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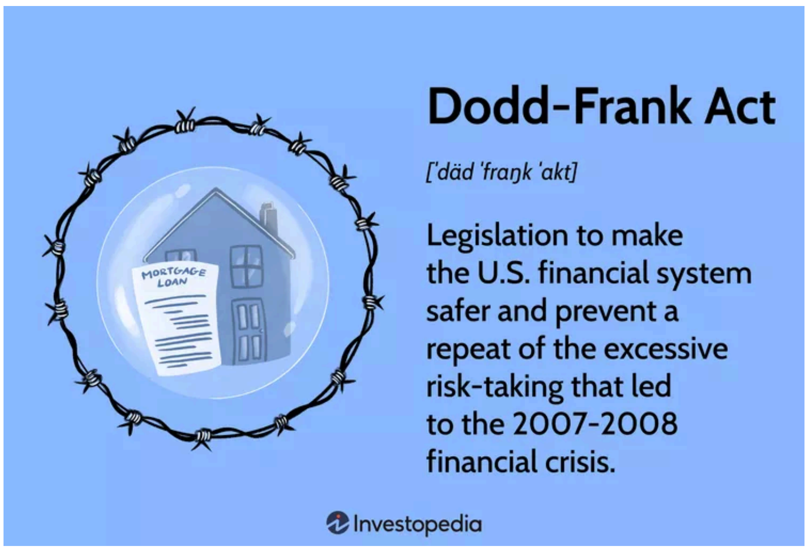
LAWS & REGULATIONS INVESTING LAWS

Dodd-Frank Act: What It Does, Major Components, and Criticisms

By ADAM HAYES Updated February 19, 2024
Reviewed by JEFREDA R. BROWN
Fact checked by RYAN EICHLER



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(D-Mass.), the act contains numerous provisions, spelled out over 848 pages, that were to be implemented over a period of several years. [1]

KEY TAKEAWAYS

- The Dodd-Frank Act targeted financial system sectors that were believed to have caused the 2007–2008 financial crisis.

institutions, and the recession.

- The institutions considered responsible for the 2007–2008 financial crisis included banks, insurance companies, investment banking firms, mortgage lenders, and credit rating agencies.
- Critics of the law argue that the regulatory burdens it imposes could make U.S. firms less competitive than their foreign counterparts. [2]
- In 2018, Congress passed a new law that rolled back some of Dodd-Frank's restrictions. [3]

Understanding the Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act is a massive piece of financial reform legislation that was passed in 2010, during the Obama administration. [1]

Commonly known as the Dodd-Frank Act, or Dodd-Frank, it established a number of new government agencies tasked with overseeing the various components of the law and, by extension, various aspects of the financial system.

The 2007–2008 financial crisis is perhaps the worst economic catastrophe to befall the country (and the world) since the Wall Street crash in 1929. Broadly speaking, it was caused by greed-driven behavior and lax oversight of financial institutions.

particular experienced massive growth that couldn't be supported.

The bubble burst, sending the banking industry and global stock markets into a downfall. It created the worst global recession in generations.

Dodd-Frank was created to keep anything similar from ever happening again.

Important: The Dodd-Frank Wall Street Reform and Consumer Protection Act was intended to prevent another financial crisis like the one in 2007–2008.

Components of the Dodd-Frank Act

Here are some of the law's key provisions and how they work:

- **Financial Stability:** Under the Dodd-Frank Act, the Financial Stability Oversight Council and the Orderly Liquidation Authority monitor the financial stability of major financial firms. The failure of these companies (deemed too big to fail) could have a serious negative impact on the U.S. economy. The law also provides for liquidations or restructurings via the Orderly Liquidation Fund. This fund was established to assist with the dismantling of financial companies that have been placed in receivership to prevent tax dollars from being used to prop up such firms. The council has the authority to break up banks that are considered so large as to pose systemic risk. It can also force banks to increase their reserve requirements. Similarly, the new Federal Insurance Office was tasked with identifying and monitoring insurance companies that were also considered too big to fail. [1] [4]
- **Consumer Financial Protection Bureau:** The Consumer Financial Protection Bureau (CFPB), established under Dodd-Frank, was given the job of preventing predatory mortgage lending and helping consumers understand the terms of a mortgage before agreeing to it. This reflected the widespread sentiment that the subprime mortgage market was the underlying cause of the 2007–2008 catastrophe. The CFPB deters mortgage brokers from earning higher commissions for closing loans with higher fees and/or higher interest

[5] [6]

allowed to be involved with hedge funds or private equity firms, which are considered too risky. To minimize possible conflicts of interest, financial firms are not allowed to trade proprietarily without sufficient "skin in the game." The Volcker Rule is clearly a pushback in the direction of the Glass-Steagall Act of 1933, which first recognized the inherent dangers of financial entities extending commercial and investment banking services at the same trading to reduce the possibility of counterparty default. It required greater disclosure of swaps trading information to increase transparency in those markets. The Volcker Rule also regulates financial firms' use of derivatives in an attempt to prevent "too big to fail" institutions from taking large risks that might wreak havoc on the broader economy. [7] [8] [1]

- **Securities and Exchange Commission (SEC) Office of Credit Ratings:** Dodd-Frank established the SEC Office of Credit Ratings because credit rating agencies had been accused of giving out misleading favorable investment ratings in the lead-up to the financial crisis. The office is charged with ensuring that agencies provide meaningful and reliable credit ratings of the businesses, municipalities, and other entities that they evaluate. [9]
- **Whistleblower Program:** Dodd-Frank also strengthened and expanded the existing whistleblower program promulgated by the Sarbanes-Oxley Act (SOX) of 2002. Specifically, it established a mandatory bounty program under which whistleblowers can receive from 10% to 30% of the proceeds from a litigation settlement, broadened the scope of a covered employee by including employees of a company's subsidiaries and affiliates, and extended the statute of limitations under which whistleblowers can bring forward a claim against their employer from 90 to 180 days after a violation is discovered. [10]

The Economic Growth, Regulatory Relief, and Consumer Protection Act

When Donald Trump was elected president in 2016, he pledged to repeal Dodd-Frank. Siding with critics, the U.S. Congress passed the Economic Growth, Regulatory Relief, and Consumer Protection Act, which rolled back significant portions of the Dodd-Frank Act.

It was signed into law by then-President Trump on May 24, 2018. [3]

These are some of the provisions of that law, and some of the areas in which previous standards were loosened:

- The new law eased the Dodd-Frank regulations for small and regional banks by increasing the asset threshold for the application of prudential standards

- The law exempted lenders with assets of less than $10 billion from requirements of the Volcker Rule and imposed less stringent reporting and capital norms on small lenders.
- The law required that the three major credit reporting agencies allow consumers to freeze their credit files free of charge as a way of deterring fraud. [3]

The Biden administration has also announced its intent to reestablish rules against other forms of predatory lending, such as payday loans, and on June 30, 2023, Bided signed a law to overturn the OCC's payday lending regulations. [11] Additionally, subprime auto loan practices are being addressed by the CFPB. [12]

Criticism of the Dodd-Frank Act

Proponents of Dodd-Frank believed that the law would prevent the economy from experiencing a crisis like that of 2007–2008 and protect consumers from many of the abuses that contributed to the crisis.

Detractors, however, have argued that the law could harm the competitiveness of U.S. firms relative to their foreign counterparts. In particular, they contend that its regulatory compliance requirements unduly burden community banks and smaller financial institutions, despite the fact that they played no role in causing the financial crisis. [2]

Such financial world notables as former Treasury Secretary Larry Summers, Blackstone Group L.P. (BX) CEO Stephen Schwarzman, activist Carl Icahn, and JPMorgan Chase & Co. (JPM) CEO Jamie Dimon also argued that, while each institution is undoubtedly safer due to the capital constraints imposed by Dodd-Frank, the constraints make for a more illiquid market overall. [13] [14]

The lack of liquidity can be especially potent in the bond market, where all securities are not marked to market and many bonds lack a constant supply of buyers and sellers. The higher reserve requirements under Dodd-Frank mean that banks must keep a higher percentage of their assets in cash. This decreases the amount that they are able to hold in marketable securities. [1]

In effect, this limits the bond market-making role that banks have traditionally undertaken. With banks unable to play the part of a market maker, prospective buyers are likely to have a harder time finding counteracting sellers. More importantly, prospective sellers may find it more difficult to find counteracting buyers.

Economic Growth, Regulatory Relief, and Consumer Protection Act in 2018. Still, certain aspects, such as the bank stress tests it called for, are in use today. The Federal Reserve publishes stress test results regularly. [15]

What Are Some Criticisms of the Dodd-Frank Act?

Detractors of the Dodd-Frank Act have argued that the law could harm the competitiveness of U.S. firms relative to their foreign counterparts. In particular, have also argued that, while each institution is undoubtedly safer due to the capital constraints imposed by Dodd-Frank, the constraints also make for a more illiquid market overall. [2] [13] [14]

What Was the Impact of the 2018 Rollback of Dodd-Frank Regulations?

In 2018, the passage of the Economic Growth, Regulatory Relief, and Consumer Protection Act rolled back numerous regulations put in place by the Dodd-Frank Act. Under the Dodd-Frank rules, banks with $50 billion in assets were subject to more strenuous capital and liquidity requirements, but the new law in 2018 increased the asset threshold to $250 billion. This change relaxed the regulations for smaller and medium-sized banks. When Silicon Valley Bank collapsed in March 2023, observers argued that the lack of regulatory scrutiny on financial institutions of this size played a key role in the bank's failure. [16] [3]

The Bottom Line

The Dodd-Frank Act, enacted in 2010, was a direct response to the financial crisis of 2007–2008 and the ensuing government bailouts under the Troubled Asset Relief Program (TARP).

This law established a wide range of reforms throughout the entire financial system, with the purpose of preventing a repeat of the 2007–2008 crisis and the need for further government bailouts. The Dodd-Frank Act also included additional protections for consumers.

Although the Trump administration reversed and weakened several aspects of the Dodd-Frank Act, particularly those affecting consumers, the Biden administration intends to reestablish and strengthen the previous reversals to protect individuals who may be subject to predatory lending practices in industries like for-profit education and automobiles.

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