Testimony of
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Before
The Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
U.S. House of Representatives
On
The Proposed "Know Your Customer" Rule
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Chairman Gekas, Ranking Member Nadler, and members of the Subcommittee, I am pleased to be with you this morning to present my views on the proposed regulation that has come to be called "Know Your Customer."

I was sworn in as Comptroller of the Currency on December 8, 1998, so I did not participate either in the process that led to this proposal, or in the formulation of the proposal itself. I come new to the issue, and this has both advantages and disadvantages.

One clear disadvantage is that I did not have a first-hand opportunity to learn of the background of the proposal before it was published or to benefit from the interagency deliberations concerning the complex issues that unquestionably surfaced as the agencies formulated the proposal.

One advantage of coming new to this issue, however, is that I believe I can bring an objective judgment to the question of what future the proposal should have -- a judgment that I hope is informed by some 37 years in the public and private sector of dealing with issues of federal banking regulation, as a lawyer in private practice representing banks, as a professor of banking law at three law schools, as General Counsel to the Federal Reserve Board, and as Under Secretary of the Treasury for Domestic Finance.

Mr. Chairman, the comment period on the proposed regulation closes this coming Monday, and we are reviewing the many comments we have received. It is my judgment, however, that the proposal should be promptly withdrawn. I firmly believe that any marginal advantages for law enforcement in this proposal are strongly outweighed by its potential for inflicting lasting damage on our banking system. I will explain my reasoning.

Let me say at the outset that the law enforcement objectives that underlie the Know Your Customer proposal are of enormous importance to our country and must not be dismissed. It is widely recognized that the ability to launder the proceeds of illegal activity -- particularly drug traffic -- facilitates criminals engaged in such activity. Stemming the flow of narcotics into the country, and combating the sale of drugs on our streets, depend heavily on the ability of law enforcement to impede the efforts of drug dealers to convert the cash proceeds of their activities into useable funds.

Since it is inevitable that criminals will seek to use depository institutions to launder their illegal revenues, it is entirely reasonable that banks and their regulators take all reasonable steps to ensure that they are not used wittingly or unwittingly to further illegal activities. For many years the Bank Secrecy Act has been aimed at achieving this objective and bankers have provided a valuable role in this effort in a working partnership with bank regulators and the law enforcement community.

Beyond the valuable contribution banks make to this effort, there are other considerations that must be weighed as we consider new regulatory initiatives. Banks play an enormously important role in our economy. They serve as a safe repository for the earnings and savings of scores of millions of citizens. They play an essential role in the financing of commercial and consumer transactions. They operate our mechanism for making and clearing payments, and they provide a broad range of fiduciary services for both individuals and businesses.

Maintaining public confidence in the banking system has long been an important objective of national policy. That is why Congress created a system of federal deposit insurance 65 years ago; it is why the Federal Reserve has been invested with the responsibility to act as a lender of last resort and provider of liquidity; and it is why we have a comprehensive system of federal bank licensing, supervision and regulation. Indeed, restoring public confidence in banks was one of the important reasons why the OCC was created over 135 years ago.

Crucial to maintaining the confidence of bank customers in our banking system is their expectation that their relationships with their banks will be private and confidential -- that information they provide to their banks will not be used for inappropriate purposes; that transactions will be processed objectively and nonjudgmentally; and that the interests of the customer will be paramount in importance. As I learned early in my legal career, many courts have held that banks have an implied contractual obligation of confidentiality to their customers.

To be sure, this confidentiality is not absolute. Banks must respond to lawful subpoenas for customer information; they have reporting obligations under the Bank Secrecy Act; they are required to report "suspicious transactions" to law enforcement authorities; and they may share certain kinds of information about credit experience with credit reporting bureaus. To date, however, these qualifications to customer confidentiality have not seriously affected customer confidence in the system as a whole -- although, as I will point out shortly, they have created enough concerns to keep millions of Americans out of the system.

My grave concern is that if federal law imposes an explicit and enforceable obligation on banks not only to adopt procedures designed to identify their customers, but also to maintain systems for "monitoring customer transactions and identifying transactions that are inconsistent with normal and expected transactions" for that customer, as the proposed regulation would

require, it could have a profoundly adverse effect on the nature of the relationship banks have with their customers, and consequently, on the banking system as a whole. Law-abiding citizens -- who make up the overwhelming proportion of bank customers -- are likely to have serious concerns that their everyday relationships with their banks will be routinely scrutinized for evidence of misconduct. They will be understandably apprehensive that their banks will report any transactions that may be the least out-of-the-ordinary, or that don't meet some predetermined customer "profile" established by a faceless bank employee or some computer program, as a "suspicious activity." And they are likely to come to the view that instead of being protectors of a confidential relationship, their banks have turned into an extension of the law enforcement apparatus. Were this to occur, it could do lasting damage to our banking system.

There are several other reasons why I have concerns about the proposed Know Your Customer regulation.

First, it would obstruct our effort to bring more Americans into the financial mainstream. In my time as Under Secretary of the Treasury, we worked hard to carry out the mandate of Congress that all federal nontax payments should be made electronically. One of the greatest obstacles to achieving this goal has been that an estimated 10 million people who regularly receive federal payments do not have bank accounts. There are a variety of reasons why this is so, but surveys indicate that almost one-quarter of those recipients who do not have bank accounts cite confidentiality as a reason. A federally-enforced "Know Your Customer" rule can only serve to heighten the concerns that already cause millions to remain outside the banking system.

Second, I believe that the proposal would create competitive disparity among different types of financial service providers, to the detriment of banks. No regulation has yet been proposed that would apply to credit unions, money market mutual funds and security brokerage accounts. It can be expected that customers who have concerns about the continued confidentiality of their financial affairs may migrate to these other institutions. Indeed, in an open marketplace one might expect those nonbank intermediaries to exploit this advantage.

Finally, I have serious concerns about the kind of regulatory compliance burdens that would inevitably develop if a new regulatory regime were adopted. Bankers have been conditioned to want certainty and precision in the rules they must operate under. I see the potential for a myriad of questions being raised, resulting in the development of a smothering body of rulings and interpretations that banks would have to consult in order to be sure they were in conformity with the law. The creation of such burdens would have a particularly heavy impact on community banks, which typically do not have the depth of compliance resources that larger banks have.

Indeed, the rulemaking proposals themselves give a forewarning of this. While the text of the proposed rule itself

is quite short, the preamble material strongly suggests that there will be a strong demand for definition and interpretation. One agency's proposal, for example, prescribes what kind of customer identification should be required by a bank when a new account is opened. An in-state drivers license is acceptable, it says, but an out-of-state license cannot be used without "corroboration" -- unless the customer happens to live in a community such as Washington, D.C., that spans several states and the license was issued by a "neighboring" state. How long will it be before a banker asks for a ruling whether an expired drivers license suffices, or an interpretation whether a state must be contiguous to qualify as "neighboring"?

None of these concerns should be taken as reflecting a belief that banks should remain oblivious to the identities of their customers or that they should not take care to have systems and controls in place that will allow them to identify suspected illegal conduct -- such as transactions that are purposely structured to remain below reporting thresholds. Banks not only have obligations under existing law, but they have a variety of good business reasons to know their customers. The large majority of banks already have processes in place to accomplish these objectives.

In that regard, bank trade associations could provide a valuable service to their members by developing and sharing information on best practices in this area. Trade groups do an effective job in communicating their members' objections to proposed government initiatives, but there is an opportunity here for them to address the Know Your Customer issue in a way that could obviate the need for any new regulation. Assisting members in developing sensible and customer-sensitive Know Your Customer programs would be a valuable service.

For all of the reasons I have expressed in my statement to you today, I am convinced that this proposal should be withdrawn. Thank you for the opportunity to address this important matter.