



Surprised or not surprised? The investors' reaction to the comprehensive assessment preceding the launch of the banking union



Marika Carboni^a, Franco Fiordelisi^{b,c}, Ornella Ricci^{b,*}, Francesco Saverio Stentella Lopes^d

^a University of Rome Tor Vergata, Department of Economics and Finance, Via Columbia 2, Rome, Italy

^b University of Roma Tre, Department of Business Studies, via Silvio D'Amico 77, Rome, Italy

^c Middlesex University, Business School, The Burroughs Hendon, London NW4 4BT, United Kingdom

^d Bangor University, Bangor Business School, College Road, LL572DG Bangor, United Kingdom

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ABSTRACT

Did the Comprehensive Assessment (CA), preceding the Single Supervisory Mechanism (SSM) launch in Europe, achieve its aims of producing new valuable information for the market? We show that the CA achieved the goal of increasing transparency: investors were able to detect weak banks at the announcement of the procedure (23rd October 2013), but gained full information on the amount of the capital shortfall only at the disclosure of the results (26th October 2014). Furthermore, at the official launch of the SSM (4th November 2014), banks under direct European Central Bank (ECB) supervision registered a more negative market reaction with respect to banks maintaining their national supervisors. Using a regression model including possible confounders and allowing for treatment effect heterogeneity, this negative reaction is confirmed. These findings suggest that, at least in the short run, investors penalized banks subject to direct ECB supervision, probably because of the fear of regulatory inconsistencies.

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1. Introduction

After the financial turmoil triggered by subprime mortgages in summer 2007, the systemic risk of European banks increased dramatically, reaching its peak in November 2011, with large scale banking rescues occurring in all major EU economies (Molyneux et al., 2014). The global financial crisis and the following European sovereign debt crisis led policymakers to recognize that the traditional micro-prudential approach to financial stability needed to be complemented with a system-wide macro-prudential approach (Black et al., 2016). In this context, the ECB intervened decisively with both standard and non-standard monetary policy interventions, enhancing liquidity conditions to restore the banking system (Ricci, 2015). The ECB not only adopted exceptional monetary policy measures, but also took charge of bank supervision. Recognizing the need for reshaping banking supervision (Girardone et al., 2013; Barth et al., 2013; Matousek, 2011; U.S. Financial Crisis Inquiry Commission, 2011), the European Commission changed the European Banking supervisory system in autumn 2012 by creating a Single Supervisory Mechanism (SSM) led by the European Cen-

tral Bank (ECB). Specifically, starting from November 4th, 2014, the SSM has involved a transfer to the European level of the regulatory and institutional framework responsible for the safeguard of the robustness and the stability of the banking industry. The most significant 130 banks in 19 countries (representing assets worth €22 trillion, i.e. 82% of total banking assets in the Euro zone) now fall under the direct supervision of the ECB, while the National Supervisory Authorities (NSAs) maintain the direct supervision (in collaboration with the ECB) of the remaining banks.

As an essential part of the preparation for the SSM, the ECB and the NSAs carried out a Comprehensive Assessment (CA) announced on October 23rd, 2013, and completed on October 26th, 2014, in order to “provide the necessary clarity on the banks that will be subject to the ECB’s direct supervision” (European Central Bank (ECB), 2013, p. 1). Explaining the rationale of the CA, the European Central Bank (ECB) (2013) underlined that supervisors and regulators had already taken many actions to address the adverse consequences of the global financial crisis and many banks had already raised new capital to reinforce their positions. However, the ECB also stated “weaknesses remain, compounded by the perception that banks’ balance sheets are not transparent and concerns about their overall risk situation” (European Central Bank (ECB), 2013, p. 2). As further specified by the European Central Bank (ECB) (2013, p. 2), “The exercise has three main goals: transparency, that is, enhancing

* Corresponding author.

E-mail address: ornella.ricci@uniroma3.it (O. Ricci).

the quality of information available concerning the condition of banks; repair, by identifying and implementing necessary corrective actions, if and where needed; and confidence building, namely assuring all stakeholders that banks are fundamentally sound and trustworthy”.

With respect to other regulatory stress test exercises conducted in Europe or in the U.S., the CA is particularly interesting because it was launched as a preliminary step for a much larger process, the implementation of the Single Supervisory Mechanism (SSM), with the most significant banking institutions falling under direct ECB supervision and the others maintaining national supervisors. Although it is true that the SSM consequences may be fully analyzed in the long term, it is possible to have a first assessment focusing on stock markets. Our paper aims to verify whether the CA reached its main objectives. Specifically, we focus on the CA's aims of increasing transparency and building confidence.

Our paper answers the following two questions: did the CA produce new valuable information for the market? Did the CA have a positive effect on the stock price of involved institutions?

The main contribution of our paper is that, to our knowledge, it is one of the first studies to provide empirical evidence of the market reaction to every single step of the CA, and to link this stress exercise to the wider SSM process. Specifically, by observing market reaction from the beginning to the end of this procedure, we are the first paper to investigate whether the CA really increased transparency and confidence in banking, as stated in its aims. Our results have important policy implications for supervisors since we shed some light on investors' perceptions about this crucial change in the European banking supervision.

The rest of the paper is structured as follows. First, we review previous studies and develop our research hypotheses (Section 2). Second, we run a preliminary inspection of market reaction to several CA announcements (Section 3), and then we discuss our main results about the information produced by this review exercise (Section 4). Finally, we run further investigation to detect some potential SSM effects in investors' reaction (Section 5). Conclusions are drawn in Section 6.

2. Literature, contribution and hypotheses

This paper focuses on the first fundamental step of the European supervisory architecture revolution, i.e., the Comprehensive Assessment (CA) run in preparation of the SSM. As such, we contribute not only to the recent research stream on regulatory stress tests, but also to the more established literature on financial stability, bank regulation and supervision.

The literature on regulatory stress tests performed by European or U.S. supervisory authorities has grown fast in the last years, including both theoretical and empirical papers. Theoretical studies mainly discuss whether results from supervisory stress tests should be disclosed or not. Following Bernanke (2013), the disclosure of stress tests results promote transparency by providing investors with consistent and comparable information about banks' financial conditions. Other authors recognize the benefits of disclosure, but also point to potential problems (Hirtle and Lehnert, 2014; Goldstein and Sapra, 2014), especially the so-called Hirshleifer effect (i.e., disclosing too much information destroys risk-sharing opportunities and reduces liquidity in the interbank market). Goldstein and Leitner (2015) conclude that in time of crisis risk-sharing arrangements are already seriously compromised by the general perception that banks are under-capitalized and (partial) disclosure of regulatory stress tests becomes optimal and able to produce a stabilizing effect. In order to produce this reassuring effect, it is important that regulatory stress tests do produce new and valuable information to the market, increasing transparency on banks' financial conditions. A complementary set of empirical papers assess market reactions to these regulatory exercises and/or

try to assess whether or not they were able to increase transparency.

To our knowledge, only a small number of papers analyze the market reaction to the stress tests performed by the U.S. or European supervisory authorities (e.g., Candelon and Sy, 2015). Focusing on the U.S., Morgan et al. (2014) find that the 2009 stress test conducted on the 19 largest U.S. bank holding companies produced valuable information for the market. Before the results were disclosed, investors had already identified weak banks. More in details, the authors demonstrate that the market reaction at February 2009 (the so called “date of clarification”) is a good predictor for the capital gap disclosed two months later, in May 2009 (the so called “date of results”). With the publication of results, investors gained information on the size of the capital gap, and banks with larger gaps experienced more negative abnormal returns. Dealing with Europe, Petrella and Resti (2013) provide evidence that the 2011 European Banking Authority (EBA) stress test produced valuable information for the market and investors were not able to anticipate its results. They also find that the stock market reacted not only to detailed historical data released after the test, but also to indicators of the bank's vulnerability to simulated downturn scenarios. Acharya et al. (2014) compare the capital shortfall measured by regulatory stress tests – conducted both in Europe and in the U.S. – to that of a benchmark methodology that employs only publicly available market data. This alternative methodology assumes a crisis scenario, defined by a 40% drop in the market equity index over six months (see Acharya et al., 2012). Results show that regulatory stress tests could be more effective using capital adequacy definitions based on total assets and market risks, rather than on risk weighted assets.

Not surprisingly, there are very few papers focusing on the market reaction to the CA results (e.g., Bank of Italy, 2014; Sahin and de Haan, 2015), due to its very recent and fast launch. Bank of Italy (2014) assessed the market reaction to the announcement of CA results as follows: “*The share prices of the banks for which capital strengthening requirements emerged recorded large losses owing to the dilution effect of any capital increases. The risk premiums on the CDS of almost all the banks involved in the exercise narrowed in the days immediately following 26th October, reflecting increased confidence on the part of investors; these improvements were subsequently scaled back*” (Bank of Italy, 2014, p. 31). Sahin and de Haan (2015) run an event study analysis by country finding a strong heterogeneity across several Euro area members.

Our study has a different perspective from the existing papers on the European case, since we aim to analyze the market reaction related to the CA, not only at the date of the results' disclosure, but also in each previous intermediate step. After the event study analysis, similarly to Morgan et al. (2014), we focus on two main dates, the announcement of the procedure and the disclosure of results, assuming that the reaction at the announcement date is a measure of the investors' expectations about the results. Consequently, at the announcement date, we expect a negative market reaction for treated banks supposed to register a capital shortfall in the CA. At the results date, the market reaction is expected to be positive if the expected capital shortfall is higher than the realized shortfall disclosed by the ECB, or negative otherwise. As a consequence, at the results date, if the stress test produces new significant information, it is possible to register both positive and negative reactions, depending on previous expectations about every single bank's conditions. At the opposite, if the stress test does not produce new valuable information, there are no significant abnormal returns in the stock price of involved banks. This is consistent with Flannery et al. (2015) outlining that, when announcement dates are known well in advance by investors, as in the case of stress test disclosure of results, their information content must be evaluated in relation to the market's prior beliefs. We believe

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