FINANCIAL REGULATION BEYOND STABILITY

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In 2008, the failure of Lehman Brothers ignited a long-simmering financial crisis, bringing the economy to its knees. Under-capitalized banks were not the initial cause of the crisis, but they accentuated its magnitude and the depth of the recession that followed. The government's interventions to help Bear Stearns, AIG and other large financial institutions avert failure, while homeowners across the country found themselves underwater and often unable to access government support, accentuated the public outrage.

The economic devastation that followed, coupled with the pervasive sense of unfairness, led many to vow "never again." Financial stability became the mantra of the day, or really, the decade and a half that followed. Banks were subject to far more robust capital requirements, expanded liquidity requirements, and other enhanced prudential requirements. The Treasury Department was placed at the helm of a new Financial Stability Oversight Council to address systemic threats outside the banking sector. And scholars and policy makers undertook a broad and still robust debate, with many arguing the government should mandate far more significant structural changes to the banking and financial sector—all with the primary aim of promoting stability.[1] Throughout much of 2023 and 2024, a heated debate about the appropriate level and structure of capital requirements—one of the key mechanisms through which regulation promotes the safety and soundness of banks—has been playing out in congressional hearings, lengthy comment letters and even NFL advertisements.

The brightness of the spotlight on the debate about how to produce a more stable financial system, however, has largely overshadowed the many aims beyond stability that the government has long sought to promote via its regulation of finance and the financial system. Among the costliest obligations imposed on banks are those enlisting banks as front-line agents in the government's efforts to tackle money laundering. Banks and other financial institutions are obliged to institute extensive compliance regime and submit an array of reports to the government, often including detailed information about customers and their financial activities. The infrastructure used for anti-money laundering (AML) today is designed not only to prevent the laundering of ill-gotten gains, but also to prevent and detect corruption in the United States and abroad, to prevent and detect tax evasion, to prevent and

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[1] See Part I, *infra.*

detect terrorist financing and, increasingly, to facilitate the implementation of sanctions serving purely foreign policy aims.[2]

There are some good reasons for the government to compel banks and other financial institutions to play a central role in this regime. Yet it has nothing to do with stability and cannot be justified by any market failure or identified externality. It is only by recognizing law enforcement and foreign policy as central government aims that the government can more easily pursue with the aid of financial institutions than without that one can begin to understand the regime now in place. This may help to explain why AML has garnered so much less attention than prudential regulation from lawmakers, academics, and the public.

The relative dearth of public and interdisciplinary engagement has not served AML or the myriad policy issues at play in the regime well. Even a brief glance at the AML regime currently in place suggests that despite the significant costs it imposes on banks and other financial institutions, the overall regime is far from effective, capturing only a small fraction of the illicit flows in the financial system. The regime also raises a host of difficulty policy questions, including tradeoffs among maximizing the efficacy of efforts to use of banks as instruments of statecraft, protecting privacy and other civil liberties and promoting broad access to financial services.

The relative neglect of AML despite its longstanding importance as a component of financial regulation is more the rule than the exception. It is emblematic of the ways that the focus on stability has often crowded out rigorous and broad debate about the myriad other policy aims at play in the regulation of finance. Saule Omarova and Graham Steele make a similar point in a new essay arguing that counteracting concentration and abuses of power are core principles that permeate bank regulation.[3] In a response to that essay, I show how the long history of unit banking in the United States helped to further the Brandeisian value of broad, diffuse economic opportunity.[4] Both pieces point to the important role that banking law has long played, and continues to play, in shaping both the structure of the banking system and, in turn, the structure of the real economy. Omarova and Steele argue that the excessive focus on stability predates the 2008 financial crisis, but the overall impact is the same: an excessive focus on stability has allowed other policy aims to whither from neglect.

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2 For more information about the AML regime currently in place, how it has evolved, its efficacy and the fundamental tradeoffs at place, *see* Part II.A., *infra*; Kathryn Judge & Anil Kahsyap, *Anti-Money Laundering: Opportunities for Improvement, Wharton Initiative on Financial Policy & Regulation White Paper* (2024), https://wifpr.wharton.upenn.edu/wp-content/uploads/2024/03/WIFPR-Anti-Money-Laundering-Judge-and-Kashyap.pdf.

3 Saule T. Omarova and Graham S. Steele, *Banking and Antitrust*, 133 YALE L.J. 1166, 1178 (2024).

4 Kathryn Judge, *Brandeisian Banking*, 133 YALE L.J. FORUM 916 (2024).

Housing finance is another domain where the government has long played a very active role using the financial system to further policy aims that have little to do with stability.[5] Today, a majority of the home loans issued in the United States end up in a securitization vehicle backed by a government agency, Ginnie Mae, or a government-sponsored enterprise (GSE), Fannie Mae or Freddie Mac.[6] Yet Fannie Mae and Freddie Mac are operating in an indefinite limbo that no one ever wanted or designed. Back in 2008, the then newly created Federal Housing Finance Agency (FHFA) rapidly placed Fannie and Freddie into a government run conservatorship at the height of the financial crisis. Conditions long ago calmed, yet they have remained in this makeshift structure ever since. At the same time, the other government-sponsored enterprise originally designed to promote home ownership, the Federal Home Loan Banks, has become completely unmoored from its original function. They also have become massive and sometimes distortionary forces in the banking system, helping weak banks, such as Silicon Valley Bank (SVB) and Signature in 2023 and WaMu and Wachovia in 2008. Nonetheless, they have been allowed to carry on, handing out large paychecks to leadership and generous dividends to member banks while doing relatively little to actually support housing.

As with AML, housing finance is a domain of financial regulation where current policies and institutions position the government to play a central role shaping who has access to a mortgage, the terms of those mortgages, the types of financial institutions underwriting mortgages, who ends up holding or otherwise possessing economic rights in those mortgages. the nature of the markets in which they trade and much more. Housing finance, at this point, is a massive public-private ecosystem where the various public and private components have co-evolved, shaping each other iteratively and in various ways over time. And yet, as with AML, this is an area that gets a lot of attention from people who focus on housing and housing finance but is not currently the subject of the type of broad, robust debate among academics, policy makers, and industry in the ways leaders in those domains still come together regularly to discuss financial stability; nor is it a common topic in financial regulation despite being central to it.

This essay does not take any position with respect to the range of aims that financial regulation should promote, much less offer any suggestions about how to achieve any given aim. Its purpose instead is to suggest that issues such as AML, housing finance and the relationship between financial regulation and the structure of the broader economy are topics that merit far more attention than they currently receive in debates about financial regulation. Moreover, that neglect itself is costly. The recent work on the interplay

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[5] For a further discussion and support regarding housing policy as financial regulation, *see* Part II.B., *infra.*

[6] LAURIE GOODMAN ET AL., HOUS. FIN. POL'Y CTR., HOUSING FINANCE: AT A GLANCE MONTHLY CHARTBOOK, JUNE 2023 (2023), https://www.urban.org/research/publication/housing-finance-glance-monthly-chartbook-june-2023.

between banking law, antitrust and Brandeisian aims shows how the neglect of values and debates that were once central to banking has produced an industry structure and collateral consequences that may never have been allowed in the presence of more focused attention and yet which are difficult to change once entrenched. AML and housing finance are both exceptionally expensive in their current forms, and yet each, in different ways, is falling far short of achieving its core aims. Moreover, those aims are growing increasingly important. As geopolitical tensions continue to mount, the capacity to track financial flows globally could become increasingly important to U.S. foreign policy and other interests. Affordable housing, or lack thereof, is a pressing challenge that is not being met despite the massive funds and infrastructure available. This creates the possibility for meaningful upside from even modest improvements in how these ecosystems work. Nonetheless, all too often, bank regulators, academics, and even industry continue to focus an outsized amount of their energy on debates about capital regulation, liquidity regulation, resolution planning, deposit insurance, stress testing and the other components of a standard prudential regulatory diet.

All of those issues matter. I have dedicated much of my career to assessing threats to financial stability and I continue to focus much of my attention on how best to promote the resilience of the financial system. This essay is a self-critique as much as it is a critique of the field more broadly. As I started delving into the far messier world of anti-money laundering laws and learned to play around the edges of housing finance, part of me wanted to go back to focusing on stability—the aim is important, requires ongoing diligence, and also has a structure that facilitates rigor and debate. AML and housing finance, by contrast, are not domains where first-principles reasoning or efforts to start by identifying market failures and then making modest proposals to fix those failures will get you anywhere near understanding the morass already in place. But, this essay contends that making more effort to understand these domains, bringing rigor and structured debate to understanding how they do and should function, and promoting the type of multistakeholder conversation among academics, policy makers, and industry participants that has characterized debates about financial stability could go a long way toward improving actual policy outcomes.

This essay briefly reviews the ways stability has dominated regulatory and academic discourse about financial regulation. It then uses AML and the Federal Home Loan Banks (FHLBanks)—the oldest government foray into housing policy—as case studies to show that banks and the financial system are already deeply engaged in efforts to further other important government policies. These case studies affirm just how hard it can be to promote healthy public-private coordination, while also revealing why such arrangements have become so pervasive. More than anything, the aim here is to force acknowledgment of the myriad aims beyond stability that financial regulation already seeks to further, and to encourage more and broader engagement with these important areas of public policy.

I. STABILITY AS THE PARAMOUNT VALUE

Fifteen years after the failure of Lehman Brothers, the stability of the banking system remains the top priority of many. There are understandable reasons for this focus. The costly failures of SVB, Signature Bank, and First Republic Bank in the spring of 2023 and the decision by the Federal Reserve, Treasury Secretary, and the Federal Deposit Insurance Corporation to invoke extraordinary authority to protect all depositors in two of those banks was a reminder of the inherent fragility of banks and the adverse systemic effects such failures can trigger. Those failures, alongside the need for the United States to come into compliance with international standards, led to a host of new proposals to further safeguard banks and the banking system. If adopted, the Basel III endgame and other recent proposals will require the largest, most complex banks to meaningfully increase the amount of capital they use to fund their operations and will require regional banks to issue more long-term debt and calculate capital requirements in a manner more akin to that used by the largest banks.

The failures in the spring of 2023 also reinvigorated an academic debate about whether more should be done to bring stability to the banking system once and for all. This vein of the academic literature has deep roots.[7] It was reinvigorated with myriad new proposals for making banks safe following the 2008 financial crisis.[8] Scholars such as Adam Levitin and Laurence Kotlikoff issued blueprints for various forms of "narrow banking," requiring all deposits to be backed by safe assts.[9] Mervyn King, former head of the Bank of England, proposed ensuring stability by requiring banks to preposition at the central bank sufficient collateral to cover all deposits.[10] Morgan Ricks proposed eliminating "shadow banking," allowing only banks to issue liabilities of less than a year and having the government insure all of them as a way to stabilize the financial system.[11] Fast forward to today and each of these proposals is again under discussed. In 2023, Ricks, for example, joined forces with Lev Menand to put forth an ambitious plan to bring all money creation into the banking system and have banks function as utilities. Again, stability was a central, though purportedly no longer sole, aim.[12]

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7 For an overview of this history, *see* Jaromir Benes and Michael Kumhof, *The Chicago Plan Revisited*, 17–20 (Int'l Monetary Fund, Working Paper No. 12/202, 2012).

8 For a history and overview of safe banking proposals, *see* George Pennachi, *Narrow Banking*, 4 ANN. REV. FIN. ECON. 141, 148–49 (2012).

9 Adam J. Levitin, *Safe Banking: Finance and Democracy*, 83 U. CHI. L. REV. 357, 361 (2016); LAURENCE J. KOTLIKOFF, JIMMY STEWART IS DEAD: ENDING THE WORLD'S ONGOING FINANCIAL PLAGUE WITH LIMITED PURPOSE BANKING 172 (2010).

10 MERVYN KING, THE END OF ALCHEMY (2017).

11 MORGAN RICKS, THE MONEY PROBLEM: RETHINKING FINANCIAL REGULATION x–xi (2016).

12 *See* Lev Menand & Morgan Ricks, *Rebuilding Banking Law: Banks as Public Utilities*, YALE J. ON REG. (2023).

Stability and resilience have also been central in setting the agenda for debates about financial regulation that are far less ambitious in nature. Capital requirements, liquidity requirements, resolution planning and a host of other reforms and debates about financial regulation have largely been focused on just how much regulation, and in what suite of forms, is needed to achieve the necessary degree of stability, or at the least, resilience.

Throughout this line of literature is an assumption that stability is such a paramount goal that it could well justify imposing significant and often fundamental transformations in the nature of banking and should dominate financial regulatory debates even among those that are far less visionary. There are good reasons for this focus on stability, as the timing of these proposals reflect. I have spent much of my career trying to better understand the causes of financial dysfunction and the best ways to enhance the resilience of banks and the broader financial system. Whatever the path ahead, resilience should remain a priority. Yet the claim here is that the debate in financial regulation over the coming decades will and should shift from this core focus on stability to other useful, and perhaps even critical, functions that financial regulation already plays, sometimes quite poorly.

To be sure, that banks and other financial companies provide socially useful services has also been much discussed over the last fifteen years. Yet the implications of this possibility have tended to come in one of two forms. To oversimplify, many on the right seek to have banks do more by regulating them less. Trusting in markets and market participants, the idea is that by reducing regulatory burdens, banks can be trusted to engage in more socially valuable activities, such as making loans that increase the welfare of households and the productivity of businesses.[13] These debates thus often end up being framed, once again, about the optimal forms of regulation to promote resilience and stability.

On the left, the assumption has tended to be that in order for finance to do more to help households and the economy, banks should do less and the government should do more, often through the creation of new, large-scale, government administered programs. Mehrsa Baradaran, for example, has argued that in order to facilitate access to financial services, in ways that would benefit both marginalized households and the economy, post offices should be able to provide a host of banking services.[14] Morgan Ricks, Lev Menand, and John Crawford have argued that many of the challenges impeding access to certain financial services could and should be addressed by allowing

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[13] This debate played out at a recent hearing discussing the virtues and drawbacks of implementing a host of new capital requirements, commonly known as the Basel III endgame reforms. *See Implementing Basel III: What's the Fed's Endgame?: Hearing before the H. Subcomm. on Fin. Insts. and Monetary Pol'y*, 118th Cong. (2023), https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=408961.

[14] MEHRSA BARADARAN, HOW THE OTHER HALF BANKS: EXCLUSION, EXPLOITATION, AND THE THREAT TO DEMOCRACY 183 (2015).

people across the country to be able to have an account directly with the Federal Reserve.[15] Saule Omarova, sometimes in conjunction with Robert Hockett, has proposed an ambitious government program, the National Investment Authority, as the solution to ways that the financial sector may be falling short in how it allocates capital.[16]

By contrast to either of these extremes, as the next Part shows, many of the domains of financial regulation that get less attention involve public-private ecosystems—regimes that have gone far beyond partnerships in which the public and private components have co-evolved over time and remain mutually dependent on each other. These systems are not conducive to the type of first-best solutions currently being offered up by many academics, which may help to explain why they have been relatively overlooked. A core role of academics is to look beyond the current policy horizon and consider not just what is, but what could and should be. Efforts to think creatively and expansively about what the government can and should do or to argue vociferously against such interventions can play a valuable role helping to expand new policy horizons. Yet, as with the focus on stability, it is entirely possible to recognize the value of the work being done and acknowledge the high cost of the opportunities foregone when such creativity is not also being brought to bear on policies that are now in effect and are ripe for improvement.

II. PUBLIC-PRIVATE ECOSYSTEMS HIDING IN PLAIN SIGHT

A. *Anti-Money Laundering and Sanctions Infrastructure*

One of the most significant ways that banks are harnessed to serve governmental aims is through the role they asked to play as the eyes and ears of law enforcement and the enforcers of economic sanctions. The Bank Secrecy Act (BSA), as amended, puts banks in the position of playing a key role helping law enforcement investigate and prosecute a whole host of crimes, combatting corruption in the United States and abroad, trying to counter terrorist financing, and furthering an array of other policy objectives. The compliance infrastructure banks have in place to facilitate AML compliance has also been used with increasing import to impose economic sanctions, as were imposed against Russia following its invasion of Ukraine.

The fruits of this regime are significant and show just how much the government can gain from enlisting the help of banks. A 2018 survey by the Government Accountability Office of more than 5,000 employees across six federal agencies engaged in investigating and prosecuting crimes found that

15 Morgan Ricks, J. Crawford, & L. Menand, *FedAccounts: Digital Dollars*, 89 GEO. WASH. L. REV. 113, 116–17 (2021).

16 SAULE OMAROVA, THE NATIONAL INVESTMENT AUTHORITY: AN INSTITUTIONAL BLUEPRINT (2022).

more than 72 percent reported using BSA reports to pursue investigations in the preceding three years.[17] Most of those had used that information for multiple aims, including quite often starting and expanding investigations.[18] The Criminal Investigation unit at the IRS reported in early 2023 that over the past three years, more than 83% of their investigations recommended for prosecution had a primary subject with a related BSA filing.[19] According to Jim Lee, head of the unit: "Hundreds of millions of dollars in restitution have been awarded to crime victims because our agents were able to use BSA data to prove a crime was committed." The 2022 National Money Laundering Risk Assessment put out by the Treasury Department is replete with case studies of how the BSA infrastructure was used to detect and prosecute a whole host of crimes.[20]

There are also some good reasons that public-private coordination of some sort may be necessary to achieve these types of aims. A regime that asks banks to keep records available and affirmatively turn over a tiny slice of transaction and customer data that they control is not that protective of financial privacy. Yet it is far more protective than if the government had direct access to all of the information available to financial institutions and other subject entities. At the other extreme, eliminating this regime entirely would not only make it far more difficult for law enforcement to do their jobs, but it would also undermine any deterrence effect this regime currently has with respect to each of the various aims it seeks to further.

Despite these significant fruits, and there being some reasons for a public-private regime of some sort in this domain, the current regime also seems to be performing well below what should be possible (admittedly, a hard thing to measure). Looking globally (itself part of the challenge, but the only way to assess actual efficacy here), available estimates suggest that this regime captures a mere 0.2 percent to 1.1 percent of illicit money flows.[21] Leaks of various forms further make it clear just how porous the current regime really is in practice. In 2020, for example, reporters got access to a small slice of the suspicious activity reports (SARS) and other confidential materials held by the Financial Crimes Enforcement Network (FinCEN), a body within

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17 U.S. GOV'T ACCOUNTABILITY OFF., GAO-20-574, ANTI-MONEY LAUNDERING: OPPORTUNITIES EXIST TO INCREASE LAW ENFORCEMENT USE OF BANK SECRECY ACT REPORTS, AND BANKS' COSTS TO COMPLY WITH THE ACT VARIED (2020).

18 *Id.*

19 IRS, PRESS RELEASE: BSA DATA SERVES KEY ROLE IN INVESTIGATING FINANCIAL CRIMES (Jan. 18, 2023), https://www.irs.gov/compliance/criminal-investigation/bsa-data-serves-key-role-in-investigating-financial-crimes.

20 DEPT. OF THE TREAS., NATIONAL MONEY LAUNDERING RISK ASSESSMENT (Feb. 2022), https://home.treasury.gov/system/files/136/2022-National-Money-Laundering-Risk-Assessment.pdf.

21 THOMAS PIETSCHMANN & JOHN WALKER, UNITED NATIONS OFFICE ON DRUGS AND CRIME, ESTIMATING ILLICIT FINANCIAL FLOWS RESULTING FROM DRUG TRAFFICKING AND OTHER TRANSNATIONAL ORGANIZED CRIMES 7 (2011); EUROPOL, CRIMINAL ASSETS BUREAU, DOES CRIME STILL PAY? CRIMINAL ASSET RECOVERY IN THE EU 4 (2016).

the Treasury Department that oversees and coordinates implementation of the BSA.[22]

The regime is also very expensive, with much of the expense borne by banks and other subject entities. An oft-cited annual survey by Lexis Nexis suggests that the total cost of financial crime compliance across financial institutions worldwide was $274 billion in 2022, with the great bulk of this cost incurred by institutions based in North America and Europe.[23] A 2018 survey by the Bank Policy Institute found that the largest banks in the survey spent a median expenditure of $600 million per year on AML compliance.[24] These costs don't just hurt banks; they can also make banks less likely to provide bank accounts and other services, harming people and small businesses.

In ongoing work with Anil Kashyap, I am exploring how to enhance the efficacy of this overall regime, and ways to better understand and address some of the inevitable tradeoffs that arise. That work examines uneven enforcement, frictions around information flows and other dynamics that can be addressed to improve outcomes without substantially increasing overall costs. It also illuminates the important civil liberties and economic liberties that, eventually, come into play and can help explain and justify a far from complete AML regime. Putting these considerations alongside one another should promote both a more effective regime and healthier engagement around the questions of when and how other important policy objectives should be traded off or protected in the design and implementation of the infrastructure around AML. Yet lurking behind this research is a looming question of just why AML seems to be performing so poorly despite the massive public and private resources invested in it.

As a starting point, it is clear that AML is an affirmative obligation imposed on banks in which they are being asked to provide a public service that flows from the nature of the services they provide, but not from any negative externality or market failure that might exist in the absence of regulation. Banks would likely avoid some money laundering on their own, given the reputational harm that can result. But less than savory clients can also be quite profitable. JP Morgan's relationship with Jeffrey Epstein, which yielded valuable connections for years while only later leading to reputational damage and potential liability is a high-profile example of the types of tradeoffs at play. It further illustrates the way the benefits are usually more near-term and more concrete than the costs. Given the imperfect incentives

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22 *Global Banks Defy U.S. Crackdowns by Serving Oligarchs, Criminals and Terrorists*, INT'L CONSORTIUM OF INVESTIGATIVE JOURNALISTS (Sept. 20, 2020), https://www.icij.org/investigations/fincen-files/global-banks-defy-u-s-crackdowns-by-serving-oligarchs-criminals-and-terrorists/.

23 LEXISNEXIS RISK SOLUTIONS, TRUE COST OF FINANCIAL CRIME COMPLIANCE STUDY (2022).

24 BANK POL'Y INST., GETTING TO EFFECTIVENESS – REPORT ON U.S. FINANCIAL INSTITUTION RESOURCES DEVOTED TO BSA./AML & SANCTIONS COMPLIANCE 4 (2018), https://bpi.com/wpcontent/uploads/2018/10/BPI_AML_Sanctions_Study_vF.pdf.

that otherwise exist, fines and other regulatory action often become central drivers of private investments in developing robust AML regimes.[25]

In the abstract, appropriately calibrated penalties can theoretically help close the gap between private and public incentives, motivating banks to make the investments and other decisions that would otherwise be socially optimal. In practice, it doesn't seem to play out like that. For one thing, neither banks nor the government/public are monoliths here. Both are broad concepts that encompass a range of different actors with very different types of information, abilities, and incentives. Within banks, for example, AML compliance officers seem very aware that they are seen as cost centers, not revenue generators, and the overall aim of the organization is to maximize profits.[26] The risk of liability can induce investments in AML, but it is not just the level but also nature of those investments that ultimately matter for outcomes.

Similarly, although AML compliance officers often do view their work as meaningful and their interests aligned with the law enforcement officials that put their findings to work, interactions between AML officials and law enforcement are minimal. Instead, the primary spot of government interaction is through supervision and enforcement. And AML officials view these government actors with far more skepticism.

Each of these challenges illuminates a related impediment that helps explain why the imposition of fines may be a far from optimal tool for achieving optimal compliance: the lack of a clear baseline from which to measure deviations. Clearly, the goal of AML is not to require banks to invest infinite resources trying to ensure they identify and report all instances of possible money laundering or terrorist financing, so some mistakes must be tolerated. But AML does impose affirmative obligations on banks to implement compliance regimes, undertake customer due diligence, and file suspicious activity reports even when there is no clear evidence of wrongdoing. Ignorance is not an option.

The current framework tries to balance resource constraints and efficacy by requiring banks to institutionalize risk-based compliance systems.[27] In theory, this is an antidote to the common fear (and potentially still quite common practice) of check-the-box approaches to compliance. It asks banks to make informed judgments about the relative risks posed by different types of offerings and clients and to allocate resources and build internal infrastructure to reflect the relative risks.

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25 For an overview of how large these fines can get, *see Top AML Fines in 2022*, COMPLY ADVANTAGE (July 26, 2023), https://complyadvantage.com/insights/aml-fines-2022/.

26 *See, e.g.*, Colleen P. Eren, *Cops, Firefighters, and Scapegoats: Anti-Money Laundering (AML) Professionals in an Era of Regulatory Bulimia*, 2 J. WHITE COLLAR AND CORP. CRIME 47, 53 (disclaiming "'We are a cost center' and 'We are not a revenue-generating function.' These two sentences were repeated by a majority of the participants, suggesting that this is a firmly entrenched framing of the AML role.").

27 *E.g.*, Introduction, FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL (FFIEC), BSA/AML MANUAL, https://bsaaml.ffiec.gov/manual (2015).

Yet even if this worked as well as theory suggests—and there are plenty of signs that it does not—there is still reasons to expect that the overall outcomes it produces would be far from socially optimal. At least six challenges remain.

First, the types of investments that can be induced through oversight and enforcement for failures could well be poorly matched to the types of investments that would enable the system to achieve meaningfully better outcomes. Technology, for example, is playing an increasingly important role in AML and its role is likely to increase. For an individual firm seeking to minimize expenditures while also taking steps needed to avoid or reduce fines, the types of technological investments that will be the most attractive are ones that: (1) reduce the type of violations that lead to fines or (2) reduces costs. Technological investments that could produce radically better outcomes, by contrast, are far less likely. This is both because there is no system of rewards, and because transformative developments often entail uncertainty and risk—not something that regulators have seemed overly willing to accept. Put bluntly, a compliance framework may get firms to want to minimize bad outcomes, but it does nothing to incent good outcomes. That would require a different type of framework.

Second, even if firms were willing to make investments focused on improving outcomes, the success of such efforts would depend critically on how those investments interacted with the broader ecosystem in which AML operates. Ultimately the burden lies with FinCEN and the myriad law enforcement agencies and other governmental bodies to make use of the information provided. Maximizing output is not just about maximizing the quality of the inputs but about the government's capacity to use the data provided to generate leads and other useful information. Public-private coordination around matters from standardizing data to the nature of the technology used to produce and analyze that data is key to overall success.

Third and relatedly, the coordination challenge here is huge. One reason is that privacy and other civil liberty concerns justify meaningful frictions in the transmission of information throughout this ecosystem. But the nature of the frictions goes far beyond and is poorly mapped onto legitimate efforts to protect privacy.

Fourth, economic liberties also come into play and can contribute to an even greater disconnect between the course of conduct that is privately and socially optimal. De-risking, that is refusing to provide certain types of financial services or to serve particular types of clients, is often the privately optimal response to a risk-based compliance regime but can also impede the ability of households and businesses to function as full participants in the economy. Even a government hesitant to impose universal or other affirmative service obligations on banks cannot turn a blind eye to the adverse impacts of its decisions to utilize the banking system to pursue other ends.

Fifth, as Kashyap and I explore, the aims of AML have a history of evolving. The optimal investments thus are often not ones that maximize output for today's regime but the one that build an infrastructure capable of evolving over time.

Sixth and relatedly, for any transformation to be possible, regulators and supervisors must be willing to tolerate errors, even ones that are preventable with today's technology. Without a credible commitment to accept short-term shortcomings for long-term gains, banks are far less likely to be willing to invest finite resources in building out new types of capacity. Yet, such commitments are hard to come by, and practically speaking, can be very hard for supervisors and other regulators to make.

Taking a step back, this very brief look into AML suggests it is one of the most extensive public-private ecosystems, and one that is performing abysmally by some metrics. It also raises some interesting questions about the conditions that may be required for the regime to perform meaningfully better than it is. Typically, economics focuses on creating the right sets of incentives, and there could well be room for significant improvement in how fines are imposed and calibrated. Yet even this cursory analysis suggests that the system is unlikely to be optimized so long as it is conceived in oppositional terms. Similarly, an accountability mentality—while potentially useful in addressing some of the blatant weaknesses in AML regimes revealed by recent leaks—is unlikely to produce optimal outcomes. Meaningful cooperation may be needed.

There are a host of reasons that may be difficult to achieve right now, and many additional reasons to be worried about efforts at cooperation. Looking at the oldest component of the public-private ecosystem around housing finance brings some of these challenges into relief. For now, it suffices.

B. *Housing Finance: The Federal Home Loan Banks*

In 1931, President Herbert Hoover gathered builders, realtors, and others in the housing industry from around the country to the White House to explore what could be done to address the acute challenges afflicting the housing market and the structural challenges impeding the ability of middle-class Americans to buy their own homes.[28] A central focal point of the gathering was housing finance. At the time, the typical mortgages had quite short durations—often under five years, required large down payments (e.g., 50%), and were structured as balloon mortgages, in which regular payments

28 ADAM J. LEVITIN & SUSAN M. WACHTER, THE GREAT AMERICAN HOUSING BUBBLE 44 (2022); President Herbert Hoover, *Statement Announcing the White House Conference on Home Building and Home Ownership* (Sept. 15, 1931), https://www.presidency.ucsb.edu/node/207591. For more on the history of the FHLBanks, *see, e.g.*, Kathryn Judge, *The Unraveling of the Federal Home Loan Bank System*, 41 YALE J. REG. __ (forthcoming 2024).

covered only interest and the full principal was due at the end.[29] President Hoover recognized that making it easier for people to access mortgages on favorable terms—with longer durations and amortization structures (with monthly payments covering principal and interest) that facilitated savings—could go a long way toward restarting the housing market and helping ordinary Americans build wealth and own their own home.[30] Yet government interventions of the type to come in housing—with widespread government guarantees of certain types of risk in order to facilitate a secondary market—were not something he was yet ready to embrace.

The solution was the Federal Home Loan Bank (FHLBanks) system, a government-sponsored enterprise that could raise money from the capital markets (still today aided by an expectation of a government backstop) and use the funds so raised to make collateralized loans to member institutions, thereby encouraging liquidity-strained members to make more of the types of loans that could be posted as collateral.[31] Although the FHLBanks today play a relatively modest role in housing finance, they continue to play a very significant role in the banking system. And they provide a useful case study in the virtues, dangers, and omnipresence of public-private coordination and cooperation in finance.

At the founding of the FHLBanks, the first pivotal policy decision was who should have access to this liquidity. The answer was shaped in part by the realities of the mortgage market, but also by what the government wanted the mortgage market to look like. Individuals that were a major source of mortgage finance at the time were excluded, as were commercial banks.[32] Those granted access were savings and loans and other types of thrifts—small, community-oriented financial institutions, typically structured as mutuals (meant to serve members, as opposed to profit-oriented, shareholder-owned organizations), designed to serve the needs of ordinary Americans and often, though not always, focused on residential housing—and insurance companies.[33] The first thrifts were modeled on counterparts abroad, and they proliferated rapidly, particularly as industrialization increasingly created groups of workers with stable incomes, other ties, and in need of homes. They played a critical role facilitating access to housing finance, but without any support, they proved incredibly vulnerable as housing prices went down and the economy contracted. Access to the FHLBanks made these inherently fragile institutions more resilient—a classic way government aids finance. But it also did something more.

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29 LEVITIN & WACHTER, *supra* note 28, at 16–27.

30 Natasha Porfirenko & James Ryan, *Archival Description of President's Conference on Home Building and Home Ownership*, ONLINE ARCHIVE OF CAL. (1998), https://oac.cdlib.org/findaid/ark:/13030/tf1w1001jf/entire_text/.

31 *See* Federal Home Loan Bank Act, 12 U.S.C. § 1421 *et seq*.

32 LEVITIN & WACHTER, *supra* note 28, at 48.

33 *See* U.S.C. § 1424(a)).

The next issue was collateral. Here, the government sought to not only to use liquidity provisioning to increase the resilience of financial institutions that made home loans and the availability of (otherwise quite illiquid) home loans, but also to make modest changes in the types of loans available. It did this by defining qualified mortgages in ways that balanced credit risk with whether the loan actually met borrower needs, and imposing value caps on the home that secured the loan. The FHLBanks also allowed members to borrow more (via smaller haircuts) when posting loans that were particularly well suited to meet the needs of middle-class Americans, via longer durations and amortization structures designed to facilitate saving.[34]

The overall regime was a success in the first decades to come. It increased the availability of home loans, in part by enhancing the viability of thrifts that played a key role in the mortgage market. Small, community-oriented financial institutions have often played a key role providing local credit but are inherently vulnerable to shocks in the local or broader economy. By standing by, ready to provide fresh liquidity as needed, and helping to redistribute liquidity among thrifts, the Federal Home Loan Bank system illustrated just how impactful a government-sponsored enterprise could be.

The story of the FHLBanks in recent decades serves as a cautionary tale in the problems that can arise. A host of developments, including the introduction of a host of other more direct and expansive government programs that massively increased the availability and consumer-friendliness of housing finance, deregulation that swept away differences between thrifts and banks, and decisions by Congress to use the FHLBanks as a source of "off-balance sheet" revenue resulted in a much larger FHLBank System, and one far more focused on serving private aims. The biggest beneficiaries today are member banks, and the biggest users of the FHLBank system are the largest banks in the country (which were granted membership in 1989).[35]

Making matters worse, the FHLBanks have used their government-granted benefits to become a lender-of-second-to-last resort to all kinds of banks, undermining accountability with respect to the role of the Federal Reserve as the nation's designated liquidity provider of last resort and chronically enabling soon-to-fail financial institutions to limp along without correcting course. The failed Savings and Loans (S&Ls) of the 1980s were far more likely than healthy counterparts to borrow from the FHLBank system; the most significant banks that failed during the 2008 crisis consistently relied heavily on the FHLBank system to prop up their liquidity;[36] and, SVB

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34 *Id.* at § 1430(a)(1)).

35 Stefan Gissler & Borghan Narajabad, *The Increased Role of the Federal Home Loan Bank System in Funding Markets, Part 1: Background*, FEDS NOTES, BD. GOVERNORS THE FED. RSRV. SYS. (Oct. 18, 2017), https://doi.org/10.17016/2380-7172.2070.

36 Adam Ashcraft et al., *The Federal Home Loan Bank System: The Lender of Next-to-Last Resort?*, 42 J. MONEY, CREDIT AND BANKING 551 (2010).

and the other regional banks that failed in the spring of 2023 were major borrowers from their regional FHLBank.[37]

In short, the FHLBanks are a poster child of all that can go right and wrong in public-private ecosystems. Government-backed entities, even if only implicitly backstopped—are far better positioned than any private bank to raise funds during periods of distress, precisely when banks and borrowers most needed it. The FHLBank model takes this one step further, showing how the provision of liquidity and the extension of longer-term collateralized loans can enhance the resilience of small, community-oriented financial institutions and benefit the borrowers and communities that they serve.

Of course, the FHLBank system, as large as it is, remains a relatively modest component of the myriad ways the government has sought to promote housing finance and housing more generally. Today, the majority of all new mortgages issued end up in securitization vehicle backed by a government-sponsored entity, namely Fannie Mae or Freddie Mac.[38] Yet the current governance of Fannie and Freddie is not a regime anyone ever wanted. Back in September 2008, just prior to the failure of Lehman Brothers, the then-newly created Federal Housing Finance Agency (FHFA) placed Fannie and Freddie into conservatorship. In so doing, the government protected all of the creditors in Fannie and Freddie, just as the market had long suspected it would, while displacing the private shareholder governance that Congress had put in place for the two GSEs. The government then was forced to inject nearly $200 billion into the GSEs to keep them afloat. Yet more than fifteen years later, that stopgap measure remains in place. As former head of Freddie Mac opined in 2022: "It really is time, after more than 14 years, to stop kicking this can down the road."[39] Unfortunately, that is the path of least resistance, and thus the one that seems likely to persist absent more attention for academics and policymakers alike.

In short, the United States has a massive array of programs designed to promote home ownership. The federal government also incurs significant costs, including billions in foregone tax revenue, to support these programs.[40]

Nonetheless, the country is currently plagued by a multi-dimensional affordability crisis for which few see any simple or near-term solutions.[41] A

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37 Fed. Home Loan Bank of S.F., Annual Report (Form 10-K) (Mar. 10, 2023).

38 Urban Institute, *Housing Finance at a Glance: A Monthly Chartbook* (Dec. 2023), at https://www.urban.org/tags/housing-finance-glance-monthly-chartbook-december-2023; Donald H. Layton, *The Fannie Mae and Freddie Mac Endgame*, THE HILL (Oct. 18, 2022), https://thehill.com/opinion/finance/3694135-the-fannie-mae-and-freddie-mac-endgame/.

39 *Id.*

40 Emma Waters, Owen Minott & Andrew Lautz*, Is it Time for Congress to Reconsider the Mortgage Interest Deduction?*, BIPARTISAN POL'Y CTR. EXPLAINER, (Nov. 2, 2023), https://bipartisanpolicy.org/explainer/is-it-time-for-congress-to-reconsider-the-mortgage-interest-deduction/.

41 *The Affordable Housing Crisis Grows While Efforts to Increase Supply Fall Short,* GAO BLOG (Oct. 12, 2023) https://www.gao.gov/blog/affordable-housing-crisis-grows-while-efforts-increase-

recent study found that half of those living in New York City cannot afford to live there given housing costs, and other cities face similar challenges.[42] Rather than helping to address the supply constraints and other challenges contributing to that crisis, many of the programs currently in place function primarily to facilitate wealth transfers, often benefitting the wealthy and financial institutions, while doing little to promote access to affordable housing.

Taking a step back, the early days of the FHLBank system demonstrated how private-public ecosystems can accomplish aims that neither could achieve without mutual support. Although in a way that is very different than AML, the original FHLBank system shows how public-private coordination can create outcomes not achievable by public or private mechanisms alone. The FHLBank system also embodies the reasons that so many academics, and others have become disillusioned with such arrangements as well. The tendency for even well-designed regimes to decline over time is hard to ignore.

Nonetheless, this is a system that current exists and is massive, with debt outstanding well in excess of $1 trillion.[43] The FHFA has recently issued a very useful report trying to lay out possible reforms.[44] Yet the proposed reforms would be more incremental than transformational, and the FHLBanks are working aggressively to fight even those reforms.[45] More importantly, the report, which had been more than a year in the making, garnered only modest attention and triggered none of the type of public engagement and debate that would be needed for meaningful reform. Echoing Don Layton, it is past time to stop kicking the can down the road, allowing a regime that is obviously suboptimal by any objective standard to continue to bilk an implicit public backstop primarily for the benefit of member financial institutions and highly paid executives.[46]

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supply-fall-short; Neil Irwin, *Why America's Housing Crisis Has Hit A New Inflection Point*, AXIOS (Sept. 19, 2023), https://www.axios.com/2023/09/19/housing-affordability-crisis.

42 Eliza Shapiro, *Half of N.Y.C. Households Can't Afford to Live Here, Report Finds*, N.Y. TIMES (Apr. 25, 2023), https://www.nytimes.com/2023/04/25/nyregion/affordable-housing-nyc.html; Joe Seydl, *When Will the Crisis in U.S. Housing Affordability End — and How?* (Nov. 14, 2023), https://privatebank.jpmorgan.com/nam/en/insights/markets-and-investing/ideas-and-insights/when-will-the-crisis-in-US-housing-affordability-end-and-how.

43 Noah Buhayar, Heather Perlberg, & Austin Weinstein, *A $1.3 Trillion Home-Loan System Gone Astray Is Fighting an Overhaul,* BLOOMBERG NEWS (Dec. 20, 2023), https://www.bloomberg.com/news/articles/2023-12-20/federal-home-loan-banks-why-lobbyists-are-fighting-housing-lending-reform?sref=0SF97H1m.

44 FHFA, FHLBank System at 100: Focusing on the Future (2023), https://www.fhfa.gov/PolicyProgramsResearch/Programs/Pages/FHLBank-Focusing-on-the-Future.aspx.

45 Buhayar, Perlberg, & Weinstein, *supra* note 43.

46 Judge, *supra* note 28.

CONCLUSION

For the first decade after the financial crisis of 2008, there were good reasons for the robustness of the debate about financial stability to largely dwarf other conversations on financial regulation. The bank failures of spring 2023 were a reminder that stability can never be taken for granted. But the excessive focus on stability has elided the reality that financial regulation already serves many other aims, from helping law enforcement go after drug traffickers to making it easier for families to own their own homes to promoting a more diffuse allocation of power and opportunity. These domains and aims are messy, having developed over decades, and in ways that are not conducive to first-best reasoning, whether economic or otherwise. Yet this is more reason, not less, for academics, think tanks and other institutions suited to promote robust and informed debate should be leading these conversations rather than avoiding them.

Rigorous analysis and public debate have the capacity to bring rigor and fresh thinking to important policy problems. By looking beyond the horizon of what is politically feasible in the short term—often the focus when conversations are dominated by those entrenched in a regime as it now exists—a broader set of voices can help lay the foundations for new and better approaches to policy making. Hopefully in the years ahead, more academics and other intellectuals will display even more willingness to move beyond the methodologies embraced in ivory towers and engage further with the challenges and great opportunities now at play in financial regulation in the broad terms in which it is actually put into practice.