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Borrowing Balance: New Regulations Raise Prices, Lower Risk

By Aileen Weiss

Though regulatory change will raise prices for financial services, borrowers will ultimately benefit from increased transparency

> The price of borrowing is projected to grow 18.0% per year on average in the three years to 2017

The Great Recession undoubtedly shook the financial landscape; even today, the events leading up to the recession and the recession itself continue to play a role in the creation of new regulation, changing the way in which financial service providers do business.

Although these changes have resulted in rising prices for borrowers, the regulations benefit borrowers overall by decreasing the amount of risk involved in using these services. Further, borrowers can combat rising prices by locking in lower rates through long-term contracts and inquiring about related services.

Though the Enron financial collapse occurred over a decade ago, it set in motion a period of significant regulatory change in the financial sector. However, the housing bubble was arguably the largest instigator of the Great Recession and the onset of regulatory reform. The housing market peaked in 2006 before hitting record lows in 2012; the collapse of the housing market, led by a high rate of foreclosures, thus incited the formation of new regulation to avoid repeat occurrences. For example, the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law in 2010 to improve the transparency and accountability of financial systems in the United States.

Suppliers of financial services generally must incur added costs to comply with these new regulations. For example, IBISWorld forecasts average wages for commercial banking to rise 4.0% annually on average in the three years to 2017 because companies will hire and pay more for specialized professionals with experience with regulations. In addition, the price of borrowing is projected to grow 18.0% per year on average during the same period. The higher costs will result in increasing prices for borrowers as suppliers attempt to maintain their profit margins, detracting from borrowers' purchasing power. The new regulations, including the Equal Credit Opportunity Act, Consumer Financial Protection Act of

Rising Input Costs for Financial Services

	Annualized Growth (2011-2014)	Forecast Annualized Growth (2014-2017)
Average Wages – Commercial Banking	3.20 %	4.00 %
Overhead Costs – Administrative Services	1.10 %	1.80 %
Price of Borrowing	11.90 %	18.00 %

SOURCE: WWW.IBISWORLD.COM

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2010 and The Volcker Rule, also may make it difficult for some borrowers to be approved for certain financial services.

In spite of higher service prices, added regulation aids borrowers overall by heightening the transparency of financial service suppliers' contracts and operations and increasing the amount of assets suppliers must have on hand. These changes make suppliers more financially stable and capable of honoring long-term contracts. Changing regulations have also reduced the likelihood of predatory lending, overleveraged households and businesses and risky banking practices that were prevalent before the recession. As such, though borrowers must pay for the ability to acquire services from more stable financial service providers, the result is lower risk for borrowers in the long run.

High Regulatory Change

Project financing, corporate treasury and commercial lending services have all faced high regulatory change over the three years to 2014, and new regulations will continue to be implemented over the next three years. Regulatory change is playing a major role in boosting prices in these markets, but it is not the only factor pressuring prices upward; greater external demand is also contributing to price growth. During the economic recovery, expansion in the number of businesses, corporate profit and residential and nonresidential construction has been increasing demand for financial services. Also, a very low and stable prime rate over the past three years has made it easier to borrow money at a lower rate, further encouraging demand growth. Though project financing, corporate treasury and commercial lending service providers are working through regulatory changes and experiencing increasing prices, borrowers will demand these services even more frequently as the economy continues to recover.

External Demand for Financial Services

	Annualized Growth (2011-2014)	Forecast Annualized Growth (2014-2017)
Number of Businesses	1.10 %	1.70 %
Corporate Profit	5.90 %	3.50 %
Value of Private Nonresidential Construction	6.40 %	7.60 %
Value of Residential Construction	11.10 %	9.30 %
Prime Rate	0.00 %	17.40 %

SOURCE: WWW.IBISWORLD.COM

Despite these rising prices, there are several measures borrowers can take to alleviate the pressure these increases may place on the purchasing process for project financing, corporate treasury and commercial lending services, and the regulations will ultimately benefit borrowers.

Project Financing Services

Borrowers seek project financing services to acquire loans on long-term projects, including construction, mining, manufacturing, energy, power and telecommunications projects. This service is highly regulated due to the large sum of money involved in most loan transactions. To comply with regulations, including the Water Resources Development Act of 2013 and the Equal Credit Opportunity Act, financing companies' costs have risen, causing interest rates as a total cost of the project to increase. According to IBISWorld estimates, project rates have risen at an average annual rate of 2.9% in the three years to 2014. Though regulatory changes will result in price increases, such changes should prevent project delays by

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reducing insolvency rates and lowering the risk of a supplier declaring bankruptcy.

One regulation that is impacting project financing services is the Water Resources Development Act of 2013. Section 225 of the act outlines the amount of private and nonfederal public funds that may be allocated for a project. The act ensures that projects are more heavily supervised to determine whether its benefits will outweigh its costs, whether it meets environmental regulations and whether it is technically feasible. Such management should ensure that each project that project financing companies fund is successfully completed and meets specific requirements critical to long-term success. Project financing companies must increase their costs and the amount of time needed to review each project, passing these costs on to the borrower. Though borrowers will then need to pay more for services and wait longer to begin a project, they are expected to ultimately benefit from the increased oversight.

Another act, the Equal Credit Opportunity Act (ECOA), was implemented in 1974 but has become extremely relevant over the past three years. ECOA benefits borrowers by keeping project financing firms from discriminating against borrowers due to their race, religion, sex, age or marital status, though borrowers must still be deemed creditworthy. The Federal Reserve Board was originally responsible for enforcing ECOA; however, the Consumer Financial Protection Bureau took over this responsibility in 2011 as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act being passed in 2010. Overall, ECOA creates demand for services because more borrowers can procure project financing, enabling financing companies to raise their service rates.

During the three years to 2017, greater regulatory change is only one factor that is anticipated to raise prices for project financing services. An improving economy will increase borrowers' cash on hand and make them feel more confident to seek loans for long-term projects. IBISWorld forecasts that service rates will rise 7.7% per year on average in the three years to 2017, which is far greater than the estimated 2.9% growth rate of the prior three-year period. Though financers will raise rates in part to cover addressing regulatory changes, borrowers may be able to avoid price growth by locking in lower rates through long-term contracts.

Corporate Treasury Services

Banks offer corporate treasury services to provide cash and liquidity management, investment management, foreign currency exchange, the transfer of funds and the management of receivables, and disbursements services. IBISWorld projects service rates to grow 1.4% per year on average in the three years to 2017. New regulations will increase this market's costs and prices as banks implement required changes into their operations. At the same time, regulations will improve services for borrowers because banks will be more financially stable.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 is one act that has greatly impacted corporate treasury services. Provisions of Dodd-Frank, such as the Volcker Rule, the Durbin Amendment and the Financial Stability Act of 2010, mandate more reform for financial service providers. The act attempts to end the notion that banks are too big to fail and aims to protect borrowers from using an aggressive financial services provider.

The National Automated Clearing House Association (NACHA) also implemented reform to monitor how money and data are moved electronically in the United States. NACHA governs

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automated clearing house payment systems, which transfer direct deposits and payments. In September 2013, the Security Framework regulation was passed to protect the privacy and security of online banking transactions. Borrowers are, therefore, better shielded from illegitimate transactions.

Basel III, which was updated in 2013 and will be implemented in 2018, sets standards for market liquidity risk, bank capital adequacy and stress testing. This act will increase service prices but also benefit borrowers by increasing the amount of transparency among suppliers.

Commercial Lending Services

Borrowers use commercial lending services to get loans from commercial banks. High regulation increases banks' compliance costs and causes banks to increase interest rates to keep up with rising costs. As such, IBISWorld forecasts interest rates to rise from 5.55% in 2014 to 5.89% in 2017. However, recent regulation provides significant benefits that outweigh price increases for many borrowers.

The Consumer Financial Protection Act of 2010, or Title X, a section from Dodd-Frank, aims to keep a borrowers' financial information private and secure by checking for compliance with federal law. In July 2011, the Consumer Advisory Board was created under the act to ensure that lenders comply with federal laws and to regulate financial products, such as commercial loans. Greater supervision may reduce future financial instabilities and provide borrowers with more security when getting loans.

The Volcker Rule, approved in January 2014 and also a provision of Dodd-Frank Act, governs banks' investments. By prohibiting proprietary trading by banks and limiting a bank's ownership in hedge funds and private equity funds, banks should face fewer conflicts of interest, thus benefiting borrowers by lowering risk. However, prices are still projected to rise as the cost of borrowing and the prime rate grow, making it more expensive for banks to lend money. Overall, because the majority of banks offer a variety of other financial services, borrowers should inquire about related services such as commercial mortgages, investment banking, business valuation and treasury services to save time and resources when looking into a new supplier.

Making the Most of Regulatory Change

To limit the effect of rising prices for financial services, borrowers should seek a supplier with a wide range of service offerings. Working with a diversified

Rising Prices for Financial Services

IBISWorld Title	2014 Average Price	2017 Forecast Average Price	Forecast Annualized Price Growth 2014-2017	Profit Level
Project Financing Services	1.2 % of the total cost of the project per year	1.5 % of the total cost of the project per year	7.70 %	14.90 %
Corporate Treasury Services	$285 per month per account maintained	$304 per month per account maintained	1.40 %	9.90 %
Commercial Lending Services	5.55 % interest rate	5.89 % interest rate	2.00 %	15.50 %

SOURCE: WWW.IBISWORLD.COM

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supplier can reduce time costs compared with working with multiple suppliers. Using a single source for several services also better enables borrowers to negotiate for discounts. Borrowers should ask prospective suppliers how they intend to handle regulatory change and what borrowers should prepare in advance to ensure that services run smoothly.

The financial services market will continue to adapt to regulatory changes in the next three years, and the initial risk and hesitancy to procure financial services during the economic recovery is expected to subside. Though greater regulatory change directs prices upward, it also contributes to greater financial stability and calls for more supervision to ensure secure funds and lower bankruptcy risk. Thus, in the long run, borrowers will be better protected and confidence in the market will increase.

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