TIME INCONSISTENCY IN STRESS-TEST DESIGN

DISCUSSION

USUAL DISCLAIMERS APPLY

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DATE

NEW TITLE: « THE STRESS-TESTER SCHYZOPHRENIA »

- Before stress-test = Central banks/Supervisors want to be **credible** and tough in terms of scenarios / process/ communication

- After stress-test = reluctance to be fully transparent about the results/ bank weakness with the fear to harm financial stability

  - ***Banks internalize this such that the Central bank credibility to incentivize banks to take prudent actions/behaviours (given the "threat" of stress-test) is low***

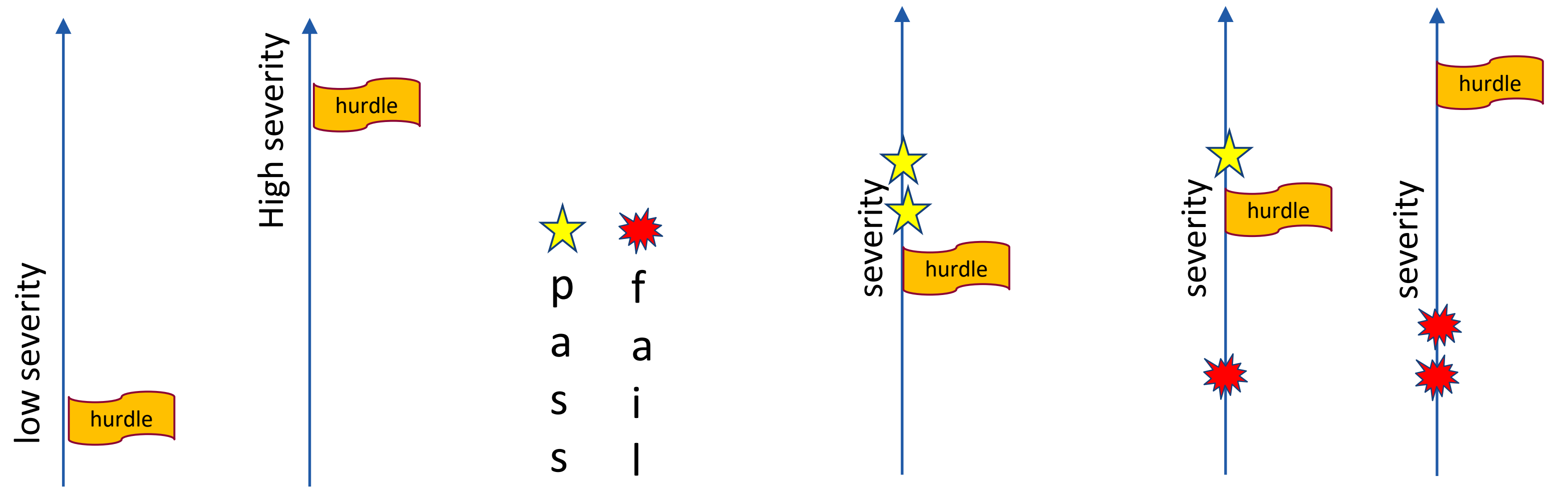
HOW TO DISCLOSE WITHIN A HURDLE RATE FRAMEWORK

- If all banks pass the test = markets beliefs about bank health deteriorates because of lack of credibility
- If few banks fail = improve the belief of bank health for banks passing the test
- There is an optimal hurdle to ensure an optimal trade-off between credibility/severity vs. reassurance
- At the extreme, no disclosure =risk sharing mechanisms between banks as any bank is perceived as an average bank. But risk of run if the average bank is in bad health -> banks make “no effort” (e.g risk management)/ low incentives
- Full disclosure = strong incentives for banks but low reassurance.

<u>Financial Times</u>
Which part of `stress test' do the eurozone's policy makers not understand? That so many European banks passed the annual exams in July yet still had their shares trashed by investors says it all: the pass mark was too low and the questions were too narrow." Financial Times, Lex, European stress tests: a grim backdrop, 6 October 2011.

EQUILIBRIUM …

- In the case of two banks:
  - If the two banks succeed = Financial markets interpret that both banks pass the test just above the critical threshold
  - If one fails = financial markets interpret that the « best » bank is at the threshold and the failing one far below.
  - High severity = increase the belief as regards good banks but strongly deteriorates the ones of the bad banks
- Contagion example:
  - if two pass the hurdle -> market intrepret the « hurdle to be set such that the weakest bank pass and assimilate all banks as « average » -> the best banks suffers this: nos discrimination.



POLICY IMPLICATIONS?

- How to limit information contagion on the best banks?
  - Could communication on thresholds (pass/fail) well in advance to the stress-test results solve part of the issue? Predefine a shortfall?
  - Should we communicate results by « buckets » such as we have several hurdles? Resulting in better discrimination but avoid full disclosure? (2021 ECB sample= results presented by range)
- What justifies that full disclosure would be sub-optimal?
  - Ensure strong commitment by the banks.
  - Should avoid informational contagion.
  - Individual results published in 2021 by EBA/ECB: was it costly for the weakest banks?