

Impact on the Firm Value of Financial Institutions from Penalties for Violating AML-OFAC Regulations

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Abstract

This study examines the valuation effects of anti-money laundering (AML) enforcement actions and the Office of Foreign Assets Control (OFAC) economic sanction violations on U.S. Financial Institutions (FIs). Using a hand-collected sample of 308 enforcement actions issued between 2000 to 2018, results show that a civil money penalty (CMP) adversely affects a bank's value in the next quarter. Neither the magnitude, nor the type of AML-OFAC violation, and neither the bank's ability to deal with an enforcement action—as proxied for by efficiency ratios and governance mechanisms—are able to moderate the adverse effect of the CMP.



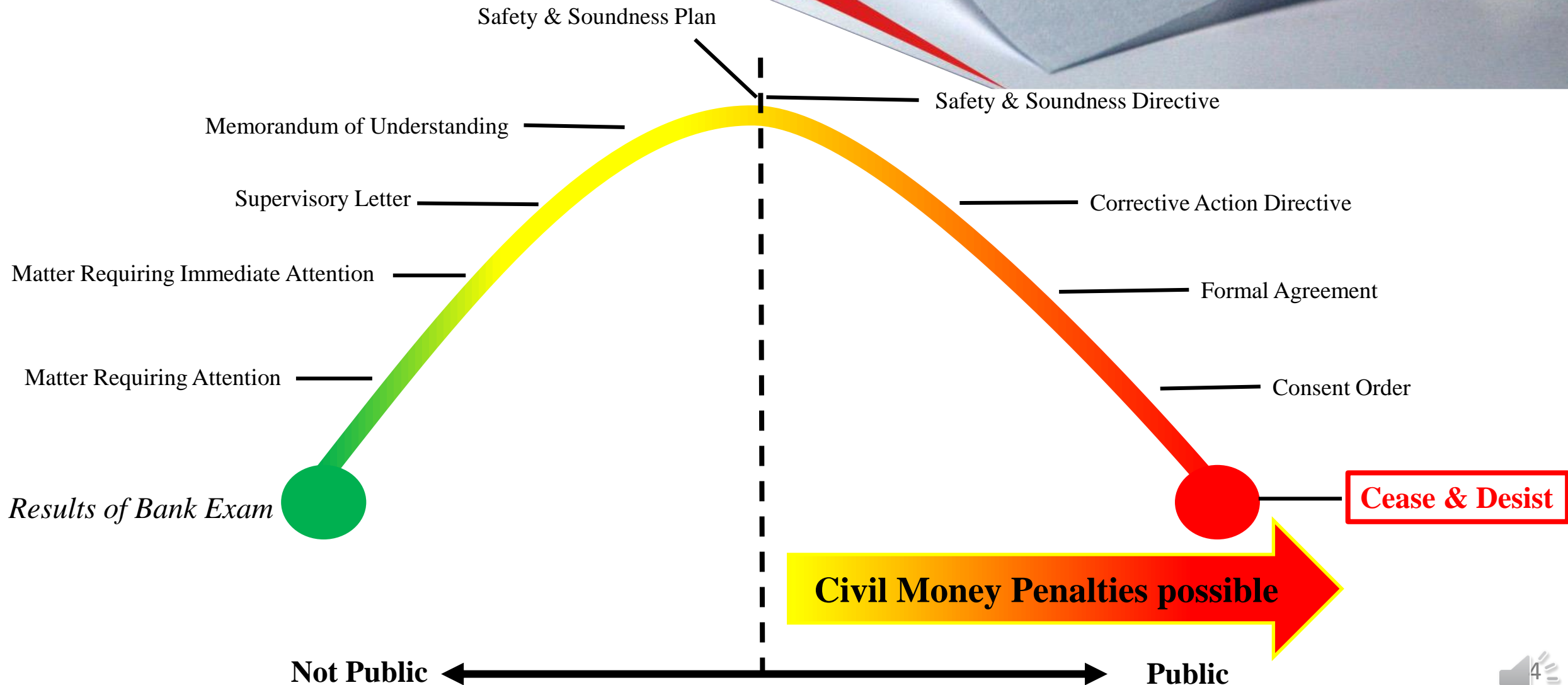
AML-OFAC Defined

- **AML = Anti-Money Laundering:**
 - Money laundering is when criminals use the banking system to hide cash from illegal activities
 - \$800 billion to \$2 trillion a year is estimated to be laundered through the global financial system
 - U.S. Financial Institutions must identify and report suspicious transactions to law enforcement
- **OFAC = Office of Foreign Assets Control:**
 - POTUS designates 33 countries* for economic sanctions, and,
 - POTUS identifies enemies or persons posing a threat to US:
 - terrorists, human traffickers, arms dealers, warlords, and dealers in weapons of mass destruction
 - SDN list – Specially Designated Nationals and Blocked Persons list with 32,830* names
 - U.S. Financial Institutions must freeze accounts or block wire transfers

* as of April 17, 2019



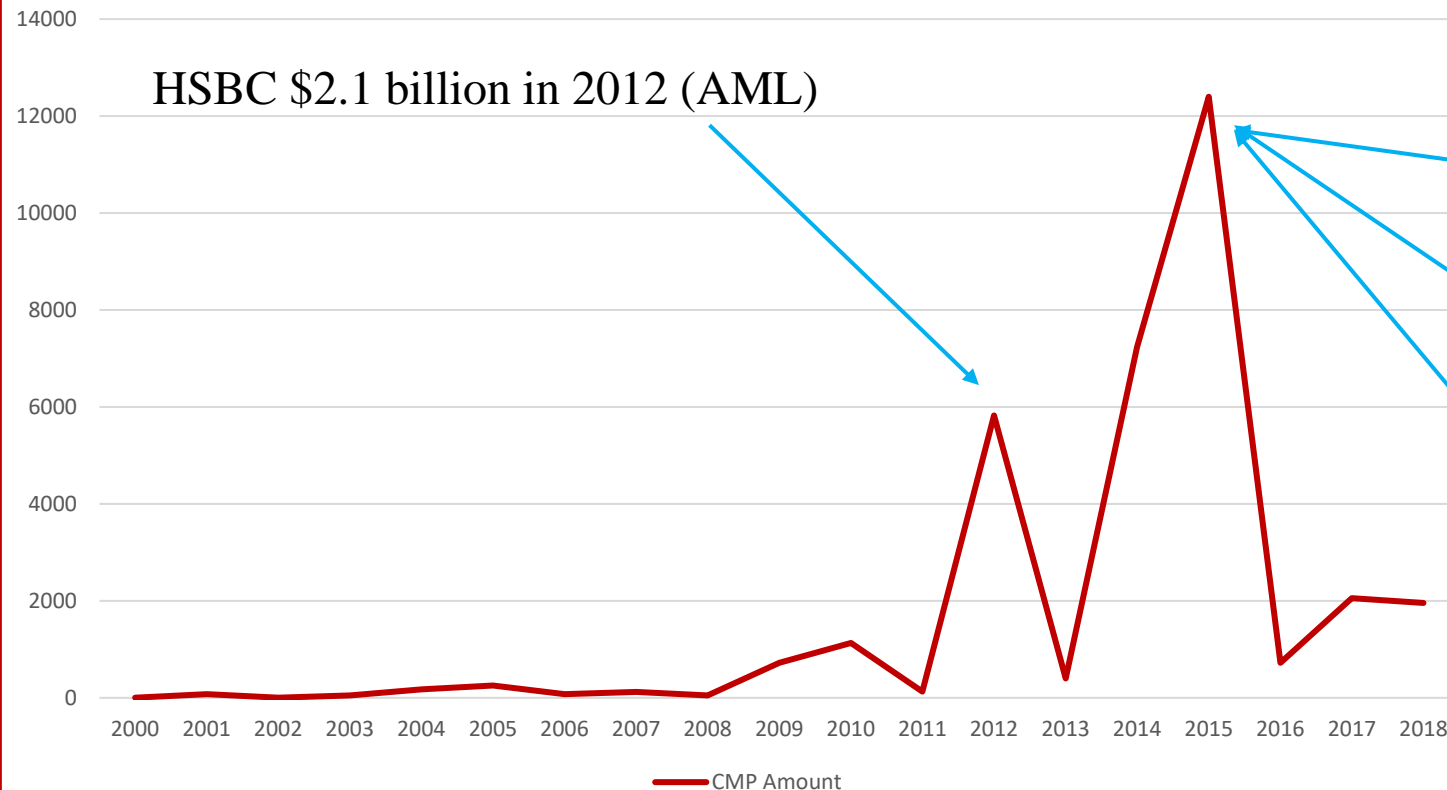
Regulatory Enforcement Actions



Key Enforcement Actions



Enforcement Actions with CMPs



JPMC \$2.5 billion (AML)

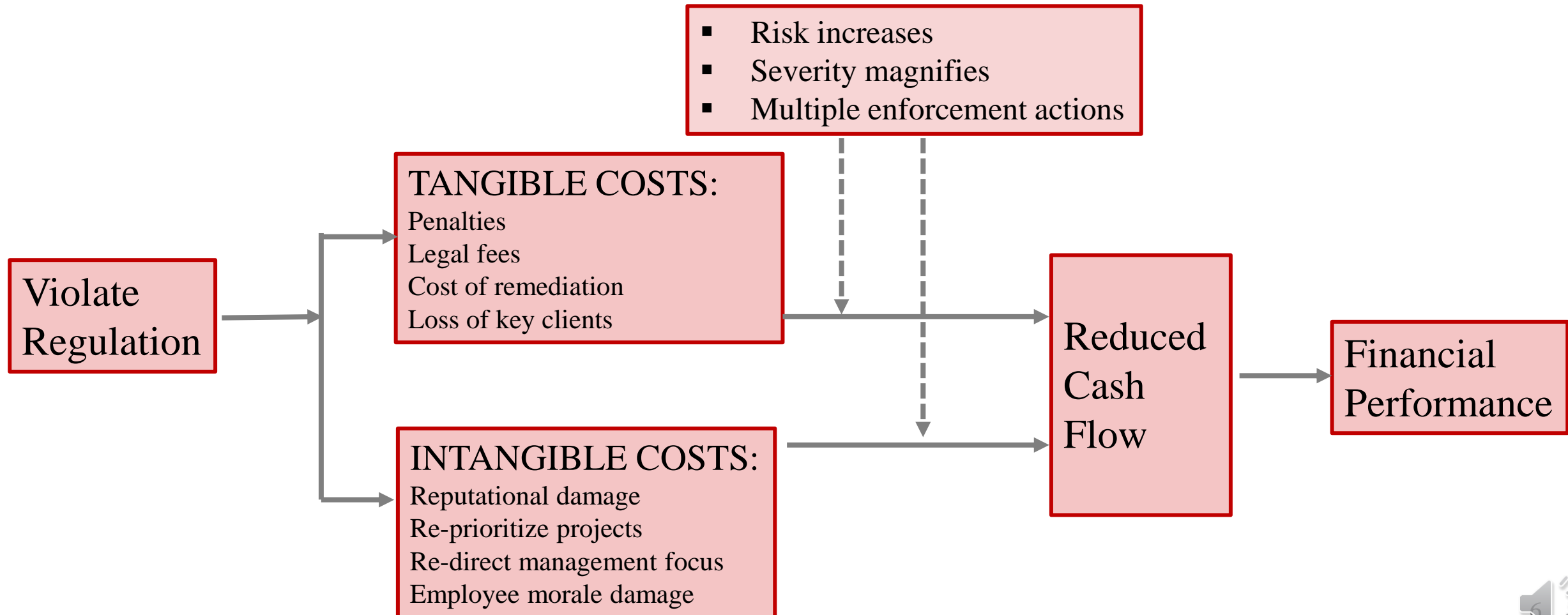
BNP Paribas \$11 billion (OFAC)

Commerz Bank \$1.4 billion (OFAC)

\$14.9 billion in 2014-15



AML-OFAC Model



Sample Selection Process

Sample	N
Enforcement Action records manually collected	989
Less: firms privately-held and cooperative banks	-509
Less: Credit Unions	-12
Less: Enforcement Action record for an individual	-1
Less: Enforcement Action records firms with no CUSIP Number	-84
Less: financial institutions not traded on U.S. stock exchanges	-8
Sample number of enforcement action records	375
Less: firms with multiple enforcement actions in the same year	-67
Number of firms with only one enforcement action per year	308
Less: CUSIP numbers not matching on Compustat	-151
Number of Sample Firms	157
Number of firm quarterly observations	8,948



Research Questions and Hypotheses

•**RQ1:** We investigate the effect that an AML-OFAC violation has on bank valuation.

• *H1: There is a **negative** impact on firm value from an AML-OFAC civil money penalty on sample firm..*

$$FIRM\ VALUE_{i,t+1} = \alpha_0 + \alpha_1 CMP_{i,t} + \sum_{j=2}^n \alpha_j CONTROLS_{i,t} + \varepsilon_{i,t}$$

•**RQ2:** We test whether more efficient FIs are better able to mitigate the negative impact on firm value.

•*H2a: There is a **positive** impact on firm value from the ER for sample firm.*

•*H2b: The negative relation between CMP-TOBINQ will not be reduced in the presence of better ER.*

$$FIRM\ VALUE_{i,t+1} = \alpha_0 + \alpha_1 BETTER_ER_{i,t} + \alpha_2 CMP_{i,t} + \alpha_3 BETTER_ER_{i,t} * CMP_{i,t} + \sum_{j=4}^n \alpha_j CONTROLS_{i,t} + \varepsilon_{i,t}$$

•**RQ3:** We test whether FIs that are better governed are more able to limit the negative impact on firm value.

•*H3a: There is a **positive** impact on firm value from corporate governance for sample firm.*

•*H3b: The negative relation between CMP-TOBINO will not be reduced in the presence of better governance.*

$$FIRM\ VALUE_{i,t+1} = \alpha_0 + \alpha_1 GOVERNANCE_{i,t} + \alpha_2 CMP_{i,t} + \alpha_3 GOVERNANCE_{i,t} * CMP_{i,t} + \sum_{j=4}^n \alpha_j CONTROLS_{i,t} + \varepsilon_{i,t}$$



Methodologies

1. **Sample and sample period:** A hand-collected sample of 308 enforcement actions issued between January 2000 and November 2018
2. **Dependent Variable:** Firm value, proxy by natural logarithmic value of Tobin's Q

$$TOBINQ_{i,t+1} = \frac{MKCAP_{i,t+1} + (TA_{i,t+1} - EQUITY_{i,t+1})}{TA_t}$$

3. **Variables of Interest:**

- Civil Money Penalty: $CMP_DUMMY_{i,t}$, CMP , $CMP_IMPACT_{i,t}$
- Efficiency Ratio: $BETTER_ER_{i,t}$
- Corporate Governance: $GOVERNANCE_{i,t}$

$$ER = \frac{\text{Non interest Expense}}{\text{Operating Income} - \text{Loan Loss Provision}}$$

4. **Research Models:** To mitigate endogeneity, we use Generalized Least Squares (GLS) regressions in Panel data.



RQ #1 – CMP on Firm Value

H1: *There is a negative impact on firm value from an AML-OFAC civil money penalty on sample firms.*

Table 11. Financial Impact on the Firm Value from CMP

VARIABLES	Prediction (+ -)	(1) <i>CMP_DUMMY</i>	(2) <i>CMP</i>	(3) <i>CMP_IMPACT</i>
<i>CMP_DUMMY</i>	┐	-0.064 *** (-3.440)		
<i>CMP</i>	┐		-0.010 *** (-7.215)	
<i>CMP_IMPACT</i>	┐			-0.011 *** (-4.615)
~ Control Variables ~				
Wald chi2		2130***	2279***	2149***
Observations		4,770	4770	4770

z-statistics in parentheses

* p<0.1, ** p<0.05, *** p<0.01



RQ# 2 – BETTER_ER on Firm Value

H2a: There is a *positive* impact on firm value from the efficiency ratio for sample firms.

H2b: The positive relationship between the efficiency ratio and firm value will be alleviated in the presence of the civil money penalty from an AML-OFAC enforcement action.

Table 13. Financial Impact on the Firm Value from Efficiency Ratio

VARIABLES	Prediction (+ -)	(1) CMP_DUMMY	(2) CMP	(3) CMP_IMPACT
BETTER_ER	+	0.041 *** (2.927)	0.032 ** -2.467	-0.006 (-0.725)
CMP_DUMMY	I	-0.033 * (-1.678)		
BETTER_ER * CMPDUMMY	I	-0.064 *** (-3.826)		
CMP	I		-0.008 *** (-5.730)	
BETTER_ER * CMP	I		-0.004 *** (-3.834)	
CMP_IMPACT	I			-0.012 *** (-4.614)
BETTER_ER * CMPIMPACT	I			0.002 (0.656)
~ Control Variables ~				
Wald chi2		2205***	2382***	2189***
Observations		4,770	4770	4,770

z-statistics in parentheses

* p<0.1, ** p<0.05, *** p<0.01



RQ #3 – GOVERNANCE on Firm Value

H3a: There is a *positive* impact on firm value from corporate governance for sample firms.

H3b: The positive relationship between corporate governance and firm value will be reduced in the presence of the civil money penalty from an AML-OFAC enforcement action.

Table 15. Financial Impact on the Firm Value from Corporate Governance

VARIABLES	Prediction		<i>CMP_DUMMY</i>	<i>CMP</i>	<i>CMP_IMPACT</i>
	(+)	(-)			
<i>GOVERNANCE</i>	·	+	0.535 *** (6.887)	0.487 *** (6.563)	0.342 *** (6.155)
<i>CMP_DUMMY</i>	·	+	-0.021 (-0.844)		
<i>GOVERNANCE * CMPDUMMY</i>	·	+	-0.357 *** (-3.420)		
<i>CMP</i>	·	+		-0.007 *** (-4.498)	
<i>GOVERNANCE * CMP</i>	·	+		-0.023 *** (-3.028)	
<i>CMP_IMPACT</i>	·	+			-0.006 * (-1.746)
<i>GOVERNANCE * CMPIMPACT</i>	·	+			-0.046 ** (-2.409)
~ Control Variables ~					
Wald chi2			2501***	2673***	2610***
Observations			4,381	4381	4,381

z-statistics in parentheses

* p<0.1, ** p<0.05, *** p<0.01



Findings Summary

- There is an adverse effect on next quarter firm value from AML-OFAC violations with CMPs.
- Neither the bank's ability to deal with an enforcement action as proxied for by ER nor by Governance mechanisms are able to moderate the adverse effect of a CMP.



Thank You – Our Contact Information

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