Analysis of Current Situation, Problems, and Countermeasures of the US Banking Industry

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Abstract. Nowadays, the US banking industry is confronting various challenges, including the procyclicality of bank lending, increased competition and failures, and the effects of the 2007/2008 financial crisis on large US banking. Moreover, the unanticipated global pandemic of COVID-19 undoubtedly added a burden to the banking industry. This paper unmasks the current situation of the banking industry and introduces several problems that the US banking industry is confronting and provides potential resolutions and recommendations regarding these problems by thoroughly synthesizing information from other literature reviews. By integrating information from diverse studies, it can accumulate different perspectives from various fields of expertise, which could further deepen this problem and encourage further investigation. Resolutions include adjusting the monitoring of the bank loan portfolios, using models to make predictions on the bank's assets, and disclosing the process of ERM. However, there are many more critical problems that the US banking industry is facing that are not covered in this paper; and other potential resolutions to the addressed problems are possible, thus, further research is recommended.

Keywords: Banking; US; Covid-19.

1. Introduction

The banking industry is an important element of the modern financial system. And it is common sense that there are numerous problems with the banking industry because people become conscious about them through their own experiences, observation from the environment around them, and potentially from media outlets. Why people are concerned because everyone is somehow involved with the banking industry, either as a customer or a working staff. With that being said, problems within the banking industry could have tremendous impacts on people; if they are customers, their customer experiences would be impacted and if they are workers otherwise, their working environment would be affected. Because of these consequences of problems, the banking industry could cause, valued professionals must acknowledge the current situations of the banking industry and how people can work as a whole to resolve the issues as much as possible for the sake of the common good. Thus, this paper particularly analyzes the banking industry for in-depth insights.

2. Current Situation

Due to the impact of COVID-19 and the regulators' reactions to the pandemic, as mentioned in Blank et al.'s paper, the authors indicated necessary strategies that regulators need to take to be prepared to respond to potential future risks in both the short run and long run. Because of COVID-19, bank stocks have dropped dramatically (50%) starting March 2020. There is an increasing risk that the banks would face credit loss and more failures influenced by stagnation of the global economic activity. The Capital and Loss Assessment under the Stress Scenarios (CLASS) model was employed by the authors to quantify the implications of various macroeconomic scenarios for U.S. BHC capital ratios over a 9-quarter horizon that begins in 2020Q1 and concludes in 2022Q1.

Policymakers realized the importance of extending their goals since the global financial crisis a decade ago, from promoting the safety of individual financial institutions to a broader view - the stability of the financial system, to prevent global financial crises like this. There was an "in-between period" during the crisis when banks have already experienced the shock but do not know how serious the influences would be. As such, the current circumstances of the banking industry can be considered an "in-between period" because the whole industry has already been negatively affected by the pandemic, but further or deeper impacts are still under investigation. Thus, it is exigent for regulators to take action and be prepared to confront more stressful situations.

The authors list various policy possibilities before suggesting that policies should be concentrated on two areas: (i) encouraging banks to raise new equity capital and (ii) relaxing marginal capital requirements. Future policy suggestions cover both immediate and long-term issues. In terms of immediate policy recommendations, the authors propose that all U.S. BHCs halt both common dividends and share repurchases and advise banks to raise additional equity capital through secondary offerings. They also criticize the current regulatory framework of "watchful waiting" by outlining its drawbacks in the face of crises like COVID-19. "Dynamic resilience" is very important in this situation. Long-term suggestions were made by the authors, who suggested that the officers should think of ways to explicitly incorporate data from bank stock prices and other market indicators into the stress test procedure. Additionally, in order to provide policymakers more flexibility, the countercyclical capital buffer needs to be activated constantly, even during prosperous periods. Finally, it would be more appropriate to say that the current SLR modifications are semi-permanent rather than permanent.

3. Literature Reviews

Considering the current performances of U.S. banks and how they changed over the years, Mester and Berger published a paper that explains these changes, including deregulation, technological change, and dynamic changes in competition. Mester and Berger address that the banking industry has improved its productivity and performance with the development of both financial and nonfinancial technologies, which help banks evaluate risks, and maximize profits. These changes in technology, deregulation, and competition are the three most factors that affect how the banking industry has been changing. Their finding is that while banks could maximize their profits, they improve their profit productivity and worsen the cost productivity. And because banks try their best to provide quality services and earn profit simultaneously, they need to increase both cost and revenue, therefore further suggesting that methods that ignore the revenue aspect of bank performances are misleading.

By focusing on the technical performance of U.S. banks, Rangan et al. investigated the efficiency of the technical aspect. The result revealed poor performances because the banks could elicit the same results even with 70% of their originally used inputs. The inefficiency mentioned in this paper is believed to be technical inefficiency instead of scale inefficiency. When pondering the factors that impact technical efficiency, the authors mention that technical efficiency is positively correlated with size and negatively correlated with product diversity.

Another way of measuring the efficiency of the U.S. banks has an emphasis on heterogeneity. Mester has accentuated the heterogeneity aspect in the paper that studies that ignore this aspect may not be comprehensive enough. Mester has compared the X-efficiency from two groups: one with the same cost frontier and the other with different cost frontiers; and the result showed a higher X-efficiency measure in the single cost function model than the other one. Thus, this study suggests that it is essential to study the X-efficiency measures to reveal the efficiency of banks and heterogeneity, meaning that different banks have different situations, is another facet that needs to be included.

In order to quantify the impact of the retail focus on performance, Hirtle and Stiroh employ research to compare the share of retail loans, retail deposits, and branches per dollar of assets with the equity market. The result demonstrates that the major banks have had low volatility and reduced equity market and accounting returns as a result of the increased emphasis on retail banking. Therefore, despite being relatively steady, retail banking offers minimal profits over the long term.

As Treacy and Carey note in their studies, internal credit risk assessment systems are other crucial components of the banking sector since they aid in measuring and managing the risks of certain portfolios. Prior to now, internal rating systems were used by the majority of banks to assist loan approval and monitoring procedures as well as to meet regulatory obligations for identification and problem tracking. In terms of controlling credit risk, the internal credit risk rating system is playing an ever-more-important role today. Thus, it is important to pay attention to heterogeneity. There is no single rating system that can accurately describe all banks due to the unique ways in which they operate. Instead, each bank has a unique ideal rating system. Banks are under a great deal of stress as a result of the quick changes in risk management procedures, therefore finding strategies to lessen this stress is essential.

4. Problem

Despite the industry is crucial to model US society, the industry faces several problems.

4.1 Procyclicality of Bank Lending

One critical problem that banks confront is the procyclicality of bank lending. According to Berger and Udell , the institutional memory hypothesis could explain why the credit standards are being lightened: loan officers' competence is diminished. Two facts are being looked into: the first is that lending exhibits a pattern of rising during business cycle expansions and falling during subsequent downturns, suggesting that these changes are due to changes in bank supply, which tends to emphasize the business cycle; the second is that measures of bank loan performance issues exhibit different patterns. Problems like past due, nonaccrual, provisions, or charge-offs, for instance, are relatively infrequent during expansions, but they start to show up at the end of the boom and soar drastically during downturns. These patterns reveal that banks experience significant risks during the business cycle expansion, however, it takes a relatively long time to discover poor loan performance problems thus causing these problems to occur during later periods. Because loan officers are unable to identify possible loan issues and distinguish between low-quality lenders and high-quality lenders, they are the primary reason that credit criteria are being lowered and money is being lent to low-quality clients. In light of the possibility that some advantageous NPV bank-borrower relationships could be harmed by the loosening of lending criteria, banks must deal with this issue. Negative NPV loans may appear in the short term, but it will maximize the advantages of banks to stretch into the next bust to weed out inept officers.

4.2 Over-competition

According to existing knowledge, another essential problem of the US banking industry is the increasing competition and instabilities among banks. Yildirim and Mohanty have examined if geographical deregulation has had effects on state-level competition across the U.S. banks, and resulted that during the period of investigation, which is 1976-2005, most of the banks operated under monopolistic competition. They have also found out that there are differences in the way of competition when partitioning all banks into large banks and small banks. Specifically, large banks across the U.S., especially those in states of DE, OR, and RI are under monopolistic competition while small banks like banks in AZ and MA are under healthy competition. Thus, the increasing competition especially among large banks is one of the problems the banking industry is facing.

4.3 Effect of 2007/2008 Financial Crisis on Large US Banks

As Daniel Zeghal and Meriem El Aoun state in their paper, the financial crisis of 2007-2008 greatly affected large US banks in several ways, especially the volume and the quality of enterprise risk management (ERM) disclosure of large US banks. A problem is what the determinants the risk management disclosure are. The financial crisis has also generated problems like increasing risks for banks and their eagerness to succeed in overcoming the challenges and bankruptcy during the crisis. The high litigation costs are another problem for US banks to consider whether to disclose their ERM. In addition, as Goldberg and Meehl [10] have mentioned, following the global financial crisis, the banks' structure has been increasingly convoluted, and it is necessary to simplify that structure.

Considering all the problems that banks are facing, either during the financial crisis or afterward, it is important to consider whether banks should disclose their ERM and also the determinants of ERM so that they can be prepared to overcome problems they have experienced during the crisis and also emerging risks in the future.

5. Solution

5.1 Adjusting Monitor of Bank Loan Portfolio

According to Berger and Udell's findings, the institutional memory hypothesis clarified why banks are lowering their credit requirements and lending to low-quality clients. It is ideal for banks and the government to improve the method they have been employing to monitor bank loan portfolios in order to address this issue and stabilize favorable bank-borrower relationships. To help senior officers learn more and become more competent later in their careers, banks and the government should think about exposing them to more loan work earlier in their careers. Furthermore, banks should think about assigning experienced officers to loans that are manageable for a certain time period and have not yet displayed any major loan issues. This would provide the experienced officers a better chance of spotting any subtle loan issues that may later emerge. The government may adopt the same tactic, assigning more inexperienced officers to banks with numerous loan problems so they can gain experience, and placing experienced officers in banks that have not disclosed severe loan problems in a set amount of time.

As was previously stated, in order to address the issue of loosening credit standards and providing loans to low-quality borrowers, which frequently results from bank officers' incapacity, banks and the government must act. The suggestion that the monitor of bank loan portfolios be adjusted should be put into practice so that all bank officers' capabilities would be increased, and they would be more capable later in their careers when they deal with high-risk situations, therefore minimizing the risk of procyclicality of bank lending and helping to maintain positive bank-borrower relationships.

5.2 Deregulation on Bank Competition

Continue discussing the studies that Yildirim and Mohanty have done, after comparing the competition indexes of the sampled banks before and after deregulation, there was a small decline after geographic deregulation. The decline appears to be salient in the small banks, especially after the interstate branching deregulation, but the decline seemed to be caused by changes in the competitive conduct of large banks, thus making the removal of geographic deregulation limited and not as efficient in declining bank competition. Thus, deregulation does have some effects in reducing monopolistic bank competition, but limited, therefore other methods are still approachable.

5.3 ERM Disclosure

As uncertainty in the business environment increases, noticing what the risks are and how they have evolved become essential, which suggests the importance of enterprise risk management. Since the financial crisis alarmed that sudden financial problems may occur, it is important to set a comprehensive approach: to integrate all potential risks so that banks would know how to deal with emerging risks adeptly.

As mentioned in the problem section, after the crisis, banks are facing increasing risks and that is why it is significant for them to disclose more information, to alleviate some of the risks: to restore customer and public trust. In addition, after the financial crisis, banks are keen to prove the success of how they overcame the problems that arose during the crisis, so the ERM disclosure could help them explain the process of how they solved the problem. Litigation costs further suggest the importance of ERM disclosure because banks could inform the public of their current situations.

In addition to stressing how crucial it is for banks to comprehend the necessity of ERM disclosure, it is important to consider the key factors that influence ERM disclosure. Daniel Zeghal and Meriem El Aoun claim that the ERM disclosure is strongly and negatively associated with profitability, leverage, and board size and considerably and positively associated with the crisis, bank size, board independence, and duality.

The quality of financial reporting in terms of ERM should be improved, allowing the public, especially investors and financial analysts, to better access and analyze certain risks banks are likely to face. This will allow them to be better prepared before a crisis occurs rather than scrambling to come up with solutions after it has already occurred.

6. Conclusion

In a nutshell, this paper outlines some of the challenges that the US banking industry faces and it is both exigent and vital for the banking industry to take action in order to change the status quo. Moreover, the banking industry has connections with everyone in some ways and its situations affect everyone in society. The recommendation of resolutions mentioned above can be seen as a synthesis of information from different places and banks need to find the most effective way to solve their specific problems. That is why further studies and research are needed to transform the current situation and improve banking services.

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