IREGE
INSTITUT DE RECHERCHE EN GESTION ET ECONOMIE

Séminaire de Recherche

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12h30 - Salle 103 (IAE Annecy)

DING H. (IREGE, Université Savoie Mont Blanc)

Market Information in Banking Supervision: The Role of Stress Test Design

This paper studies the optimal degree of leniency in a bank stress test, when the latter serves two purposes. First, the stress test directly provides information to the bank supervisor, regarding whether or not a bank is well capitalized. Poorly capitalized banks engage in risk shifting and the supervisor can intervene to prevent it. Intervention destroys value in well capitalized banks who do not engage in risk shifting. Second, the stress test result indirectly a¤ects the amount of information that the bank.s stock price reveals, due to its impact on a speculator.s incentives to acquire costly information and trade on it. We show that a supervisor optimally distorts the stress test towards leniency for banks whose shares are relatively illiquid, and about whom the supervisor has little private information. When the supervisor has substantial private information about a bank, it may be optimal to apply a conservative stress test.

Keywords: Stress test, leniency, monitoring, feedback

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Liberated companies: Are they more socially responsible?