



Information asymmetry around operational risk announcements



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ABSTRACT

Operational risk incidences are likely to increase the degree of information asymmetry between firms and investors. We analyze operational risk disclosures by US financial firms during 1995–2009 and their impact on different measures of information asymmetry in the firms' equity markets. Effective spreads and the price impact of trades are shown to increase around the first announcements of such events and to revert after the announcement of their settlement. This is especially pronounced for internal fraud and business practices related events. Market makers respond to higher information risk around the first press cutting date by increasing the quoted depth to accommodate an increase in trading volumes.

The degree of information asymmetry around operational risk events may be influenced by the bank's risk management function and the bank's governance structure. We indeed find that information asymmetry increases more strongly after events' first announcements when firms have weaker governance structures—lower board independence ratios, lower equity incentives of executive directors, and lower levels of institutional ownership. In contrast, the firms' risk management function has little to no impact on information asymmetry. We interpret this as evidence that the risk management function is primarily driven by regulatory compliance needs. The results of this study contribute to our understanding of information asymmetry around operational risk announcements. They help to shed light on the role that regulation and corporate governance can play in order to establish effective disclosure practices and to promote a liquid and transparent securities market.

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1. Introduction

We study information asymmetry in the equity market around operational risk announcements in US public financial firms. Better disclosure practices of financial information improve liquidity, provide a monitoring role over the behavior of senior management, and help maintain the trust of stakeholders—shareholders, supervisors, governments, and depositors. Diamond (1985) argued that releasing information makes shareholders better-off by maximizing their welfare. Recent US regulatory initiatives that address disclosure include the Gramm–Leach–Bliley Act (GLBA) of 1999 that broadens the range of permissible banking activities and adds provisions regarding information-sharing, the Health Insurance Portability and Accountability Act (HIPAA) of 1996 that deals with security and privacy of data in the healthcare industry, the Basel II Capital Accord of 2001 that mandates regulatory capital for risks

and their market disclosure, the Sarbanes–Oxley Act (SOX) of 2002 that mandates disclosures of internal control weaknesses in compliance with the SEC's disclosure laws,¹ and the Dodd–Frank Act of 2010 that calls for stricter reporting and disclosure requirements in the financial industry, along with a mortgage reform and consumer protection rules.

The Basel Committee on Banking Supervision (BCBS) mandates the measurement and management of operational risk, defined as the risk of loss resulting from inadequate or failed internal processes, people, systems, or from external events. Operational risk may arise from diverse causes, such as unauthorized transactions, business disruptions due to technology and software failures, flawed financial models and products, poor business practices, natural disasters, employment issues and discrimination, and execution and delivery failures. Along with credit, market, and liquidity risks, operational risk has been acknowledged as a major source of material failures in financial firms. Trading errors and

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¹ SOX's relevant sections are Section 302 (Corporate Responsibility for Financial Reports) and Section 404 (Management Assessment of Internal Controls).

excessive risk-taking that led to a \$6.2 billion trading fiasco for JPMorgan Chase in 2012 (“London Whale”), Bernard Madoff’s \$50 billion Ponzi scheme in 2008, a \$7.2 billion trading loss at Société Générale in 2008, and the colossal losses from the September 11, 2001 terrorist attacks, are some recent examples. Chernobai et al. (2011) showed that operational risk events are manifestations of internal control weaknesses and can be traced to improper business practices, weak economy, poor governance, and excessive risk-taking of executives. Wang and Hsu (2013) also found that stronger governance helps reduce occurrence of operational risk in financial firms. Basel II Capital Accord’s Pillar III calls for more stringent market discipline and transparency via public disclosures of operational risk:

“The Committee aims to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution. In principle, banks’ disclosures should be consistent with how senior management and the board of directors assess and manage the risks of the bank.” (BCBS, 2006b, p. 226).

To date, much of academic work on operational risk has been focused in the area of Pillar I of the Capital Accord that deals with the quantification of the regulatory risk capital. Recent studies of the equity market reaction to operational risk public announcements (Perry and Fontnouvelle, 2005; Cummins et al., 2006; Gillet et al., 2010) found that such news spur large drops in market prices, in particular for internal fraud events. Cummins et al. (2006) showed that the cumulative abnormal returns are over 1% for banks and over 3% for insurers, and Gillet et al. (2010) found the cumulative abnormal returns to exceed 4%. Motivated by recent regulatory advancements and prior research on operational risk, our question is: if operational risk announcements are informative releases, then do such releases affect information asymmetry between informed and uninformed traders in the equity market, and how?

Information asymmetry arises from differential information between informed and non-informed traders. In classical information asymmetry models (e.g., Copeland and Galai, 1983; Glosten and Milgrom, 1985), informed traders (e.g., large shareholders, financial analysts, creditors, and managers at competing firms) possess superior price-relevant firm-specific information not available to non-informed traders, or can extract private information from public releases. They profit from trading on private information (not yet) available to uninformed traders (e.g., market makers and discretionary liquidity traders). Market makers bear losses incurred due to the informational disadvantage when they make public the prices at which they commit to sell or buy; however, they offset them by imposing a bid-ask spread—wide enough to recoup the losses but tight enough to maintain fair liquidity demand. Hence, bid-ask spreads widen when market makers perceive higher levels of information asymmetry. Market makers may also reduce the quoted depth, thus adversely affecting liquidity.

Information asymmetry has been studied predominantly in the context of corporate earnings announcements. Bessembinder and Kaufman (1997), Stoll (2000), Venkataraman (2001), Chung et al. (2013) and Bhattacharya et al. (2012, 2013) found increased levels of information asymmetry around such announcements.² Kim and Verrecchia (1994), Lee et al. (1993), Krinsky and Lee (1996) and Affleck-Graves et al. (2002) showed that market makers react to

increased information asymmetry around earnings releases by temporarily widening the bid-ask spread. By doing so, they attempt to protect themselves against informed investors who may be responsible for the high volumes and volatility in trading (Lee et al., 1993; Easley and O’Hara, 1992; Harris and Raviv, 1993).

Earnings announcements are scheduled releases. For scheduled announcements, elevated trading prior to the release is primarily due to informed traders who trade to profit from information leakage, but may also be enhanced by uninformed traders who try to gamble on the upcoming news. In contrast, operational risk announcements are unscheduled and almost always constitute bad surprises to investors. When an event is unscheduled, any excess trading prior to the announcement is accounted for by informed traders. Literature on unscheduled announcements is sparse. Chae (2005) studied information asymmetry around the announcements of acquisition, target, and Moody’s bond ratings changes, and Brooks et al. (2003) investigated CEO deaths, plane crashes, and plant explosions. These studies found that information asymmetry increases in general, but their data consisted of announcements of many diverse causes without focusing on a single one. Our study differs from these by focusing on a single well-defined class of unscheduled announcements—operational risk events. In addition to studying information asymmetry around the first press cutting of such events, we also study it around the settlement announcements (that are more anticipated).

“Banks’ disclosures should be consistent with how senior management and the board of directors assess and manage the risks of the bank.” (BCBS, 2006b, p. 226) The quality of information disclosed by the management is positively associated with the strength of corporate governance (Klein, 2002; Ajinkya et al., 2005; Karamanou and Vafeas, 2005). Kanagaretnam et al. (2007) found that firms with more active and independent boards and with higher insider holdings incur less information asymmetry around quarterly earnings releases. Prior research showed operational risk to be inversely related to the strength of corporate governance (Chernobai et al., 2011; Wang and Hsu, 2013). Establishments of operational risk committees and Chief Operational Risk Officer positions should reduce lower-tail risk and also promote better communication of risk to the senior management and key stakeholders. This study examines whether better governance and risk management initiatives improve disclosure quality and reduce information asymmetry around operational risk announcements.

We use a rich sample of 331 operational risk announcements from US financial firms during 1995–2009 and examine their trades and quotes on NYSE, AMEX, and NASDAQ exchanges. We study separately the first press cutting and settlement announcements. We find that information asymmetry—measured by effective spread and price impact of trade (and their changes from the non-event period)—significantly increases around operational risk first announcements but decreases around the settlement announcements, particularly for internal fraud events and events related to flawed business practices. Furthermore, firms with stronger governance (higher board independence ratio, higher equity incentives of insiders, and higher institutional ownership) experience lower levels of information asymmetry around the first announcements, and around settlements better governed firms see a smaller reduction in information asymmetry, but that the effect of risk management initiatives is limited. We interpret this as evidence of the risk management function being primarily driven by the need for regulatory compliance.

To the best of our knowledge, this is the first study that investigates market microstructure around operational risk announcements in financial firms. Identifying the factors affecting information asymmetry around such events may help regulators develop policies that would ensure a transparent and liquid securities market, which would provide investors with greater

² Recent studies of corporate earnings restatement announcements (Palmrose et al., 2004; Anderson and Yohn, 2002) also found that information asymmetry is increased around such news releases.

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