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Bank governance, regulation, supervision, and risk reporting: Evidence from operational risk disclosures in European banks

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ABSTRACT

This paper investigates the direct and joint effects of bank governance, regulation, and supervision on the quality of risk reporting in the banking industry, as proxied for by operational risk disclosure (ORD) quality in European banks. After controlling for the endogeneity between bank stability and risk reporting quality, we find that banks having a higher proportion of outside board directors, lower executive ownership, concentrated outside non-governmental ownership, and more active audit committee, and operating under regulations promoting bank competition (i.e., less stringent entry to banking requirements) provide ORD of higher quality. In addition, we find that the contribution of bank supervisors to the enhancement of ORD quality depends on the ownership structure of the bank. Specifically, powerful and independent bank supervisors mitigate the incentives for entrenched bank executives to withhold voluntary ORD. Moreover, bank supervisors and largest shareholders perform substitutive roles in monitoring the bank management's compliance with mandatory ORD requirements. For the sake of enhancing risk reporting quality in banks, our findings recommend sustaining board independence, enhancing audit committee activity, easing entry to banking requirements, and promoting a more proactive role for bank supervisors.

1. Introduction

Disclosure of financial and risk information represents an important mechanism for improving market efficiency through various channels. First, it serves as an outside mechanism for monitoring the behavior of senior management (Eng & Mak, 2003). Second, it lowers investors' uncertainty about firm's expected future cash flows and enables public firms to access external finance at a reasonable cost of capital (Botosan, 1997; Botosan & Plumlee, 2002; Easley & O'Hara, 2004; Kothari, Li, & Short, 2009; Nier & Baumann, 2004). Third, it supports the firm's legitimacy and reputation thus maintaining the trust of various stakeholders (Lindblom, 1994; Oliveira, Rodrigues, & Craig, 2011b).

In the banking industry, one main stream of disclosure is risk reporting. The Basel Committee on Banking Supervision (BCBS), in the Basel II Capital Accord (Pillar 3), emphasizes the importance of informative risk disclosures in banks for enhancing market discipline (Basel Committee on Banking Supervision, 2006b). Literature also showed that banks disclosing more comprehensive risk information choose a higher capital buffer and lower default risk (Boot & Schmeits, 2000; Cordella & Yeyati, 1998; Nier & Baumann, 2006). Moreover, banks are risk-oriented institutions whose disclosures should be studied independently of those of non-financial firms (Bessis, 2002; Linsley & Shrives, 2005, 2006). Furthermore, following the Global Financial Crisis (GFC), risk disclosures in banks have been emphasized as an effective tool for avoiding banking crises (Financial Stability Board, 2012).

Previous research has mainly focused on the mechanical effects of a bank's contextual factors such as size, leverage, riskiness, profitability, and capital adequacy on risk reporting quality (Bischof, 2009; Ford, Sundmacher, Finch, & Carlin, 2009; Helbok & Wagner, 2006; Linsley, Shrives, & Crumpton, 2006; Oliveira, Rodrigues, & Craig, 2011a; Oliveira et al., 2011b; Woods, Dowd, & Humphrey, 2009; Yong, Chalmers, & Faff, 2005). However, to the best of our knowledge, no previous research has examined the direct and joint effects of bank governance, regulation, and supervision on risk reporting quality. Agency, management entrenchment, legitimacy, resource dependence and stakeholder theories suggest that the heavy regulation and strict supervision of the banking sector as well as bank level governance structures could shape the discretionary decision of bank management to report risk information. This paper contributes to the governance and disclosure literature by theoretically justifying and empirically examining the implications of these theories with respect to risk reporting quality in the heavily regulated and strictly supervised banking sector. Practically, this contribution is important because our findings inform

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banking stakeholders, regulators, supervisors, and other relevant policy makers on the most important country level and bank level governance mechanisms that could be employed to enhance risk disclosures in banks thus boosting market efficiency and discipline.

The Basel II Capital Accord identifies three major risk types against exposure to which banks are required to reserve sufficient capital resources (i.e., regulatory capital). These are credit risk, market risk, and operational risk (Basel Committee on Banking Supervision, 2006b). The Basel II Capital Accord defines operational risk as '*… the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk*' (Basel Committee on Banking Supervision, 2006b, p. 144). Moreover, operational risk per se is a major source of risk and financial distress in banks.[1] Therefore, operational risk management and disclosure practices in financial institutions have recently attracted increased attention from academics, professionals, and regulators (Basel Committee on Banking Supervision, 1998b, 2001; Ford et al., 2009; Helbok & Wagner, 2006).

In this paper, we argue that disclosures on operational risk exposure and management, unlike disclosures on credit and market risks, present a unique opportunity to consistently evaluate the discretionary decision of bank management to provide risk disclosures of a certain quality in the annual reports and risk reports. Our argument is based on the following grounds. First, operational risk represents a purely idiosyncratic risk that is free from any contagion effects (Daníelsson et al., 2001; Perry & de Fontnouvelle, 2005). Hence, disclosures on operational risk exposure and management represent information that is unique to the disclosing bank. Second, annual reports and risk reports are the major media through which banks communicate their regular operational risk information to various stakeholders. While regular information on other major risk types (i.e., credit risk and market risk) can be extracted from other sources such as credit ratings announced by specialized rating agencies (e.g., Fitch Inc., Moody's, and Standard & Poor's) as well as currency, commodity and stock exchanges, no regular information on operational risk is disclosed in public sources. Third, while comprehensive disclosures on credit and market risks are imposed by the requirements of International Financial Reporting Standard No. 7: *Financial Instruments: Disclosures* (IFRS 7), no accounting standard has yet been proposed to regulate operational risk disclosures (ORD). Hence, unlike ORD, the quality of disclosures on credit and market risks could be contaminated by contagion effects, diluted by the availability of such disclosures from other public sources of information, or driven by the mandatory requirements of accounting standards.

The remainder of this paper is organized as follows. Section 2 presents a background on operational risk disclosures in the banking industry and its implementation in European banks. Section 3 reviews prior research on risk disclosures in banks and develops our research hypotheses. Section 4 introduces our measure for operational risk disclosure quality and provides details on the data and sample selection, variable definitions, and empirical model design. Section 5 presents and discusses the empirical results. Section 6 concludes.

[1] Many huge operational losses have hit large financial institutions all over the world leading to severe financial disturbance or even the collapse of these institutions. For example, Allied Irish Banks (AIB), the second largest bank in Ireland, was hit by one of the worst scandals in banking history in 2002, losing over $691 million when a currency trader in their Baltimore office invested unsuccessfully in Japanese yen and kept the bank's losses a secret for about five years. More recently, there was a rogue trading loss of €4.9 billion that was discovered by Société Générale in 2008. This operational risk event had been running undetected for about one year. In terms of the financial consequences of operational losses, one of the worst examples might have been the unauthorized speculative trading loss caused by Nick Leeson to Barings Bank during the period 1992–1995 which accumulated a loss of £827 million (approximately $1.3 billion) leading the United Kingdom's oldest investment bank to totally collapse.

2. Overview of operational risk disclosures in the banking industry

The Basel II Capital Accord calls on banks to reserve sufficient capital resources to protect against operational risk exposure (i.e., regulatory capital for operational risk). Regarding operational risk in banks, the Basel II Capital Accord uses a "three pillars" concept. Pillar 1 capital represents the minimum of their own funds that banks have to hold against their ex post operational risk exposure from a regulatory point of view. Pillar 2 capital is determined according to the Internal Capital Adequacy Assessment Process (ICAAP) by which additional operational risk capital could be computed using the bank's internal models to reflect the bank's own assessment of its ex post operational risk exposure. Pillar 2 capital is sometimes called economic capital or operational Value-at-Risk (operational VaR). Pillar 2 capital is subject to review by the relevant banking supervisory authorities if it differs from the Pillar 1 capital. Pillar 3 requires certain operational risk disclosures which could encourage market discipline. Although considered as an important step toward enhancing operational risk disclosures in banks, many professionals and academics still see these requirements as being very general and qualitative in nature (Ford et al., 2009).

In 2006, the European Parliament (EP) issued the Capital Requirements Directive (CRD) to implement the requirements of the three pillars of the Basel II Capital Accord in banks within the European Union (EU) (European Parliament, 2006). Most EU banks started implementing the CRD requirements in the fiscal year 2008 (Deloitte, 2009). However, as is the case for Pillar 3 of the Basel II Capital Accord, the disclosure requirements in the CRD are very general in nature and do not impose a clear-cut framework for disclosure on operational risk exposure and management. Thus, bank managers in the EU still have a great deal of discretion regarding the ORD quality to be provided in their annual reports and risk reports. Such a high level of discretion is evident from the outcomes of two recent surveys conducted by the Committee of European Banking Supervisors (CEBS) and Deloitte in 2009 (Committee of European Banking Supervisors, 2009; Deloitte, 2009). CEBS, in its assessment of Pillar 3 disclosures in 25 European banks for the fiscal year 2008, documented the fact that only 32% of these banks had disclosed detailed information on their operational risk exposure and management (Committee of European Banking Supervisors, 2009). Moreover, Committee of European Banking Supervisors (2009) criticized the lack of information disclosed on the measurement methodology used to quantify the regulatory capital for operational risk especially in banks applying Advanced Measurement Approaches (AMA). Furthermore, Deloitte (2009) documented the fact that 29% of the 47 banks they surveyed had disclosed no information on the measurement methodology used to quantify their regulatory capital for operational risk. Both surveys clearly show that there are still remarkable variations in the ORD quality in EU banks even after the promulgation and implementation of the CRD.

3. Prior research and hypothesis development

3.1. Prior research on risk reporting quality in the banking industry

The determinants of the quality of risk reporting in financial institutions are under-researched. For example, using the BCBS and International Organization of Securities Commissions (IOSCO) joint recommendations as a benchmark, Yong et al. (2005) documented significant variations in the level of risk management disclosures (not including operational risk) by Asia Pacific banks across regions and levels of economic development. Helbok and Wagner (2006) inspected the attributes and determinants of ORD in the annual reports of 59 banks in North America, Asia, and Europe in the period 1998–2001. They documented an increase in ORD in terms of extent (measured by word and page counts) and content (measured by an ORD index). Moreover, they found that banks with a lower equity to assets ratio or profitability ratio are more likely to disclose detailed