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The Fed Wants to Loosen Rules Around Big Banks and Venture Capital

Proposed tweaks to the Volcker Rule, which curbs bank risk-taking, would allow firms to invest heavily in funds backing start-ups.

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WASHINGTON — Banks could invest heavily in or even sponsor venture capital funds under a proposed change to a post-crisis rule that was intended to limit their risk-taking.

The proposal, unveiled Thursday by the Federal Reserve and other banking agencies, would revamp the Volcker Rule, which was created as part of the 2010 Dodd-Frank law. The rule restricts banks like Goldman Sachs and J.P. Morgan from making risky bets with customer deposits and generally prevents firms from sponsoring or investing in private equity and hedge funds.

The proposed changes would loosen some of those restrictions, allowing banks to invest in some credit funds and either sponsor or take ownership stakes in venture capital funds, which pool ultrarich investors' money and make high-risk investments in start-ups that can yield enormous returns or huge losses.

Restrictions would apply: Banks could not guarantee the funds' performance, for instance.

Regulators portrayed the changes as common-sense adjustments that will allow banks to better support small businesses by providing capital. Fed Chair Jerome H. Powell said the changes would "permit banks to provide limited services to covered funds in ways that do not raise the types of concerns the Volcker rule was intended to address."

But Fed Governor Lael Brainard, the last remaining Fed Board member nominated to her current job by President Barack Obama, opposed the move, saying it could weaken the post-crisis safety net and encourage the kind of risk-taking the Volcker Rule was meant to prevent.

"I am concerned that several of the proposed changes will weaken core protections in the Volcker Rule and enable banking firms again to engage in high-risk activities," Ms. Brainard said in her dissent. "The proposal opens the door for firms to invest without limit in venture capital funds and credit funds."

Regulators tapped by President Trump have been steadily chipping away at post-crisis banking rules. This would mark the second set of changes to the Volcker Rule, named for the late Paul Volcker, the former Fed chairman who championed it. While the adjustments have been carefully researched and are often subtle, they generally cut in one direction: bank-friendly.

"These actions, particularly the Volcker covered funds proposal, are clearly helpful to big banks," Ian Katz, an analyst at Capital Alpha Partners, said in a note.

The newly proposed tweaks were couched by regulators as minor, and even as responsive to Congress.

In a staff memo, regulators explained that "during congressional consideration of the Volcker Rule, several members of Congress expressed support for excluding venture capital funds" from the restrictions, specifically referencing comments by Representative Anna Eshoo, a California Democrat, and three retired senators, including Chris Dodd, a Democrat and one of the lawmakers for whom Dodd-Frank is named.

But Ms. Brainard said that "it is notable that Congress amended the Volcker rule two years ago and chose not to make any of today's proposed changes."

While banks can directly back venture capital projects already, the change would allow them to invest heavily in a bundle of such projects. That could help them to diversify risk — and in doing so, it could help them make more money, enabling easier exposure to investments that they might have been hesitant about or incapable of backing individually.

"If they already have the authority to basically do this thing, why would they have spent years and millions of dollars on lobbying?" said Gregg Gelzinis, a senior policy analyst at the Center for American Progress, a liberal think tank. "It's different."

Douglas Landy, a lawyer at Milbank with Volcker Rule expertise, said the proposed changes could help smaller banks get involved in investments they could not have made directly on their own. It would also offer banks a "tax advantaged" way to invest in start-ups, Mr. Landy said, giving banks more freedom to study tax laws and decide what kind of investment was best — a direct stake in a company or a more passive contribution to a venture capital fund.

The tweaks directly address industry complaints about the Volcker Rule and its fund investment limits, which banks have criticized as regulatory overreach.

“The current definition of ‘covered fund’ remains significantly overbroad and unduly complex,” Kenneth E. Bentsen Jr. said in a statement. Mr. Bentsen, a former lawmaker, is the head of the Securities Industry and Financial Markets Association, a trade group for broker-dealers, investment banks and asset managers. “We are reviewing the proposal with our members and look forward to offering our views during the comment period.”

The Fed is proposing the changes to the covered funds rule alongside the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Securities and Exchange Commission and the Commodity Futures Trading Commission.

The agencies will now take comments, address them, and, if they chose to do so, push forward with a final rule. There is no set timeline for that process.

Chris Cole, the senior regulatory counsel for the Independent Community Bankers of America, a trade group that represents small banks, said the group was taking Ms. Brainard’s concerns seriously and studying the proposal to try to decide whether the loosening of restrictions on big banks’ venture capital investments went too far.

The group’s biggest concern is that if big banks’ venture capital investments went belly up and destabilized the banks themselves, the Federal Deposit Insurance Corporation would end up having to bail them out using money collected for the deposit insurance fund. After that, the premiums on the deposit insurance that all banks are required to pay would go up.

“That would mean that the small banks would get hurt,” Mr. Cole said.

In a separate and unilateral move, the Fed also clearly defined how much of a stake banks can take in other companies — and vice versa — before becoming subject to heavier oversight.

A company that controls a banking organization generally falls under the Fed’s rules and regulations. But precisely what constitutes “control” has never been clearly outlined.

“It’s no accident that they did these two things together today because in some sense they’re two sides of the same coin,” Mr. Landy said. “The control definition makes it easier for funds to invest in banks and the banks to invest in venture capital. It’s kind of like more capital flowing through the entire banking system and clarifying the rules for making that happen.”

Randal K. Quarles, the Fed’s vice chair for supervision, said a clearer definition was necessary because the Fed’s old framework created compliance uncertainty for banks. And even Ms. Brainard, who dissents regularly on such matters, sounded comfortable with the decision.

“The final rule substantially increases the transparency and clarity of the Board’s control framework, and I support it,” she said, noting that “It will also be important to monitor how the control framework interacts with other regulations.”

One big change that could come from the update to the “control” rules: Private equity firms would be able to invest in banks in a way they have previously been restricted from doing. A private equity firm can now take a stake of up to one-third of a bank’s total equity — or 24.9 percent of its voting equity — without worrying that the Fed would determine that it had a controlling interest in the bank, which would suddenly subject it to a slew of bank regulations.

That could come in handy if another emergency like the 2008 financial crisis occurred and smaller banks needed to raise money quickly.

But it could also allow private equity investors to gain influence over small banks and then gamble with them, said Jeremy Kress, who teaches at the University of Michigan and was formerly a Fed regulator.

“Collectively, this final rule represents a significant deregulation,” he said.