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The Reaction of Medium-Sized Banks to Stress Test Implementation

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Recent events have led to discussions about rolling back the Dodd-Frank Wall Street Reform and Consumer Protection Act. One portion of the Act required stress testing of major financial institutions. Much of the current literature on the value of stress testing has focused on the announcement of results for the largest financial institutions operating in the United States. Far less has been done on the market's reaction to the implementation of the stress testing process. This is, in part, because stress testing was initially implemented for large financial firms during February 2009 in the aftermath of the financial crisis to manage market concerns over bank capital levels. However Dodd-Frank also required medium-sized banks (those with total assets of between $10 billion and $50 billion) to conduct stress tests and publicly release their results. As those requirements on medium-sized banks were implemented during a period of less market disruption, 2011-2015, it is possible to examine the market response to different steps in the process. The results suggest a positive reaction by the financial markets to announcements indicating progress toward implementing stress testing. There is also some evidence that progress toward the public release of information may be an important component of that reaction.

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