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Effect of Financial Regulation on Performance of Banking Sector in the United States of America

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Abstract

Financial institutions are the most regulated in the market regardless of the development level of the nation. Financial regulations are the laws that have been put in place by the state to govern financial institutions. The stability of financial institutions can be influenced by the regulations put in place. Thus, the study sought to examine the effect of financial regulation on the performance of the banking sector in the United States of America. The study was literature-based. The inferences of the study were based on the findings from the previous studies. Based on the findings of the study, it was established that financial regulations have both positive and negative effects on the performance of the banking sector in the United States of America. The convenient policies positively affect performance, while unfavorable policies/regulations diminish performance. Unfavorable regulations harm bank competition, causing greater loan prices and a greater probability of loan defaults. The research concluded that government regulations are vital in determining the performance of the banking sector in the country. The study also concluded that it is crucial for the government to offer the financial systems with favorable conditions of the financial regulation. The government of the United States must make use of the guideline plans which do not adversely impact the banks. The study recommended that all commercial banks in the country should comply fully with the stipulated regulations and the federal bank must ensure that all banks comply. This will ensure a stable banking sector that plays a significant role in the economy. If this sector is sound, the economy will thrive, and the country will avoid a financial crisis. Moreover, it is recommended that the government regulations not be so stringent, rather should be more friendly. This will promote the banking sector to grow and enhance performance positively.

Keywords: *Financial Regulation, Banking System, United States of America*

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1.1 Background Of The Study

The banking industry has for a long period of time the most and extremely controlled sectors in the United States, concerning unique roles that banks play in taking down payments, assigning credit and running the payments sector. Regulation may be done by the government or independent financial institutions mandated to control the financial system (Barth, Caprio & Levine, 2019). Government regulation influences monetary system market in different aspects yet details impacted relies upon the nature of the law. Enhanced policy typically indicates greater workload for individuals within the economic solutions since it consumes some time and initiative to adapt company methods in line with the new policies appropriately. Boosted time and workload resulting from government guideline might be harmful to private financial or credit services business within the short-term, government guidelines may benefit the financial services sector as a whole in future. Government plays duty of moderator within the brokerage companies and customers. More regulation may suppress innovation and increase costs whereby inadequate regulation might result in mismanagement, corruption and collapse (Johnston, 2018). This makes it tough to figure out precise effect government policy will have in the economic services market but that influence is commonly far reaching and long-term.

While the majority of nations have only one bank regulator in the U.S., banking is controlled at both the government and state level. Relying on its sort of charter and organizational structure, financial firms may undergo many governmental and state banking policies. Unlike Switzerland and the United Kingdom where regulatory authority over the banking, safety, securities and insurance markets is combined into one solitary monetary service agency, USA maintains different protections, products and insurance regulatory agencies separate from the bank regulatory agencies at the state level. USA financial guidelines resolve privacy, disclosure, fraudulence avoidance, anti-money laundering, anti-terrorism, anti-usury lending and the promotion of lending to lower income residents (Lessambo, 2020). Private cities additionally pass their own economic guidelines laws like specifying what comprises usurious lending. There are various classifications and charters that a bank can get in the United States and relying on their category they might be overseen by the Federal Reserve.

Financial regulation entails the constraint imposed on the financial institutions resources, concentration share owner's right, race and financial entry and exit (Berger, Klappe, Peria & Zaidi, 2018). The USA banking system can appear challenging and confusing; also numerous Americans do not entirely comprehend it a lot of the time. For students from other nations going to United States, it can seem downright complicated. Banks create money in the country by providing loans. The Federal Reserve establishes a reserve requirement for financial institutions which establishes quantity of cash the financial institutions are allowed to lend. There are a number of separate kinds of financial establishments, even though initially they were all really distinct, presently they are basically exact the same, they consist of; commercial banks, savings banks, savings and loans, in addition to lending institution. Financial institutions make money by charging rate of interest on the loans they provide; they do this since the rates of interest they charge on loans are greater than the interest they transfer right to their clients' accounts. Lending money may be dangerous for the financial firms so banks charge greater interest rates for riskier loans. Many nationwide financial institutions are required to be participants of the Federal Reserve System; nonetheless, they are regulated by the Office of the Comptroller of the Currency (Blair & Kushmeider, 2021). The Federal Reserve monitors and

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regulates several big financial firms since it is the regulatory authority for financial institution holding companies.

The United States has what is known as dual financial system showing that U.S financial institutions can be chartered by one of the fifty states or at the government stage. Financial regulation is overall word for the guideline of firms of finance like banks, stock exchanges or investment capital. Because of the boosting rate of exchange and the high state of interconnectedness in our world economic sector, it is essential to bring in strict laws and regulations in order to avoid more threat taking of huge financial corporations. Nonetheless, there are likewise few issues associated with the regulation of banks. The majority of financial institutions in USA are owned by banks holding firms, whereby they are typically forbidden from getting into or regulating firms except financial institutions or entities participated in tasks that are very closely pertaining to banking. There is need to put in tighter and beneficial monetary law to boost financial security and significance of building steady buffers to fulfill any type of monetary distress. Few scientists suggested that stricter law may destabilize the banking sector. (Shaddady & Moore, 2019) stated that onerous guideline may attenuate the capacity of financial institutions to give funds for private sectors.

Financial institutions are the most regulated market regardless of the development level of the nation. Nevertheless, policy makers are always ballooned on the analysis of what regulative level can promote a well-functioning banking system and there is no a precise academic and empirical evidence concerning the result of different guideline level on the financial institutions' efficiency. A few of the regulation might have a negative impact on bank competitions causing greater loan prices and greater probability of loans defaults. (Tabak, Fazio, Karine & Cajueiro, 2018) did not locate any kind of significant favorable effect of policy and supervision on financial security. Law will continue to impact bank's profits by: Raising the operating costs, derived from execution of new governing responsibilities, new reporting and model needs and more guidelines on compliance; new policies enforcing additional funding needs beyond the levels set by existing Basel III targets to be implemented by 2019. Financial institution policies are targeted at bringing the advantage of high growth via stable financial system. Similar to all policies, they also develop a cost in the economy that makes the field a windbag to participants. Via this nature, the degree of financial institution laws involves many complex trade-off considering that expense and benefits from bank policy may have so resemblance.

Since the banking market spreads out the economic climate, the increasing price of the economy from inappropriate guideline of the financial sector has a wide consequence (Ruozi & Ferrari, 2020). This indicates that, it is necessary to analyze the result of bank law very carefully before its implementation and consistently evaluate to stay clear of the cost of unfitting bank regulation from the economic situation. Bank regulators focused on making certain that individual financial institutions had enough resources to prevent failure but did not consider organized ramifications. The United States financial institution regulatory authorities embraced a macro prudential viewpoint and expanded their emphasis to ensuring that the financial system stays clear of failing. Resources demands now increase the bigger and extra complex that a bank expands (Barth & Miller, 2018). On top of that, activities regarded over risky, such as proprietary trading, are being limited or outlawed altogether. The regulators have additionally set up annual stress tests in which financial institutions are required to demonstrate

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to their regulators that they would preserve an adequate amount of funding also under incredibly negative theoretical economic circumstances.

Financial institution regulatory authorities have a formidable selection of enforcement devices (Baxter, 2019). All financial institutions preserve a close managerial relationship with their key regulators. When that relationship is operating at its best, all worldly transactions and plans are shared and talked about with the banks regulators and a good deal of informal supervisory direction is provided by the regulators to the financial institution. All financial institutions receive casual advice and instructions from their regulators and typically make significant changes to their procedures and capital, liquidity and controls as a result of that informal input. Bank regulatory authorities supply formal assessment reports to their regulated financial institutions on a regular periodic basis (Eisenbach, Haughwout, Hirtle, Kovner, Lucca & Plosser, 2017). These assessment records typically contain reveal criticisms or problems regarding a bank's procedures or controls and instructions from the regulators worrying the steps that require to be taken to remedy such shortages or address such issues.

2.1 Literature Review

Bank guidelines in United States of America are extremely fragmented as related to other G10 nations, whereby many nations have just one financial institution regulator (Helleiner, Pagliari & Zimmermann, 2021). Regulation goes to a transforming factor as the tendency on the way to deregulation and soft guidance has actually paved the way to even more comprehensive and ample guideline and supervision. The United State of America has a complex regulative procedure that have myriad of government regulatory agencies having usually overlapping obligation for banking guideline. Reserve System in central bank of United States and conducts united states financial plan. Furthermore, it manages bank holding firms, financial holding companies, state chartered financial institutions which are participants of The Reserve System, United States tasks of international financial companies, and systematically important banks marked by the financial security oversight council. The down payment insurance coverage corporations are key regulator for state hired financial institutions that are not participants of the Reserve System in addition to state chartered thrifts (Blair & Kushmeider, 2020). Deposit insurance company likewise insures financial institution and second hand deposits and has receivership powers over FDIC-insured banks and particular various other establishments.

Office of the comptroller of the money is an independent bureau of the united states department of the treasury led by the Comptroller of the Currency that charters, manages and monitors overall national financial institutions, government cost savings organizations in addition to government branches and companies of international banks although a lot of FBOs function with state-licensed branches. Consumer Financial security Bureau has key power to establish consumer defense laws to be applied to both financial institutions and non-financial firms and impose conformity with such legislations by banks with US 10 billion or more in possessions and their affiliates along with particular non-financial firms. Financial Stability Oversight Council is chaired by Secretary of the Treasury and is composed of the heads of eight financial regulatory authorities and one independent participant with insurance policy exposure (Aikman, Bridges, Kashyap & Siebert, 2019). FSOC is encouraged to assign clearly essential non-bank financial firms usually referred as non-bank SIFIs for supervision by the Federal Reserve. Nonetheless, no organizations are presently marked by FSOC.

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The National Bank Act 1863 developed the fundamental structure for the United State of America financial sector and the chartering of national banks. The Federal Reserve Act, established in 1914, developed the Reserve System. The Banking Act of 1933 usually differentiated commercial banks from financial investment banks and developed the system of federal deposit insurance. Federal Deposit Insurance coverage Act combined previous FDIC regulation right into one act and accredited the FDIC to serve as the receiver of fallen short financial institutions. There arrangement of Bank Merger Act within the FDI Act which subjects suggested mergers entailing FDIC-insured depository institutions before regulative authorization. The bank holding company Act of 1956 calls for Federal Reserve authorization for a company to get a bank and calls for BHCs to acquire prior Federal Reserve approval to get a rate of interest in additional financial institutions and certain non-bank firms. The act frequently referred to as the Bank Secrecy Act of 1970 demands all banks consisting of financial institutions to develop a threat based process of interior controls to control cash laundering and terrorist financing (Shaddady, & Moore, 2019). Worldwide Banking Act of 1978 develops a structure for government regulation of foreign banks running in the United States.

However, it is pointed out that a rigorous funding demand decreases keeping track of power. Furthermore, (Kendall, 2020) argued that a stringent capital demand undermines competition for loans; therefore financial institutions elevate loan rates, leading to a raising possibility of financial institution default amongst customers. However, a reliable capital demand is taken into consideration a valuable tool to soak up losses and serve as a barrier. The way in which a resources demand can remedy the prejudice towards risk. Even more, although financial institutions might have to fund their capital needs by new share concerns, strict capital demands might motivate banks to reduce high-risk lending. (Shaddady & Moore, 2019) added that adequate capital needs may optimize financial institutions' worth by improving investors' confidence, enhancing financial institutions' reputations and their franchise values. There are clashing recommendations pertaining to the influence of constraints in non-traditional economic tasks like insurance policy, protections and building on economic stability. It is said that limited limitations may increase surveillance as a result of reduced intricate financial tasks paired with a decrease in educational crookedness. Nevertheless, relaxing constraints enables financial institutions to get the advantages of expanding their services. This might impact financial services and assist financial institutions to offer much more efficient services which boost bank stability.

The main supervision might get over market failure brought on by imperfect information (Jacobs, 2021). Such guidance, together with increased surveillance and the disciplining of banks might subsequently increase the governance of financial institution lending and decrease corruption. In particular, the energetic managerial firms boost banks' effectiveness and the banks' capability to deal with any kind of monetary problem. Influential and more independent managers operating in a weak governance setting may interfere with prudential supervision, developing an economic situation which is less resistant to financial shocks. Yet, guidance has different effects from nation to nation and from one financial sector to another. As a whole, effective and independent supervisory authorities in a well-developed economic sector are much less vulnerable to financial shocks, but managerial authorities in inadequate financial governance environments could be more sensitive to monetary distress. The financial institutions' inner monitoring decreases the credit scores danger via the decrease of asymmetric details problems between banks and borrowers (Ivashina, 2019). Additionally increases inner

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administration and also consequently enhancing security in banks. Financial institutions and banks that are significant and highly interconnected enforce systematic threat to the financial system. A default by a financial institution can result in the default of its creditor banks on their own counter parties. This effect by one big financial institution may bring about a disastrous impact on the remainder of the various other financial institutions. Encountering the too-big-to-fail problem, regulatory authorities are required to check and restrict financial activities that may lead to such range of banking failing.

The depositors, being the creditors of a financial institution are normally not well informed on the banks investment activities. Moral hazard might emerge when financial institutions take part in investments that are too risky at the expense of its depositors (Allen, Carletti, Goldstein & Leonello, 2021). Having a regulatory authority to keep track of count on the part of depositors gives assurance and maintains their self-confidence in the economic system. Additionally with down payment insurance policy by the government, it protects the depositors and decreases the chance of a financial institution run which may result in the collapse of the monetary system. Bank regulation by the national government of the United States transpired after a decade of intense lobbying by the big banks looking for protection from startups, coordination and security of a cartel and the capacity to obtain funds from the government when they found themselves in monetary problem. Since the late 1790s banks have been allowed to embezzle depositor funds and use them to offer debt without informing depositors when this embezzling, known as fractional reserve banking, got them right into problem, making them not able to return deposited money due to the fact that they merely did not have it in their vaults they encouraged state governments and the national governments to stop them from returning transferred cash, preventions that often lasted a decade.

A bank failing produces adverse externalities for two concerns; ruins certain capital and it may bring about additional contagion losses in the sector (Alessandri, Gai, Kapadia, Mora & Pühr, 2018). On the one hand, a financial institution closure minimizes financial welfare due to the fact that there is reduction of partnership with financial institution's customers and the specific understanding of monitoring and danger preferences. Once again the expenses of such closures are more acute, since the failure may disburse throughout the financial system, magnifying the negative results on unassociated intermediaries. Extremely justifications of financial intermediation show out the probable threat of contamination. Testing and monitoring validations, a bank failing might signal failure in financial institution properties generally. Furthermore, if systemic, it may lead the depositors to doubt the whole sector as it doubts the rewards of any kind of financial institution to effectively check its debtors. If banks are seen as missing some incentives to monitor, they will participate in fraudulent functions and more risk taking (Macey & O'hara, 2020). In such instance, a bank failure might lead depositor in other banks to run in financial institution and withdraw their down payments, at a high liquidation price, even with the sturdiness of the impacted additional financial institution. All the same, if one bank falls short, this might generate a completely reasonable updating of the assessment of any other bank threat and a generalized withdrawal of deposits.

United States banking regulatory authorities has often implemented a more incredibly equal version of regulations that are part of the post-financial dilemma governing program developed by the Dodd-Frank Act and by global typical setup groups such as the Group of Twenty, the Basel Committee on Banking Supervision and the Financial Stability Board (Buckley & Howarth, 2019). Within the Trump regime this move towards extremely equal guidelines was

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curtailed and initiatives ended up being much more concentrated on customizing and including transparency to regulatory demands. For instance, EGRRCPA customized particular arrangements of the Dodd-Frank Act and normally minimized regulative demands for banks holding less than 250 billion United States dollars in total consolidated assets. The agendas for USA financial regulatory agencies will alter in 2021 to reflect the concerns of the Biden Administration (Ayanian, 2021). The essential themes consist of sustaining the United States economic healing, progressing racial justice and equity, fighting environment modification and boosting customer defense. An additional location of raising regulatory focus is the possible licensing of fintech companies.

One more area of arising regulation includes cryptocurrency tasks. In July 2020 and January 2021, the OCC published letters making clear national banks and financial savings association's authority to; provide cryptocurrency custody services for clients and take part in independent node confirmation networks and use steady coins to carry out repayment tasks and various other bank allowable functions. The internal audit function within banking companies generally is accountable for ensuring that the bank adheres to its own policies and also treatments and those required by law and regulation (Eisenberg, 2018). In the USA, interior audit should be positioned within the institution in a manner that makes sure impartiality and also enough freedom. Inner audit must preserve an in-depth threat analysis method, an audit plan, audit program and audit record. The frequency of the interior audit testimonial should follow the nature, intricacy and risk of the establishment's activities. Deposit insurance coverage is likewise deemed to use a security barrier in the financial system. This assurance can increase depositors' confidence and decrease the duty of government with regard to financial institutions' responsibilities despite financial shocks. However, deposit insurance policy might raise the motivation of banks to take risks (Anginer, Demirguc-Kunt & Zhu, 2019). In addition, achieving an optimum deposit insurance system with a suitable structure is an arduous task with governments potentially absorbing up all losses. This accelerates banks to take more risks that make them a lot more susceptible to financial shocks.

Regulators discover that fewer market operators can enhance reliable supervision, increase tracking and decrease the threat of contagion within financial institutions (Beck, 2020). There is almost an agreement concerning the energetic function of governance in increasing stability in the financial sector. The substantial proof that weaknesses in the execution of governance concepts have actually led to the failings of banks and bad threat monitoring since mistakes in passing information and additionally an inadequate disclosure of predicted threat. The freedom of people and organizations are among one of the most essential columns of financial growth that have been sought to attain economic objectives and to enhance financial security. Banks can successfully manage their expenses and decrease threat with the reduction of constraints (Herring & Santomero, 2020). It definitely needs to have more effective impact on the advancement of economic intermediaries. It is again suggested that a high level of economic flexibility produces greater political stability and therefore minimizes unpredictability in the financial system. An unsteady economic development raises uncertainty about an economic system's future. The consistent financial development to improve banks' capital buffers and boost financial strength. When it comes to inflation, it is typically that an obstacle to security in the economic markets. An inflationary atmosphere might raise a bank's motivation to enhance loan rates and banks.

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Considering that bank failures indicates a solid externalities in regards to liquidity, bankruptcy costs, property damage, a vital part of banking guideline is made to avoid bank failings or, a minimum of, to limit their impacts (Freixas & Santomero, 2019). This is described as the safeguard that borders the banking sector and secures bank consumers. Exactly how comprehensive this safety net ought to be is still a matter of concern, between economic experts and politicians alike. In nations like France or Japan, permitting a bank to fall short and its unsecured creditors to endure the consequences of the bank choices is thought inappropriate. While in the US and New Zealand, it is an event expected in law. Passion after that looked to a change in law that would demand that banks satisfy defined part of their capital requirement with subordinated financial debt, as a device to boost market self-control (Evanoff & Wall Surface, 2017). Subordinated debt, as a junior case, works as a buffer against losses by the down payment insurer. Subordinated debt has a few of the characteristics of client cash, since it normally have maturation above one year and cannot be retrieved easily throughout a dilemma. Subordinated lenders have strong incentives to monitor financial institution risk taking and enforce technique.

When bank risk increases all of a sudden, banks may not have to pay higher rates or face possible quantity technique till their subordinated debt develops (Levonian, 2021). Due to this reason, subordinated financial obligation proposals normally demands that the bank startle the maturities of financial obligation concern to make sure that a moderate proportion matures each quarter. This way, market discipline via price and quantity assents might work and interesting, however sufficiently limited in magnitude to give period for dilemma resolution or organized termination. Financial markets offer crucial information that assists to work with decentralized choices throughout the economic situation (Merton, 2020). Much better access to excellent quality information by participants on a timely basis will permit economic markets to give good rates signals and to designate resources more efficiently. This depends not just to information regarding issuers of financial tools, instead additionally to financial organizations themselves and the services they offer. Disclosure standards thus additionally offer enhanced general economic effectiveness along with consumer protection reasoning. Effectiveness would additionally be increased if regulators are called for to warrant each new policy with a careful analysis of its prices and advantages.

3.1 Research Findings

The study found that there are a lot of effects of financial regulation on the banking system in the United States of America which are influencing the financial system either positively or negatively. Other impacts are short lived while others influence the banking system in the long run and detrimentally. Policy is either done by the independent financial institutions or the government. Unlike various other countries where law is done by one bank regulator in United States of America financial is regulated at both the government and state level. United States financial regulations addresses privacy, disclosure, fraudulence avoidance, anti-money laundering, anti-terrorism, anti-usury loaning and the promotion of providing to lower earnings populations. In United States there is the Federal Reserve which establishes the reserve need for financial institutions that determines the quantity of money that banks are allowed to offer. There are various financial organizations including business financial institutions, savings banks, savings and loans, in addition to cooperative credit union concerned with provision of financial capital to debtors.

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It is also discovered that the Federal Reserve System in the central bank of the United States conducts the monetary plan. A few of these policies might have an unfavorable impact on financial competition therefore leading to greater funding rates which ultimately leads to a higher possibility of loan defaults. Regulation of banking systems might impact financial solutions and help banks to supply a lot more efficient solutions and enhance financial institution stability. There is an energetic and well-arranged supervisory company wherein policy of financial system has enhanced financial institutions' effectiveness and the banks' capacity to encounter any kind of financial distress. In the United States of America there is arising regulation which includes cryptocurrency activities. The weaknesses in the implementation of governance concepts have brought about the failings of financial institutions and inadequate danger administration due to mistakes in sharing details and an inadequate disclosure of predicted danger. The rising cost of living environment may elevate financial institution's motivation to increase loan rates and banks.

4.1 Conclusion

The study concluded that it is crucial for the government to offer the financial systems with favorable conditions of the financial regulation. The government of United States must just make use of the guideline plans which do not adversely impact the banks. If there is increased regulation generally it implies that a greater workload for individuals in the economic services given that it takes time and effort to adjust business techniques that comply with the new guidelines without delay therefore it might trigger delays in the financial system since you need to train another group of workers or launch some so that the institution might adapt with the set policies. When the government places in too much of regulations they can suppress down advancement and drive up expenses while too little can result in mismanagement, corruption and collapse of the financial system. In the regulations which reduce competition among banks, there might be high social costs in the form of restricting credit score supply, high purchase cost, high interest rate and reduction in motivation.

The study likewise concluded that the Federal Reserve established need to be sensible at various durations to manage the flow of currency out there which may lead to inflation if in excess thus making the economy of a particular nation to degrade. The financial institutions ought to give loans at practical rate of interest to avoid lots of people from failing to pay the loans due to high interest rates. Furthermore, it is also concluded that with the main supervision banking system might get over market failure caused by the incomplete information; once again banks need to not participate in investments that are also risky at the expense of its depositors without notifying them therefore there is demand for regulatory authority to keep an eye on banks on the part of depositors and supply guarantee and maintain their confidence in the economic system. Finally the research concluded that, bank failure might signal weakness in financial institution properties as a whole which might create depositors to wonder about the whole sector as it questions the rewards of any kind of bank to appropriately check its customers. If banks are viewed as lacking motivations to keep an eye on, they will certainly take part in deceptive procedures and extreme risk taking.

5.1 Recommendations

The study recommended that other nations should comply with the United States way of having both federal and state level laws of the banking system because it brings about excellent

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company and efficiency of the banks. United States of America banking guidelines must advance with the fraud prevention, address personal privacy, disclosure, anti-money laundering, anti-terrorism, anti-usury lending and the increase of lending to lower earnings citizens so that it can make everyone active in the economy for this reason decreasing the high joblessness rates and minimize crime rates in the country. The research additionally recommended that activities considered over risky, like the proprietary trading, need to be limited or banned altogether due to the fact that the regulatory authorities have also set up yearly stress test whereby banks are required to demonstrate to their regulators that they would retain an adequate quantity of funding also under very damaging theoretical financial circumstances. Financial institutions are required not to elevate loan rates, considering that it results in a boosting chance of bank debtors among customers which adversely might trigger the financial institutions to fall short thus reducing the economic growth of a country.

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