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Financial Reform: What It Is and Why It Matters to You

The 2008 financial crisis was the most significant disruption of the global financial system since the Great Depression. It's hardly surprising, then, that the legislation designed to address the problems that contributed to the crisis also is considered the most wide-ranging reform of the U.S. financial system since the 1930s.

Signed into law in July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act is an attempt to tackle not only the way Wall Street functions, but issues that affect individual consumers and investors. Here's a brief summary of some of the law's key provisions.

Revised credit and lending practices

The legislation creates new mortgage lending rules intended to provide greater protection for borrowers. For example, for loans that don't meet certain standards, lenders will have to verify whether, based on income, credit history, and other data, a borrower has a reasonable ability to repay a mortgage, including any associated taxes, insurance, and other costs. That could mean that self-employed people and others whose income is undocumented or irregular will need better documentation to qualify for a loan.

While these rules may limit the size of the mortgage you qualify for, they're intended to prevent you from being steered into a loan that's not suitable for you. Lenders can no longer provide mortgage originators and loan officers with financial incentives, such as higher commissions, for steering potential borrowers to a mortgage with a higher interest rate. Mortgage originators also must disclose any conflicts of interest and compare the costs and benefits of mortgages offered to a potential borrower.

Financial reform at-a-glance

- *Revises credit and lending practices*
- *Increases transparency and accountability for investors*
- *Mandates greater financial product oversight*
- *Limits risky banking practices*
- *Sets up process for addressing system-wide risk*
- *Establishes procedures for dissolving major failing financial institutions*

Lenders are prohibited from refinancing an existing mortgage unless the new mortgage offers a net benefit to the borrower. And they also may not coerce or encourage an appraiser to make a faulty appraisal of a property's value so the borrower may obtain a loan more easily. Borrowers are entitled to a copy of the lender's appraisal of the property no later than three days prior to the closing.

There also are new limits on balloon payments and prepayment penalties, which must be disclosed, and mortgages without prepayment penalties must be offered as an alternative. And depending on the type of mortgage, a lender may be required to give you at least six months' advance notice of any interest rate change.

Other consumer protection provisions

Under the law, a new Consumer Financial Protection Bureau will regulate consumer financial products issued by banks and other financial institutions, such as mortgages and private student loans. The bureau's authority has been compared to the role of the Food and Drug Administration (FDA) in screening for harmful substances. In addition to serving as a consumer watchdog, the agency will give students access to information about private student loans.

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 per-owner per-bank limit is now permanent. The way the limit is applied means that if you and your spouse each have separate deposit accounts as well as a single joint account at a single bank, the two of you could qualify for as much as $1 million worth of total FDIC protection for those accounts. (Coverage for retirement accounts is separate.)

You also will be able to get your credit score for free if you have a negative credit experience--for example, if your score was a contributing factor when:

- You were turned down on an application for credit
- You were denied housing or a job
- Your credit card company changed your credit terms

Greater transparency and accountability for investment-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 the value of 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 firms 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 non-binding 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% to 30% of the funds collected, and can sue more easily if an employer retaliates.

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

Limits on risky banking practices

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. Financial institutions also will be required to retain a financial interest in at least 5% of the value of a loan they make if the loan is sold 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.)

Financial institutions 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 derivatives trades, such as swaps. A bank will not be permitted to invest more than 3% 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.

Addressing systemic risk

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 any financial institution whose failure the Treasury Secretary determines would disrupt the stability of that system. This can 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 the assets of the bank or company, and, if necessary, assessments on large financial institutions. The law 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 for multiple institutions.

In some cases, this far-reaching legislation's impact will be felt only after regulations are developed to implement its provisions. That's why it's important to have someone help you monitor those regulations as they evolve and evaluate just how they might affect you. Don't hesitate to seek expert advice.

Disclosure Information -- Important -- Please Review

Information contained in this publication is not intended to provide specific advice or recommendations for any individual. For specific advice regarding investment, retirement, tax, and other financial planning issues, you should have a private consultation to address your needs.

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