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Summary of the New Financial Reform Law

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The financial reform bill recently signed into law is an attempt to address some of the problems that contributed to the 2008 financial crisis. The legislation, officially known as the Dodd-Frank Wall Street Reform and Consumer Protection Act, is considered the most wide-ranging overhaul of the U.S. financial system since the aftermath of the Great Depression. Because the problems it addresses are complex, the legislation itself is complex; much of the real impact will be felt only after regulations are developed to implement the law's provisions. Also, some provisions, such as those dealing with lending practices, will have a direct impact on individuals and investors; others will primarily affect the ways in which Wall Street functions. This is only a brief summary of some key provisions; consult your financial professional to see how these changes may affect you.

Credit and lending practices are revised

The Act requires originators of residential mortgages to disclose any conflicts of interest and compare costs and benefits of mortgages offered to a potential borrower. Lenders also will be required to verify whether, based on income, credit history, and other data, a borrower has a reasonable ability to repay a loan plus its associated taxes, insurance, and other costs. This could mean that self-employed people and others whose income is undocumented or irregular will need better documentation to qualify for a loan.

Lenders will no longer be able to give loan officers financial incentives that induce them to steer customers to a mortgage with a higher interest rate simply to increase their own commission. Their ability to impose prepayment penalties when a borrower repays a loan early also will be more limited, and a holder of a hybrid adjustable rate mortgage must receive notice of any change in the interest rate six months in advance.

Lenders are prohibited from refinancing an existing mortgage unless the new mortgage offers a net benefit to the borrower, and they may not coerce or induce an appraiser to make a faulty appraisal of a property's value. Loan applicants must receive a copy of the appraisal on the property no later than three days prior to the closing.

High-cost mortgages are subject to special regulations. Any balloon payments on high-cost mortgages cannot be more than twice as large as the average of earlier payments, and a borrower must receive qualified counseling on the advisability of a high-cost mortgage before credit can be extended.

Homeowners who are unable to make mortgage payments as a result of losing their jobs or because of a medical condition may now qualify for up to $50,000 in assistance loaned through HUD's existing Emergency Mortgage Assistance Fund.

Increased protection of bank deposits becomes permanent

During the financial crisis, the Federal Deposit Insurance Corp. (FDIC) temporarily increased from $100,000 to $250,000 the amount it will insure on deposit accounts in FDIC-insured banks. The $250,000 limit is now permanent.

Greater transparency and accountability for investments and related services

Institutional investors' inability to determine the amount of global financial exposure to derivatives--investments based on the value of other investments--contributed to the panic at the height of the financial crisis. Over-the-counter derivatives must now be traded on a public exchange, and trades must be cleared through a registered clearinghouse. Nonstandard derivatives can still be traded privately, but must be reported to a central authority in order to increase regulators' ability to monitor the overall level of activity.

Hedge funds and private-equity advisors will be required to register with the Securities and Exchange Commission (SEC) and disclose to the commission information such as investment positions and the amount of leverage involved. Also, the $1 million minimum net worth required to be an accredited investor eligible to invest in such funds will no longer include a principal residence, and that $1 million threshold will be reviewed every four years.

Credit rating firms, which were criticized for being too lax in their evaluations of securities based on subprime mortgages, will be subject to oversight by the SEC, which can fine those that issue too many faulty ratings over time. Also, investors will now have the right to sue an agency for issuing ratings it knew or should have known were flawed.

Shareholders of public companies will have the right to a nonbinding vote on compensation for the company's executives. Also, protections for people reporting securities law violations have been enhanced. Whistle-blowers with information that leads to monetary sanctions of more than $1 million will be eligible for 10 percent to 30 percent of the funds collected from the offender; if an employer retaliates, a whistle-blower can sue without waiting until administrative remedies have been exhausted.

An Investor Advocate office will be established within the SEC to help individual investors resolve significant problems and to promote investor interests.

Risky banking practices are addressed

Banks will be required to hold additional capital to cover potential losses, and some securities are no longer acceptable as vehicles for capital reserves held by large banks. Banks also will be required to retain at least 5 percent of a loan on their books if the loan is sold and/or repackaged with other loans and securitized. (However, some relatively low-risk mortgages, such as fully documented loans with a fixed interest rate, are exempted.)

Banks also will be more limited in their ability to engage in proprietary trading in their own accounts, which could represent a conflict of interest with their responsibility to their clients. They also will have to set up separate operations to handle their most risky derivative trades, such as swaps. A bank will not be permitted to invest more than 3 percent of its core capital in hedge funds and private equity, but it may still organize and offer them as long as certain conditions are met.

A Consumer Financial Protection Bureau overseen by the Federal Reserve will be created to regulate consumer financial products and services.

Systemic risk will be monitored, and liquidation of large banks will be overseen

A new Financial Stability Oversight Council is charged with assessing and managing risks that could threaten the entire U.S. financial system. Also, the FDIC will manage the liquidation of a bank whose failure the Treasury Secretary determines would disrupt the stability of the nation's financial system. That will include firing corporate management responsible for the failure and prohibiting any payments to shareholders until all other claims are paid. The FDIC may borrow from an Orderly Liquidation Fund to pay for a liquidation, but those costs must be replenished not from taxpayer funds but from claims on the bank and, if necessary, assessments on large financial institutions. The Act does not permit the Federal Reserve or the FDIC to lend to or provide a guarantee for individual or insolvent companies or banks, but both may lend funds to provide liquidity.

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