The Information Content of Stress Test Announcements

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8th Research Workshop of the MPC TF on Banking Analysis for Monetary Policy
Bank of Greece, September 2022

Introduction

- Do stress tests enhance transparency on financial institutions?
- What is the information content of stress test announcements?

$\rightarrow$ This paper: How do investors react to these announcements?

Empirical strategy

- Inferring information content of stress test announcements from investors' reaction
  - Reaction of banks' **stock prices**:
    1. Stress test results affect banks' ability to pay out dividends
    2. Information about banks' ability to withstand adverse shocks
  - Reaction of banks' **CDS spreads** can help distinguish between **1** & **2**

US stress test framework

- Two stages, same supervisory scenarios:

1. Dodd Frank Act Stress Tests (DFAST)

- Released first
- No direct supervisory consequences
- Assumes capital plans for dividends and share buybacks based on previous cycle

2. Comprehensive Capital Analysis and Review (CCAR)

- Released one week later
- Could trigger limits to capital distributions
- Incorporates actual new capital plans

Results

- Release of **DFAST** positive results followed by $\uparrow$ **stock prices** and $\downarrow$ **CDS spreads**

- Release of **CCAR** positive results followed by **no significant effects**, except when **capital distributions** are curbed

Comment #1: Empirical strategy

- Inferring information content of stress test announcements from investors' reaction
  - Reaction of banks' **stock prices**:
    1. Stress test results affect banks' ability to pay out dividends
    2. Information about banks' ability to withstand adverse shocks
    3. Information about banks' future profitability
  - Reaction of banks' **CDS spreads** can help distinguish between **1** & **2**
  - Reaction of banks' **dividend futures** could help distinguish between **1** & **3**
    - Stock prices affected by infinite stream of future dividends, while dividend futures refer to specific years only

Comment #2: Relevant channels?

- Higher capital might imply higher dividends in the future because of:
  - Lower funding costs $\rightarrow$ higher profits
  - More room to increase leverage

- Do banks with higher capital in stress test results...
  - Have higher profits in following years?
  - Increase their leverage?
  - Increase their debt issuance?
  - Increase their lending?

Concluding remarks

- Very nice paper
- Neat empirical strategy, relevant results
- Room for additional exercises to dig deeper into the mechanisms at play