Stress tests and capital requirement disclosures

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Discussion

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Summary of paper

Question

- What is the CAUSAL effect of disclosing changes in required capital requirements on banks' lending and risk-taking?
  - Do banks deleverage or derisk?
  - What is the effect on profitability?

Data

- Results of centralised European stress tests (2016 and 2018, excl. 2021) on approx. 90 banks
  - published results on (approx. 35) banks of the "European Banking Authority" (EBA) sample
  - unpublished on (approx. 55) banks of the "Supervisory Review and Evaluation Process" (SREP) sample
    - some disclose Pillar 2 Requirements (P2R)
- Quarterly supervisory info. on approx. 1000 banks (stress tested and not)
    - some disclose Pillar 2 Requirements (P2R)

Summary of paper

Identification

- static diff-in-diff model as baseline
- dynamic diff-in-diff model to identify dynamic reaction of banks to the publication of the stress test results, over the subsequent quarters and in anticipation
  - similar in spirit to local projection

Challanges

- exogenous variation in capital requirements, not-observable and possibly common to the entire banking system
- bank-specific requirements related to bank characteristics
- disentangling credit supply from credit demand

Solutions

- Changes in credit demand controlled with: bank and quarter fixed-effects + country-year + country specific unemployment rate and banks' voluntary buffer
- Standard errors clustered at bank level.

Validation

- Parallel trend assumption, placebo dates and alternative specifications

Summary of paper

Method

- Quasi-natural experiment to account for the selection of banks into the stress test

Findings

- DERISKING: overall stress test-ed banks DO reallocate credit away from riskier borrowers, by reducing risk weights to household sector
  - SREP banks reduce risk weights by more
  - become safer but LESS PROFITABLE
- DELEVERAGING: overall stress test-ed banks DO NOT reduce lending
  - but SREP banks reduce lending to both NFCs and households (risky borrowers)
  - result driven by SREP banks that do not voluntarily disclose P2R

Bottomline

- EVIDENCE: overall, stress test-ed banks do not deleverage but do derisk, resulting in safer (and less profitable) banks
- CLAIM: reduced banks' risk-taking is the main disciplinary effect of the publication of stress test results
- POLICY IMPLICATION: publication of bank requirements improves market discipline, promoting financial stability, without causing credit crunches

Comments

Why not a different diff-in-diff strategy:

- use 2021 for a "reverse" diff-in-diff
  - DID is a static methodology and the timing of the treatment is irrelevant
  - before: 2021 - after: 2016, 2018
  - treatment: undisclosed stress test results
  - treatment is only in the "before" sample

Parallel trend assumption: similar trend in the absence of stress tests (after)

- credibly test for a common pre-trend
- how realistic is the assumption for the after?
- argue with robustness of results when using the overlap sample
- what if non-tested banks "become" different after test because benefit from hiding information wrt tested banks?
- need a detailed discussion of the plausibility of the assumption