination reports and, in a few cases, supporting workpapers. We spoke with FRBNY examiners; Federal Reserve Bank of Atlanta examiners; and OCC examiners in California, New York, and North Carolina to discuss specific monitoring practices related to banks engaged in offshore private banking activities.

To identify deficiencies related to offshore private banking activities and corrective actions taken by banks, we reviewed 35 examination reports for 21 banks included in FRBNY's private banking initiative. We also reviewed 21 OCC examination reports<sup>11</sup> for 6 banks identified as actively involved in offshore private banking activities. The banks reviewed do not represent all banks that may be involved in offshore private banking activities. They are a subset of banks with a significant level of offshore assets in certain jurisdictions identified to be particularly susceptible to money laundering. (See app. I for more information on the methodology we used to identify banks actively involved in offshore private banking.) For the most part, examinations reviewed were conducted during 1996 and 1997. We interviewed FRBNY and OCC examiners to determine the extent to which general private banking deficiencies identified during examinations applied to the banks' offshore private banking activities or to obtain their perspectives on the adequacy of corrective actions taken by banks. In addition, we followed up with selected banks to obtain an update on the status of corrective actions that were planned or in process during the last examination.

To identify barriers associated with overseeing offshore private banking activities, we interviewed federal banking regulators and officials from the Financial Action Task Force (FATF),<sup>12</sup> the Caribbean Financial Action Task Force (CFATF),<sup>13</sup> the Basle Committee on Banking Supervision,<sup>14</sup> and the

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<sup>11</sup>These reports covered safety and soundness, consumer and BSA compliance, and KYC policies.

<sup>12</sup>FATF was established by the G-7 Summit in Paris in 1989 to examine measures to combat money laundering. The membership of FATF comprises 26 countries and 2 regional organizations.

<sup>13</sup>CFATF is an organization of 19 member states of the Caribbean basin that have agreed to implement common countermeasures to address the problem of money laundering. It was established as a result of meetings convened in 1990 and 1992.

<sup>14</sup>The Basle Committee on Banking Supervision is a committee of banking supervisory authorities that was established by the central-bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks.

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Offshore Group of Banking Supervisors.<sup>15</sup> We also interviewed officials of the Central Bank of the Bahamas, Cayman Islands Monetary Authority, and International Monetary Fund. In addition, we reviewed reports issued by FATF, CFATF, and the Offshore Group of Banking Supervisors. We also conducted literature searches on the laws of nine offshore jurisdictions selected for review and on their KYC policies and policies for reporting suspicious activity. The nine jurisdictions are the Bahamas, Bahrain, Cayman Islands, Channel Islands, Hong Kong, Luxembourg, Panama, Singapore, and Switzerland. (See app. I for more information on how we selected the nine offshore jurisdictions for review.) The information on foreign laws and policies in this report does not reflect our independent legal analysis but is based on interviews and secondary sources.

To obtain industry views about regulatory access to beneficial owner documentation, we conducted a survey of 15 banks examined by FRBNY during its recent private banking initiative. We inquired about actions the banks had taken or planned to take to comply with FRBNY's request for access to beneficial owner documentation, the impact of this request on the banks' private banking business, and the potential impact on them if regulatory access to beneficial owner documentation became a requirement.

Our work was done primarily in New York, NY; San Francisco, CA; and Washington, D.C., between December 1997 and April 1998 in accordance with generally accepted government auditing standards.

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## Regulatory Efforts to Oversee Offshore Private Banking Activities

Federal banking regulators may review banks' efforts to prevent or detect money laundering in their offshore private banking activities during overall compliance or BSA examinations; safety and soundness examinations; or, more recently, during targeted examinations of their private banking activities. Regulatory oversight of banks' anti-money-laundering efforts during these examinations reflects an attempt to assess the commitment of senior bank management to combatting money laundering while focusing on bank programs for complying with BSA, corporate KYC policies, and internal controls.

In the course of these examinations, examiners are to ensure that banks' anti-money-laundering programs identify high-risk activities, businesses, and transactions associated with foreign countries viewed to be

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<sup>15</sup>The Offshore Group of Banking Supervisors was established in 1980 as a forum for supervisory cooperation among the banking supervisors in offshore financial centers.

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particularly susceptible to money laundering. OCC's BSA Manual, for example, cites transactions involving private banking and those involving offshore secrecy jurisdictions as warranting particular attention during examinations. The Federal Reserve also identifies private banking activities, including the establishment of offshore shell companies, as warranting supervisory attention; and it provides specific guidance to banks on sound practices for documenting and exercising due diligence in their conduct of such private banking activities. During examinations, examiners are also tasked with ensuring that banks' compliance programs and KYC policies extend to their private banking activities, including those that involve offshore jurisdictions.

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## Offshore Private Banking Accounts

Recognizing that offshore entities, such as PICS, that maintain U.S. private banking accounts tend to obscure account holders' true identities, examiners are to look for specific KYC procedures that enable banks to identify and profile the beneficial owners of these offshore entities and their private banking accounts. In the course of examinations, examiners may test the adequacy of beneficial owner documentation maintained in the United States. However, with the recent exception of FRBNY, we found no evidence that examiners have attempted to examine the documentation that banks maintain in offshore secrecy jurisdictions.

Examiners we contacted expressed varying views about accessing such documentation for examination purposes. Some examiners said that they do not see a need to examine documents maintained offshore if they are confident about the bank's commitment to combatting money laundering and to exercising due diligence when establishing offshore entities through private banking accounts. A few examiners expressed reservations about their ability to compel banks, without the leverage of a KYC regulation, to obtain documents maintained in offshore jurisdictions. Others were uncertain about whether a request to export documents from certain offshore jurisdictions could violate their secrecy laws.

During examinations conducted under its private banking initiative, FRBNY took a different supervisory approach that involved examiners seeking to review beneficial owner documentation regardless of where it was maintained. Because this was the Federal Reserve's first focused review of private banking activities, verifying whether banks had the ability to identify and profile the beneficial owners of offshore entities that maintained U.S. private banking accounts was viewed as particularly important, according to officials. A senior FRBNY examiner explained that

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seeking out beneficial owner documentation was also a way to encourage banks to develop or improve their systems for maintaining appropriately detailed information on the beneficial owners of offshore entities that maintain U.S. accounts.

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### Private Banking Activities by Offshore Branches of U.S. Banks

Offshore branches are extensions of U.S. banks and are subject to supervision by host countries as well as U.S. regulators. However, they are generally not subject to the BSA and, therefore, U.S. banking regulators do not attempt to determine whether offshore branches are in compliance with this U.S. anti-money-laundering law. Instead, U.S. banking regulators attempt to identify the branches' anti-money-laundering efforts and to determine whether the banks' corporate KYC policies are being applied to activities, such as private banking activities, that these U.S. offshore branches may engage in.

Although examiners are able to review the written policies and procedures being used in these branches, they must rely primarily on the banks' internal audit functions to verify that the procedures are actually being implemented in offshore branches where U.S. regulators may be precluded from conducting on-site examinations or have restricted access to individual customer information. They may also rely on external audits, but they are apparently less prone to do so, because external audits tend to focus on financial rather than KYC issues. In our review of 56 examinations, we noted only 1 instance in which examiners relied on the work of an external auditor for a review of KYC procedures at a bank's offshore branches. Regardless of whether examiners rely on internal or external audits, officials explained they can bring any significant or recurring problems identified in an offshore branch's anti-money-laundering efforts to the attention of the bank's board of directors for corrective action.

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### Deficiencies Related to Offshore Private Banking Activities and Corrective Actions Taken by Banks

Our review of 1996 and 1997 examinations conducted under the FRBNY's private banking initiative found that the most prevalent deficiency related to offshore private banking activities was a lack of documentation on the beneficial owners of PICS and other offshore entities that maintained U.S. accounts. Our review of FRBNY and OCC examinations and discussions with examiners indicated that some deficiencies they identified that were related to private banking in general, such as inadequate client profiles and weak management information systems, also pertained to offshore private banking activities. We found that banks had started to take

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corrective actions to address the deficiencies, but improvements were still needed.

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### Deficiencies Related to Offshore Private Banking Activities

We found that 9 of the 21 banks whose FRBNY examinations we reviewed were identified by examiners as lacking information on the beneficial owners of PICS and other offshore entities that maintained U.S. accounts. FRBNY identified this deficiency at seven foreign banks and two domestic banks. Although there is no current regulation mandating that banks retain information on the beneficial owners of these offshore entities in the United States, maintaining such information in clients' U.S. files or having the ability to bring it on-shore in a reasonable amount of time promotes sound private banking practices, according to the Federal Reserve.

We also found in our review of FRBNY and OCC examinations that examiners identified two U.S. banks with inadequate KYC policies at their offshore locations. Examiners found that one of the banks had insufficient KYC documentation and had not fully implemented a transaction monitoring process at its Switzerland branch. At the other bank, examiners noted inconsistencies between the local KYC policy in its Switzerland branch and the bank's corporate policy. For example, the examiners noted that the local KYC policy did not address requirements for obtaining references or maintaining a documentation tracking system.

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### Some Deficiencies Relating to Private Banking in General Also Applied to Offshore Private Banking Activities

FRBNY and OCC examination reports and our discussions with examiners indicated that some deficiencies relating to private banking in general, such as inadequate client profiles, were also applicable to banks' offshore private banking activities. Examiners found that client profiles contained little or no documentation on the client's background, source of wealth, expected account activity, and client contacts and visits by bank representatives. Regulators specify that adequate client profiles are a key component of a sound KYC policy because they enable the bank to more effectively monitor for unusual or suspicious transactions.

Another general private banking deficiency pertaining to offshore private banking activities identified by examiners was weak management information systems. Examiners found that some banks' management information systems did not track client activity or aggregate related client accounts. Regulatory KYC guidelines emphasize the importance of a sound management information system that can enable banks to track clients' account activity and identify unusual or suspicious activity.

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## Most Banks Had Started Taking Actions to Correct Deficiencies, but Improvements Were Still Needed

FREBNY's private banking initiative established guidelines to be used during examinations to monitor banks' progress in implementing corrective actions, and OCC's BSA examination guidelines also provide for the monitoring of corrective actions. Our review of FREBNY's and OCC's 1996 and 1997 examinations and our discussions with examiners and bank officials indicated that banks had started to take corrective actions to address deficiencies related to offshore private banking activities, but further improvements were needed.

We noted that most banks were in the process of resolving the problem of a lack of documentation on the beneficial owners of PICS and other offshore entities that maintained U.S. accounts. Seven of the nine banks that did not have information on the beneficial owners of these offshore entities in their clients' U.S. files were attempting to resolve the problem, with most either asking clients to sign confidentiality waivers or reconstructing information on the beneficial owners from documentation already in their U.S. offices. Of the remaining two banks, one provided examiners with the identity of the beneficial owners of several PICS that maintained accounts with the bank. The other bank, which offered services to offshore mutual funds, provided examiners with documentation certifying that the administrator of these funds had applied KYC policies to the shareholders (i.e., beneficial owners) of the funds.

The two banks with inadequate KYC policies at their offshore locations were at different stages of correcting the deficiency. One of the banks had made changes to its KYC policies for its Switzerland branch to make them consistent with its corporate policies. The other bank had developed a corporate KYC policy and dedicated resources towards bringing its KYC policies at the Switzerland branch into compliance with its corporate policy, but both regulators and bank officials we spoke with indicated that greater progress was needed. Regulators told us that they were going to continue monitoring the situation.

Most of the banks with inadequate client profiles were making progress on improving these profiles, but some shortfalls remained. Some of the banks were developing strategies to improve the documentation on their client profiles. For example, a few banks prioritized the process for updating their client base by focusing first on high-risk accounts such as those associated with PICS. We found that despite these efforts, regulators noted that some banks' client profiles were still inadequate, and other banks were not updating their clients' profiles in a timely manner. One bank

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official we spoke with explained that updating thousands of client profiles was much more time intensive than the bank had initially anticipated.

We noted that most of the banks identified by examiners as having weak management information systems were either reviewing their systems or in the process of installing software to monitor unusual or suspicious transactions. Some bank officials and examiners indicated that regardless of what changes were being made to their systems, banks would continue to be unable to aggregate international accounts because some secrecy laws prohibit them from doing so unless clients sign confidentiality waivers.

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## Offshore Jurisdictions' Bank Secrecy Laws Represent Key Barriers to U.S. Regulators' Oversight of Offshore Private Banking Activities

Bank secrecy laws of offshore jurisdictions represent significant barriers to U.S. regulators' efforts to oversee offshore private banking activities. These secrecy laws, which are intended to preserve the privacy of individual bank customers, restrict U.S. regulators from accessing information on customers and their accounts and often prohibit regulators from conducting on-site examinations at U.S. bank branches in offshore jurisdictions. In some offshore jurisdictions, a bank employee found to have violated secrecy laws may be subject to criminal penalties, including imprisonment.

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## Limited Regulatory Access to Information in Nine Offshore Jurisdictions

Our review of nine offshore jurisdictions found some limitations that hindered U.S. and other foreign banking regulators' access to bank information. Secrecy laws to protect the privacy of individual accounts were in effect in all nine jurisdictions, and five of them impose criminal penalties on bank employees found to be in violation of the law (see table 1). None of the nine jurisdictions typically provide foreign regulators with access to individual bank account information, and only two (Hong Kong and Singapore) have allowed U.S. regulators to conduct on-site examinations of banking institutions in their jurisdictions. Examinations in Singapore were limited to a review of bank policies and general operations. The jurisdiction did not allow examiners to access individual bank account or customer information.

Another jurisdiction, the Cayman Islands, has not permitted foreign regulators to conduct on-site examinations of bank branches located within its borders in the past, but a Cayman Islands official told us that U.S. and other foreign regulators would be allowed into the Cayman

Islands to assess the safety and soundness of branches of banks under the regulators’ supervision. The official emphasized, however, that foreign regulators would continue to be prohibited from looking at documents or files containing individual customer information.

Seven of the nine jurisdictions reviewed provide for an exception to their secrecy laws when criminal investigations are involved. In such cases, officials of offshore jurisdictions explained that they have established judicial processes in their jurisdictions through which U.S. and other foreign law enforcement officials may obtain access to individual bank account or customer information.<sup>16</sup>

**Table 1: Extent of U.S. Regulatory Access to Bank Information in Nine Offshore Jurisdictions**

Jurisdiction	Jurisdiction has bank secrecy laws that include criminal sanctions		U.S. banking regulators allowed access to individual customer information		U.S. banking regulators allowed to conduct on-site examinations		U.S. judicial authorities allowed access to individual customer information	
	Yes	No	Yes	No	Yes	No	Yes <sup>a</sup>	No
Bahamas	•			•		•	•	
Bahrain		•		•		•		•
Cayman Islands	•			•		•	•	
Channel Islands		•		•		•	•	
Hong Kong		•		<sup>b</sup>	•		•	
Luxembourg	•			•		•		<sup>c</sup>
Panama	•			•		•	•	
Singapore		•		•	<sup>d</sup>			•
Switzerland	•			•		•	•	

<sup>a</sup>A “yes” in this column indicates that the jurisdiction has a mutual legal assistance treaty in force with the United States and that it allows access to individual account information if a formal criminal investigation is under way.

<sup>b</sup>In a recent trip to Hong Kong, a U.S. examiner noted that access to information, including individual account information, was provided at a branch of a U.S. bank.

<sup>c</sup>A mutual legal assistance treaty has been signed with the United States but not ratified.

<sup>d</sup>Singapore allows limited-scope examinations.

Source: Documents from the Internal Revenue Service, the Department of State, the Federal Reserve, OCC, and the Economist Intelligence Unit of the United Kingdom; and interviews with officials from FATF, CFATF, and offshore jurisdictions.

<sup>16</sup>Two conditions must be met for foreign law enforcement officials to obtain such information: (1) a criminal investigation must be under way, which customarily means that a formal judicial process has been initiated (e.g., a court order has been issued); and (2) the offshore jurisdiction must have a mutual legal assistance treaty with the foreign judicial authority requesting access to the information.

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## Federal Banking Regulators' Efforts to Work Around Secrecy Barriers Have Limitations

U.S. banking regulators are attempting to work around barriers related to offshore secrecy laws, but they remain hampered by limitations associated with these efforts. For example, in jurisdictions where they have been precluded from conducting on-site examinations, U.S. regulators rely primarily on banks' internal audits to determine how well KYC policies and procedures are being applied to offshore branches of U.S. banks. In our review of examination reports, however, we found several instances in which examiners noted that the bank's internal audit inadequately covered KYC issues pertaining to its private banking activities. At one major bank, we also observed that recurring deficiencies in KYC documentation, monitoring, and training identified by internal audits of the bank's key private banking offshore branch were allowed to go unattended for several years. An examiner explained that this particular bank, which was undergoing major changes in its private banking operations, was in the process of correcting weaknesses identified by regulators, including branch management's lack of responsiveness to identified internal audit deficiencies.

Another difficulty impeding regulators' attempts to rely on internal audits for overseeing offshore branches stems from U.S. regulators' inability to review banks' internal audit workpapers in some offshore jurisdictions that require the retention of such workpapers in the jurisdiction. Examiners explained that without access to supporting audit workpapers, it is difficult to verify that audit programs were followed and to assess the general quality of internal audits of offshore branches. One examiner added that without direct access to either bank documents or internal audit workpapers, it is difficult to explain to bank management the basis for regulatory concerns about particular activities conducted in their offshore branches.

Other, more recent attempts by U.S. regulators to work around barriers related to offshore secrecy laws also have encountered limitations. For example, FRBNY's previously discussed recent efforts to review beneficial owner documents represented an attempt to oversee private banking accounts maintained by banks operating in the United States for offshore entities. These efforts could not cover similar accounts or other private banking activities conducted on behalf of customers who deal directly with offshore branches of U.S. banks that are considered to be outside the purview of U.S. regulators. Finally, during 1998, U.S. regulators visited U.S. bank branches located in Hong Kong and Uruguay,<sup>17</sup> also viewed as a

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<sup>17</sup>Uruguay was one of three South American countries visited as part of an OCC anti-money-laundering initiative to conduct on-site reviews of foreign branches of U.S. banks.

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financial secrecy jurisdiction. Although examiners were given full access to information requested in Hong Kong, this was not the case in Uruguay. An examiner explained that although U.S. examiners were not given complete access to account documentation in Uruguay, they were able to review the branches' local KYC policies and related quality assurance reviews to help determine the extent of their anti-money-laundering efforts.

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### Impact of Offshore Jurisdictions' Activities to Combat Money Laundering Remains Uncertain

We found that all nine offshore jurisdictions selected for review were engaged in some type of anti-money-laundering activities. Their activities ranged from participating in international task forces aimed at combatting money laundering to requiring their financial institutions to report suspicious activities. The efforts of individual jurisdictions may contribute to the international fight against money laundering. However, it remains uncertain what impact these efforts may have on how the offshore jurisdictions' own banking sectors operate or on the extent to which their secrecy laws will continue to represent barriers to U.S. and other foreign regulators.

All nine of the offshore jurisdictions reviewed are members of either the Basle Committee on Banking Supervision or the Offshore Group of Banking Supervisors (see table 2). Both of these international supervisory groups place special emphasis on the on-site monitoring of banks to ensure, for example, that they have effective KYC policies. Seven of the nine offshore jurisdictions reviewed are also members of either FATF or CFATF, international task forces created to develop and promote anti-money-laundering policies. Both of these task forces have agreed on recommendations that establish a basic framework for anti-money-laundering efforts in individual countries, including standard measures intended to increase the due diligence<sup>18</sup> of financial institutions. For example, one of the recommendations adopted by the two task forces advocates that financial institutions be required to report suspicious activity to competent authorities.

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<sup>18</sup>Examples of due diligence include determining the client's source of wealth and understanding the types of transactions the client will typically conduct.

**Table 2: Nine Offshore Jurisdictions' Membership in International Supervisory Groups or Anti-Money-Laundering Task Forces**

Jurisdiction	Basle Committee on Banking Supervision	Offshore Group of Banking Supervisors	Financial Action Task Force	Caribbean Financial Action Task Force
Bahamas		•		•
Bahrain		•	<sup>a</sup>	
Cayman Islands		•		•
Channel Islands		•		
Hong Kong		•	•	
Luxembourg	•		•	
Panama		•		•
Singapore		•	•	
Switzerland	•		•	

<sup>a</sup>Bahrain is not a member country of FATF. It is, however, a member of the Gulf Cooperation Council, one of two regional organizations that participate in FATF.

Source: Reports from FATF, CFATF, the Basle Committee on Banking Supervision, and Offshore Group of Banking Supervisors.

Membership in such organizations implies that the jurisdiction intends to work towards the organization's principles and recommendations, including those related to financial institutions, such as establishing KYC policies and policies to report suspicious transactions. Membership, however, does not necessarily mean that these principles and recommendations are being adequately followed by the financial institutions or monitored by the jurisdiction's government authorities. We found that eight of the nine offshore jurisdictions selected for review required banks to report suspicious transactions to their supervisory authorities (see table 3). However, according to CFATF officials, only a few of its members have an established authority that is capable of monitoring and acting on such reports. We also noted that eight of the nine offshore jurisdictions had established some form of KYC policies or guidelines for banks operating in their jurisdictions, but the extent to which such policies are actually being implemented and enforced in these jurisdictions has yet to be determined.

Mutual evaluations periodically conducted by FATF or CFATF represent one indication of how well the organizations' recommendations are being

addressed by individual jurisdictions.<sup>19</sup> All seven offshore jurisdictions that are members of FATF or CFATF have been assessed through a mutual evaluation (see table 3). Four jurisdictions were evaluated by FATF and three by CFATF. According to summaries of these evaluations, the Cayman Islands, Luxembourg, and Switzerland were viewed as having adequately addressed applicable recommendations, but Hong Kong and Singapore were noted as still in the process of implementing recommendations. The summary for Hong Kong identified some gaps in the jurisdiction's legislative framework for combatting money laundering. The summary for Singapore indicated that although it had begun to address most of the recommendations, the extent to which they would be implemented was still uncertain. The mutual evaluations for Panama and the Bahamas had not been formally summarized at the time of our review.

**Table 3: KYC Policies, Suspicious Activity Reporting Requirements, and Mutual Evaluations for Nine Offshore Jurisdictions**

Jurisdiction	Jurisdiction has KYC policies or guidelines for banks		Jurisdiction requires banks to report suspicious transactions		Jurisdiction has had a mutual evaluation	
	Yes	No	Yes	No	Yes <sup>a</sup>	No
Bahamas	•		•		b	
Bahrain		•		•		N/A
Cayman Islands	•		•		1996	
Channel Islands	•		•			N/A
Hong Kong	•		•		1994	
Luxembourg	•		•		1995	
Panama	•		•		b	
Singapore	•		•		1995	
Switzerland	•		•		1993	

Note: N/A indicates not applicable because the jurisdiction is not a country member of either FATF or CFATF.

<sup>a</sup>Year noted in this column indicates the year in which the mutual evaluation was summarized in the task force's annual report.

<sup>b</sup>At the time of our review, a mutual evaluation had been conducted but not formally summarized, according to a CFATF official.

Source: International Financial Law Review, documents published by the Institutional Investor, Inc., and various papers presented during the 7th International Conference on Money Laundering, Cyberpayments, Corporate and Bank Security, and International Financial Crimes. Also, interviews with officials from FATF, CFATF, and offshore jurisdictions.

<sup>19</sup>FATF and CFATF have developed a peer review process known as mutual evaluations to monitor members' adherence to the groups' recommendations. The results of these evaluations are summarized in the two groups' annual reports. Individual evaluation reports by jurisdictions are also issued, but we were unable to review these individual reports because they are subject to restricted access.

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## Industry Concerns Regarding Regulatory Access to Beneficial Owner Documentation

Officials from 15 banks we surveyed expressed a number of concerns over FRBNY's request that they provide its examiners with documentation on the beneficial owners of PICS and other offshore entities that maintain U.S. accounts. One of their most prevalent concerns related to perceived inconsistencies within and among regulators regarding requests for access to beneficial owner documentation, which was of concern to 10 of the 15 bank officials. Some officials observed that only banks supervised by FRBNY were asked to provide access to this documentation, but banks supervised by the Federal Reserve in Atlanta and OCC were not.

Officials from 9 of the 15 banks also expressed concerns over compromising their clients' confidentiality. They indicated that providing FRBNY with access to documentation on the beneficial owners of PICS and other offshore entities that maintain U.S. accounts would likely displease their clients, who typically regard confidentiality as a valuable means of ensuring that their banking information is inaccessible to their home governments or to litigants filing lawsuits. Officials from 6 of the 15 banks were also concerned that if they complied with FRBNY's request, their banks could be held liable for breaching confidentiality in the offshore jurisdictions.

Another concern, which was expressed by officials from 7 of the 15 banks, involved a potential loss of business because of the "uneven playing field." They believed beneficial owner documentation requirements created an additional burden for banks compared to other financial institutions, including securities broker/dealers, that are engaged in private banking activities, such as managing and maintaining accounts for PICS. Although these firms are engaged in private banking activities similar to those offered by banks, they are not yet subject to regulations requiring the reporting of suspicious transactions.<sup>20</sup>

Bank officials also expressed concerns over the effect pending KYC regulations might have on regulatory access to beneficial owner documentation. We sought the views of bank officials on two possible approaches to regulatory access to such documentation. The first approach would be for banks to routinely retain records in the United States on the beneficial owners of offshore entities that maintain U.S. private banking accounts. The second approach would be for banks to bring records on the beneficial owners of these offshore entities into the

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<sup>20</sup>The Securities and Exchange Commission and Treasury's Financial Crimes Enforcement Network are working together to develop regulations for broker/dealers regarding suspicious activity reports, according to officials from both agencies. At the time of our review, these regulations had not yet been issued.

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United States only if requested during an examination. We found that both approaches caused a similar level of concern, with some bank officials stating that the bank would need to make the same changes to how it maintains documentation on the beneficial owners of offshore entities in either case. Bank officials believed that for the most part, under both approaches, their banks would be at a competitive disadvantage with other financial institutions (e.g., securities broker/dealers, foreign banks) not subject to the same requirement. To a great extent, bank officials also said that either of these approaches would cause them to lose the business of foreign clients. See appendix II for the banks' views on these two approaches.

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**Banks Changing Procedures to Provide FRBNY With Access to Beneficial Owner Documentation**

In spite of their concerns, officials from 11 of the 15 banks surveyed indicated that their banks had changed the way they maintain documentation on the beneficial owners of offshore entities that have U.S. accounts. Officials from the remaining four banks indicated that their banks already had such documentation in their U.S. files as a matter of bank policy. We found that 6 of the 11 banks that changed the way they maintain beneficial owner documentation were in the process of obtaining confidentiality waivers from their clients who were the beneficial owners of PICs and other offshore entities. Officials from the remaining five banks indicated that their banks could reconstruct information on the beneficial owners of these offshore entities from information they already maintain in their U.S. files.

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**Too Early to Determine Impact of Changes on Banks' Private Banking Business**

We found that of the 11 banks that changed the way they maintain documentation on the beneficial owners of offshore entities that have U.S. accounts, 9 were unable to provide us with specific information on the impact these changes have had on their private banking business. Officials from five of the nine banks indicated that it was too early to determine the impact because they had only recently begun this process. Officials from two banks were able to provide us with some preliminary information. In 1 case, the bank requested confidentiality waivers from 16 clients and reported that 15 of the clients agreed to sign waivers. The single client who refused to sign a waiver reportedly closed his account. In another case, the bank asked 116 clients to sign confidentiality waivers. In this case, 31 of the 116 clients, or 27 percent, did not sign the waivers. Twenty-six of these 31 clients transferred their accounts to the bank's offshore affiliates; the other 5 clients closed their accounts, according to the bank officials we surveyed.

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## Agency Comments and Our Evaluation

The Federal Reserve and OCC provided written comments on a draft of this report. (See apps. III and IV). Both agencies generally agreed with our analysis and observations on the oversight of private banking activities involving offshore jurisdictions. We also obtained oral comments of a technical nature from the Federal Reserve and OCC that have been incorporated in the report where appropriate.

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As agreed with your office, unless you announce the contents of this report earlier, we plan no further distribution until 30 days after the date of this letter. At that time, we will send copies of this report to the Ranking Minority Member of your Subcommittee and to the Chairmen and Ranking Minority Members of other interested congressional committees, the Chairman of the Federal Reserve Board, the Comptroller of the Currency, and the Chairman of the Federal Deposit Insurance Corporation. We will also make copies available to others on request.

Major contributors to this report are listed in appendix V. Please call me on (202) 512-8678 if you or your staff have any questions about the report.

Sincerely yours,



Susan S. Westin  
Associate Director, Financial Institutions  
and Markets Issues

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# Contents

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Letter	1
Appendix I Methodology for Identifying Banks Actively Involved in Offshore Private Banking	24
Appendix II Alternative Approaches to Regulatory Access to Beneficial Owner Documentation	27
Appendix III Comments From the Federal Reserve Board	30
Appendix IV Comments From the Office of the Comptroller of the Currency	31
Appendix V Major Contributors to This Report	32

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Tables

Table 1: Extent of U.S. Regulatory Access to Bank Information in Nine Offshore Jurisdictions	13
Table 2: Nine Offshore Jurisdictions' Membership in International Supervisory Groups or Anti-Money-Laundering Task Forces	16
Table 3: KYC Policies, Suspicious Activity Reporting Requirements, and Mutual Evaluations for Nine Offshore Jurisdictions	17

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Abbreviations

BSA	Bank Secrecy Act
CFATF	Caribbean Financial Action Task Force
FATF	Financial Action Task Force
FRBNY	Federal Reserve Bank of New York
KYC	know your customer
OCC	Office of the Comptroller of the Currency
PIC	private investment company

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# Methodology for Identifying Banks Actively Involved in Offshore Private Banking

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We found in our prior work on private banking that there was no comprehensive database on the extent of private banking activities, let alone offshore private banking activities, by banks or other financial institutions operating in the United States.<sup>21</sup> We also found that the most recent information identified on private banking in the United States was a general overview of the area, which did not consistently identify the providers that were engaged in international, specifically offshore, activities.<sup>22</sup> Given this constraint, we attempted to identify banks that were actively involved in offshore private banking activities by first identifying banks with large amounts of assets in selected offshore jurisdictions, then determining through input from regulators if these banks were engaged in offshore private banking activities involving these jurisdictions. Our methodology is described in greater detail below.

We identified 16 banks that were actively involved in offshore private banking activities. We supplemented this group of banks with information from the Federal Reserve Bank of New York (FRBNY) on banks in its district involved in private banking activities. This FRBNY information helped us identify an additional nine banks actively involved in offshore private banking activities. In total, we identified 25 banks for our review. It should be noted that these banks do not represent all banks that may be involved in offshore private banking activities, only a subset of banks with a significant level of offshore assets in certain jurisdictions identified to be particularly susceptible to money laundering.

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## Methodology to Identify Banks Actively Involved in Offshore Private Banking Activities

We applied the following steps to identify banks actively involved in offshore private banking activities.

Step 1: Identified offshore jurisdictions that represent areas particularly susceptible to money laundering.

We identified 17 offshore jurisdictions that were viewed as financial secrecy havens and particularly susceptible to money laundering. We identified these jurisdictions using information from the Internal Revenue Service, the Department of State, and the Economist Intelligence Unit of the United Kingdom.

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<sup>21</sup>See *Private Banking: Information on Private Banking and Its Vulnerability to Money Laundering* (GAO/GGD-98-19R, Oct. 30, 1997).

<sup>22</sup>*Private Banking Register*, 1996, Worth Magazine Supplement.

Step 2: Identified which of the 17 offshore jurisdictions had a “significant” amount of assets managed or controlled by banks operating in the United States.

We identified nine jurisdictions—the Bahamas, Bahrain, the Cayman Islands, the Channel Islands, Hong Kong, Luxembourg, Panama, Singapore, and Switzerland—that had a significant amount of assets managed or controlled by banks operating in the United States. We identified these jurisdictions on the basis of a minimum threshold of \$1 billion in total U.S. bank branch or subsidiary assets. Our source of asset information was a report generated by the Federal Reserve on foreign branches and subsidiaries of U.S. banks.

Step 3: Identified banks with a significant amount of assets in one or more of the nine offshore jurisdictions identified in step 2.

We used two thresholds, one for domestic banks and the other for foreign banks, to determine which banks had a significant amount of assets in any of the nine offshore jurisdictions selected for review. For domestic banks we identified 29 banks that met a minimum threshold of \$1 billion. For the foreign banks we identified nine banks that met a minimum threshold of \$10 billion. Our key sources of information were reports generated by the Federal Reserve on foreign branches and subsidiaries of U.S. banks and on non-U.S. branches that are managed or controlled by a U.S. branch or agency of a foreign (non-U.S.) bank.

Step 4: Determined if banks identified in step 3 were engaged in offshore private banking activities involving any of the nine offshore jurisdictions.

We asked banking regulators to verify whether the banks identified in step 3 were actively involved in offshore private banking activities. They identified 16 banks as actively involved in offshore private banking activities. Ten of these banks were supervised by the Federal Reserve, and the remaining 6 were supervised by the Office of the Comptroller of the Currency.

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**Appendix I**  
**Methodology for Identifying Banks Actively**  
**Involved in Offshore Private Banking**

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# Alternative Approaches to Regulatory Access to Beneficial Owner Documentation

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As part of our survey of 15 banks that had been examined by FRBNY during its private banking initiative, we sought the views of bank officials on two approaches that were being considered by the Federal Reserve to regulatory access to documentation on the beneficial owners of PICS and other offshore entities that maintain U.S. accounts. The first approach would be for banks to routinely retain records in the United States on the beneficial owners of offshore entities that maintain U.S. private banking accounts. The second approach would be for banks to bring records on the beneficial owners of these offshore entities into the United States only if requested during an examination. We found that bank officials had a similar level of concern with both approaches, with some officials stating that the bank would need to make the same changes to how it maintains documentation on the beneficial owners of these offshore entities under either approach.

Below are the questions from our survey that we used to solicit the views of bank officials on the two approaches to regulatory access to beneficial owner documentation. The tables show the number of bank officials who responded in a given category. Bank officials did not consistently provide their input on all of the categories; therefore, the responses in each row do not always add up to 15, the total number of banks surveyed.

**Appendix II  
Alternative Approaches to Regulatory  
Access to Beneficial Owner Documentation**

“If your bank were to routinely maintain records on the beneficial owners of offshore accounts in the United States for regulatory oversight purposes, how likely or unlikely would the following occur? (Please check one box in each row.)”

	Very likely	Somewhat likely	As likely as unlikely	Somewhat unlikely	Very unlikely	No basis to judge
Change the way you do business (e.g., ask clients to sign confidentiality waivers up-front)	9			1	3	1
Lose business to other banks and/or financial institutions (e.g. brokerage houses) that do not have this requirement	8	3			1	2
Lose business primarily of foreign clients who value their confidentiality	11	1	2			
Transfer accounts of foreign clients to offshore affiliates	5	2	3		1	2
Change your approach to the private banking business (e.g, reduce the size or eliminate the bank’s private banking business in the United States)	5	2		2	5	
Other changes: Trust company in offshore location would have to counsel its clients to direct their assets elsewhere (i.e., outside of the United States)	1					
Other changes: Increase in civil litigation against clients because information will be readily available.	1					
Other changes: Lose account officers to other financial institutions with less stringent requirements.	1					

**n = 15**

Note: A few officials suggested that other changes were somewhat likely to occur, including added system requirements to track accounts and an increase in compliance staff, the cost of doing business, and the amount of training required of client advisors.

**Appendix II  
Alternative Approaches to Regulatory  
Access to Beneficial Owner Documentation**

“Alternatively, if your bank were to bring records on the beneficial owners of offshore accounts (e.g., PICs, trusts, offshore mutual funds) into the United States only upon request during an examination, how likely or unlikely would the following occur? (Please check one box in each row.)”

	Very likely	Somewhat likely	As likely as unlikely	Somewhat unlikely	Very unlikely	No basis to judge
Change the way you do business (e.g., ask clients to sign confidentiality waivers up-front)	8				2	1
Lose business to other banks and/or financial institutions (e.g. brokerage houses) that do not have this requirement	7	1		2		1
Lose business primarily of foreign clients who value their confidentiality	8	2		1		
Transfer accounts of foreign clients to offshore affiliates	6		1	1	1	2
Change your approach to the private banking business (e.g, reduce the size or eliminate the bank's private banking business in the United States)	5	1		2	3	
Other changes: Trust company in offshore location would have to counsel its clients to direct their assets elsewhere (i.e., outside of the United States)	1					
Other changes: Increase in civil litigation against clients because information will be readily available.	1					
Other changes: Lose account officers to other financial institutions with less stringent requirements.	1					

**n = 15**

# Comments From the Federal Reserve Board



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20561

DIVISION OF BANKING  
SUPERVISION AND REGULATION

June 17, 1998

Susan S. Westin  
Associate Director, Financial Institutions  
and Market Issues  
United States General Accounting Office  
General Government Division  
Washington, D.C. 20548

Dear Ms. Westin:

Thank you for sharing your draft report entitled Money Laundering: Regulatory Oversight of Offshore Private Banking Activities. We have reviewed the report and commend your staff for its comprehensive analysis. The Division of Banking Supervision and Regulation staff has a few technical edits that have been provided to the General Accounting Office under separate cover.

Sincerely,

A handwritten signature in black ink, appearing to read "Richard Spillenkothen".

Richard Spillenkothen  
Director

cc: Mr. Frost  
Ms. Wells

# Comments From the Office of the Comptroller of the Currency



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Comptroller of the Currency  
Administrator of National Banks

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Washington, DC 20219

June 16, 1998

Ms. Susan S. Westin  
Associate Director, Financial Institutions and Markets Issues  
General Government Division  
United States General Accounting Office  
Washington, D.C. 20548

Dear Ms. Westin:

We have reviewed your draft audit report titled *Money Laundering: Regulatory Oversight of Offshore Private Banking Activities*. The report was prepared in response to a congressional request that you review U.S. regulatory oversight of private banking activities involving offshore jurisdictions. The report concludes that offshore jurisdictions' bank secrecy laws represent key barriers to U.S. regulators' oversight of offshore private banking activities.

The report is informative and it correctly identifies the key issues facing the regulators in their anti-money laundering efforts. More specifically, the report notes that the regulators have limited access to information in the nine offshore jurisdictions that were the focus of the review and that our efforts to work around the barriers have met with only limited success.

Thank you for the opportunity to review and comment on the draft report. Technical comments were provided to the evaluators separately.

Sincerely,

  
Edward J. Hanley  
Senior Deputy Comptroller for Administration

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