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RISK MANAGEMENT DISCLOSURES AMONG THE FINANCIAL INSTITUTIONS: AN OVERVIEW

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ABSTRACT

The global financial crisis has raised questions on the risk management disclosures of the financial institutions. As a result, the importance of adequate and transparent risk disclosures among the financial institutions has been exclusively highlighted. The paper discusses about the concept, need, benefits and the existing literature on Risk Management Disclosures. An adequate and timely risk disclosure help the stakeholders to make informed decisions and benefits the institution through improved reputation, enhanced confidence and improved communication to the stakeholders and lower financing cost. However, the existing literature provides evidence for inadequate risk disclosures being qualitative in nature. Hence, it is suggested that the qualitative risk disclosures should be supplemented by quantitative risk disclosures to be of relevance to the stakeholders in decision making. Moreover, regulatory bodies should enhance the risk disclosure requirements for the financial institutions by making it mandatory in nature.

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1. INTRODUCTION

During the course of the operations, financial institutions are invariably faced with different types of risks that may have a potentially adverse effect on their business. These risks can negatively affect the institution and damage its reputation in the market. The major risk types among the financial institutions may be categorized as Credit risk; Market risk; Operational Risk; Liquidity risk; Interest rate risk and other risk categories (example strategic and reputational risk). Risk management process in the financial institutions includes risk identification, measurement, and assessment, monitoring and control with an objective to minimize the negative effects of risks on the financial result and capital of the financial institution. They are, therefore, required to form a special organizational unit in charge of risk management and required to prescribe procedures for risk identification, measurement, and assessment, as well as for monitoring and control.

Management Accounting Guideline: AICPA (2006) clearly explains risk reporting as: "All process associated with communicating risks of a business to stakeholders. It can be broadly divided in to two areas - internal and external reporting. Internal risk reporting is where Organizational risks are reported to the management and board to support corporate decision-making. External reporting is where Organizational risks are communicated to external stakeholders like investors, potential investors, customers, and financiers to help them make calculated decisions about their investments and continuity of business relationship." However, the present paper focuses on External Reporting referred to as Disclosure made to the external stakeholders.

Disclosures form the Pillar III of Basel Capital Accord. Pillar III ─ market discipline complements Pillar I (the minimum capital requirements) and Pillar II (the supervisory review process) of Basel Capital Accord. Pillar III defines the disclosure requirements an institution must meet which will allow market participants to assess key information on the capital adequacy of the institution. Basel 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[1]. This indicates the importance attached to the Risk Management Disclosures by the regulatory bodies.

1 BCBS International Convergence of Capital Measurement and Capital Standards: A Revised Framework (June 2004)

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Moreover, the importance of Transparency in Risk Disclosures has been stressed upon by a number of commentators. Transparency is defined as the disclosure of all information that will ensure the proper accountability of institutions to their boards, investors, shareholders, regulators and other stakeholders[2]. Transparency of risk positions and risk management processes is very important to investors, clients and other stakeholder groups of financial institutions. For the effectiveness of market discipline, institutions need to make transparent disclosures. Economic Research - Federal Reserve Bank of San Francisco (2003) suggests that "banks must be sufficiently transparent; that is banks must provide a sufficient amount of accurate and timely information regarding their conditions and operations to the public".

Risk Disclosures made to the External Stakeholders also forms an important element of a sound Risk Management Framework. Transparent Disclosures on the risk management positions and the risk management policies and practices implemented is required by the external stakeholders for the purpose of decision making. KPMG (2012) indicates that Supervisors; Auditors; Rating agencies; Clients and Shareholders are the External Stakeholders of the institution. Hence, it is essential that financial institutions adequately and timely disclose their practices and policies with respect to Risk Management to their stakeholders.

2. TYPES OF RISKS –

The basic constituents of a risk management system are risk identification of the risks that an institution is exposed to, risk assessment, risk monitoring and risk mitigation. Hence, understanding the different types of risks is essential. These include:

1. Credit Risk - Credit risk also called as the default risk which involves failure of a customer or counterparty to meet its obligations in relation to lending, trading etc. It includes prediction of the possibility that the customer will pay back the loan amount and interest.

2. Market Risk - Market risk is the risk of losing value on financial instruments because of adverse changes in the prices of equities, interest rates, commodity prices, and foreign exchange changes.

2 The role of transparency in the financial Sector by Transparency International; EU Office; Group of Experts on Banking Issues (GEBI) dated 01 June 2011

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3. Operational Risk - Operational risk has been defined by the Basel Committee on Banking Supervision, "as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events."

4. Liquidity Risk – It may be defined as the risk that an institution will not be able to meet its contractual obligations because of inadequate liquidity (amount and composition of funding).

5. Capital risk – It is the risk that an institution has an insufficient capital in terms of level and composition to carry out its business operations.

6. Country risk – It is the risk that a sovereign event causes changes to the value of contractual obligations, adversely affecting the markets of a particular country.

7. Compliance risk - It is the risk of failure to compliance with the existing applicable rules and regulations.

8. Conduct risk - It is that risk that arises because of an employee's actions negatively affecting the institution causing harm to its value and reputation.

9. Legal risk - It is that risk arising from imposition of damages, penalties, or other liabilities of the firm arising from non-compliance of rules and regulations.

10. Model risk – It is the risk of loss from adverse consequences of decisions based on incorrect model outputs.

11. Reputation risk – It is the risk of losses arising from adverse effects to the reputation of an institution.

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Hence, there is variety of risks faced by financial institutions and the institutions should clearly indicate how they are managing these risks through appropriate risk management disclosures in the annual report.

3. RISK MANAGEMENT STRUCTURE-

As suggested by Reserve Bank of India, the organizational structure for a risk management function shall compromise of the following:

1. Board of Directors
2. Risk Management Committee of the Board
3. Risk Management Committee
4. Risk Management Department
5. Risk Managers
6. Support Group for Risk Management

It is the responsibility of each of the financial institutions to create a successful Risk Management Structure to effectively manage the risks faced.

4. NEED FOR RISK MANAGEMENT DISCLOSURES

The recent financial crisis has greatly emphasized the importance of adequate and transparent risk disclosures among the financial institutions. Transparent risk disclosures encourage the financial institutions to function in a safe and sound manner as well as enhance the confidence levels of investors in the market. Enforcing transparent risk disclosures can lead to system stability and minimize the probability of systemic crisis among the financial institutions. Further, Management Accounting Guideline, AICPA (2006) also emphasizes that stakeholders require increased corporate disclosure to take more informed decisions.

As suggested by KPMG (2008), 'if the quality of risk management systems in an institution is poor, then it is likely that the risk disclosure will be inadequate; however, when risk management systems in place are effective, adequate risk disclosures help in gaining market confidence[3]. This

3 Financial Institution Risk Disclosure Best Practice Survey; KPMG(2008)

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indicates that sound risk management systems enhance the quality of risk disclosures whereas inadequate disclosures point out towards the inferiority of the risk management systems put in place by the institutions in other words, risk disclosures signal about the soundness of risk management systems employed by the institutions. Thus, Risk Disclosures provide an insight into the risk management policies and practices adopted by the institutions.

Jaime Caruana, [General Manager, Bank of International Settlement] in a Keynote speech on 'Financial Stability and Risk Disclosure' (December 2011) indicates that quality risk disclosures are good for markets, for the prudential supervisors and for financial stability, as it decreases the effects of unexpected events.

Further, prior literature on risk disclosures provides enough evidence of a strong relationship between financial institutions' system stability and level of risk disclosures. Cordella and Yeyati (1998) reveal that the likelihood of banking crisis is less where there are higher transparency and regulatory disclosures. Nier (2005) provides evidence of positive effects of transparent disclosures on banking stability. Tadesse (2006) proves that mandatory disclosures are strongly associated with banking system stability. Homolle (2009) concludes that risk reporting does not generally decrease bank's risk exposure or lessen the probability of bank runs but may lead to an increase in insolvency risk of risky banks. Hence, the previous research studies confirm that transparent risk disclosures lead to financial institutions' system stability. Thus, risk management disclosures are essential for financial institutions for a Stable Environment.

For all the above reasons, risk management disclosures are essential. Thus, financial institutions should provide appropriate, adequate, and timely disclosures to the various stakeholder groups. Moreover, the regulatory body should ensure that these institutions make adequate risk disclosures relevant for all the stakeholders.

5. BENEFITS OF RISK MANAGEMENT DISCLOSURES

A variety of benefits accruing from Risk Disclosures are reported through the existing literature and reports of global consultancy companies. These sources include KPMG Financial Institution Risk Disclosure Best Practice Survey (2008); Management Accounting Guideline, AICPA (2006); KPMG Business Dialogue, Operational Risk (2012) and Keynote speech by Jaime Caruana on 'Financial Stability and Risk Disclosure' (December 2011). The Benefits comprise of:

1.) Compliance with the Regulation – The third pillar of Basel Framework i.e. market discipline requires the financial institutions to make adequate risk disclosures allowing market

participants to make informed decisions. To promote market discipline, regulators want timely and sufficient disclosures from the financial institutions. Hence, by making adequate risk disclosures, financial institutions are able to comply with the regulation and decrease their costs of regulatory penalties.

2.) Enhanced Reputation – Financial Institutions providing adequate risk disclosures enjoy increased reputation with regard to their competitors. A strong reputation is the biggest asset of the bank. Management Accounting Guideline on Risk Reporting, AICPA (2006) suggests that institutions are able to benefit from Risk Disclosures to stakeholders in the form of increased sales from existing and new customers, staff retention and enhanced recruitment.

3.) Maintains Market Confidence – Adequate disclosures to the stakeholders helps in sustaining the confidence of the stakeholders in the institution. This leads to earnings stability and hence increases the shareholders' value. Thus, adequate risk disclosures lead to valuation efficiency.

4.) Lower Cost of Capital – Enhanced reputation reduces the cost of equity funding for the institutions and, thus, benefits the institution in the form of reduced financing cost.

5.) Promotes Market Discipline – Risk Disclosures promote market discipline and helps the investors to make more informed decisions.

6.) Managing Reputational Risk – Providing accurate and timely risk disclosures lessens the institutions' exposure to reputational risk. This is because disclosures minimize the shock from unexpected information.

7.) Improved communication to the external stakeholders – Institutions are able to communicate their risk management practices and policies to the external stakeholders by the way of adequate risk disclosures.

8.) Increased accountability to the Supervisors – Adequate risk disclosures make the financial institutions more responsible for their actions to the supervisory bodies and other stakeholders.

9.) Leads to Financial stability – Risk Reporting promote stability among the entire financial system.

6. LITERATURE REVIEW

A number of studies have examined the issue of disclosure of risk information in the annual reports of financial as well as non-financial institutions. Although, Basel Committee was the first to study the Risk Disclosures made by banking institutions in their annual reports, thereafter, a number of research studies examining various Risk Disclosures of financial as well as non-financial institutions and the factors affecting these disclosures appeared. These studies have been carried out for diverse risk categories covering different countries and differing periods of study. A summary of these studies is presented in Table 1:

Table 1: Summary of Studies on Risk Disclosures

Author (s) and Year	Disclosure Category	Method, Period and Sample for Study	Main Findings
Basel Committee on Banking Supervision (2001); [similar studies carried out in 2002 & 2003]	Overall Risk Disclosures	Survey of annual reports; annual reports- 1999; 57 internationally active banks	Lack of disclosures with regards to credit risk modelling, use of internal and external ratings, derivative and securitization; disclosure levels above 60% for operational, interest rate and liquidity risks
Beretta and Bozollan (2004)	Voluntary Risk Disclosure	Content Analysis Approach, Disclosure Index and regression; annual reports- 2000; 85 non financial companies listed on Italian Stock Exchange	Disclosures reported are narrative; firms' voluntary disclose the future strategies but not about their expected impact; disclosures biased towards management's self-justification; firms prefer to disclose management's future expectations rather than conveying the risk management decisions and actions taken
Lajili and Zeghal (2005)	Overall Risk Disclosures and Risk Management Information	Content Analysis Approach and regression; annual reports- 1999; TSE 300 Canadian companies	Risk information disclosed is almost qualitative in nature; located in the notes to the financial statements and/or in the MD&A; most frequently cited risk categories are financial risk, commodity and market risk; risk disclosures lack valuable quantitative insights
Helbok and Wagner (2006)	Operational Risk Disclosures	Content and Extent Analysis, Disclosure Index and random effects ordered logit model; annual reports: 1998 to 2001; 59 banks covering North America, Asia and Europe	Both extent and content of banks disclosure increased substantially; institutions with lower equity ratio and /or are less profitable choose higher levels of operational risk disclosure.
Linsley and Shrives (2006)	Overall Risk Disclosures	Content Analysis using risk disclosure sentences	Positive significant correlation between risk disclosures and

Author (s) and Year	Disclosure Category	Method, Period and Sample for Study	Main Findings
		and Pearson correlation and Wilcoxon signed ranks test ; annual reports: 2000; 79 non-financial firms listed within FT-SE 100 Index	company size and risk disclosures and level of environmental risk; no association between risk disclosures and gearing ratio, asset cover, quiscore, book to market value of equity and beta factor
Sundmacher and Ford (2006)	Operational Risk Disclosures	Content Analysis Approach, Disclosure Index; annual reports:2004 & 2005; 57 internationally active banks across 5 countries	Quantity and quality of operational risk disclosures vary significantly across institutions; disclosures are descriptive in nature and need to be supplemented by quantitative information in order to be useful
Abraham and Cox (2007)	Narrative risk information comprising of business risk , financial risk and internal control risk reporting	Content Analysis Approach and regression; annual reports: 2002; 71 firms listed on FTSE 100 index in UK	Pattern of risk disclosures depend upon the form that reporting regulation takes; corporate risk reporting is negatively related to share ownership by long-term institutions and positively related to independent directors
KPMG (2008)	Bank specific (credit, market and ALM risk); insurance specific (insurance, investment & ALM & liquidity risks); common risk (business risk, operational risk and overall risk and capital strategy)	Content Analysis Approach, Disclosure Index; annual reports:2007; 25 European banks and 14 insurance companies	Higher levels of risk disclosure in banking sector than insurance sector; regulation is an important driver for risk disclosure; Poor structure and lack of forward looking information reduces the quality of risk disclosures
Woods (2008)	Market Risk Disclosures	Content Analysis Approach, construction of score sheet; annual reports: 2000, 2003 & 2006; world's top 25 banks	Diversity in the market risk disclosure practices, both numerical and narrative; that is why progress towards international harmonisation remains apparent with regards to market risk disclosures; no relation between the level of disclosure and bank size
Hossain (2008)	Overall risk disclosures	Content Analysis Approach; Disclosure Index and regression; annual reports: 2003; 38 listed banks in India	Higher compliance to mandatory disclosure and lower compliance for voluntary disclosures; size, profitability, board composition, and market discipline are significant in explaining the level of disclosures, whereas age, complexity of business and asset-in-place are insignificant in explaining disclosures

Author (s) and Year	Disclosure Category	Method, Period and Sample for Study	Main Findings
Hassan (2009)	Corporate risk disclosures	Content Analysis Approach; Disclosure Index and regression; annual reports: 2005; 41 listed UAE corporations	Insignificant relationship between corporate size and level of disclosure and reserves; level of risk and industry type are significant in explaining disclosures
Oorschot (2009)	Market, credit and liquidity risk disclosures	Content Analysis Approach; Disclosure Index (disclosure quality and disclosure quantity framework) and regression; annual reports: 2005–2008; 8 German banks	Regulation (GAS 5-10, IFRS 7) is the main driver for the increased disclosures for German banks; not the size and profitability of a bank
Oliveira, Rodrigues and Craig (2011)	Voluntary disclosure of operational risk and capital structure and adequacy	Content Analysis Approach; Disclosure Index and regression; annual reports: 2006; 111 Portuguese banks	Low levels of disclosure; public visibility (assessed by size and company listing status) and reputation (assessed by company age, depositor confidence level, and company risk management abilities) significantly affect disclosures
Hemrit and Arab (2011)	Operational risk disclosures	Content Analysis Approach; Disclosure Index and regression; annual reports: 2000-2009; 14 Tunisian insurance companies	Substantial increase in disclosure levels; significant relationship between disclosures and size, intensity of provisions & leverage; insignificant relationship between disclosures and profitability & cost of capital
Haija and Hayek (2012)	Operational risk disclosures	Content Analysis Approach; Disclosure Index; annual reports: 2010; 12 Jordanian banks	Content of Jordanian banks' disclosure on operational risk is substantially good but primarily meets the requirements of Central Bank of Jordan which are not enough as compared to BCBS
Barakat and Hussainey (2013)	Operational risk disclosures	Content Analysis Approach; Disclosure Index and two stage random-effects model with generalized least squares (GLS); annual reports: 2008-2010; 85 European banks	High variation in disclosure quality; banks with higher proportion of outside board directors, lower executive ownership, concentrated outside non-governmental ownership, more active audit committee and operating under less stringent entry to banking requirements provide higher quality of operational risk disclosures
Ismail, Rahman and Ahmad (2013)	Overall Risk Disclosures	Content Analysis Approach; Disclosure Index; annual reports: 2006-2009; 17 Islamic	Risk disclosure has greatly improved from around 80% to more than 90%; hence Islamic financial institutions have enhanc

Author (s) and Year	Disclosure Category	Method, Period and Sample for Study	Main Findings
		financial institutions in Malaysia	their disclosure considerably
Hassan (2014)	Overall Risk Disclosures	Content Analysis Approach; Disclosure Index and regression; annual reports: 2006-2010; 27 Egyptian listed companies	Low level of improvement in disclosure quality; disclosures are relevant and understandable to some extent but less comparable and verifiable; firm size and leverage are the most important determinants of disclosure quality
Buckby,.Gallery, .and Ma (2015)	Overall Risk Disclosures	Content Analysis and Regression Analysis; 300 Australian Securities Exchange -listed companies by market capitalisation	Widespread divergence in disclosure practices; low conformance with the Principle 7 of the ASX Corporate Governance Principles and Recommendations. Also companies do not disclose all "material business risks"
Raemaekers, Maroun and Padia (2015)	Overall Risk Disclosures	Content Analysis; annual reports 2010-12; few large firms listed on the Johannesburg Stock Exchange	Increase in disclosure over the period; possibility of reporting on the governance of risk being a compliance-based exercise rather than an effective stakeholder communication
Jia, Munro and Buckby (2016)	Overall Risk Disclosures	Semantic content analysis; annual reports 2010-12; 100 Australian Securities Exchange (ASX) listed companies	Disclosures are considerably lacking in quality, from the dimension "quantity", "width" and "depth" dimension and sub-dimensions
Kakanda, Salim and Chandren (2017)	Overall Risk Disclosures	Content Analysis Approach; Disclosure Index; annual reports 2012-15; 45 listed financial service Nigerian firms	Significant disclosure w.r.t. risk management committee structure and its responsibility, risk management policies, audit committee availability and function, and capital/market risks
Rujjina and Sukirman (2020)	Enterprise Risk Management Disclosures	Content Analysis and Regression Analysis; annual reports 2013-17; manufacturing firm registered on Indonesia Stock Exchange	Firm size and firm age have significant positive effect on enterprise risk management disclosure, while leverage, profitability, domestic institutional ownership structure, foreign ownership structure, local individual ownership structure hadvea significant negative effect
Nahar and Azim (2022)	Executives' perceptions of risk management disclosures	Semi-structured in-depth interviews with 36 executives involved in risk management disclosures, policy-making	Corporate risk management disclosures still at a low level.; reasons for non-disclosure may be related to institutional weaknesses, lack of disciplinary action and Political interference.

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The above studies may be segregated as studies examining the overall risk disclosures and studies examining disclosure of a specific risk type. The studies based on overall risk disclosures [eg. BCBS (2001); BCBS (2002); BCBS (2003); Beretta and Bozollan (2004); Lajili and Zeghal (2005); Linsley and Shrives (2006); Hossain (2008); Hassan (2009); Ismail, Rahman and Ahmad (2013); Hassan (2014); Raemaekers, Maroun and Padia (2015); Raemaekers, Maroun and Padia (2015); Jia, Munro and Buckby (2016); Kakanda, Salim and Chandren (2017)] provide evidence for the qualitatvie nature of overall risk information. The remaining studies relate to the disclosure of specific risk type [eg. Sundmacher and Ford (2006); Helbok and Wagner (2006); Abraham and Cox (2007); KPMG (2008); Woods (2008) and Oorschot (2009); Oliveira, Rodrigues and Craig (2011); Hemrit and Arab (2011); Hajia and Hayek (2012); and Barakat and Hussainey (2013) and Rujjina and Sukirman (2020)]. These studies examine the disclosure quality and the factors affecting the disclosures on various risk categories. Majority of these studies also observe that risk disclosures are descriptive but regulation is an important driver for risk disclosure. However, with regards to the determinants of disclosure on various risk categories, mixed results have been observed. On the whole, size; profitability; age of the institution; leverage; effective Audit Committee among others are important factors affecting quality and quantity of risk disclosures among financial institutions.

7. CONCLUSIONS

The disclosures on Risk Management are important in understanding the strength of Risk Management Framework and the associated policies and practices employed by the institutions. The stakeholders of the institution are able to assess its ability to effectively manage various risks and, hence, make more informed decisions. The benefits of adequate and timely risk disclosures to the institution include improved reputation, enhanced confidence of stakeholders, improved communication to the stakeholders and lower financing cost.

On examining the existing literature, it is evident that the risk management disclosures among the financial institutions are predominantly descriptive in nature [Beretta and Bozollan (2004); Lajili and Zeghal (2005); Linsley and Shrives (2006); Hossain (2008); Hassan (2009); Ismail, Rahman and Ahmad (2013); Hassan (2014)]. The findings also indicate inadequacy of operational risk

disclosures [Sundmacher and Ford (2006); Oliveira, Rodrigues and Craig (2011); Hajia and Hayek (2012) and Barakat and Hussainey (2013); Buckby,.Gallery, .and Ma (2015); Jia, Munro and Buckby (2016)]. It is observed that the quality of risk disclosures is dependent upon the Reporting regulations in the country. Moreover, the quality and quantity of risk disclosures varies significantly across financial institutions in a country.

Therefore, it is suggested that the qualitative risk disclosures should be supplemented by quantitative risk disclosures to be of relevance to the stakeholders in decision making. It is also recommended that the regulatory bodies should enhance the risk disclosure requirements for the financial institutions by making it mandatory in nature. This will help in ensuring better quality and quantity of risk disclosures among the financial institutions.

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