



Operational risk and reputation in the financial industry

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ABSTRACT

By examining stock market reactions to the announcement of operational losses by financial companies, this paper attempts to disentangle operational losses from reputational damage. Our analysis deals with 154 events coming from the FIRST database of OpVantage. Events occurred between 1990 and 2004 in companies belonging to the financial sector and that are listed on the major European and US Stock Exchanges. Results show significant, negative abnormal returns at the announcement date of the loss, along with an increase in the volumes of trade. In cases of internal fraud, the loss in market value is greater than the operational loss amount announced, which is interpreted as a sign of reputational damage. Negative impact is proportionally greater when the loss amount represents a larger share in the company's net profit.

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1. Introduction

Major operational events have drawn a lot of attention in the press and in the academic literature: the Barings bank losing 1.4 billion USD from rogue trading in its branch in Singapore leading to the failure of the whole institution (Ross, 1997; Stonham, 1996; Sheaffer et al., 1998); Allied Irish Banks losing 750 MM USD in rogue trading (Dunne and Helliard, 2002), or Prudential Insurance incurring 2 billion USD settlement in class action lawsuit (Walker et al., 2001), to name a few. These events, as well as developments such as the growth of e-commerce or changes in banks' risks management have led regulators and the banking industry to recognize the importance of operational risk in shaping the risk profiles of financial institutions. Reflecting this recognition, the Basel Committee on Banking Supervision, in its proposal for A New Capital Accord, has incorporated into its proposed capital framework an explicit capital requirement for operational risk. Consequently, financial markets put henceforth a closer focus on this type of risk. While all these events are classified as operational, their consequences go far beyond the mere mechanical effect on the bank's P&L. They affect the reputation of the financial institu-

tion that bears them. Sometimes even the business continuity of the institution suffers more from the indirect backlash than from the direct loss.

From a strict regulatory point of view, the Basel Committee for Banking Supervision (BIS) deliberately ignores these side effects. It defines operational risk as: "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, 2005, p. 140). Thus, this definition specifically dissociates operational risk from reputational risk. It follows that banks are not required to allocate regulatory capital to hedge reputational risk.

Murphy et al. (2004), specifically focusing on reputational damage, examine the market impact of allegations of firms misconduct such as anti-trust violations, bribery, copyright infringements, or accounting fraud. Their contribution builds on a previous line of results showing significant negative price impacts of firms accused of fraudulent activities (Skantz et al., 1990; Karpoff and Lott, 1993; Reichert et al., 1996). The study of Murphy et al. (2004) comprises firms of all sectors between 1982 and 1996 using the Factiva database. The authors find significant declines in reported earnings, increased stock return volatility, and declines in analyst's estimates. Larger firms experience smaller negative impacts since losses behave as fixed costs. A strong brand name mitigates the impacts and is interpreted as a protection against reputational damage.

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Yet to our knowledge, only two papers examine the reputation impact on market returns of operational events affecting financial institutions. Using external public data, Cummins et al. (2006) and de Fontnouvelle and Perry (2005) analyze stock market reactions to operational loss announcements. Cummins et al. (2006) compare the price impact of operational loss announcements larger than 10 millions USD in listed US banks and insurance companies. Banks experience smaller negative impact than insurance companies. The authors interpret this result as a positive consequence of better operational risk management actions in banks following the new regulation of Basel II. Both types of companies however experience significant negative price reactions and market value drops exceeding the amount of the operational losses. The effect is larger for firms with a high Tobin's Q, suggesting that the expected cash-flows correction is larger for high growth firms. Based on an event study of operational loss announcements for 115 banks listed on developed financial markets worldwide, de Fontnouvelle and Perry (2005) find that the announcement date only has a significant, negative impact on the price. The explanatory variable is the "loss ratio", defined as the ratio between the loss amount and the market capitalization of the firm. A market value loss greater than the operational loss announced is interpreted as evidence of reputational damage. The authors show that negative price impacts are larger when the operational loss is due to internal fraud. Additionally, a loss in market value appears to be up to six times larger than the actual loss amount when the internal fraud event takes place in a country with strong shareholders rights.

Our paper follows this line of research by examining stock market reaction after the announcement of operational losses in listed financial companies. Our analysis focuses on 152 financial companies listed on major Stock Exchanges where we expect to witness a broad and reliable coverage of corporate events by analysts and financial press. We propose a refined measure of reputational risk, by accounting for the difference between the market value loss and the announced loss amount of the firm. This adjustment allows us to isolate the pure reputational effect of the operational loss event on market returns.

Departing from the extant literature, we perform in-depth investigation of the sequence of events triggering reputational effects. For a given operational loss, we define three events per firm: first press cutting, explicit recognition by the company, and settlement date. The identification of three distinct event windows for the same operational loss gives us a valuable opportunity to analyze the influence of gradual release of information on the market reaction towards the reputation of a financial institution, as also investigated in Chernobai and Yildirim (2008). This distinction between event dates also enables us to discriminate the impact, for the same kind of event (press cutting, recognition or settlement), of the various qualities of information regarding this event (from an accurate and recognized figure to complete uncertainty).

The type of operational event, its location, and the proportion of the loss in the firm's market value are also taken into account. Moreover, for each event date, we discriminate the losses on the basis of the investors' knowledge of the real loss amount, including the process of the resolution of uncertainty on the market over time. This type of disclosure is extremely valuable in the event study setup, as it integrates the level of informational efficiency on the stock market. We give a specific attention to the "Clients, Products and Business Practices" and "Internal Fraud" event types, as the first represents 72% of our sample, and the latter was given specific attention in de Fontnouvelle and Perry (2005). Furthermore, our event study includes impacts on trading volumes, and investigates on changes in market alphas and betas through a Cusum of squares test.

This paper is organized as follows: Section 2 describes the sample construction, presents descriptive statistics on that sample and explains the methodology used for our event study. Section 3 presents our results for the whole sample and the different sub-samples constructed on the basis of the knowledge of the loss amount, the event type and the relative loss size. Section 4 provides evidence from the variation of volumes and sensitivity coefficients around the event dates. Finally, we report results from the cross-section analysis of abnormal returns in Section 5.

2. Data and event study methodology

2.1. Database

The empirical analysis uses OpVantage First, a data set provided by the Fitch Group. This resource provides 8000 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.

Our aim is to gather a workable sample of events affecting US and European financial institutions. In order to construct our sample, we use a first series of criteria to filter this data collection: the company group is incorporated either in United States or in Europe; the companies that suffered the loss belong to the financial industry; in a concern of sufficient impact on the firms, operational losses have to be higher than 10 millions US dollars¹; the loss has to be settled no sooner than January 1994. From this first sample, we eliminate the losses for which the companies are not publicly listed and removed the "September 11th" events, as no market data are available for the 5 days following this event.

After removing additional firms belonging to the same group, and in order to focus on the largest effects, our final sample is composed of the 103 largest losses having occurred between April 1994 and July 2006, in 64 US companies from 44 different groups and the 49 largest losses in 47 European companies from 33 different groups.² Daily stock prices come from Thomson Financial DataStream. For each company we select the data from the domestic exchange. The returns for each company i at time t are continuously compounded. The market benchmarks are the S&P500 for United States and the FTSEurofirst 100 for Europe. Both series are extracted from DataStream. As the European market benchmark is expressed in Euros, an additional filter is set for the non-euro European countries for which we have not an exchange rate: Switzerland, England and Sweden before January 1999. For the risk free rate, we use the annualized 3-months LIBOR for European countries and the 3-month US T-Bill for US companies.³ These rates are extracted from the FRED database.

For each loss, three event dates are identified:

- The first press cutting date, available through the source of OpVantage First. We double-check this date manually through the Nexis Lexus database and correct it if necessary. For each case study, we select the date of the first press cutting mentioning the operational loss event. We further call it "Press date".
- The recognition by the company date, corresponding to an announcement of the loss (the event or the amount) by the company itself. We find this date (when available) in the complete description and history of the loss event, provided by OpVantage. We refer to it as "Recognition date".
- The settlement date, directly given by OpVantage.

¹ Smaller losses were first considered in the sample but were removed as we were confronted to a loss of explanatory power. The same threshold as ours was also used by Cummins et al. (2006).

² Descriptive statistics on loss sizes are given further in Tables 2 and 3.

³ The use of the 10-year T-Bond did not significantly change our results.

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