No, Repealing the Volcker Rule Won't Cause an Economic Collapse

Instead of limiting what risks banks can take, the government should force banks to live with the consequences of those risks.

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The Federal Reserve on Wednesday announced a series of changes to Obama-era banking regulations intended to prevent banks from taking unnecessary risks with their clients' money. The move will free smaller financial institutions from onerous federal rules and allow regulators to focus their attention on bigger banks that take greater risks.

The changes to the so-called Volcker Rule—named for former Federal Reserve Chairman Paul Volcker, who suggested the basic premise behind what eventually become a 700-plus page regulation included as part of the Dodd-Frank Act—were quickly criticized for supposedly bringing the entire financial system back to the precipice of 2008.

"This proposal is no minor set of technical tweaks to the Volcker Rule, but an attempt to unravel fundamental elements of the response to the 2008 financial crisis, when banks financed their gambling with taxpayer-insured deposits," Marcus Stanley, policy director at Americans for Financial Reform, told *The New York Times*. "If implemented, these proposals could turn the Volcker Rule into a dead letter, a regulation that would not meaningfully restrict trading activities at the banks whose problems could drag down the entire financial system—again."

The reality is quite different. For starters, that's because the Volcker Rule isn't actually being repealed.

In theory, the Volcker rule is supposed to stop banks from engaging in what's known as "proprietary trading"—using money on the bank's own balance sheet to engage in speculative trades intended to generate profit for the bank. Typically, financial institutions make money by charging a fee for transactions on behalf of their clients, but proprietary trading allows banks to make direct bets on the market in the same way that individual investors might.

Complicating matters is that fact that banks routinely *do* invest some of their holdings as a way of protecting against risk in other parts of their portfolios. This hedging is a sound, and important, banking practice. But how do you tell the difference between hedging and risking proprietary trading? As *Reason*'s Peter Suderman noted in 2012, that question hamstrung much of the debate over the Volcker Rule and the Dodd-Frank Act in general. In the end, the law evolved as the legislation was written and ended up leaving banks with significant leeway to hedge various risks.

But like so much in Dodd-Frank, the Volcker Rule has never been very clear about the distinction between hedging and taking unnecessary risks. No one less significant than the "Frank" in Dodd-Frank slammed the final version of the Volcker Rule when it went into effect for creating an "untenable" situation where banks were being forced to comply with a rule that failed to articulate how to comply with it.

"The results reflected in the proposed rule are far too complex, and the final rules should be simplified significantly," then-Rep. Barney Frank (D-Mass.) told *The Hill* in July 2012.

That's exactly what's finally happening.

"This proposed rule will tailor the Volcker rule's requirements by focusing the most comprehensive compliance regime on the firms that do the most trading," Fed Chair Jerome Powell said in a statement. "Firms that do more modest amounts of trading will face fewer requirements."

Specifically, the changes divide financial institutions into three tiers. As CNBC explains, banks with more than $10 billion in assets—Wells Fargos and Goldman Sachses of the banking world—will still need to comply with the strictest set of rules, while banks with between $1 billion and $10 billion in assets will face "reduced compliance requirements" and those with less than $1 billion will no longer have to demonstrate compliance with the Volcker Rule at all.

That's in line with a set of Dodd-Frank reforms passed by Congress and signed by President Donald Trump earlier this month. That law will exempt banks with less than $250 billion in assets from Dodd-Frank's so-called "enhanced prudential standards"—strict regulations regarding liquidity, risk management, and capital meant to serve as a "stress test" for banks' balance sheets. Together, the two actions indicate that the Trump administration is taking a pretty reasonable approach to financial regulation: asking bigger banks to shoulder heavier regulations and preventing those rules from swamping smaller financial institutions. Additionally, the changes will allow federal regulators to focus their enforcement efforts on the banks that could prove to be an actual risk to the economy if they overplay their hands.

Of course, it might be preferable to have fewer financial regulations on all banks. Instead of limiting the types of risk that financial institutions can take, government should simply force banks to face the consequences when those risks fail to pay off. But as long as there is an implicit—or explicit—promise that taxpayers will serve as a backstop to banks considered "too big to fail," then it probably makes sense to force the banks representing the biggest potential cost to taxpayers to comply with additional rules.

Addressing that moral hazard is essential to correcting the current shape of financial regulations. In the meantime, setting the little guys free from rules that were only ever meant to be aimed at Wall Street's biggest banks is likely to benefit investors and entrepreneurs by increasing market liquidity and access to credit.