Financial reform law: What's in it and how does it work?

President Obama signed a sweeping financial reform bill into law Wednesday giving the federal government new powers to regulate Wall Street.

President Barack Obama signs the Dodd-Frank Wall Street Reform and Consumer Protection financial overhaul bill at the Ronald Reagan Building in Washington on July 21.
(Charles Dharapak/AP)

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posted July 21, 2010 at 5:13 pm EDT

Washington —
The financial reform bill signed into law by President Obama Wednesday constitutes a sweeping attempt to reallocate power from Wall Street to Washington and prevent future financial crises.

Will it work?

The full answer to that question won't be known for years to come. Some critics say the new law just creates unnecessary bureaucracy and ignores the federal government's own role in the recent financial crisis. Others say it doesn't go far enough – that it should have done more to break up huge banks, for instance, to address the problem of firms that become too big to fail.

Other analysts feel that it is a good start, and that it will at least soften the impact of any future monetary meltdown.

"In my view, the bill, plus upcoming regulatory actions, will get us two-thirds the way to where we should be, which is a major improvement on our current situation," writes Douglass Elliott, a fellow in economic studies at the Brookings Institution in Washington.

It's true that the bill will make loans a little more costly, and a little harder to obtain, according to Mr. Elliott. Economic growth in future years will be a bit slower as a result.

"This is a trade-off worth making, because the real benefit will be from avoiding the severe economic damage that comes in crisis years," he writes.

What's in the bill? Here are some of its major provisions:

• *New consumer watchdog*. The bill establishes a Consumer Financial Protection Bureau within the Federal Reserve. This agency will enforce existing consumer-oriented regulations that apply to big financial firms, mortgage-related businesses, and payday and student lenders. It will also ensure that the fine print on financial services is clear and accurate, and will maintain a single toll-free hotline for consumers to report possibly deceptive practices.

• *Financial early warning system*. The law sets up a Financial Services Oversight Council that is intended to work as a sort of bureaucratic early warning radar that scans the horizons looking for trouble in financial markets. Composed largely of existing officials, such as the Secretary of the Treasury, the group could require Federal Reserve oversight for big nonbank financial firms whose failure might destabilize the US economy. The council could also vote to require big, troubled companies to sell off assets – but only as a last resort.

• *Breakup authority*. Federal regulators will have the power to seize and dismantle troubled financial firms whose collapse might pull other companies down as well. This resolution authority would be overseen by the Federal Deposit Insurance Corporation. Taxpayers would pay for upfront costs but regulators would then be required to recoup the money by levying fees on financial firms with more than $50 billion in assets.

• *Tighter leash for financial firms*. The bill establishes tight restrictions on the ability of banks to trade in financial markets with their own funds. Proprietary trading – when banks place market bets for their own profits, instead of their customers – will be banned. Banks will be able to invest sums equal to only 3 percent of their capital in hedge and private equity investment instruments. In addition, the complex financial risk swaps known as derivatives will face comprehensive regulation for the first time. Most will have to be traded through public clearinghouses or exchanges.

• *Mortgage reforms*. In the years leading up to the financial meltdown it seemed as if banks and other financial firms would give a mortgage to any person with a pulse. Those loose practices are supposed to end, under the terms of the financial overhaul bill. Banks and other financial companies must review the income and credit histories of mortgage applicants, to ensure they can afford payments. Firms that bundle mortgages into pooled investment instruments must keep at least 5 percent of these instruments on their books. This is intended to serve as an incentive for the firms to make solid loans – not questionable ones that are then dumped entirely on outside investors.

The bill does not address the problems of Fannie Mae and Freddie Mac, the large government-sponsored corporations that are at the heart of the nation's mortgage system. The federal government had to bail out these firms when their investments soured, to the tune of $145 billion in taxpayer funds so far.

This is a major omission, to some critics of the legislation.

“Rather than fix the endless bailout that Fannie and Freddie have become, Congress believes it is more important to expand federal regulation and litigation to lenders that had nothing to do with the crisis,” writes Mark Calabria, director of financial regulation studies at the Cato Institute, in his analysis of the bill.

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