

# **Bank Stress Testing: Public Interest or Regulatory Capture?**

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# Research Questions

- Does banks' influence on regulators affect stress test outcomes?
  - Regulatory capture vs Public Interest
    - “... as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit” – Stigler (1971)
  - Setting
    - U.S. Stress Tests (2013-2019)

# Measuring influence

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  - Large Trading Banks (TBTF)  
BoA, Citigroup, Goldman Sachs, JPMorgan, Morgan Stanley, Wells Fargo
  - Regulatory Connections  
Banks with executive officers who have held senior positions at bank regulators
  - Political Connections  
Political contributions + lobbying expenses  
*over the past two congressional election cycles, scaled by assets*

# Stress Tests

- Does banks' influence on regulators affect **stress test outcomes**?
  - Comprehensive Capital Analysis and Review (CCAR)
  - Dodd-Frank Act Stress Tests, run by the Fed (DFAST-Fed)
  - Dodd-Frank Act Stress Tests, run by banks (DFAST-Bank)

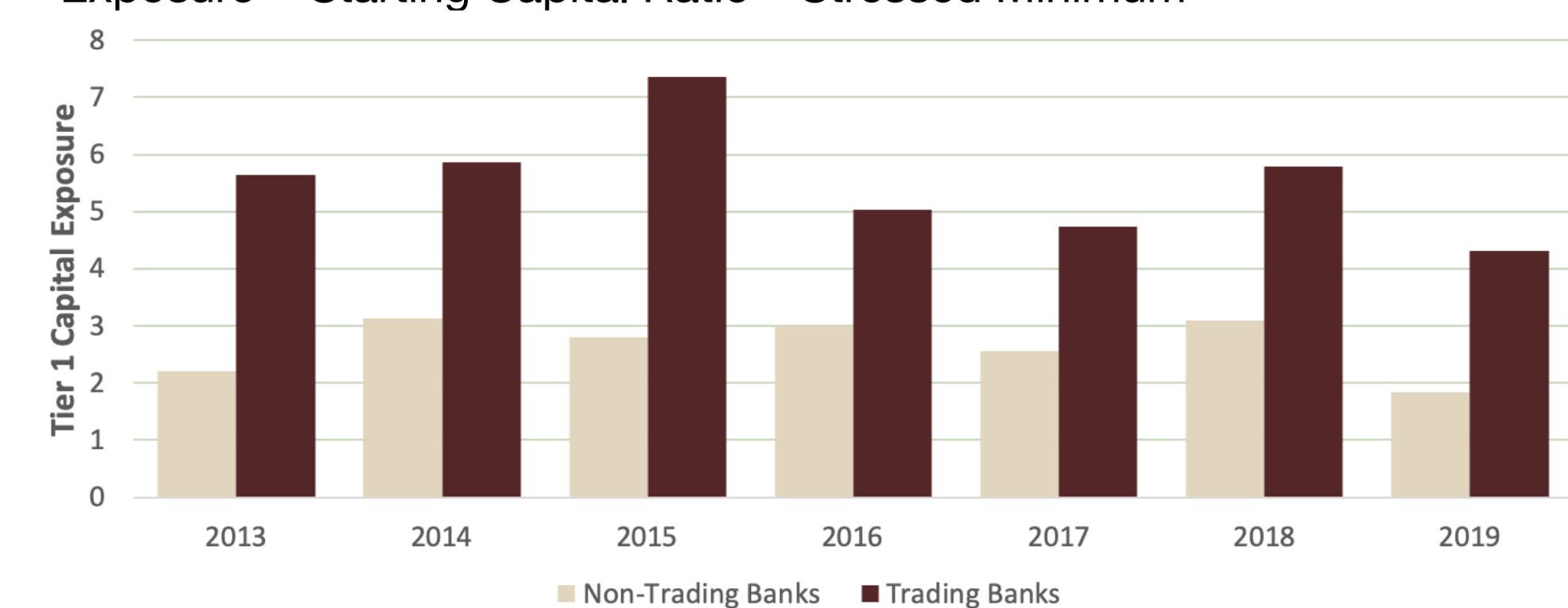
# Stress Tests

- Does banks' influence on regulators affect **stress test outcomes**?

CCAR vs DFAST-Fed	DFAST-Fed vs DFAST-Bank
<p>Similarities</p> <ul style="list-style-type: none"><li>Fed's model and scenarios</li><li>Banks' (start) positions</li></ul>	<p>Similarities</p> <ul style="list-style-type: none"><li>Fed's scenarios</li><li>Flat capital distribution</li><li>Banks' (start) positions</li></ul>
<p>Differences</p> <ul style="list-style-type: none"><li>Banks' proposed capital distribution plan vs flat capital distribution</li><li>Qualitative test</li></ul>	<p>Differences</p> <ul style="list-style-type: none"><li>Fed's model vs Banks' model</li></ul>

# 1. Who are more stressed?

- Exposure to stress test:
  - Exposure = Starting Capital Ratio – Stressed Minimum



# 1. Who are more stressed?

- Takeaways:
  - Large trading banks' portfolios are much more stressed than that of other banks.
    - Effect goes beyond the *Global Market Shock*
    - Additional tests rule out riskiness
  - No evidence of favoritism to banks with regulatory or political influence

## 2. Who fails CCAR?

	Any Failure	
Trading Bank	0.22** (0.09)	0.17** (0.08)
Regulatory Connection	-0.04 (0.07)	-0.04 (0.07)
Political Connection	0.02 (0.04)	0.01 (0.04)
Below Any Barrier, DFAST-Bank	Not Identified	
Min Distance, DFAST-Bank	0 (0.03)	
Below Any Barrier, DFAST-Fed	0.58*** (0.16)	
Min Distance, DFAST-Fed	-0.05* (0.02)	
Year FEs	Yes	Yes
Observations	154	154
Adjusted R-squared	0.06	0.13

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    - More aggressive capital plans

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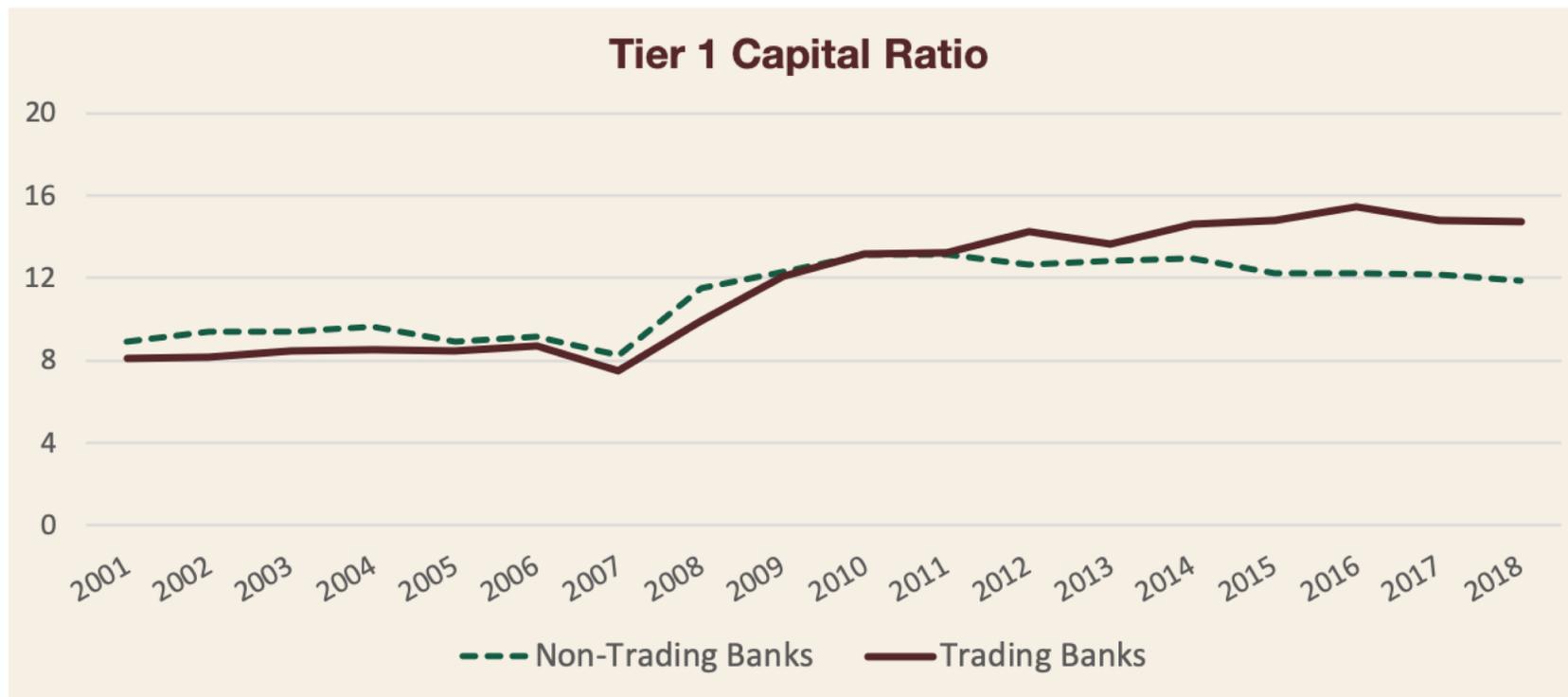
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    - Face greater scrutiny on the qualitative dimensions
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  - Political or Regulatory connections do not matter

### 3. Who 'knows' the Fed's model?

- Takeaway: no evidence of influential banks have a better understanding of the Fed's model

# Evolution of Capital

- Within tested banks, trading banks are better capitalized.



# Conclusions

- Public Interest View
  - Large trading banks (TBTF)
    - Face tougher stress tests
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  - Large trading banks (TBTF)
    - Face tougher stress tests
    - Are more likely to fail
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- But things are changing...
  - Less disclosure of results
  - More disclosure of Fed's model
  - Looser connection between test results and capital plans