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Know Your Customer - Or Not

Genci Bilali

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KNOW YOUR CUSTOMER - OR NOT

by

Genci Bilali*

I. Introduction .................................................................................................................... 2

II. The Know Your Customer Principle as an Established Part of Bank Practice ............. 3

III. Know Your Customer in Securities Law ..................................................................... 8

   A. The Common Law ............................................................................................ 9
   B. NASD Rules ...................................................................................................... 9
   C. New York Stock Exchange Rule 405 .............................................................. 10
   D. Future Trading ................................................................................................. 10

IV. The USA Patriot Act ................................................................................................. 11

V. International Papers .................................................................................................... 13

   A. Basle Activity ................................................................................................. 13
   B. G20 Activity ................................................................................................... 15

VI. 1998 Know Your Customer Proposed Regulations ................................................... 15

VII. Federal Reserve 2008 Regulation ............................................................................. 17

VIII. Failure to Know Customers in the Making of Sub-Prime Real Estate Mortgages.. 19

   A. Failure of Regulators ....................................................................................... 20
   B. Trigger to 2007-9 International Economic Dislocation .................................. 27
   C. Would Knowledge of Customers Have Averted, Relieved or Reduced Crisis? 27

IX. Regulatory Reform ...................................................................................................36

X. Dodd-Frank Wall Street Reform and Consumer Protection Act Act ..................37

   A. The Consumer Financial Protection Bureau ....................................................37
   B. “Know Your Customer” and “Suitability” FINRA Rules ...............................39

XI. Conclusion ................................................................................................................41

* Attorney at law, New York, Solicitor in England and Wales.
I. INTRODUCTION

“Know Your Customer” (KYC) is the due diligence and bank regulation that banks and other financial institutions perform in order to identify their clients and ascertain relevant information pertinent to doing financial business with them.¹ The KYC is a policy implemented to conform to a customer identification program mandated under the acts and regulations issued by the Congress and supervision authorities.

The KYC policies are largely applied from banks and other financial institutions not only to prevent identity theft fraud, money laundering and terrorist financing but also to regulate the risk in business of lending and investment banking activities between banks and their customers.

Commercial and investment banks failed to comply and implement fully the KYC policies in lending monies and selling financial products to their customers, which affected in the economic and financial crisis of 2008 - 2009.² As a result, bank regulators have undertaken a sweeping reform in addressing lessons learnt from the financial crisis in order to consolidate the KYC policies in order to become more efficient in implementation. Key to the success of the KYC policies and regulations will depend on the close supervision level of bank and financial authorities, ensuring full and adequate enforcement of these rules.

In this paper, I discuss a brief history of the KYC, its development and evolution throughout time, efforts made by the banking authorities in order to shape and improve implementation of the KYC rules in commercial and investment banking activities, culminating with the enactment of the Dodd-Frank Act. I conclude that the KYC is an evolving concept and in order to make its implementation effective towards banks and other financial institutions, regulators should supervise banks of proper compliance. The role of banks to ensure adequate education of their staff in order to effectively comply with the KYC rules and recommendations is significant in a successful implementation of the KYC provisions in the banking system.

Notwithstanding the fact that there is no clear evidence to prove whether or not a full compliance from banks and other financial institutions of KYC principle may have averted, relieved or even reduced the financial crisis of 2008 - 2009, it is a clear conclusion that compliance of such principle from the banks and other financial institutions may have had a positive effect to the severity of the crisis.

II. THE KNOW YOUR CUSTOMER PRINCIPLE IS AN ESTABLISHED PART OF BANK PRACTICE

The phrase “know your customer” (henceforth “KYC”) stands for the due diligence that financial institutions, both regulated and unregulated, must observe in order to identify their clients and ascertain relevant information pertinent to conducting financial business with them. KYC is typically a policy implemented to conform to customer identification programs mandated under such laws as the Bank Secrecy Act and USA Patriot Act. KYC policies have become increasingly important globally to prevent identity theft, fraud, money laundering and terrorist financing.

Most financial institutions build value for their customers by offering them constantly expanding financial services tailored to their needs. Mass marketing of products is being supplanted by Customer Relationship Management (CRM), a fundamentally different approach in which customer acquisition (e.g., via a credit card product) is just one stage of projected long-term relationships between businesses and their customers.

Nowhere are the advantages of CRM more keenly felt than in the financial services industry. It used to be relatively simple for a skilled banker to create an effective banking experience for customers. But today there are diverse products, a broader geography, new technology, and new delivery channels. Even the best and brightest bankers cannot service their customers in a customized or cookie-cutter manner. They must rely on information to direct their efforts more effectively, to personalize the interaction their customers have with the bank.

The concept of “KYC” is at once ancient and revolutionary. The nineteenth century shopkeeper built long-term relationships with his customers. The storeowner knew customers personally, could greet them, anticipate their needs, and win their continued business. In today’s markets dominated by large corporations, relationships cannot be built around a customer contacting the same company employee every time. Instead technology allows firms of all sizes to collect and store information about customers at every opportunity, and make it available to company employees in order to personalize the service whenever they have contact with customers. In essence, today’s company knows its customers through its database.

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7 See Beverly B. Wells, At Wachovia, Customer Focus Means Information-Driven Continuous Relationship Management, 21 J. Retail Banking Services 33, 34 (1999).
We have heard as recently as the late 1990s that there will be KYC formal regulations. As we discuss below, the first regulations foundered and the question now seems to be will it really happen and, if so, when. However, the real question is what to do until there is a regulation. Because knowing your customer has been pending regulation by those officials who regulate banks, it is more than pending regulation. It is safe and sound banking.

KYC involves a lot of common sense. It also incorporates basic business and banking principles. There are also practical sources. One such source is John Atkinson, of the Federal Reserve Bank of Atlanta. Atkinson, although not privy to the initial “KYC” draft regulation, was familiar with the issues being considered, and shared his version of KYC with banks to help them develop KYC policies and procedures.

Atkinson stressed that each bank must develop its own KYC program. The bank, the nature of its community and the types of products the bank offers are important to consider or include in the program. So, much like the Community Reinvestment Act, a good KYC program involves knowing the bank’s community.

Another point that Atkinson made was that the KYC policy should cover loans - including commercial loans - as well as deposits. Loan proceeds and the activities supported by loans are an effective method of laundering the profits of illegal activity. So loan officers should be equally sensitive to the issues of KYC and requirements for identifying and reporting suspicious activities.

A KYC principle should accomplish several goals:

First, it should establish the true identity of the bank’s customers. Before beginning a loan or account relationship with an individual or company, the bank should know who they are.

Second, the bank should verify the source of funds. This step is something that mortgage lenders have long taken. The borrower’s down-payment must be verified before the application is underwritten and approved. It’s necessary to know whether the applicant actually has the funds they claim to. The concept in KYC is similar. Verifying the source of funds is a step to ensure that the bank is dealing with legitimate money.

Third, the program should monitor ongoing activity. Many accounts that are used by criminals were legitimate when established. Others are established to appear innocent and maintained that way for a period of time before being put to illegal use such as money laundering. This can happen to commercial loan relationships as well as to deposit accounts.

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10 See Know Your Customers Soon – Somehow, Bankers Online, http://www.bankersonline.com/articles/v02n1213/v02n1213a5.html.
These KYC principle elements are designed to determine the true identity of the customer, determine and document the source of funds, and the normal and expected transactions or activity.

In addition, on the practical side, KYC procedures help the bank to determine what documentation requirements apply and how to monitor transactions. Monitoring accounts enables the bank to determine whether routine activity is taking place or whether there has been a significant change. When changes are identified and determined to be suspicious, the bank should file a Suspicious Activity Report.11

Banks apply the KYC principle mainly in two areas of business: lending and deposit accounts.

In order to apply KYC to the lending business, banks need to spend extra time with their borrowers; both commercial and consumer; ask them for examples of unusual forms of down payment and unusual loan purposes such as a purchase that is inconsistent with the applicant’s lifestyle. Banks should ask about the businesses in borrowers’ portfolios; and generally use the information banks get from them in the procedures banks develop. Better yet, banks should involve borrowers in development of the procedures.

As for consumer borrowers, revolving credit lending arrangements such as credit cards or inventory loans, involves subtle procedures. A borrower might not reapply to a lender for years. In the recent financial crisis, masses of consumer borrowers might be grouped together with individual scrutiny as a lender develops often an unwarranted sense of security. Procedures for reviewing borrowers on some form of periodic timetable must be created to see the KYC is honored but not overdone.

As for the applicability of KYC for personal deposit accounts, there are always many variations in a spread of consumer accounts. Banks should examine such factors as the customer’s previous address; get the customer’s Social Security Number; obtain proof of the customer’s identification; get at least one picture identification such as a passport, driver’s license, or college or work photo ID; determine the customer’s current and previous employers; determine the location of the customer’s place of work and residence; verify the residence and/or employment with a phone call; consider the source of funds used to open the account; for large accounts, ask the customer for a prior bank reference and write the institution about the customer; check with service bureaus for information on how previous accounts were handled; and check for other relationships with the institution.

KYC elements for business accounts include determination of the previous business name and address, if any; obtaining the company’s taxpayer identification number, and evidence of the customer’s legal status; the source of funds used to open the account; often a visit the place of business to determine whether the business is as represented; obtaining a description of the customer’s primary line or nature of business

11 Required to be filed with the Treasury Department under Sec. 314 of the USA Patriot Act of 2001.
in order to evaluate information about the customer’s account activity; the business’s financial statements, including an estimation of cash sales and related deposits to determine whether they are sound and consistent with the customer’s statements.

KYC guidelines, from which the proposed KYC regulations emanate, have a long, hotly-debated history, which originated with language in a legislative report on the Bank Secrecy Act. The report and the Act, however, do not define the term “know your customer” and do not give examples of what it means. KYC principles, such as development of internal policies, procedures, and controls, designation of a compliance officer, ongoing employee training programs, and independent audit function, however, are embodied in provisions of, and amendments to, the Act. The lack of definitively articulated standards has been one of the central criticisms of KYC policies since their inception.

On several occasions codification of KYC guidelines appeared imminent. The authority to promulgate KYC regulation under the USA Patriot Act (“PA”) which incorporates KYC as a major principle is vested in the U.S. Department of Treasury. Again, KYC guidelines are not codified. Basic reliance is on the federal banking agencies to require banks to establish and maintain adequate internal compliance programs. Throughout the 1980s and 1990s, law enforcement officials and the U.S. banking regulatory agencies promoted KYC policies and procedures as one of the most

14 Id. 5318(h)(1)(b).
15 Id. 5318(h)(1)(c).
16 Id. 5318(h)(1)(d).
20 See S. Rep. No. 101-460 (1990) (noting that Money Laundering Enforcement Amendments of 1990 authorized U.S. Department of Treasury to promulgate regulations to address money laundering through model KYC procedures); 136 Cong. Rec. S14465-01, S14466 (daily ed. Oct. 3, 1990) (statement of Sen. D’Amato) (explaining that Department of Treasury should have authority to require financial institutions to have stronger KYC procedures); In Brief, Know Your Customer, 4 No. 20 DOJ Alert 13 (1994) (Dept. of Justice) (reporting that top anti-money laundering officials previewed anticipated KYC regulations, which were expected but never issued by Department of Treasury, at 1994 money laundering conference).
effective ways for banks to prevent money laundering\textsuperscript{23} and to avoid liability under money laundering laws.\textsuperscript{24}

KYC guidelines in such statutes as the Bank Secrecy Act (“BSA”) and the PA serve several purposes.\textsuperscript{25} First, they may deter criminals posing as legitimate customers who would use financial institutions as tools to launder proceeds from their illicit activities.\textsuperscript{26} Second, strict adherence to KYC guidelines may reveal the illicit nature of a customer's business.\textsuperscript{27} Third, the information obtained from a customer will be transferred onto a database that will indicate when transactions are inconsistent with a customer's normal business transactions.\textsuperscript{28}

The potential to generate immense profits is at the source of drug trafficking and money laundering.\textsuperscript{29} Many experts agree that the key stage to limit this potential is when the illicit cash first enters the financial system.\textsuperscript{30} The BSA, the PA and their KYC


\textsuperscript{24} See Robert S. Bennett et al., Taking It to the Banks: The Use of the Criminal Process to Regulate Financial Institutions, 109 Banking L.J. 28, 30 (1992) (commenting on comprehensive enhancements to BSA through related banking legislation and noting civil penalties for violation of FIRREA are up to US$ 1,000,000 per day per violation).

\textsuperscript{25} See Peter E. Meltzer, Keeping Drug Money from Reaching the Wash Cycle: A Guide to the Bank Secrecy Act, 108 Banking L.J. 230, 239 (1991) (describing laundering process consisting of three distinct components: placement - deposit of cash into financial institution; layering - creating series of transactions through various accounts to disguise true origin of funds; integration - shifting funds to legitimate organizations with no apparent link to organized crime).

\textsuperscript{26} See id. (noting that investigation of client might reveal services that they desire are more consistent with needs of money laundering operation).

\textsuperscript{27} See 31 C.F.R. pt. 103, app. at 10 (1998) (suggesting that strong policies are only way to reveal transactions inconsistent with customer profile).

\textsuperscript{28} See Peter E. Meltzer, Keeping Drug Money from Reaching the Wash Cycle: A Guide to the Bank Secrecy Act, 108 Banking L.J. 230, 239 (1991) (describing laundering process consisting of three distinct components: placement - deposit of cash into financial institution; layering - creating series of transactions through various accounts to disguise true origin of funds; integration - shifting funds to legitimate organizations with no apparent link to organized crime).

\textsuperscript{29} See H.R. Rep. No. 101-446 at 21-22 (1990) (noting that street sales in United States generate up to US$ 110 billion per year).

\textsuperscript{30} See id. (reporting that Congressional Banking Committee recognized importance of monitoring flow of money entering financial system when enacting BSA); see also Statement by Edward W. Kelly, Jr., Member Board of Governors of the Federal Reserve System, Before the Committee on Banking and Financial Services, U.S. House of Representatives, Feb. 28, 1996, 82 Fed. Res. Bull. 322 [hereinafter Statement by Edward W. Kelly, Jr.] (noting that bank systems and bank employees are first and best line of defense against financial crimes); Elizabeth Kingma, New Frontiers in the Regulation of International Money Movement in the Wake of BCCI, 86 Am. Soc'y Intl L. Proc. 188, 199 (1992) (opining that placement is key stage in prevention of money laundering); Meltzer, supra note 3, at 231-32 (arguing that
guidelines, were designed to prevent entry of illicit funds into the system\textsuperscript{31} and to keep banks from becoming unwitting participants in money laundering schemes.\textsuperscript{32} KYC guidelines do so by requiring banks to obtain the information summarized above. Many scholars and banking experts argue that a financial institution with sound KYC guidelines in place will have the ability to prevent the opening of fictitious accounts and will provide the financial institution with a customer profile that will enable it to predict, with relative certainty, the types of transactions in which the customer is likely to engage.\textsuperscript{33}

The ability of a financial institution, under a strong KYC policy, to detect suspicious transactions has become one of the most significant elements in the prevention of criminal activity.\textsuperscript{34} Capitalizing on the ability to detect suspicious transactions, the Fed and other federal supervisory agencies required banks to report suspected criminal activity,\textsuperscript{35} Congress, however, has acknowledged that continuing suspicious transaction reporting places a substantial burden on financial institutions,\textsuperscript{36} and the U.S. regulatory authorities have made attempts to ease the burden of the reporting requirements.\textsuperscript{37}

III. “KNOW YOUR CUSTOMER” IN SECURITIES LAW

record keeping of cash transactions at point of entry into financial system is necessary to successful anti-money laundering system).
\textsuperscript{31} See H.R. Rep. No. 101-446, at 21-22 (discussing Congressional acknowledgement that monitoring and reporting cash flows, as well as identifying illegal source of funds, are important tools to thwart money launderers).
\textsuperscript{32} See Rudnick & Noonan, supra note 13, at 5 (reporting that banks are particularly susceptible to abuse by financial criminals).
\textsuperscript{33} See Guidelines for Monitoring Bank Secrecy Act Compliance, supra note 7, at *2 (noting that bank employee education programs are essential for proper administration of KYC programs, particularly identification of suspicious transactions); see also Kingma, supra note 250, at 200-01 (arguing for full or partial adoption of OAS Model Regulations, which support both KYC programs and suspicious activity reporting); Shockey, supra note 13, at 16-17 (contending that KYC programs promote basic safety and soundness considerations and that identifying and reporting suspected criminal activity is one of more significant elements of KYC program).
\textsuperscript{34} See Statement by Edward W. Kelly, Jr., supra note 250, at 323-24 (commenting that KYC policies are best way to prevent illicit funds from entering system and that suspicious transaction reporting is essential element).
\textsuperscript{35} 31 U.S.C. 5318(g) (1994).
\textsuperscript{36} See H.R. Rep. No. 101-446, at 24 (1990) (noting that compliance with BSA is difficult and costly, as staff must be trained to identify suspicious transactions and that financial community, and taxpayers, must be reassured by government that filing of over six million CTRs results in criminal liability for money launderers).
\textsuperscript{37} See Statement by Edward W. Kelly, Jr., supra note 250, at 323-24 (commenting that Fed and other federal bank supervisory agencies, along with U.S. Department of Treasury, changed suspicious transaction criminal referral process, combining current supervisory agency rules with Department of Treasury’s suspicious-activity reporting requirements). Additionally, a uniform inter-agency reporting form has reduced the need for repetitive reports. Id. Banks will now also have the ability to use computer software to help prepare magnetic filing of the reports. Id.; see Lee v. Bankers Trust Company, 1999 WL 64633 (2d Cir. 1999) (holding that safe harbor provision of 31 U.S.C. 5318(g) provides unqualified privilege against liability for defamation or liable for filing Suspicious Activity Report).
A major area of financial law where the KYC principle is applied is the relationship of securities investors to the broker-dealers who represent them. Essentially an agency relationship, a broker-dealer has a variously described fiduciary duty to his customer. This duty is often not fixed by statute, regulation or rule and may appear in different guises. We will mention three, beginning with the common law setting.

A. THE COMMON LAW

The fiduciary duty committing a broker-dealer to know its customer is often described as an “inherent” ingredient of that position. Its parameters are not precise; its requirements vary from state to state and often within a state; it may be described as being governed by state law or by federal law. At bottom, it is a continuing duty to carry out the customers orders “in a manner best suited to serve the customer’s interests.” Obviously, one cannot serve the customer’s interests without knowing the customer.

This fiduciary relationship is said to be based upon the trust a securities customer places in an adviser more expert than himself in a specialized field where both training and experience give the broker-dealer a superior position. It can be seen as analogous to the relationship between a customer and a bank where trust is placed in a bank when the customer places its money with the bank and relies upon the bank not only to care for the money and report to the depositor regularly and accurately but also will comply with demands that money be transferred to particular parties at particular times by check, electronic means and personal identification and carry out those demands so that the customer’s obligations will be met. It is a truism that the customer must be known.

An aspect of this fiduciary relationship is said to be based upon the “shingle theory.” By essentially hanging up a shingle and publicizing its services, a broker-dealer announces that it will deal fairly with the customer who answers the shingle’s call.

B. NASD RULES

The principles of the common law on knowing your customer have been made specific in various ways. One is the Rules of the National Association of Securities Dealers, the NASD, which regulates trading in equities, corporate bonds, securities futures and options, with authority over the activities of more than 5,100 brokerage firms and more than 676,000 securities representatives (consolidated in 2007 into the Financial
Industry Regulatory Authority). NASD Rule 2310 is clear about the duty of a broker-dealer to know its customer:

2310. Recommendations to Customers (Suitability)

(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

(b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:

- (1) the customer’s financial status;
- (2) the customer’s tax status;
- (3) the customer’s investment objectives;
- (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

C. NEW YORK STOCK EXCHANGE RULE 405

New York Stock Exchange rules apply to individuals and companies that are members of the New York Stock Exchange. While the Stock Exchange is located in New York City, it would seem that the rules are of relatively restricted operation. However, the rules make clear that they are applicable to branch offices of Stock Exchange members wherever they may be; they clearly have, therefore, a strong national and more modified international application.

Rule 405 states its essential purpose at its beginning:

Diligence As To Accounts

Every member organization is required ...to (1) Use due diligence to learn the essential facts relative to every customer...

For present purposes, the duty to know one’s customer is clearly and succinctly stated and it is unnecessary to go further.

D. FUTURES TRADING

The Commodities Futures Trading Commission, formed in 1975 to protect market users and the public from fraud, manipulation and abusive practices related to the sale of commodity and financial futures has adopted a set of regulations under the Commodity
Exchange Act. In part, it requires a futures commission merchant and introducing broker to furnish a customer with a prescribed disclosure statement containing the following language:

The risk of loss in trading commodity futures contracts can be substantial. You should, therefore, carefully consider whether such trading is suitable for you in light of your circumstances and financial resources. You should be aware of the following points.  

IV. THE USA PATRIOT ACT

One of the clearest and most compelling examples of a statutory requirement that a bank know its customer is the statute generally referred to as the USA Patriot Act. The principle substantive provisions of the Act are contained in Titles II and III.

Title II is controversial and has been the subject of heated exchanges among those concerned with issues of civil rights. It contains a series of amendments to the Foreign Intelligence Surveillance Act of 1978 generally expanding the scope of available methods of surveillance over perceived foreign threats. Title II contains a hierarchy of supervisory standards over electronic and personal surveillance including roles to be played by the President, the Attorney General, the Director of the C.I.A., the courts and specifically in the last category, the Chief Justice of the Supreme Court. Civil rights groups in the United States have expressed concern over the increased personal surveillance the Patriot Act makes available. The Attorney General has given his views that the increases are essential for national security and, in addition, do not violate Constitutional protections. While some lower courts have agreed that the Patriot Act oversteps Constitutional bounds, its scope has generally been affirmed by appellate courts, including the Supreme Court.

One result of Title II of the Patriot Act is that there has been little recent activity in the once flourishing area of privacy law. A significant area of discussion in federal law not too long ago was that privacy protections needed refurbishing and that too many individuals - and to some extent businesses - needed an upgrade in their privacy protections. As Title II of the Patriot Act developed a certain life, the interest in learning more about the affairs of terrorists necessarily made advances in privacy protection less significant. In sum, next to nothing has been done since late 1971. Parenthetically, it seems to the present authors that national interest in privacy protection has actually been diminishing. Increased involvement of the young in internet communication including

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43 The Commodities Futures Trading Commission Rules, 17 C.F.R. Sec. 1.55. The National Futures Association Compliance Rule 2-320 has a similar provision.
45 50 USC Sec. 1800 et seq.
FaceBook, Google and related internet devices has seem to have made privacy a less
desired matter; what many seem to want now is more, not less, personal disclosure."47
How this will play out against the know your customer principle remains to be seen.48

Our principal concern now, however, is with Patriot Act Title III, entitled the
International Money Laundering Abatement and Anti-Terrorist Financing Act. of 2001, a
complex assortment of provisions covering financial transactions and designed to ensure
that our system of finance does not allow terrorist financing. The Title concentrates
upon the banks’ relationships with their foreign depositors, their customers, and ensures
that they are known and that no unnecessary risk is taken. Banks are required, to a
degree not previously made a part of statutory law, to know their customers. Title III is
based upon a set of findings, including that “money laundering, estimated by the
International Monetary Fund to amount to between 2 and 5 percent of global domestic
product, which is at least $600,000,000,000 annually, provides the financial fuel that
permits transnational criminal enterprises to conduct and expand their operations to the
detriment of the safety and security of American citizens.” Among the official purposes
of Title III, it is designed “to increase the strength of the United States measures to
prevent, detect, and prosecute international money laundering and the financing of
terrorism.”49

Title III covers financial transactions with 26 domestic institutions together
defined as “financial institutions.”50 This is a bewildering list starting with “insured
bank” going through telegraph companies and automobile dealers and ending with “any
other business designated by the Secretary (of the Treasury) whose cash transactions have
a high degree of usefulness in criminal, tax, or regulatory matters.” A high degree of
regulatory discretion is accorded the Treasury in the administration of the Patriot Act and
through this authority the financial institutions to which any particular statutory directive
is addressed has become pruned through the years so that the Act is workable. A number
of the significant sections follows:

Sec. 312.51 Financial institutions that establish or maintain a private banking
account or a correspondent account in the United States for a non-U.S. person must
establish due diligence procedures that are reasonably designed to detect money
laundering. The provision is self-executing. The provision asserts as minimum standards
that the financial institution “ascertain the identity of the nominal and beneficial owners
of, and the source of funds deposited into, such account as needed to guard against
money laundering.”

The policies and procedures apply if a United States account is requested or
maintained by a foreign bank operating under an ‘offshore banking license.’ This type of
license illustrates the lengths the statute goes to uncover possible terrorist financial

47 Google Latitude allows subscribers to broadcast their locations and also learn where their friends are.
49 Id.
51 31 U.S.C. Sec. 5318 (i).
activities; it covers a license to conduct banking activities ‘which, as a condition of the
license, prohibits the licensed entity from conducting banking activities with the citizens
of ... the country which issued the license.’ A banking license which prohibits doing
business with local citizens is strange indeed.

Sec. 313.\(^{52}\) Applicable to those financial institutions that may attempt to maintain
a correspondent account in the United States for a foreign bank that does not have a
physical presence in any country\(^{53}\), the section would seem inapplicable to such
institutions as boat or car dealers among others. It is therefore made inapplicable by its
own terms to all financial institutions but those that are defined as “covered financial
institutions.” Those include some ten of the 26 financial institutions\(^{54}\) and cover those
institutions most likely to open accounts. The statute implements the know your
customer principle by requiring that the United States bank inform itself how the
correspondent account is likely to be used.

The Treasury Department has promulgated a regulation\(^{55}\) providing the
procedures a covered institution must follow to ensure that an account for a foreign bank
with an actual physical presence does not act as a bridge for yet another institution
without one thereby bringing Sec. 313 into play. Included is a certification of forms
process and the use of due diligence\(^{56}\) that “enable the covered financial institution to
detect and report ... any known or suspected money laundering activity.”

Sec. 326. In this provision, the Patriot Act requires the Secretary of the Treasury
to “prescribe regulations setting forth the minimum standards for financial institutions
and their customers regarding the identity of the customer that shall apply in connection
with the opening of an account at a financial institution.”\(^{57}\) For those financial
institutions that the Secretary has defined to be subject to the requirement.\(^{58}\)

V. INTERNATIONAL PAPERS

A. BASLE ACTIVITY

Know your customer has a strong situs in the international banking community.
The Bank for International Settlements located in Basle, Switzerland has from the early
1930s provided a place for the banks of the world to meet, store their data and share their
thoughts for the development of an international banking community. One of the core

\(^{52}\) 31 U.S.C. Sec. 5318(j).
\(^{53}\) Called “shell” banks.
\(^{54}\) 31 U.S.C. Sec 5312(a)(2).
\(^{55}\) 31 C.F.R. Secs. 103.175 and 103.177.
\(^{56}\) 313 C.F.R. Sec. 103.176
\(^{57}\) 31 U.S.C. Sec 5318(i).
\(^{58}\) Those institutions that have a “functional regulator,” defined to mean the Federal Reserve System, the
Comptroller of the Currency, the Federal Deposit Insurance Corporation, th Office of Thrift Supervision,
the National Credit Union Administration, the Securities and Exchange Commission and the Commodities
Futures Trading Commission.
institutions for this work has been the Committee on Banking Supervision. Created by the central bank governors of the Group of Ten nations, it began in 1974 and meets regularly four times a year, usually in Basle where its permanent Secretariat is located. The Committee has no founding treaty and does not issue binding regulations. Rather, its main function is to act as an informal forum to recommend international banking standards. Its recommendations have been taken seriously and frequently implemented locally by bank supervisory legislators and regulators around the world.\footnote{See Carl Felsenfeld and Genci Bilali, “The Role of the Bank for International Settlements in Shaping the World Financial System,” 25 U. Pa. J. Int’l Econ. L. 945.}

The Committee on Banking Supervision has no formal authority over the banks and related institutions on whose behalf it drafts rules and regulations. It is rather one of several movements that strive to tie disparate organizations in different countries that economic pressures force to do business with one another into a cohesive pattern. In this sense it is not unlike the United Nations that continually attempts to achieve a working harmony among its members. In the fields of finance, one sees bankruptcy reforms, capital proposals, rules of the sea and of the air, climate controls and many other efforts that constantly expand their recommendations to international organizations. Much has been achieved even within a framework that has little in the way of formal controls. Discussions are frequently undertaken to create responsibilities of a formal nature but little exists in the form of true international law. When it is discussed, however, the groups at Basle are frequently mentioned as potential institutions for further exploration.\footnote{See Duncan E. Alford, “Core Principles for Effective Banking Supervision: An Enforceable International Financial Standard?”, 28 B.C. Int’l & Comp. L. Rev. 237. See also \url{www.bis.org} on information about the Committee on Banking Supervision.}

The Committee on Banking Supervision published a paper on “Customer Due Diligence for Banks” in October 2001 and supplemented it in February 2003 to provide a customer identification and know-your-customer framework that may serve as a benchmark for banking supervisors. Both papers are concentrated upon the know your customer principle and advise banks of the steps to be taken in order to be sure of both the identity and quality of their customers. They are divided into two parts: personal customers and business customers. The recommendations are often essentially identical (like how to ascertain that the customer name is correct) but also vary in directing how to establish customer legitimacy and wealth.\footnote{See Herbert V. Morais, Symposium: Brave New World: U.S. Responses to the Rise in International Crime: Article: Fighting International Crime and Its Financing: The Importance of Following a Coherent Global Strategy Based on the Rule of Law, 50 Vill. L. Rev. 583.}

The papers require banks to develop clear customer acceptance policies and procedures, including a description of the types of customer that are likely to pose a higher than average risk. In preparing these policies, factors such as a customer’s background, country of origin, public or high profile position, linked accounts and business activities are areas that are considered. As different countries have different
banking systems, local peculiarities are also filtered into the advices. Adherence to broad common principles, however, should make the papers susceptible to a single governing law should the international system develop that far.  

B. G20 ACTIVITY

The Group of Twenty Finance Ministers and Central Bank Governors generally referred to as G20 is an informal group of countries that promotes discussion between industrial and emerging market countries on key issues related to global stability. G20 was established in 1999; its first meeting took place in Berlin in December. Actually, G20 consists of only 19 countries. The 20th is the European Central Bank.

The G20 group has also interested itself in international banking regulation. On April 2, 2009, G20 released a Declaration on Strengthening the Financial System which concentrates on the inconsistency in regulatory controls in the different countries. It affirms the continuing need to promote financial stability and to meet regulatory standards.

The Declaration, while filled with firm recommendations for the international financial system, reads like a work in progress; G20 “have taken, and will continue to take, action to strengthen regulation and supervision.” Although a relatively brief document of at best informal authority, it generally questions the adequacy of the risk management techniques in current use. The need for adequate risk management is stressed. The Declaration anticipates additional papers as the regulatory areas receive additional study. As with the other Basle papers, the work of G20 may be considered to be in an early stage.

VI. 1998 KNOW YOUR CUSTOMER PROPOSED REGULATIONS

On December 7, 1998, three major federal bank regulatory agencies, the Federal Reserve System, the Comptroller of the Currency and the Federal Deposit Insurance Corporation published in the Federal Register almost identical regulations requiring the banks under their jurisdictions to know their customers. Each regulation began with a background summary emphasizing the importance of this standard. The following is an extract from the statement of the Federal Reserve:

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63 The Declaration was a continuation of a prior report on the world financial system called the Washington Action Plan.

The integrity of the financial sector depends on the ability of banks and other financial institutions to attract and retain legitimate funds from legitimate customers. Banking organizations are able to attract and retain the business of legitimate customers because of the quality and reliability of the services being rendered and, as important, the sound and highly respected reputation of banking organizations. Illicit activities, such as money laundering, fraud, and other transactions designed to assist criminals in their illegal ventures, pose a serious threat to the integrity of financial institutions. When transactions at financial institutions involving illicit funds are revealed, these transactions invariably damage the reputation of the institution involved. While it is impossible to identify every transaction at a financial institution that is potentially illegal or is being conducted to assist criminals in the movement of illegally derived funds, it is fundamental for safe and sound operations that financial institutions take reasonable measures to identify their customers, understand the legitimate transactions to be conducted by those customers and, consequently, identify those transactions conducted by their customers that are suspicious in nature. By identifying and, when appropriate, reporting such transactions, in accordance with existing suspicious activity reporting requirements, financial institutions are protecting their integrity and are assisting the efforts of the bank regulatory agencies and law enforcement authorities to thwart illicit activities at financial institutions.

The Board has long advocated that one of the most effective means by which a financial institution can both protect itself from engaging in transactions designed to facilitate illicit activities and ensure compliance with applicable suspicious activity reporting requirements is for the institution to have adequate "Know Your Customer" policies and procedures. While some customers may view "Know Your Customer" procedures as an unnecessary intrusion into their privacy, these procedures are important for complying with the Bank Secrecy Act and suspicious activity reporting requirements. The adoption of the proposed "Know Your Customer" requirements may also assist banks in ascertaining those banking services that will most effectively serve the customers' interests and for managing risks to the bank. Many financial institutions have already adopted policies and procedures that are consistent with the proposed "Know Your Customer" requirements. Additionally, such policies and procedures have enabled banks to better serve their clientele, as well as comply with existing regulatory requirements.65

Comments on the proposed regulations were invited by March 8, 1999. None of the regulations was adopted.

65 63 F.R. 67516
In response to its Know Your Customer proposal, the OCC received over 16,000 comments during the comment period, which closed on March 8, 1999. Virtually all of the commenters opposed adoption of the proposed rule. Commenters were concerned primarily about the privacy implications of the proposal and the burden it would impose on financial institutions.

The overwhelming majority of commenters were individual, private citizens who voiced very strong opposition to the proposal as an invasion of personal privacy. Other issues raised by these commenters included that the Agencies lack the authority to issue the proposal; the cost of any Know Your Customer program would be passed on to customers; and the regulation would be ineffective in preventing money laundering and other illicit financial activities.

Banks, bank holding companies, and banking trade groups that commented uniformly opposed the proposal. Their concerns included the following: (1) the regulation would be very costly to implement, especially for small banks; (2) the Know Your Customer program would invade customer privacy; (3) commercial banks would be unfairly disadvantaged and lose customers if all segments of the financial services industry are not covered; (4) compliance with the regulation would divert resources from Y2K preparation; (5) the Agencies lack authority to adopt the regulation; (6) public confidence in the banking industry would be harmed by the regulation; and (7) the regulation is both unnecessary and redundant, as banks are already familiar with their customers and have adequate procedures in place.

In light of the comments received, the OCC is withdrawing the proposal. While the OCC believes that banks should adopt their own policies and procedures to determine the identities of their customers, and should have systems and controls that will allow them to identify suspected illegal conduct, the large majority of national banks already have policies and processes in place to accomplish these objectives.  

VII. FEDERAL RESERVE 2008 REGULATION

On December 20, 2007, the Federal Reserve Board proposed new regulations under the Truth in Lending Act. One of these prohibited creditors from engaging in a practice or pattern of soliciting ‘higher-priced mortgage loans” without reviewing the repayment ability of the borrower or proposed borrower by reference to certain accepted

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64 F.R. 15137
67 73 F.R. 1672, Jan. 9, 2008.
68 Defined as a loan secured by the consumer’s principal dwelling and priced to exceed the yield on Treasury securities by 3 percent for a lien on a dwelling or 5 percent for a subordinate lien on a dwelling. Id., at 1725.
records such as internal revenue documents. Clearly an example of the ‘know your customer’ principle, one would normally assume that the newly-established requirement was already part of a reasonable bank’s practice with or without the new regulation and was as much for the protection of the borrower as the lender.69

The Board wrote:

The Board has considered that some of the practices that would be prohibited may benefit some consumers in some circumstances. As discussed more fully below with respect to each prohibited practice, however, the Board believes that in connections with higher-priced mortgages loans these practices are likely to cause more injury to consumers than any benefit the practices may provide them.70

...Injuries from unaffordable loans. When borrowers cannot afford to meet their payment obligations, they and their communities suffer significant injury. Such borrowers are forced to use up home equity or other assets to cover the costs of refinancing. If refinancing is not an option, then borrowers must make sacrifices to keep their homes. If they cannot keep their homes, then they must sell before they had planned or endure foreclosure and eviction; in either case they may owe the lender more than the house is worth.71

The Board does not satisfactorily explain why these consequential problems are not present also in mortgages at normal (ie, not higher priced) market rates. One must assume that they are present, perhaps in a somewhat reduced form. One of the proposed regulations,72 prohibited creditors from engaging in a practice or pattern of ‘higher-priced mortgage loans” without reviewing the repayment ability of the borrower or proposed borrower.

The world-wide financial crisis that began in late 2007 is often said to be triggered by the sub-prime mortgage problem. This is not to say that other factors such as an unregulated investment banking system, wild and ununderstood forays into the newly-created derivatives system and major misunderstandings of the real estate market among others did not bear substantial responsibility. But the collapse of sub-prime real estate mortgages has often been referred to a the trigger that set off the collapse.

A major cause of the sub-prime disaster was a failure of lenders to evaluate their customers and their ability to repay loans. This actually encouraged potential borrowers to accept credit beyond their abilities to repay and led to the extraordinary volume of loan defaults, creditor foreclosures and the decline in real estate values. At the same time,

69 Although a Federal Reserve regulation, the fact that it modifies the Truth in Lending Act makes clear that it applies to financial institutions whether regulated by the Federal Reserve or some other agency.
70 Id, at 1686.
71 Id, at 1687.
72 Id, at 1725.
regulators almost completely failed to uncover the disastrous lending practices.\textsuperscript{73} In terms of this article, there was a massive failure of lenders to know their customers. In recognition of this, the Federal Reserve promulgated these regulations under the Truth in Lending Act to ensure that creditors would be prohibited from “engaging in a pattern or practice of making higher-priced mortgage loans (that is, sub-prime loans) ... without regard to repayment ability.”\textsuperscript{74} The new rules became effective on July 30, 2009.\textsuperscript{75} The core of the new regulatory requirement appears in the Federal Reserve rules as follows:

A creditor shall not extend credit based on the value of the consumer’s collateral without regard to the consumer’s repayment ability.\textsuperscript{76}

One can only speculate on the effect this simple but basic requirement would have had upon real estate lending practices had it been in effect during the period that sub-prime mortgage loans had been casually made without the lender knowing its customer. There were enough problem practices in effect to make it difficult to say that the recession had not occurred. But we can assume that a gun will not go off when its trigger is missing.

VIII. FAILURE TO KNOW YOUR CUSTOMERS IN THE MAKING OF SUB-PRIME REAL ESTATE MORTGAGES

The financial crisis of 2007 revealed many flaws in the financial and banking system. Under the umbrella of so-called “innovation” in lending practices, banks lent monies to borrowers without exercising proper due diligence but simply showing irrational greed and recklessness, which led to a dozen of bank lenders collapsing, plunging the US into the worst recession since the Great Depression.\textsuperscript{77}

Banks justified their “innovative” lending practices claiming that “innovative” credit terms made possible to extend needed credit to consumers who were excluded from traditional lending. Bank lenders took for granted the “Know Your Customer” principle under which they drew red lines on city maps around neighborhoods in which banks would not lend. Sub-prime mortgages, credit-default swaps and structured investment instruments inflated the housing mortgage bubble, dodged regulations and created risks of unmeasurable proportion that were totally missed by banking authorities.\textsuperscript{78}

\textsuperscript{73} This in turn led to the proposals to amend the bank regulatory system described in Part IX, below.
\textsuperscript{74} Whether a revision in the regulatory structure will encourage the regulators to perform their jobs is a question beyond the scope of this article.
\textsuperscript{75} 72 F.R. 1672, 1680, January 9, 2008.
\textsuperscript{76} 74 F.R. 23289, May 19, 2009.
\textsuperscript{77} 12 C.F.R. Sec.226.35(b)(1).
\textsuperscript{78} See Kevin Villani, Housing Finance? Easy, Until the Crash, Pg. 14, Vol. 175, No. 102, American Banker, July 6, 2010.
Sub-prime lending bursted in an almost unregulated area of the financial and banking industry. Banks throw away “Know Your Customer” policy, and instead they packaged their mortgage portfolios and sold them to other lenders, who in turn would re-package these mortgages and sell them to other banks, making the ultimate holders of these mortgage portfolios holding toxic or worthless assets in their balance sheets.  

A. FAILURE OF REGULATORS

Looking back over the run-up to the financial crisis and its initial stages, it is obvious now with the benefit of hindsight that short-term tactical missteps and long-term strategic miscalculations were made by both the banks and their regulators. Many of the strategic miscalculations were based on permitting perverse incentives to build within the financial and banking system, and allowing significant gaps in the regulatory framework to persist.

Some of the tactical missteps were the failure of banking regulators to force high quality capital raises early enough in the financial crisis, and the failure of the banks and other financial institutions to engage in adequate liquidity contingency planning, and the failure of their regulators to recognize the vulnerability of the financial system to erosion in liquidity conditions.

The failure of banking regulators to protect consumers contributed significantly to the financial crisis of 2007. Prospective home-buyers were directed into mortgage products which obtained risks and costs that they could neither understand nor afford to pay back. Regulators failed to restrict predatory financial products and unfair business practices of banks and other financial lending institutions in terms of preventing unscrupulous service providers from taking advantage of consumers.

The lack of regulatory oversight resulted from the failure of banking regulators to have noticed and have taken proper measures to the unique position the rating agencies assumed in the banking and financial markets. The rating agencies were granted their preferred status by the Securities and Exchange Commission. Other regulators followed suite and incorporated ratings into their investment and capital rules. There was no

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regulatory oversight nor were standards established to measure the performance or
quality of the ratings.\textsuperscript{83}

As a result of their preferred position, the rating agencies came to believe that the
increasing revenues and profits they were enjoying were the result of superior
management skill and insight rather than the oligopoly granted them by various banking
and financial regulators and accommodative Fed interest rates. Thus success brought
complacency and an aversion to change.\textsuperscript{84}

Resistance to change from the rating agencies was a significant cause of the
failure of the ratings and the ultimate financial crisis of 2007. Rating agencies were
forced to create and implement the best risk analytical models and
methodologies possible, focusing on revenue, profit and ultimately share price. They
desired and aimed at increasing revenues and profit while analysts wanted more staff,
data and IT support which increased expenses and obviously reduced profit.\textsuperscript{85}

The Office of Thrift Supervision\textsuperscript{86} failed miserably in its responsibility to regulate
Washington Mutual bank (WAMu)\textsuperscript{87}, and to protect the borrowers from the consequences
of WaMu’s excessive and unwarranted risk taking, including the toleration of widespread
fraud.\textsuperscript{88}

Though WaMu accounted for about 20 percent of the assets overseen by the OTS’
and 12 percent of its budget, the agency adopted a \textit{laissez-faire} regulatory towards
WaMu. The OTS took almost no preventive measures to address the situation when line

\textsuperscript{83} See Paul Davidson, Paul Wiseman and John Waggoner, “7 Things That Helped Break the Economy and
How Congress Aims to Fix Them,” USA TODAY, Section: Money, Pg. 1B, June 28, 2010.
\textsuperscript{84} See “Winners and Losers in the U.S. Financial Bill”, HedgeWorld Daily News, Section: Legislative
Agenda, June 25, 2010.
\textsuperscript{85} See Senate Homeland Security and Governmental Affairs Subcommittee on Investigations Hearing; Wall
Street and the Financial Crisis: The Role of Credit Rating Agencies; Testimony by Frank Raiter, Former
Managing Director, Mortgage-Backed Securities, Standard and Poor’s, Congressional Documents and
\textsuperscript{86} The OTS supervises a national thrift industry, supplying affordable home financing for borrowers. For
more information about the OTS, visit www.ots.treas.gov. The US Congress with the support of the Obama
administration proposed to merge the OTS with the Office of the Comptroller of the Currency.

\textsuperscript{87} Washington Mutual Inc. was a savings bank holding company and the former owner of Washington
Mutual Bank, which was the U.S.’ largest savings and loan association until it became the largest bank
failure in U.S. history. On September 25, 2008, the Office of Thrift Supervision seized Washington Mutual
Bank from Washington Mutual, Inc. For more information, see

\textsuperscript{88} See Sen. Carl Levin Statement on Dodd-Frank Wall Street Reform Bill, Capitol Hill Press Releases, July
14, 2010.
bank examiners identified the high prevalence of fraud and weak internal controls at WaMu.  

In contrary, the OTS advocated for WaMu among other banking regulators and even actively thwarted an investigation by the FDIC into WaMu during 2007 and 2008. The complete abdication of regulatory responsibility by the OTS may find unfortunate explanation that the OTS was dependent upon WaMu’s user fees for of its budget.  

However, the failed regulatory of the OTS was not unique. The overall banking and financial regulatory environment prior to the financial crisis of 2007 was extremely deferential to the market, principally based on the widespread but faulty assumption that markets can effectively self-regulate.  

During a testimony by the Inspector General of the Department of the U.S. Treasury before the U.S. Congress in April 2010, he stated that banking regulators “hesitate to take any action, whether it’s because they get too close after so many years or they’re just hesitant or maybe the amount of fees enters into it . . . I don’t know. But whatever it is, this is not unique to WaMu and it is not unique to OTS.” The failure of banking regulators to harness the lawless nature of conflicted banks and other lending institutions was not unique to WaMu or to the OTS.  

Another banking regulator who failed to carry out its mission, which brought the financial crisis of 2007, was the Federal Reserve. Where it proved necessary and feasible to do so, the Fed used its emergency lending power to forestall the disorderly failure of systemically major banking and financial institutions.  

These Fed actions were extraordinary and well outside the scope of its normal activities. They justified taking those actions alleging that not taking such actions would have risked a broader collapse of the financial and banking system, creating a significantly deeper and more protracted recession.  

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Faced with the choice between taking unprecedented actions and seemingly a broader systemic collapse, the Fed along with the U.S. Treasury, invoked its emergency lending authority that aimed at preventing collapse of various financial and banking institutions which were considered to have been outside the safety net.96

The fact that the Fed took those actions provides a stark illustration of the significant gaps in the US bank regulatory structure, gaps which need being eliminated. Among those loopholes was the absence of effective consolidated oversight of certain large and deeply interconnected banks and other lending institutions, the collective failure of the Fed and other regulators to appreciate the linkages and amplification mechanisms embedded in the banking system, and absence of a resolution process which would permit even the largest and most complex of banks to fail without putting at risk the flow of credit to the economy.97

The U.S. entered the financial crisis of 2007 with an obsolete banking and financial regulatory system. The regulatory system was not structured in such a way in which an increasingly large amount of credit intermediation was occurring in nonbank financial institutions. Therefore, little or often no attention was paid to the systemic implications of the actions of a large number of increasingly banks and other financial institutions.98

Many large banks were funded through market-based mechanisms such as tri-party repo, making the financial system more fragile and vulnerable to runs when market confidence faltered.99

The Fed and other banking regulators did not sufficiently understand or refused to understand the importance of some of these changes in the domestic and global financial system. They did not see some of the critical vulnerabilities these changes had already created including the large number of self-amplifying mechanisms that were embedded in the financial system. Nor were all the ramifications of the growth in the intermediation of credit by the nonbank or “shadow banking” system appreciated and their linkages back to regulated banking and financial institutions understood until after the financial crisis of 2007 started.100

The banking regulatory community undoubtedly should have pressed the alarm button sooner than 2007, and they should have done more to address the vulnerabilities facing banks and the entire financial system.\footnote{See Rep. Barney Frank Holds a Hearing on Fed Bank Supervision and Monetary Policy Before the House Committee on Financial Services, U.S. Congress, Financial Markets Regulatory Wire, March 17, 2010.}

Although banking and nonbank institutions played a significant role in credit intermediation, they were subject to differing degrees of regulation and supervision by different regulatory authorities. These gaps existed for years, however, their consequences were not apparent until the financial crisis.\footnote{See speech by Brian P. Sack, Executive Vice President of the Federal Reserve of New York, “Dollar Asset Markets: Prospects After the Crisis,” Targeted News Service, March 26, 2010.}

Difficulties in one part of the financial system exposed unseen vulnerabilities in other parts of the system in such a way that the patchwork banking regulatory system was not designed to detect or address.\footnote{See Neil Irwin and Renae Merle, “Greenspan Defends Decisions; Former Fed Chief Faces Sharp Questioning by Panel Probing Crisis,” The Washington Post, Section: A-Section, Pg. A16, April 8, 2010.}

The financial crisis of 2007 also revealed the critical deficiencies in the toolkits available to the banking regulators to deal with nonbank institutions in duress.\footnote{See Sen. Christopher J. Dodd Holds a Hearing Before the Senate Committee On Banking, Housing and Urban Affairs, “On High-Risk Bank Investment Activities,” CQ Transcriptions, February 2, 2010.}

Emergency lending made by the Fed could be sufficient to slow the disorderly failure of a systemically big bank or financial institution and the damage such a failure could cause. However, it was a blunt and messy solution, employed as a stopgap measure because better alternatives were unavailable.\footnote{See Prometheus Bound; Central Banks Under Scrutiny (2),” The Economist, U.S. Edition, Finance & Economics, May 22, 2010.}

The U.S. banking system still lacks a large-bank resolution process which would allow for the orderly failure even of a systemically important financial institution. As a result, in the fall of 2008, the Fed and other banking regulators faced the prospect of the total collapse of a complex and interconnected banking and financial system.\footnote{See Speech by the Fed Chairman Bernanke at Economic Club of Washington D.C., Washington D.C. US Fed News, December 15, 2009.}

The Fed failed to work with other banking regulators in order to strengthen bank capital standards, both by raising the required level of capital where appropriate and improving the risk capture of lending standards. They did not issue guidelines on compensation practices so that banking and financial sector employees reward for long-term performance, while discouraging from excessive risk-taking. In addition, the Fed failed to coordinate with foreign banking regulators to develop a robust international standards for bank liquidity, making the tri-party repo system more robust and reducing...
settlement risk by facilitating the settlement of over-the-counter derivatives trades on central counterparties (CCPs).

Federal banking regulators have already admitted that they did not do enough to keep banks from failing. And now lending institutions and their borrowers are feeling the effects of regulators’ tougher approach. “Regulators have really taken their role into another level and they are being far more proactive than they were even six months ago,” said Jim Graham, president and CEO of Waccamaw Bank, the only locally based North Carolina bank left standing. “They have been scolded for their performance and they are reacting in a very strong way,” said Graham.

The FDIC has been chanting *mea culpa* in one bank failure after another starting from 2007 to date. For instance, the FDIC came out in Cooperative Bank’s case located in North Carolina, when the FDIC Inspector General issued the material loss review on the bank’s failure.

That report revealed that the FDIC’s bank examiners in 2006 had seen trouble ahead for Cooperative on several fronts such as a large concentration of its loan portfolio in acquisition, development and construction loans, poor loan underwriting standards and credit administration, and a heavy reliance for cash on brokered deposits.

Part of the blame can be aimed at regulators who grew too lax. For example, Alpha Bank of Alpharetta was one of those banks created to cash in on the development spree. Its collapse last November after just 29 months in existence forced the Federal Deposit Insurance Corp. to cough up $158 million to cover deposits.

Unfortunately, that proposal met with strong objections from bankers and state regulators. Robert Braswell, commissioner of the Georgia Department of Banking and

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108 See Wayne Faulkner, Bank Regulators Say They Didn’t Do Enough, Star-News (Wilmington, NC), Pg. 6C, January 13, 2010.
109 See Wayne Faulkner, Bank Regulators Say They Didn’t Do Enough, Star-News (Wilmington, NC), Pg. 6C, January 13, 2010.
110 The Federal Deposit Insurance Corporation (FDIC) preserves and promotes public confidence in the U.S. financial system by insuring deposits in banks and thrift institutions for at least $250,000; by identifying, monitoring and addressing risks to the deposit insurance funds; and by limiting the effect on the economy and the financial system when a bank or thrift institution fails. An independent agency of the federal government, the FDIC was created in 1933 in response to the thousands of bank failures that occurred in the 1920s and early 1930s. Since the start of FDIC insurance on January 1, 1934, no depositor has lost a single cent of insured funds as a result of a failure. For more information, see the official web site of FDIC at www.fdic.gov.
Finance, acknowledged in a 2006 letter to federal regulators that under the proposed rules, “a materially large percentage of banks that are in the metro Atlanta area are going to be subject to the expanded procedures.” However, Braswell argued that the rules were unnecessary because regulators and bank officials were aware of the danger and knew how to handle it. Joe Brannen, president of the Georgia Bankers Association, was even more blunt. He wrote that “the proposed guidance unreasonably exaggerates the potential exposure of those institutions to weaknesses in the commercial real-estate sector. ... we strongly believe that more formal or more extensive regulatory measures are neither necessary nor appropriate.”

The FDIC’s harder line is a sign that forces within the agency that have been calling for more regulation for years, even prior to the financial crisis, have won out over those who favored so-called market-driven regulation.

According to Tony Plath, associate finance professor at the University of North Carolina Charlotte “A lot of voices in the FDIC were arguing that supervision should have been more rigorous. There was at the top level of government during the [former Chairman of the Federal Reserve Alan] Greenspan years a decidedly more markets approach, and that trickled down into other agencies. We saw this coming big time.”

In fact as early as 2005, rapid growth and concentrations of loans in commercial real estate had already started to become a concerning issue. However, those voices which spoke of those concerning issues were silenced. The enforcement of the banking rules has its price, which in this case was the financial crisis of 2007.


118 See Wayne Faulkner, Bank Regulators Say They Didn’t Do Enough, Star-News (Wilmington, NC), Pg. 6C, January 13, 2010.

119 See Dave Lindorff, A Fair Fight?: Credit Unions Scramble For Survival As Regulators Attempt to Throw Them in With Banks, Banking Wire, Pg. 45, June 23, 2008.

120 See Hearing of the House Financial Services Committee; Subject: “Experts’ Perspectives On Systemic Risk and Resolution Issues”; Chaired by: Representative Barney Frank (D-MS); Witness: Panel I Former Federal Reserve Chairman Paul Volcker; Panel II Arthur Levitt Jr., Former Securities and Exchange Commission Chairman, Senior Advisor With The Carlyle Group; Jeffrey Miron, Senior Lecturer and Director of Undergraduate Studies in Harvard University’s Department of Economics; Mark Zandi, Chief Economist at Moody’s Economy.Com; John Cochrane, Professor of Finance at the University of Chicago Booth School of Business; Location: 2128 Rayburn House Office Building, Washington, D.C., Federal News Service, September 24, 2009.
“The answer to banks’ plight isn’t more regulation, said Mr. Plath, just enforcement of current rules. “We didn’t have a failure of regulation,” he said. "We had a failure of regulators.”121

The financial crisis showed how essential effective regulators are in order to prevent economic catastrophe and epidemics of fraud. Among banking regulators the Feds’ failure appears to bear the most harmful because it had unique authority to prevent the fraud epidemic and the resulting economic crisis. However, the Fed refused to exercise that authority despite knowing of the fraud epidemic and potential for crisis.122

For instance, at the end of 2006, the U.S. banking system had grown so large that commercial banks share of credit market assets had fallen to only 17.7 percent, down from 27.3 percent in 1980. Commercial paper outstanding grew from $1.3 trillion at the end of 2003 to a peak of about $2.3 trillion. Repo funding by dealers to nonbank financial institutions as measured by the reverse repos on primary dealer balance sheets grew from less than $1.3 trillion to a peak of nearly $2.8 trillion over this period. In contrast, commercial bank retail deposits rose by less than 30 percent in the four year period from 2003 to 2007.123

Several U.S. lawmakers have admitted that the financial crisis was spurred not by a lack of authority but as a result of the failure of banking regulators to use it. “Merely designating someone to do a job does not guarantee a job gets done,” said Senate Banking Committee Chairman Chris Dodd. “Giving them [Fed] the power and making them act are two different things,” said Sen. Jim Bunning. “What makes you think the Fed will do it better this time around?”124

“We have been asleep at the switch,” Obama said, referring to the failure of banking regulators, lawmakers and White House officials to foresee the systemic meltdown that battered the economy and financial markets.125

B. TRIGGER TO 2007 - 2009 INTERNATIONAL ECONOMIC DISLOCATION

Confidence among banks and financial market participants collapsed following the Lehman Brothers bankruptcy in September 2008. The price of credit jumped up both in money and bond markets. Equity prices declined, increasing the cost of raising new

121 See Wayne Faulkner, Bank Regulators Say They Didn’t Do Enough, Star-News (Wilmington, NC), Pg. 6C, January 13, 2010.
122 See Edward Harrison, Bill Black and The Federal Reserve’s War Against Effective Regulation, Credit Writedowns, January 12, 2010.
125 See Jeanne Sahadi, Obama names 3 financial watchdogs CNNMoney.com, December 18, 2008.
equity capital. The authorities worldwide responded by supplying substantial liquidity to banks and central bank key rates were reduced.  

In many countries, the authorities provided extraordinary loans or took over banks to maintain confidence in institutions and market activity. In some countries, the authorities purchased securities to bring down long-term interest rates. Stimulus has also been provided through increased public sector demand and government budget deficits have grown to unprecedented levels.

In spring 2009, world trade was around 20 per cent below the level prevailing one year earlier. In many countries, the total value of goods and services production (GDP) declined over several consecutive quarters. Countries that were heavily reliant on exports of manufactured goods were particularly hard hit.

When the Queen of England visited the London School of Economics in November 2008, she asked her host why no one had foreseen the financial crisis. In July 2009, her question was answered by a panel of 33 prominent economists from British universities, government institutions and the business sector.

The panel did not cite only a single cause, but a web of causation. An important factor behind the crisis can be found in global macroeconomic developments in the years preceding the crisis.

The global financial crisis has revealed weaknesses in the financial system. It is obvious that financial sector regulation was not adequate. Regulation was primarily designed to ensure that individual banks had sufficient equity capital to protect lenders and depositors against losses, instead of ensuring stability in the system.

For instance, there were no requirements stipulating the size of liquid assets that a bank must hold to weather periods of failure in market funding. Nor were there any

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131 See “This Is How We Let the Recession Happen, Ma'am,” The New Zealand Herald, Section: News; World, July 27, 2009.
minimum requirements as to funding stability. Failure of these requirements brought the collapse of the British bank Northern Rock in September 2007.  

The bank had a residential mortgage portfolio which was unexposed to risk. The bank expanded rapidly over several years, which was based on short-term market funding. When funding markets failed, the bank faced liquidity problems and was compelled to turn to the Bank of England for financial support. When it became known that the bank had sought government support, depositors lost confidence and the UK experienced its first bank run since 1866.  

The global financial crisis was triggered by increasing defaults on subprime mortgages and the turn of the housing cycle in the U.S. Subsequently, the credit ratings of structured products were sharply downgraded, raising uncertainty about the valuation of such products.  

Banks at the centre of the financial system were hit much more than most had envisaged before the international financial crisis. The drying-up of the market for asset-backed commercial paper created pressure on banks’ funding liquidity.  

Banks needed to make more use of their own funding liquidity at the same time as their future liquidity needs were becoming both bigger and more uncertain. They were also becoming more uncertain about the creditworthiness of other banks, not knowing where the exposure to the toxic subprime and structured product stuff was or which banks might face problems due to being forced into a distressed sale of assets as a result of a lack of funding liquidity.  

This hoarding of funding liquidity made the global financial crisis come to the fore in the drying-up of market liquidity in interbank money markets in the U.S. and in

133 In 2008 the Northern Rock bank was nationalized by the British Government, due to financial problems caused by the subprime mortgage crisis. In 2010 the bank was split into two parts (assets and banking) to aid the eventual sale of the bank back to the private sector. On 14 September 2007, the Bank sought and received a liquidity support facility from the Bank of England, following problems in the credit markets, during the financial crisis of 2007 – 2010. For more information, see http://en.wikipedia.org/wiki/Nationalisation_of_Northern_Rock


Europe, prompting central banks to inject massive amounts of liquidity for stopping money market interest rates from rising far above targeted levels.\(^{138}\)

The global financial crisis from what appeared to be initially a U.S. problem turned to be an increasingly a global problem, from valuation problems in specific segments of financial markets turned into a broader-based downturn in asset prices, from a liquidity problem turned into major losses and writedowns of bank capital.\(^{139}\)

One result of the decline of wholesale funding has been a significantly higher degree of competition for deposits, particularly in Europe. The metamorphosis of the crisis from its initial stages to date is easier to understand when we realize that it had deeper causes than the faults in U.S. subprime loan origination and the associated securitization process.\(^{140}\)

The global financial crisis preceded by a period of low real interest rates and easy access to credit, which fuelled risk-taking and debt accumulation. Although the increased indebtedness of the U.S. household sector was clear to see, the increased leverage of the financial sector was somewhat hidden.\(^{141}\)

Easy monetary policy in the aftermath of the bursting of the tech stock bubble in 2001 might have contributed at the margin, although easy credit preceded it.\(^{142}\)

Financial innovation also contributed to debt accumulation, in particular, the originate-to-distribute model made it possible to originate loans to households, securitize


them in large quantities, slice and dice them into differently rated tranches and then selling them all over the world to both risk-averse and risk-seeking investors.\footnote{See Keynote address by Már Gudmundsson, Deputy Head of the Monetary and Economic Department of the BIS, “How Might the Current Financial Crisis Shape Financial Sector Regulation and Structure?”, at the Financial Technology Congress 2008, Boston, 23 September 2008 at www.bis.org/speeches/sp081119.htm.}

The global financial crisis arose out of the interaction of financial innovation, information asymmetries, regulatory failures and lax supervision with macroeconomic conditions characterised by low interest rates, asset-price misalignments, and large saving-investment imbalances. These factors prompted the financial sector to take large and poorly understood risks, to raise leverage to disproportionate levels and to rely on wholesale short-term funding, thus creating further sources of contagion.\footnote{See speech by Ignazio Visco, Deputy Director General of the Bank of Italy, “Financial Education in the Aftermath of the Financial Crisis”, to the OECD-Bank of Italy Symposium on Financial Literacy, “Improving financial education efficiency”, Rome, June 9, 2010.}

Lending institutions did not see a need to underwrite carefully the suprime mortgage packages because they did not intend to hold the loans themselves. Also, investors expected property prices to rise, not appreciating the extent of the bubble in housing prices, and so they did not focus as much as they should have on the ability of the borrowers to repay the loans they were purchasing.\footnote{See Remarks by FDIC Chairman Sheila C. Blair Before the Consumer Federation of America, December 4, 2008. FDIC web site, Speeches & Testimony, at http://www.fdic.gov/news/news/speeches/archives/2008/chairman/spdec0408_2.html}


Securities declined sharply. Uncertainty about the extent of banks’ mortgage-related losses and their potential liquidity in order to support off-balance-sheet entities led lending institutions to become much less willing to lend to each other.\footnote{See Elod Takáts, “Was It Credit Supply? Cross-Border Bank Lending to Emerging Market Economies During the Financial Crisis,” BIS Quarterly Review, 14 June 2010. Bank for International Settlements web site at http://www.bis.org/publ/qtrpdf/r_qt1006g.htm.}

As banks moved to reduce their risk exposures, they became less willing to make markets, and the liquidity of many securities declined. Housing was the trigger and the largest single source of problems during the financial crisis.\footnote{See Matthew Monks, “Two Lean Years Foreseen As Banks Clean Up Loans,” American Banker, Pg. 16, Vol. 174, No. 105, June 3, 2009.}
Reflecting the deterioration in funding conditions and efforts to conserve capital and liquidity, banks tightened lending standards and terms on loans to both businesses and consumers. With both financial markets and intermediaries under considerable strain, credit became more expensive and almost unobtainable.

Failures of major banks greatly undermined confidence in financial institutions and severely disrupted financial markets, leading to a further sharp tightening of credit conditions. Risk spreads escalated further and equity prices fell.\textsuperscript{149}

As a result of the increased banks’ propensity to make loans on increasingly liberal and imprudent terms, borrowers with very poor or insufficient creditworthiness were able to obtain mortgages far in excess of what they should have been able to, for houses that were far beyond their means.\textsuperscript{150}

Sub-prime mortgages were granted to borrowers with limited or no credit history at variable interest rates, characterized by very low initial “teaser” rates, which would be sharply adjusted upwards after the initial period, normally after two years. As house prices rose, borrowers’ equity in the properties grew and they were able to sell their homes and take out profits or as was more frequently the case, they borrowed against their increased equity in the properties and used such “secondary mortgages” to engage in increased consumer spending and to make payments on the original mortgage.\textsuperscript{151}

The sub-prime mortgage crisis started in the US and thereafter had a “contagion effect” spreading around the world where housing prices had risen rapidly. The effect also had a global effect because the US consumer demand amounts to more than 40 percent of the total OECD demand, and to 18 percent of world demand.\textsuperscript{152}

\section{C. WOULD KNOWLEDGE OF CUSTOMERS HAVE AVERTED, RELIEVED OR REDUCED CRISIS?}

The financial crisis showed many flaws in the banking and financial system, but reform without effective regulation of consumer lending is a crisis gone to waste. Lending practices that the banking industry celebrated rushed to call a triumph of

\begin{itemize}
\item \textsuperscript{149} See speech by Donald L. Kohn, Vice Chairman of the Board of Governors of the US Federal Reserve System, “Policies to Bring Us Out of the Financial Crisis and Recession”, at the Forum on Great Decisions in the Economic Crisis, College of Wooster, Wooster, Ohio, 3 April 2009. The original speech can be found on the US Federal Reserve at www.federalreserve.gov/newsevents/speech/kohn20090403a.htm.
\item \textsuperscript{151} See Congresswoman Chellie Pingree Opens Debate On Major Mortgage Reform Bill, States News Service, May 7, 2009.
\item \textsuperscript{152} See Rep. Brad Miller, VIEWPOINT: Case for Financial Product Safety Panel, American Banker, Pg. 9, Vol. 174, No. 120, June 24, 2009.
\end{itemize}
“innovation” have cheated borrowers, bankrupted lending institutions and plunged the U.S. into the worst recession since the Great Depression.153

An undeniable lesson is that trapping borrowers in debt they cannot pay back in the end eventually becomes a problem for the lending institutions. Prior to 2007, the banking industry’s justification on the consumer credit practice was that “innovative” credit terms which could appear predatory to the unsophisticated made it possible to extend needed credit to households who were excluded from traditional lending.154

The financial crisis diminished the appeal of financial “innovation”. Subprime mortgages, credit-default swaps and structured investment instruments which helped inflate the housing bubble, dodged lending regulations and created risks that were dimly understood by banking regulators, investors or even by the directors and CEOs of the companies which created them.155

The lending “model” implemented by banks in the last years prior to the crisis was the antithesis of the “Know Your Customer” approach, which went out of fashion and the complex bundling of thousands of mortgages came in. Although the Latin meaning of the word “credit” means “to believe in” proper lending to borrowers, banks did not heed to the excessive risks in lending but instead focused on greed – make monies notwithstanding the consequences.156

The macroeconomic forces that were unleashed prior to the financial crisis were strong. It is unlikely that a single country could have stemmed the tide.

China’s participation in international trade in goods added several hundred million persons to the global workforce over almost a decade, increasing appetite for strong, non-inflationary global growth. However, China was not ready to liberalise its capital markets such as unwillingness to allow its currency to float freely and to manage the exchange rate against the US dollar. This disabled an important stabiliser and contributed increasing world trade imbalances.157


156 See Rana Foroohar, “The Poor Always Pay; An Asian Bank for Low-Income Women is Out to Teach Wall Street a Lesson”, Newsweek, July 12, 2010.

Long-term interest rates were kept low in spite of substantial monetary policy tightening in the US between 2004 and 2006.\footnote{See Testimony by Eugene Ludwig, Chief Executive Officer, Promontory Financial Group, LLC, House Financial Services Subcommittee on FI and Consumer Credit Hearing; Perspectives and Proposals on the Community Reinvestment Act, Congressional Documents and Publications, April 15, 2010.}

International organisations such as the Bank for International Settlements, OECD, IMF and others expressed openly their concerns that growing imbalances in the world economy were a source of problem which required serious consideration.\footnote{See Kiyohiko G. Nishimura, “Financial System Stability and Market Confidence,” Asian Economic Papers, Pg. 25, Winter/Spring 2010.}

Financial crisis demonstrated that the imbalances ahead of the crisis were unsustainable and that they could have been reduced through regulatory improvements. The reason that this did not occur may be that the risk had taken on the form of several interwoven imbalances that no single authority had the power to correct.\footnote{See Remarks from Timothy F. Geithner at the Global Financial Imbalances Conference at Chatham House, London, January 23, 2006 at the web site of the Federal Reserve Bank of New York at http://www.ny.frb.org/newsevents/speeches/2006/gei060123.html.}

A natural consequence of the financial crisis is that increased weight is given to ensuring system-wide stability and not only the stability of individual banks. Other important questions are whether systemically important banks should be subject to tighter regulation and how to reduce the procyclicality of bank behaviour.\footnote{See Rep. Grijalva Applauds Finalized Wall Street Reform Law – Highlights Consumer Financial Protection Agency As Check On Industry Abuses, US Fed News, July 22, 2010.}

In a world with a global financial market, there are limits to how far a single country goes it alone. International coordination is important for new regulations to have the intended effect. The crisis has opened a political window for tighter regulation of the financial system, but it is uncertain how long the window will remain open.\footnote{See speech by Jan F Qvigstad, Deputy Governor of Norges Bank (Central Bank of Norway), “Could the Financial Crisis Have Been Avoided? Challenges to International Cooperation And Conflict”, at a Seminar on the Financial Crisis Arranged by Prio, Oslo, 8 December 2009 at www.bis.org/review/r091215d.pdf.}

Not all banks and other lending institutions went in red during the financial crisis. Those (few) banks proved that there is still money to be made in taking deposits and extending loans, as long as you know your customers and watch your leverage.\footnote{See Erik Ipsen, NY Area’s Losers Swamp The Winners, Crain’s New York Business, January 12, 2009.}

For instance, the benefits of the Wells Fargo model include more local decision-making, more responsibility at the local office level, stronger compliance and “Know Your Customer” practices, a stronger credit culture, and more upfront due diligence. All of these translate into allowing banks to have a much deeper understanding of their
borrowers that translates into an ability to serve borrowers better and to even sell them more.\textsuperscript{164}

One of the lessons learnt from the crisis was that lenders really have to know their customers. And not only in the way that the “Know Your Customer” are written, but also in the way that a true marketer would understand their customer and their needs. In other words, as a quote says “Meet them where they are, not where you’d like them to be.”\textsuperscript{165}

And this is not taking a photograph of a license of bank’s customer, but rather, understanding them at a relatively deep level. Know what customers say and what they are actually thinking.\textsuperscript{166}

The financial crisis exposed the fundamental fragility of the international financial system. No segment of the market or category of players has been saved by this crisis.\textsuperscript{167}

The fundamental role of financial markets is the intermediation of funds between lenders and borrowers. This function has been expanded by increasing possibilities for diversification of risks for lenders, diversification of funding sources for borrowers. The demand for hedging against economic risk among lending institutions grew in tandem with the growing supply of new and innovative financial techniques. But, supply outgrew demand. Financial “innovation” ceased to facilitate adequate investment opportunities from banks and started to become self-sustaining. This weakened incentives to conduct prudent screening and a thorough monitoring of loan quality pursuant to the “Know Your Customer” rules. Credit became plentiful and market liquidity expanded at a level that could ultimately no longer be justified.\textsuperscript{168}

The tendency for lending and mortgage financing to become pro-cyclical even at a system-wide level needs to be strongly mitigated. The quality and quantity of bank capital and their liquidity buffers should provide a sufficient buffer for bank equity when the cycle turns. The cyclicity of market economies is inevitable. But the financial system should not be allowed to amplify swings.\textsuperscript{169}

\textsuperscript{165} \textit{See} FDIC Advisory Committee on Economic Inclusion Holds a Conference to Discuss Safe Bank Accounts for Underserved Consumers - Final FD (Fair Disclosure) Wire April 1, 2010.
\textsuperscript{166} \textit{See} Banking/Finance Banks Race to Get Customer Details As KYC Deadline Looms, Business Line, March 6, 2010.
Loan managers and risk committees in banks were given strong economic incentives to focus on short-term profits. Long-term value creation was not a concern in the pre-crisis world. This resulted in excessive risk taking.

If one lesson can be learnt from the financial crisis, it is that the reach of financial banking supervision and regulation needs to be extended to better monitor lending institutions which can arbitrage across national borders and across oversight jurisdictions.\textsuperscript{170}

Banks’ and other financial institutions failures to comply with “Know Your Customer” principle were one of the main reasons that created the financial crisis. Banks failed to properly understand their customers (borrowers) needs and to minimize the risk of loans default. The author of this paper believes that although there is no clear evidence to prove whether or not a full compliance from banks of “Know Your Customer” principle may have averted, relieved or even reduced the financial crisis, it is a clear conclusion that compliance of such principle from the banks may have had a positive effect to the severity of the crisis.\textsuperscript{171}

\section{IX. REGULATORY REFORM}

In May 2009, the Department of the Treasury, pursuant to commitments made in the course of the most recent Presidential campaign published an 88 page report proposing a massive revision in the financial regulatory structure. It is beyond argument that the present system is fractured and substantially dysfunctional. The federal commercial banking system is regulated in one way or another by the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve System, the Office of Thrift Supervision, the Securities and Exchange Commission and the collection of State Insurance Commissioners. On top of this is the presence of the dual banking system that tends to divide the financial system into two large mirror images. The commercial banking system exists in parallel with other banking systems like investment banking that are largely not regulated at all. We thus have, for example, mortgage lenders among the regulated commercial banks and also among essentially unregulated loan companies. The awkward picture may be rounded out by hedge funds, trading in futures of various types and derivatives and insurance companies. It was generally acknowledged that the financial regulatory system was in need of review and repair.

A dominant support for the process of review is the Congressional Oversight Panel created by Congress as part of its work in analyzing the international worldwide financial crisis after the succession to the presidency in 2008. Elizabeth Warren, Leo Gottlieb Professor of Law at the Harvard Law School was selected as chair of the panel;

\textsuperscript{170} See speech “Key Lessons From the Crisis” by Jean-Claude Trichet, President of the ECB at the “Annual conference 2009” organised by the Asociación de Mercados Financieros Madrid, 23 November 2009 http://www.ecb.de/press/key/date/2009/html/sp091123_1.en.html.

\textsuperscript{171} This is the author paper’s note.
the other members consisted of Richard H. Neiman, Superintendent of Banks of the State of New York, Damon Silvers, Associate General Counsel of the American Federation of Labor and Congress of Industrial Organizations, Congressman Jeb Hensarling and Senator John E. Sununu.

A major disclosure by the panel was a factor that was becoming increasingly recognized as the recent financial disaster was examined and re-examined. 79 The panel stated as unequivocally as anyone that the regulators themselves necessarily bore considerable fault for the real estate mortgage downfall. Although the “regulators had the tools (they) failed to use them.”172

How the proposed new consumer protection agency plans to deal with the know your customer issue remains to be seen. Assuming that the agency comes into existence, it seems inevitable that any action on know your customer will in some manner brush against the 2008 Federal Reserve amendment. It seems likely that there will be some interplay with existing regulatory positions taken by the existing bank regulators. Undoubtedly life will become more complex even as it becomes safer.

X. DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

A. THE CONSUMER FINANCIAL PROTECTION BUREAU

Protection of consumers from unfair and abusive practices from banks is an important goal in the financial services industry, which relies on public trust to exist.173

Congress sought to improve consumer protection by enacting the Dodd-Frank Wall Street Reform and Consumer Protection Act174 under which it established an independent consumer protection bureau – the Consumer Financial Protection Bureau (“CFPB”) – in order to oversee relationships between consumers and providers of financial products and services.175

CFPB is an independent agency and in charge writing regulations and issuing orders under federal consumer finance laws. Its regulations will apply not only to banks, thrifts and credit unions but also, with few exceptions, to any other provider of a wide range of consumer financial products or services.176

175 Id.
Under the Act, the Treasury secretary must transfer consumer protection powers to the CFPB between six months to a year after enactment of the legislation, with the option to extend it to 18 months if necessary. Once the transfer of power occurs, the Act would give the CFPB broad authority over a long list of consumer protection laws, such as the Truth-in-Lending Act\textsuperscript{177}, the Real Estate Settlement Procedures Act\textsuperscript{178}, the Home Mortgage Disclosure Act\textsuperscript{179} and the Home Ownership and Equity Protection Act\textsuperscript{180}. It would also have the power to identify services or products that it considers unfair, deceptive or abusive. This authority could be used to address consumer payment services protection issues that are not specifically addressed in other statutes. Beyond those laws, however, the CFPB has a relatively free hand to claim jurisdiction over other consumer issues. Under the law, the director of the CFPB must publish in the Federal Register a list of the rules and orders under its purview before the transfer of authority takes place.\textsuperscript{181}

The Act provides authority to the CFPB to cover payment services provided through mobile telecommunications networks, a provision which could enable the extension of payment protections to new technologies.\textsuperscript{182}

Besides implementation of existing consumer protections rules and prevention of unfair practices, the CFPB is expected to use its authority to harmonize and to clarify financial institutions’ applications to competing payments products. These harmonized protections should include redress protections including error resolution, refunds, disputed transactions and prompt re-credit of funds after a consumer reports unauthorized use or resolves a dispute with a merchant.\textsuperscript{183}

Instead of issuing new regulations every day, the CFPB’s goal would be to ensure products are understandable and fair. “Can you build a product that most people can read, understand and make comparisons with?” said Elizabeth Warren, the Obama administration official leading the CFPB’s development. “If that becomes the goal, then it’s not a list of a thousand ‘thou shalt nots’ that are essential. What’s essential is to clear out the regulatory underbrush that created thousands of words of disclosure that are not helpful to consumers and brought up costs for the industry.”\textsuperscript{184}

The CFPB’s challenge in enforcing rules on banks, loans, and credit cards that could affect consumers would be closely watched in particular in combination of the Real Estate Settlement Procedures Act with conflicting mortgage disclosure requirements under the Truth in Lending Act regulations. If the bureau combines the Truth in Lending

\textsuperscript{177} See 15 USC § 1601.
\textsuperscript{178} See 12 USC § 2601.
\textsuperscript{179} See 12 U.S.C. § 2801.
\textsuperscript{180} See 15 U.S.C. § 1639
\textsuperscript{181} See Cheyenne Hopkins, “Myriad of Challenges Lie Ahead for CFPB; Agency must provide outline of authority, merge lending laws”, American Banker, July 2, 2010.
\textsuperscript{183} See Mark MacCarthy and Gail Hillebrand, VIEWPOINT: Consumers Need Mobile Payment Protections; Bank Think; Viewpoint essay American Banker August 10, 2010.
\textsuperscript{184} See Joe Adler, Birth of a New Kind of Regulator; American Banker, December 2, 2010.
Act with the Real Estate Settlement Procedures Act in a document which would fairly regulate the relationship between banks and consumers that would be innovative.185

The CFPB also could level the playing field with nonbanks that face lighter supervision than banks. According to bankers, most of the abusive financial practices are by nonbanks like check cashers and payday lenders. Unlike most other regulations set by the US banking authorities, the bureau’s rules will apply to money-services businesses. The bureau will also have enforcement power over nonbanks.186

Differentiated pricing on consumer loans will be subject to greater regulatory scrutiny from the CFPB. While the ambit of the bureau does not extend to commercial lending, it is possible that transactions falling within its authority may extend to financial transactions in relation to small-businesses customers with less than $1 million in sales.187

The Act gives the CFPB authority to limit or bar a product or practice that the bureau deems unfair, deceptive or abusive. Critiques have expressed concern that the “abusive” definition will give the CFPB broad flexibility to crack down wherever the bureau sees fit. “We think the addition of abusive to the standard in the CFPB provisions” is “the most egregious” part of Dodd-Frank, said Richard Hunt, president of the Consumer Bankers Association. “This is the primary example of how this legislation will stifle innovation.”188

Critiques also believe that removing responsibility from the bank regulators to the CFPB would probably weaken consumer protection, as the bank regulators have significant moral suasion with banks that the bureau will lack. The vast majority of consumer abuses in the last years occurred among nonbanks. The Dodd-Frank Act does little to address them.189 In addition, the Act does not address the principal causes of the housing bubble, mortgage meltdown and consequent financial crisis in the US.190

B. “KNOW YOUR CUSTOMER” AND “SUITABILITY” FINRA RULES


186 See Joe Adler, Birth of a New Kind of Regulator; American Banker, December 2, 2010.


Following implementation of the Act, the SEC approved the Financial Industry Regulatory Authority’s proposal to adopt consolidated rules governing “Know Your Customer” and “Suitability” obligations with the effective date October 7, 2011. The “Know Your Customer” rule will replace New York Stock Exchange Rule 405(1) and will require member firms to use reasonable diligence, in regard to the opening and maintenance of every account, to know the essential facts concerning every customer. The “Know Your Customer” obligation arises at the beginning of the customer-broker relationship and does not depend on whether the broker has made a recommendation. Unlike NYSE Rule 405, the “Know Your Customer” rule does not specifically address account opening, supervision or orders.

“Know Your Customer” is a concept that is intended to take a look at the qualifications of a customer to trade generally. The futures market has looked at risk disclosure and has looked at qualification of customers in a fairly generic way because of the nature of our products.

The “Know Your Customer” rules would impose obligations on broker-dealers in regards to the opening and maintenance of every account of how to use “due diligence” and how to know the “essential facts” concerning every customer. The rules define “essential facts” as those required to effectively service the customer’s account; act in accordance with special handling instructions for the account; understand the authority of each person acting on behalf of the customer; and comply with applicable laws, regulations and rules.

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191 See FINRA Regulatory Notice 11-02 at www.finra.org.

192 See under the NYSE Rules, Rule 405 (1) (“Diligence as to Accounts”), at www.nyse.com.

193 See Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No. 1 to a Proposed Rule Change and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1, To Adopt FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability) in the Consolidated FINRA Rulebook; Federal Register Extracts Securities and Exchange Commission Documents and Publications November 23, 2010.


195 See Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No. 1 to a Proposed Rule Change and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1, To Adopt FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability) in the Consolidated FINRA Rulebook; Federal Register Extracts, Securities and Exchange Commission Documents and Publications, November 23, 2010.

196 See Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change To Adopt FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability) in the Consolidated FINRA Rulebook; Correction; Federal Register Extracts, Securities and Exchange Commission Documents and Publications, August 26, 2010.
Obligations under the rules would arise at the outset of the customer/broker relationship regardless of whether the broker has made a recommendation. Moreover, the proposed “Know Your Customer” rules would eliminate the existing requirement to learn the essential facts relative to “every order.”

The “Suitability” rule, FINRA Rule 2111, will replace NASD Rule 2310 and will require a member firm or associated person to have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer’s investment profile. The triggering event for the new rule will continue to be a broker-dealer’s recommendation. Additionally, this rule applies to recommended investment strategies or securities regardless of whether the recommendation results in a transaction or generates transaction-based compensation. The rule also clarifies the types of information that brokers must attempt to obtain and analyze as part of their suitability analysis, condenses the sections relating to the three main suitability obligations and harmonizes the institutional-investor exemption with the more common definition of institutional account in NASD Rule 3110(c)(4).

The “Suitability” rules would impose a reasonableness standard on broker-dealers in order to determine whether a transaction or investment strategy is suitable for a customer. This suitability assessment would require the broker-dealer to use reasonable diligence to ascertain the customer’s investment profile. Relevant customer information would include, but would not be limited to age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, and risk tolerance.

XI. CONCLUSION

Supervisors in the US, and around the world, are increasingly recognizing the importance of ensuring that their banks have adequate controls and procedures in place so that they know the customers with whom they are dealing. Adequate due diligence on new and existing customers is a key part of these controls. Without this due diligence,

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198 See FINRA Regulatory Notice 11-02 at www.finra.org.
200 See NASD Rule 3110(c)(4).
201 See Significant Changes to FINRAs Know Your Customer and Suitability Rules to Take Effect in 2011, JD Supra, February 9, 2011. Byline: Sutherland Asbill & Brennan LLP.
banks can become subject to reputational, operational, legal and concentration risks, which can result in significant financial cost.\textsuperscript{202}

The US bank authorities’ approach to KYC should be from a wider prudential, not just anti-money laundering, perspective. Sound KYC provisions should be seen as a critical element in the effective management of banking risks. KYC safeguards go beyond simple account opening and record-keeping, and require banks to formulate a customer acceptance policy and a tiered customer identification program that involves more extensive due diligence for higher risk accounts, and includes proactive account monitoring for suspicious activities. Bank authorities’ interest in sound KYC standards originates from its concerns for market integrity and has been heightened by the direct and indirect losses incurred by banks during the economic and financial crisis of 2008 – 2009 due to their lack of diligence in applying appropriate procedures. These losses could probably have been avoided and damage to the banks’ reputation significantly diminished had the banks maintained effective KYC programs.\textsuperscript{203}

Although there is no clear evidence to prove whether or not a full compliance from banks and other financial institutions of KYC principle may have averted, relieved or even reduced the financial crisis of 2008 - 2009, it is a clear conclusion that compliance of such principle from the banks and other financial institutions may have had a positive effect to the severity of the crisis.


\textsuperscript{203} Id.