Lockboxes, Iraqi Loot and a Trail to the Fed

By TIMOTHY L. O'BRIEN

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WHEN a United States Army sergeant broke through a false wall in a small building in Baghdad on a Friday afternoon a little over a year ago, he discovered more than three dozen sealed boxes containing about $160 million in neatly bundled $100 bills.

Polaris

Maj. Rodney King with some of the millions in cash that American troops found during raids in Iraq in April 2003.

Later that day, soldiers found more cash in other hideaways near the Tigris River, in an exclusive neighborhood that elite members of Saddam Hussein's government once called home. By the end of the evening, they had amassed 164 metal boxes, all riveted shut, that held about $650 million in shrink-wrapped greenbacks. The cash was so heavy, and so valuable, that the Army needed a C-130 Hercules cargo plane to airlift it to a secure location.

Just two days later, on Sunday, April 20, 2003, Thomas C. Baxter, head of the legal unit of the Federal Reserve Bank of New York, read a brief news account of the discovery. Most of the money that turned up in Baghdad was new, bore sequential serial numbers and was stored with documents indicating that it had once been held in Iraq's central bank. One fact particularly bothered Mr. Baxter: the money had markings from three Fed banks, including his own in New York.

Iraq, of course, had been subject to more than a decade of trade sanctions by the United States and the United Nations, so large piles of dollars, especially new bills, were not supposed to have found their way to Baghdad.

"How could that happen?" Mr. Baxter thought to himself, as he recalled later in Senate testimony. "Not only with U.S. sanctions, but with U.N. sanctions. How could that happen?"

Mr. Baxter and the New York Fed, along with the Treasury Department and the Customs Service, immediately began an investigation into Baghdad's currency stockpile. The continuing inquiry offers a rudimentary road map of illicit dealings - including lucrative oil smuggling - in Iraq and neighboring countries during the Hussein years, the federal authorities say.

The investigation led quickly to the vaults of four Western banks that were among a select group handling the sensitive task of distributing freshly printed dollars overseas: the Bank of America, the HSBC Group, the Royal Bank of Scotland and UBS. Several other commercial banks and foreign central banks, which the Fed did not name, also served as stopovers along Baghdad's money trail, according to a written account Mr. Baxter provided to the Senate Banking Committee about two weeks ago.

None of the four main banks the Fed scrutinized had sent currency directly to Iraq. But as the inquiry wore on last year, investigators learned that UBS, Switzerland's largest bank, had transferred $4 billion to $5 billion to four other countries that were under sanctions: Libya, Iran, Cuba and the former Yugoslavia. Over an eight-year period, UBS employees had quietly shipped the money to those countries from a vault at the Zurich airport, undetected by Fed auditors who made regular visits to the site.

EARLY last month, the Federal Reserve Board fined UBS $100 million for the currency violations. It was the second-largest penalty ever levied by America's central bank, surpassed only by a $200 million fine imposed on the Bank of Credit and Commerce International, or B.C.C.I., in 1991 for violating American banking laws. The B.C.C.I. case was part of a global investigation of fraud and money laundering.

UBS's transgressions don't appear to be in the same league as those at B.C.C.I. Several people briefed on the transfers said most of the UBS transactions involved currency exchanges for the Cuban tourism industry; such transactions anger Washington but do not evoke security fears in most of the world. A handful of lower-level UBS employees are said to have doctored trading records that misled their employers and American officials. All of them have been fired or have left the bank. UBS has not been charged with any crimes in the matter.

A former Fed official and others involved in the investigation say the hefty fine reflects the Fed's displeasure at having been misled by UBS employees for so many years. Members of Congress have accused the Fed of being asleep at the regulatory switch, an added incentive for a marquee-size fine at a time when regulators of all stripes have come under fire for overlooking abuses and excesses on Wall Street.

Yet UBS's trades with Libya, Iran and Yugoslavia, and the investigation into how hundreds of millions of dollars circumvented sanctions and regulatory barriers on their way to Baghdad, are hardly trivial affairs.

Of the $680 billion in cash that the Fed has in circulation, more than $400 billion, or nearly 60 percent, is outside the United States. That overseas supply, particularly in economically unstable regions, is the financial lifeblood of businesses, and even of pensioners who stow dollars in their mattresses. The authorities constantly monitor that supply to keep counterfeiters from tainting it, and hub banks like UBS play a pivotal role in ferreting out currency forgers.

Those billions overseas, however, also grease the wheels of more nefarious commerce - arms trafficking, smuggling and the timeless crafts of political and financial graft.

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Maj. Rodney King with some of the millions in cash that American troops found during raids in Iraq in April 2003.

The trail of the cash that soldiers found in Baghdad last year remains murky. David Aufhauser, a senior Treasury Department official who supervised investigations of Saddam Hussein's finances until October, said in an interview last year that investigators thought the funds were part of about $1 billion that Mr. Hussein's son Qusay looted from Iraq's central bank hours before American-led forces invaded in early 2003. Qusay Hussein, who was killed in a shootout with American troops in Baghdad last July, oversaw the Iraqi government's oil smuggling, according to a report published in 2002 by the Coalition for International Justice, a Washington group that monitors human rights issues.

From 1996 to 2003, the United Nations controlled Iraq's oil profits, which were intended to be used for food and other goods for Iraqi civilians. The United Nations has defended its stewardship, but the General Accounting Office recently estimated that oil smuggling and kickbacks linked to that program allowed Mr. Hussein to steal about $10 billion.

The United Nations recently appointed a former Fed chairman, Paul A. Volcker, to lead a panel investigating possible fraud in the oil-for-food program. The Treasury Department says that a large Syrian bank that does business with major American banks helped divert and disguise oil-for-food funds stolen by the Hussein government.

Senator Richard C. Shelby, an Alabama Republican and chairman of the Banking Committee, grilled Mr. Baxter two weeks ago about the monitoring of currency the Fed ships overseas, and about the challenges that arise when some people, like UBS's former employees, cover up their use of the money.

"What about an oversight regime that appeared exceedingly dependent upon the voluntary compliance of the banks?" the senator asked Mr. Baxter about the Fed's vigilance.

Mr. Baxter responded, "That gets into one of the fundamental problems here, and that is trying to

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trace bank notes once they're outside of the United States." Mr. Baxter, a graduate of Georgetown University Law School who has spent 23 years at the New York Fed, is well regarded by colleagues and is considered a gifted financial sleuth. One former colleague fondly described him as "golden."

When Mr. Baxter, 50, began tracing the Baghdad funds last year, according to his Senate testimony, he first acquired serial numbers for some of the notes and turned over that information to Fed currency analysts in East Rutherford, N.J.

On April 24, 2003, just four days after Mr. Baxter first read about the money, the analysts linked it to 24 cash shipments the New York Fed made to special vaults it had at HSBC in London, and Bank of America and UBS in Zurich. After American forces in Iraq discovered an additional $112 million in hidden cash, on top of the $650 million they had already found, the Fed's cashiers tracked it to the same vaults and to a Fed vault at HSBC in Frankfurt, a Royal Bank of Scotland vault in London and to other locations the Fed has not disclosed.

All of those overseas vaults are part of a Fed program begun in 1996 to combat counterfeiting, retire worn-out dollars and keep currency circulating, especially during emergencies. For example, the vaults were opened when the Year 2000 computer problem caused banking jitters overseas four years ago and again after the Sept. 11, 2001, terrorist attacks in New York grounded planes that would have normally delivered cash abroad.

UNTIL the mid-1990's, American currency was relatively easy to forge, compared with most other leading currencies. Its colors were not as varied, it did not bear watermarks or special security bands, and its linen and cotton composition was much like that of another currency still widely used by counterfeiters to mint fake dollars: the Hussein-era Iraqi dinar.

Though successful counterfeiting is usually short-lived, and fakes are just a minuscule portion of the bills in circulation, there are moments when near-perfect copies, known as supernotes, circulate for uncomfortably long periods. Phony $100 bills are the forgers' favorite.

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In 1996, the Treasury Department was about to introduce a new, more secure $100 bill into circulation in Europe, aware that the note would be eagerly snapped up in the booming Russian economy. Also aware that sophisticated Russian criminal groups and forgers would pounce on the newly minted bill, the American authorities wanted a safe harbor in Zurich to monitor it. Republic Bank, an American bank that had once handled those duties, was leaving the business. UBS was eager to make inroads in Russia, so the Fed contracted its services.

By the end of last May, according to Mr. Baxter's testimony, nearly all banks contacted by his team about the money found in Baghdad had identified the countries or parties with whom they had traded dollars. The exception was UBS. According to Mr. Baxter's Senate testimony, UBS initially told the Fed that it did not track the serial numbers of currency it traded and that Swiss law precluded its identifying of specific trading partners. Eventually, however, UBS agreed to identify countries. Iraq was not on the list, and that appeared to satisfy the Fed until June 25, when one of its auditors made a routine visit to Zurich.

That day, UBS gave the auditor a report showing that eight shipments of dollars had been sent to Iran, a country under American sanctions. UBS said its trading had been a mistake. A month later, Mr. Baxter and the Swiss Federal Banking Commission began a deeper investigation. By October, according to Mr. Baxter's testimony, the Fed had learned that UBS had also traded currency with Cuba and Libya and that employees had covered up the Cuban transactions. Mr. Baxter revoked the Fed's contract with UBS on Oct. 28. About a week later, UBS told the Fed that it had also traded currency with the former Yugoslavia, which was also under American sanctions.

UBS declined to comment on its transactions with Libya, Yugoslavia and Iran.

UBS, in cooperation with the Fed and the Swiss authorities, then began an internal investigation. Over the next six months, investigators interviewed 48 UBS employees, often more than once, and reviewed several thousand documents, including e-mail messages, Mr. Baxter said in written Senate testimony.

UBS reported the results of its investigation to the Fed on April 16, and the Fed levied its $100 million fine on May 10. Only a handful of UBS employees conducted the trades, and none took bribes or received extra income from the transactions, according to a senior investigator with the Swiss Federal Banking Commission and several others briefed on the matter.

But some on Capitol Hill say that there is more to be learned about the UBS transactions. Representative Michael G. Oxley, an Ohio Republican who is chairman of the House Financial Services Committee, said last week that he thought the size of the UBS fine might be inadequate "in light of the gravity" of the problems uncovered at the bank.

Although Mr. Baxter's team quickly identified the source of the cash found in Baghdad, it is still not clear how it got into the hands of members of the Hussein government.

"UBS never had any direct delivery to Iraq," Urs Zulauf, director of the Swiss Federal Banking Commission's enforcement division, said in an interview. "They delivered to other Arab countries that were not under sanctions."

Jordan and Syria, two neighbors of Iraq, were routinely accused by Western politicians and law enforcement officials of helping Iraq flout sanctions during the Hussein era. But both countries have repeatedly denied those accusations. A Los Angeles Times article last year said that some of the currency found by American soldiers in Baghdad had been sent to Iraq's central bank by the Jordan National Bank. In an interview last year, an official at the Jordan bank disputed any involvement; the bank did not respond last week to calls and an e-mail message on the issue.

On May 11, a day after the Fed fined UBS, the federal government issued trade sanctions against Syria, saying it supported terrorism. The same day, the Treasury Department shut off access to the American banking system for Syria's main state-owned bank, the Commercial Bank of Syria, citing suspicions that transactions at the bank were used to finance terrorism and launder money related to the United Nations oil-for-food program.

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"Numerous transactions that may be indicative of terrorist financing and money laundering have been observed" moving through the Syrian bank's accounts, according to a Treasury Department document, adding that the transfers include several transactions "that reference a reputed financier for Osama bin Laden."

According to the Treasury Department, Iraq's state oil agency maintained accounts at the Commercial Bank of Syria through which oil-for-food money was diverted. Imad Moustapha, Iraq's ambassador to the United States, said in an interview on Thursday that the Syrian bank had about $265 million in funds legally deposited there by the Hussein government. He denied all accusations of money laundering and other financial improprieties involving Syria and the Hussein government, describing them as "politically motivated" and part of a "campaign of disinformation about Syria."

The Treasury Department document says the Commercial Bank of Syria maintains correspondent accounts with a few American banks. Though not named in the document, the banks are Citigroup, J. P. Morgan and the Bank of New York. The American banks declined to comment.

Although the document says that unnamed American-based accounts appeared legitimate, it also says that "suspicious wire transfers, totaling more than $1 million" moved through those accounts on their way to the Syrian bank.

THE difficulty of mapping the full journey of the money found in Baghdad last year shows some of the forensic hurdles confronting Fed and Treasury investigators. But the supervision of UBS has shown some of the Fed's regulatory weaknesses.

"The Fed just seemed to take UBS at their word as to where they traded the money," Senator Jim Bunning, Republican of Kentucky, said in a statement two weeks ago. "As long as the bottom line matched up, the Fed didn't seem to worry that much about where the money went.

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UBS falsified documents, but I do not believe the Fed showed the proper due diligence."

When B.C.C.I.'s problems first spilled into the open more than a decade ago, Fed regulators said that the bank had lied to them and that they therefore could not have detected abuses sooner. That is the same reason they have given recently for being slow to catch problems at UBS.

Senate testimony also suggests that the Fed may have been too credulous in its relationship with UBS.

"Did the Fed ever conduct unannounced audits" of UBS? Senator Shelby asked Mr. Baxter two weeks ago.

Mr. Baxter responded, "I think they always knew we were coming."

Regulators previously walked softly around accusations of money laundering. The two biggest such investigations of the late 1990's, involving Citigroup and the Bank of New York, did not result in any regulatory fines and stalled after investigators hit dead ends in gathering evidence outside the United States.

But Sept. 11 changed some things. Suspect financial activities that were once perceived as an exotic form of white-collar crime are now looked upon with a tangible threat in mind: terrorist financing. For instance, the Riggs National Corporation is mired in an investigation of suspect transactions in its banking accounts and, like UBS, has found itself saddled by federal regulators with a hefty fine - $25 million - for regulatory violations. Riggs has denied any wrongdoing.

During a hearing on Thursday attended by Susan S. Bies, a Federal Reserve board governor, and William J. Fox, head of the Treasury Department's Financial Crimes Enforcement Network, the Senate Banking Committee criticized several of the country's leading regulators as moving too slowly after the Sept. 11 attacks, saying examiners might have overlooked gaps in the global banking system that may pose national security risks.

Asked by the House Financial Services Committee last Wednesday what mistakes the Fed made in its examinations of UBS, Mr. Baxter said, "We did not follow the old audit admonition: trust, but verify."

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