How will regulators deal with firms deemed "too big to fail"?

- Identify and regulate systemically important institutions

  The mission of the FSOC, a council of key regulators, is to identify systemically important institutions. These are the largest and most interconnected financial companies whose failure would threaten the health of other firms, the financial system as a whole, or the broader economy. Systemically important firms will be supervised by the Federal Reserve, which has broad regulatory powers to guard against overly risky behavior. In the past, the fragmented structure of regulation sometimes allowed problems to grow unchecked. The goal is to prevent catastrophic failures and make costly rescues unnecessary, such as that of insurance giant AIG, whose connections with financial institutions around the world threatened disastrous ripple effects.

  References:
  - Brief Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, United States Senate Committee on Banking, Housing and Urban Affairs, July 1, 2010.

- Limit destabilizing failures

  To reduce the potential systemic threat to the financial system and broader economy, the legislation requires larger and more interconnected firms to hold more shareholder capital as a buffer against losses. The so-called Volcker rule restricts the extent to which banks can use federally insured funds for speculative trading and other risky investments. The new law also shifts many complex financial instruments called derivatives onto open exchanges rather than being privately negotiated between trading partners. This makes such transactions more transparent to market participants and regulators and provides greater assurance that contracts will be honored even if a counterparty fails. Finally, the reform restricts the Federal Reserve's ability to bail out individual institutions. This signals to financial companies and their shareholders and creditors that they will bear the cost of risks that lead to big losses.

  References:
  - Brief Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, United States Senate Committee on Banking, Housing and Urban Affairs, July 1, 2010.

- Create an orderly resolution process

  During the financial crisis, federal regulators lacked the tools to close large, failing financial institutions that weren't banks or thrifts in ways that protected the financial system. Regulators now have new authority to take over and close failing nonbank financial institutions in the same way the FDIC can take over failing banks. The reform act also requires that firms create "living wills" or "funeral plans," which explain how they could be shut down in a rapid and orderly way if they fail. If an institution cannot come up with a credible plan, it will face financial penalties and constraints on its activities. This new framework seeks to ensure that failure of a nonbank financial institution doesn't ignite financial panic, and that shareholders and creditors, not taxpayers, bear the costs.

  References: