Lost in the Wash

"Know your customer" rules send privacy to the cleaners.

By Walter Olson

Late last year the federal government proposed new rules requiring banks to adopt "Know Your Customer" programs. Such programs are intended "to deter and detect financial crimes, such as money laundering, tax evasion, and fraud," according to the Federal Deposit Insurance Corporation, one of the agencies involved.

If the rules go into effect as planned on April 1, 2000, banks will be required to monitor and investigate "abnormal" activity in their customers' accounts. Unless a satisfactory explanation is forthcoming, they will then have to report such activity to a centralized government database of "suspicious-activities reports" jointly maintained by the Internal Revenue Service and other agencies. Federal and state law enforcers have instant electronic access to these reports and frequently use them as the basis for launching investigations.

To determine what counts as "abnormal," each bank will need to establish profiles of "normal and expected" activity for its depositors' accounts. To assemble such profiles, bankers will probably gather information about depositors' occupations and lines of business, their typical patterns of deposits and withdrawals, the nature of any overseas financial ties they maintain, and what their relationship may be to other persons who use the same account. Customers who decline to answer questions or provide documentation may be refused new accounts or required to close old ones. Irregular cash deposits—ranging from tip income to holiday bonuses and inheritances—would be especially likely to elicit questions from bank officers.

Much to the apparent surprise of federal officials, the proposed regulations were met almost at once with a storm of public outrage. "Don't turn banks into Big Brother," editorialized the *St. Petersburg Times*. The *Sacramento Bee* blasted the proposal as "a potentially grave invasion of the privacy of every bank customer in the country....Know Your Customer means Snoop on Your Customer." Thousands of Internet-fueled complaints (blamed by an FDIC official on "anti-government groups") poured in, some from smaller banks that objected to the rules' anticipated burdens, but most from ordinary consumers and citizens. (The comment period on the regulations ends March 8; the relevant addresses are comments@fdic.gov, public.info@ots.treas.gov, and regs.comments@occ.treas.gov.)

Federal bank regulators complain that the protests are quite unfair. After all, it's not as if these regulations appeared out of the blue: They're a logical next step in an ongoing campaign dating back more than a decade, since "money laundering" was criminalized in 1986. Informally, the trade press has reported, examiners have been instructing banks for years to set up know-your-customer policies, and by now most banks are collecting information on their customers' transaction patterns and, increasingly, combining such information into "profiles" of account activity. "No one seems to understand," griped Federal Reserve spokesman Richard Small, "that the information that we want as part of this know-your-customer proposal is not new and has been collected for years." Which falls into the category of Reassurances That Leave Us More Alarmed Than Ever.

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It's easy to forget what a new crime money laundering is, or how rapidly it has expanded in its short history on the books. Originally referring to highly complex financial ploys devised to move criminally obtained (usually drug) money from one form and place to another while disguising its provenance, it has become a concept under which all sorts of professionals, from real estate agents and insurance brokers to yacht salesmen and interior decorators, can be menaced with 20-year prison sentences if they do business with big spenders who acquired their down payments by illegal means. Prosecutors need only allege that the recipients knew—or maybe just should have known (a convenient doctrine of "willful blindness" helps out here)—that the money was dirty.

At the same time, the crusade against laundering has served as an excuse for criminalizing a wide range of conduct, such as cash transactions over $10,000 not reported to the government, in which none of the participants would in other respects be deemed criminal and no one is trying to "launder" anything. Somewhere along the way, tax authorities discovered that anti-laundering rules were a highly useful weapon in the campaign against their age-old enemy, the economy's unrecorded cash sector.

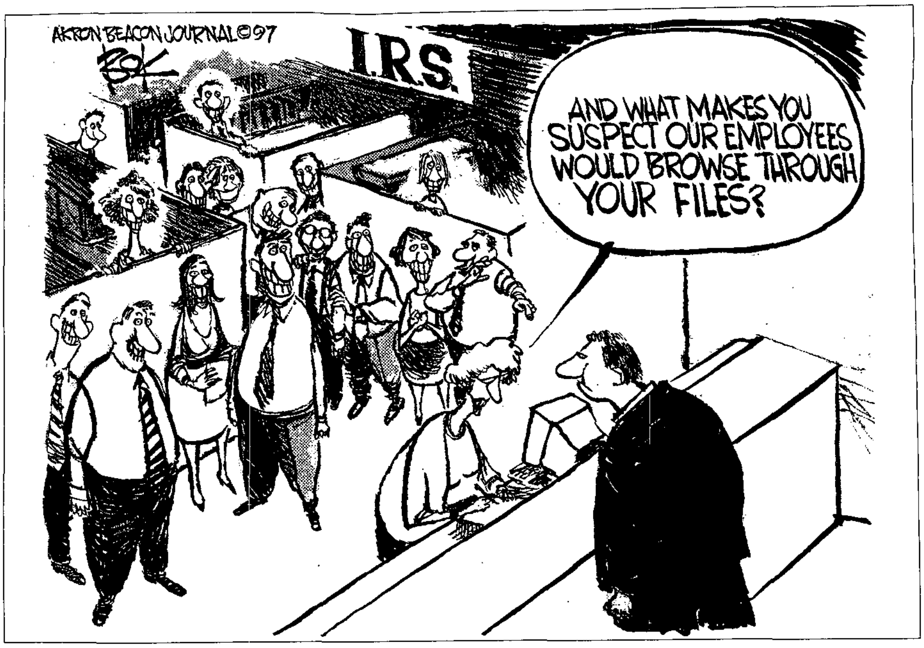
Nowadays, federal officials boast of a "growing partnership between the banking industry and law enforcement." Not that the partnership is entirely voluntary: As White House drug czar Barry McCaffrey warned in a November 1997 keynote address to the American Bankers Association, banks that do not cooperate risk "being fined" or "having their charters revoked." Perhaps the key step came three years ago, when federal law began requiring banks to report "suspicious" transactions, defined as those that have no "business or apparent lawful purpose" or are "not the sort of transaction in which the particular customer would normally be expected to engage, [when] the institution [can learn of] no reasonable explanation for the transaction."

The 1996 law instructs banks to file "suspicious activity reports" in such cases, while forbidding them to tell their customers that they have filed such reports. By late 1997 the resulting database was getting 4,600 queries a month from state and local authorities. (It also shares information with foreign law enforcement authorities.) The backup material ("supporting documentation") on a suspicious activity report is held by the bank but is considered U.S. government property, which means the bank must deliver it on the demand of an agency, with no need for subpoenas or those pesky warrants.

Until now, while obliged to report any suspicious activities that come to their notice, banks have not been required to go searching for such activities. That's where the new rules come in. Which leaves a lot riding on the question of what counts as a "suspicious" transaction. According to McCaffrey, "telltale signs" include "multiple bank accounts opened by more than one individual using the same address" as well as "cash deposits in amounts that far exceed what could normally be expected from a person with the type of job description found on the signature card." Another telltale sign is "the use of a foreign address to open an account, which is subsequently changed to a U.S. address soon after the account is opened"—although that sequence might typify the arrival home of a repatriating corporate transferee, artist, or student. McCaffrey also says banks should be suspicious of an account "in which a cellular phone...is given as the reference telephone number on the account opening forms," advice that might alarm the small but growing cadre of consumers who have dispensed with landline telephone accounts in favor of portable phones.

Other expert and official sources suggest that a customer's concern for privacy all by itself—as distinct from, say, a nervous demeanor—should be taken as a mark of suspiciousness. According to the February 1996 issue of *Money Laundering Alerts*, "A customer should be monitored if he or she...is unwilling to provide personal background data," shows reluctance to proceed with a transaction after learning that it is considered suspicious, or wires a lot of money to "tax havens such as... Hong Kong."

As a concept, suspiciousness can be bafflingly inclusive. "Unusual use of night deposit boxes or safe deposit boxes" is to be flagged, according to the Alert, but so is the action of the customer who "opens a safety deposit box, uses it once or twice, and never returns." And what's good news for bankers—"paying off problem loans unexpectedly"—turns out to be bad news for borrowers, when the bank's compliance officer ungratefully reports them to the feds. Other indicia of suspiciousness could as easily signal eccentricity or inattentiveness: keeping accounts with several banks in the same city; "mak[ing] cash deposits without first counting the cash"; "abnormal practices, such as bypassing the chance to obtain higher interest rates on large balances"; and that favorite habit of day traders, "buying and sell-



ing a security with no discernible purpose."

Among the clear losers under the new rules would be small banks; Robert Rowe of the Independent Bankers Association of America termed the proposal a "compliance nightmare." (On the other hand, many big banks, which have generally implemented know-your-customer programs already, seem to be on board with the plan; so does the American Bankers Association.) Also hard hit would be residents of many lower-income and immigrant neighborhoods; even law-abiding persons in those categories often fit a financial profile that includes numerous wire transfers, under-the-mattress cash hoards, and overseas payments. Lawrence Lindsay, formerly a Federal Reserve Board governor and now a scholar at the American Enterprise Institute, has noted that honest poor persons, after scrimping to amass the cash for a down payment on a house, are now stymied when wary bankers demand that they prove their money is untainted.

As readers of Hayek know, it's awfully hard for government to regulate just one thing. Citizens alter their behavior to dodge the rule, and soon officials face a choice of either extending the regulation or giving up on the original idea. The history of the crusade against money laundering exemplifies the point.

Thus controls on large cash transactions led holders of hot money to divide it into multiple deposits below the threshold—so-called smurfing—which meant smaller transactions had to be scrutinized too. Nor can enforcement efforts be tightly focused on major drug entrepôts such as Miami and New York, since money is so easily moved from city to city.

Already on the horizon are demands for stricter controls on brokerages, which make handy cash conduits, and perhaps life insurers too. "We want to see a level playing field," American Bankers Association laundering specialist John Byrne has announced, "and we won't be satisfied until every financial service provider in some way is accountable for knowing its customers in a similar way that banks are being asked to know theirs." Also looming is an even stranger fight over what might be called "merchandise laundering": Treasury and Customs are threatening legislation aimed at retailers who accept cash payment for bulk purchases of various goods—two of the most-publicized instances have involved sunglasses and home appliances—without investigating the buyers' bona fides.

Fear of financial freedom is also shaping up as a major impediment to the emergence of new transaction-settling technologies, such as Internet banking and smart cards. If genuine anonymity is permitted in such instruments, officialdom fears, the war against laundering is as good as lost. As a result, national regulators are tending to attach the kind of conditions to

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such technologies that significantly limit their usefulness: restricting the "stored value" in a smart card to a low denomination, for example, or providing that only banks can issue such cards and only to their depositors. The other possibility—requiring full documentation on every transaction—is a privacy invader's dream. An anti-laundering panel of the Organization for Economic Cooperation and Development has discussed not only requiring a trail for transactions done on smart cards but also forcing all card issuers to enter such transactions into a central database.

From his side, drug czar McCaffrey has identified the issue clearly enough. "Money will flow to whatever market is willing and available," he told the bankers association, which means victory in the drug war "requires us to close all markets to tainted funds." In plain English, that means imposing controls, presumably barbed with today's Draconian penalties, on all markets. Not just the occasional Caribbean money order wired from a Miami bank but every transaction in the economy is to suffer the resulting inefficiency, friction, and privacy loss.

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Lindsay, the former Fed governor, argues that the laws against money laundering have proved ineffective. "We are asking for a lot of compliance to catch a few people," Lindsay told a Cato Institute gathering in 1997. "We have overstepped the bounds of balance and reason today," he added, "and we as citizens should start reining our government back before [its] powers increase even further."

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Burning Los Angeles

By Nick Gillespie

Ecology of Fear: Los Angeles and the Imagination of Disaster, by Mike Davis, New York: Metropolitan Books/Henry Holt, 484 pages, $27.50

No major American city seems more precarious than Los Angeles. There's a certain moon-base feel to the place, a sense that its inhabitants are living in a massive, well-provisioned bubble resting uncomfortably on a stunning but generally inhospitable landscape. It's damn near perfect inside the bubble, which is really a pleasure dome: glorious day after glorious day; striking mountains running into beautiful beaches; every possible human opportunity and diversion in overabundant supply.

But there are also constant reminders that the bubble might burst at any moment: smog alert days when the ventilation system isn't working quite right; wildfires that deposit ash over large sections of the city; brief but fierce rainstorms that create raging rivers of mud; and, of course, earthquakes that threaten to level the entire place in a few seconds. The potential for physical apocalypse has a psychic counterpart, too, in ever-present threats of race riots, gang warfare, street shootouts, and home-invasion robberies.

Ecology of Fear is a detailed litany of those various eco-threats to L.A. The result is a sort of Irwin Allen production that, if nothing else, provides aid and comfort to East Coast intellectuals who scorn Southern California as a Potemkin metropolis beset by everything from killer bees to the Black Death.

This is to say that, at least in terms of its negatives, L.A. is pretty much like every other city on the planet: It is constantly threatened with ruin from within and without. To be sure, on a superficial level, L.A. may seem even more artificial, more obviously constructed than most cities—signature flourishes such as carefully manicured foliage and ubiquitous automatic sprinkler systems underscore the effort necessary to grow things in the region. But that distinction fades when one strives to suggest a more "natural" alternative. None of the other largest American cities—New York, Chicago, Houston, and Philadelphia—is free of environmental and demographic tensions similar to those found in Los Angeles. While none of those places is prone to the spectacular rupture accompanying earthquakes, none would survive very long without constant maintenance, repair, rebuilding, and repopulation. (Consider, for instance, winter in Chicago and summer in Houston.) In the end, all cities are artificial in the best sense of that word: They are the result of massive, concerted, and continuing human activity.

In *Ecology of Fear: Los Angeles and the Imagination of Disaster*, Mike Davis takes a very different line. It's not simply that L.A. is plainly an unsustainable affront to Nature. Indeed, for Davis, author of *City of Quartz* and a fixture in left-wing publications such as *The Nation*, even the weather there stinks (he describes Southern California as a "secret Kansas" rife with tornadoes and vicious windstorms that the delinquent media fail to investigate fully). Although theoretically unconvincing and factually dubious, *Ecology of Fear* is nonetheless a compelling document. That's because Davis embodies fully the contradictory and incoherent impulses inherent in what F.A. Hayek rightly derided as the "engineering mentality," the notion that complex social interactions—such as city building—can be readily managed from above by planners and other wise souls.

If there's one thing that piques such a mind-set, it's messy, volatile, unpredictable market forces that decentralize decision making, thereby confounding prediction and control. Davis wastes no time in fingering the real culprit behind Hell A. "For generations," he writes on page 9, "market-driven urbanization has transgressed environmental common sense. Historic wildfire corridors have been turned into view-lot suburbs, wetland liquefaction zones into marinas, and floodplains into industrial districts and housing tracts. Monolithic public works have been substituted for regional planning and a responsible land ethic. As a result, Southern California has reaped flood, fire, and earthquake tragedies that were as avoidable, as unnatural, as the beating of Rodney King and the ensuing explosion in the streets."

The bulk of *Ecology of Fear* is a detailed litany of those various eco-threats to the Los Angeles metro area. The result is a sort of Irwin Allen production that, if nothing else, provides aid and comfort to East Coast intellectuals who scorn Southern California as a Potemkin metropolis beset by everything from killer bees to the Black Death. In wide-ranging and quirky chapters, Davis explores endemic perils both obvious (earthquakes, forest fires) and arcane (mountain lion attacks, plague-carrying squirrels). Despite its often tendentious analyses of specific works, the long section titled "The Literary Destruction of Los Angeles" is a consistently engaging and nearly exhaustive compendium of books and movies that feature apocalyptic versions of the city's ultimate demise. The works surveyed run the gamut from Philip Francis Nowlan's Buck Rogers novellas to the *Turner Diaries* to *Blade Runner*; if nothing else, Davis has compiled a useful bibliography on the subject.

Davis simultaneously bemoans a general lack of public oversight and investment and critiques what he deems to be