



Reputational damage of operational loss on the bond market: Evidence from the financial industry

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ABSTRACT

We examine bond market reactions to the announcement of operational losses by financial companies. Thanks to the fact the corporate debt is senior to equity, we interpret the cumulated abnormal returns on the bond market of the companies having suffered those losses as a pure reputational impact of operational loss announcements. For a given operational loss, bond returns might be affected at up to three different periods: at the first press release date, when the company recognizes the loss itself and at the settlement date. These impacts hold stronger than for common stocks. We also study the effect of investors' knowledge of the loss amount, and show that the type of operational event and the proportion of the loss in the firm's market value influence the effect of the loss announcement. Cross-sectional analysis indicates that the abnormal return is mostly affected by market-based characteristics for the first press release date, while firm-related characteristics largely affect bond returns upon loss recognition.

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1. Introduction

In its January 2001 Consultative Package, the Basel Committee proposed for the first time its definition of the operational risk: “*The risk of losses resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic risk and reputational risk*” (Basel Committee on Banking Supervision, 2001).³ Consequently, banks were not required to allocate regulatory capital to hedge reputational risk. However, in

the last decades, several operational loss events have caused market value losses much higher than the loss amount (see Ross, 1997; Dunne & Helliar, 2002).

Assessing the impact of operational losses on a firm's reputation, and its associated drop in economic value, is an uneasy task. Because the reputational damage coincides, at least partly, with the identification of a direct operational loss, it is necessary to precisely identify its extent in order to isolate the pure reputational effect. When the magnitude of the operational loss is known, its identification is immediate. But if there remains some uncertainty vis-à-vis the global amount of the loss – which is usually the case when the loss event is announced – then the stock price reaction mixes the direct (operational) and indirect (reputational) effects with unknown proportions. Disentangling these two effects is indeed less likely to be problematic with corporate debt. As stated by Gebhardt, Hvidkjaer, and Swaminathan (2002), bonds and stocks are different claims to the same underlying operating cash flows and are, therefore, affected by the same fundamental risks although to varying degrees. We consider that the use of a debt market allows us to better isolate the reputational damage due to events related to operational risk than the equity market. As shareholders' equity represents a residual claim on the economic value of the firm, it naturally experiences the first,

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³ The final Basel II Accord features a limitative list of seven loss events that qualify as operational: Internal Fraud, External Fraud, Employment Practices and Workplace Safety, Clients, Products, and Business Practices, Damage to Physical Assets, Business Disruption and Systems Failures, and Execution, Delivery, and Process Management. Any indirect effect resulting from these events on the reputation of the financial institution is left out of the regulatory scope.

mechanical loss due to an operational event, whatever its magnitude and degree of certainty. Thus, although the return effect is likely to be much less pronounced on debt contracts, it is also presumably purely reputational. The hypothesis of a strong sensitivity of bond returns to adverse events tends to be confirmed by the only two event studies that analyze announcements that have the same (positive or negative) impact on both markets. Hand, Holthausen, and Leftwich (1992) examine the impact of bond rating agency downgrade and upgrade announcements on the stock and bond markets and find that the latter react only for downgrades, but more strongly than stock markets, which react significantly for both positive and negative events. DeFond and Zhang (2009) study the stock and bond market reactions on bad and good news earnings surprises, and also find that bond markets tend to react more strongly to bad news, while stock markets react more strongly to good news.

This paper represents, to our knowledge, the first study purely dedicated to the bond market reactions to the announcement of operational losses. So far, three articles have examined the reputational damage of operational losses in the financial industry, but all of them focus on the impact on the stock market. Cummins, Lewis, and Wei (2006) compare the impact of large operational loss announcements in listed US banks and insurance companies. Both types of companies experience significant negative price reactions and their market value drops by an amount exceeding their operational loss. de Fontnouvelle and Perry (2005) conduct an event study of operational loss announcements for banks listed on developed financial markets worldwide, and find that only the announcement date has a significant, negative impact on the price. Their explanatory variable is a “loss ratio”, defined as the ratio between the loss amount and the market capitalization of the firm. They interpret a market value loss greater than the operational loss announced as evidence of reputational damage. In the most closely related paper to ours, Gillet, Hübner, and Plunus (2010) assimilate operational losses to reputational losses, but their approach suffers from the fact that common equity is the most junior claim on the firm value, as discussed above.

We exploit a clean database of bonds issued by listed US financial companies having experienced a significant operational loss. We carry out an event study methodology in two steps. In the first stage, we study the abnormal bond returns around dates that may have an influence on the firm reputation. Three event dates could matter: the first press release, the recognition by the company, and the final settlement. We discriminate, for the first press release date,⁴ the losses on the basis of the investors' knowledge of the real loss amount, the type of operational event and the proportion of the loss in the firm's market value. In the second stage, we perform a cross-sectional analysis with the aim to detect the determinants of the market reaction to the operational loss events.

Our results indicate that it is worthwhile to perform a distinct analysis on the bond market. We find economically as well as statistically different evidence from the one retrieved from the stock market analysis of similar events. In particular, the date of recognition of the loss by the company has a particular meaning for the bond market participants. As we can provide a “clean” reputational interpretation of abnormal bond returns, this sheds particular light on the informational content of firm disclosures of operational events in the financial sector.

Section 2 describes the sample construction and displays the descriptive statistics on the final sample and the methodology used for measuring the impact of operational losses on reputation. Section 3 presents the empirical results of our event study. In the last section (Section 4), a cross-sectional analysis is performed on the abnormal returns computed in Section 3.

2. Data and methodology

2.1. Data

We extract loss event from the Algo FIRST database provided by the Fitch Group. This resource provides ca. 10,000 case studies analyzing operational risk loss events. It supplies the loss size, the name of the company and its group, the country of the company, the event type, as well as complete explanation of the loss event.

In the context of our study, the criteria used to filter this data collection are the following:

- The company group is resident in the United States⁵;
- The company that suffers the loss belongs to the financial industry;
- The operational losses have to be higher than 10 million US dollars⁶;
- The loss has to be settled not earlier than January 1994;
- The company group⁷ has to be publicly traded;
- The operational event causing the loss cannot be a “September 11th” event;
- The company group has at least one listed bond outstanding⁸ issued at least a year before the first press release date regarding the event and with a maturity sufficiently long to cover the whole period until the settlement date. If several bonds fill these conditions, we retain the bond with the longest maturity⁹;
- A company experiencing two operational events within the same month has to be removed to avoid contamination.

Our sample is finally composed of the 71 largest losses having occurred between April 1994 and July 2006, in 41 US companies from 23 different company groups. Similar to Gillet et al. (2010), we adopt three event dates:

- The first press release date: this date is available through the source of Algo FIRST. This date is manually double-checked through the Nexis Lexus database and corrected if necessary. For each case study, the selected date corresponds to the first press release mentioning the operational loss event.
- The recognition by the company date: this date corresponds to an announcement of the loss (the event or the amount) by the company itself. This date, when available, is found in the complete description and history of the loss event, provided by Algo.
- The settlement date: this date, directly given by Algo, is the one on which all losses are materialized, that is, the loss is considered to be definite and all loss amounts are known.

To illustrate our date classification we provide below the description of an operational loss event suffered by Aon Corp.

A lawsuit filed against Aon Corp. alleges that Aon “devised, implemented, supervised and enforced” a scheme to conceal contingent commissions from its clients.

⁵ As the European sample was too small, we decided to remove these observations from the analysis.

⁶ This threshold is also used in (Cummins et al., 2006).

⁷ For instance, the American General Corp. and the National Union Fire Insurance Company are two companies belonging to the group “American International Group Inc.”. The American International Group Inc. is publicly traded.

⁸ We control for selection bias by checking the variation of average Price-to-Book Value, PTBV, between Gillet et al.'s (2010) US sample and our reduced sample due to the absence of “right” bonds. Our sample has a 5% lower average PTBV, but as it is proven to affect positively the abnormal return in Gillet et al. (2010), it should not affect our results.

⁹ We justify the choice of bonds with the longest maturity on two dimensions: first, they are the most sensitive to a change in the yield to maturity thanks to their high duration, and so the reputational effect is most easily identifiable; and second, they are least likely to be affected by the shortening of the time-to-maturity from the first press release to the settlement date. This dimension is more important than the transaction costs issue emphasized by Edwards, Harris, and Piwowar (2007) as we only deal with publicly listed bonds.

⁴ We do not create sub-samples for the other event dates due to a lack of data.

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