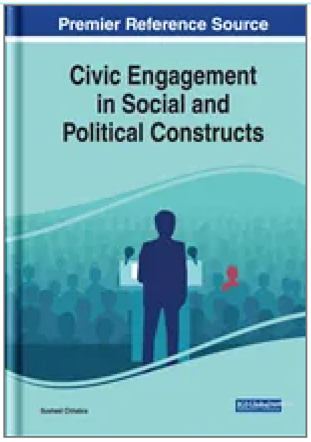

Operational Risk Disclosure Practices in Emerging Economies: A Study of Indian Banks

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Abstract

Risk disclosures provide an insight into the risk management policies and practices adopted by institutions and are useful in assessing the risk for various stakeholder groups. With the increasing incidence and complexity of operational risks in banks, it is imperative for banks to establish and follow suitable operational risk disclosure practices. The chapter attempts to examine the operational risk disclosure practices and the impact of bank specific characteristics on disclosure practices among Indian banks. Findings indicate disclosure levels to be inadequate, showing an insignificant improvement over the years. Bank profitability and depositor confidence significantly impact disclosure practices. The authors suggest that Indian banks should enhance their current operational risk disclosure levels to communicate to the stakeholders about the strength of their operational risk management framework. The Reserve Bank of India may issue new guidelines with respect to minimum disclosure requirements on operational risk to improve the quality of disclosures.

Chapter Preview

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Introduction

The banks, world over are operating in an environment marked by growing restructuring, rising expectations, increasing regulatory requirements, proliferating financial engineering, rapid changes in technology and increased competition. This has significantly increased the risk of failures in the banking operations. Losses caused by operational failures have the potential to institutional failures. It is more so in the case of banks as the operations are voluminous and geographically well distributed. Therefore, adequate and timely risk disclosures are highly essential in the banking industry.

Risk disclosure is the process of external risk reporting and may be defined as a process "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" (Management Accounting Guideline; AICPA, 2006). Disclosures are made to form the Pillar III of Basel Capital Accord being the core of market discipline complementing Pillar I (the minimum capital requirements) and Pillar II (the supervisory review process). Pillar III encompasses the disclosure requirements an institution must meet which will allow market participants to assess key information on the capital adequacy of the institution[1].

The importance of Transparency in risk disclosures has also been stressed upon in a number of studies [Mallin (2002); Bernandi and LaCross (2005); Barth and Skipper (2008)]. However, it is difficult to find a proper definition of transparency in the existing literature. It may be understood as the disclosure of all information that will ensure the proper accountability of institutions to their boards, investors, shareholders, regulators and other stakeholders[2] Federal Reserve Bank of San Francisco, Economic Research (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". Thus, transparency of risk positions and risk management processes is important to investors, clients and other stakeholder groups and also for the effectiveness of market discipline.

The recent financial crisis has profoundly underlined the importance of adequate and transparent risk disclosures among the financial institutions. The prior literature also provides enough evidence of a strong relationship between banking 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 generally does not reduce bank's risk exposure or probability of bank runs, but may lead to an increase in insolvency risk of risky banks.

Key Terms in this Chapter

Operational Risk Management Framework (/dictionary/operational-risk-management-framework/82570): Framework comprises of all the aspects of Operational Risk Management i.e. the policies, processes and procedures associated with Operational Risk Identification; Assessment and Measurement; Monitoring; Reporting and Control.

Operational Risk Strategy (/dictionary/operational-risk-strategy/82573): Operational Risk Strategy provides strategic guidance regarding management of operational risk articulating the types and the tolerance limits of the each type of operational risk an institution undertakes.

Operational Risk Assessment and Measurement (/dictionary/operational-risk-assessment-and-measurement/82569): Operational Risk Measurement relates to quantification of operational risk. Operational Risk Assessment is a qualitative process broader than Operational Risk Measurement.

Operational Risk Identification (/dictionary/operational-risk-identification/82568): It relates to identifying the activities; processes; and business units vulnerable to operational risk.

Risk Disclosure (/dictionary/risk-disclosure/82575): Risk Disclosure involves communicating to the external stakeholders of the institution like investors, creditors, supervisors and regulators of the risk management policies, practices and risk exposure.

Operational Risk Organization Structure (/dictionary/operational-risk-organization-structure/82572): An appropriate Governance Structure with clear cut roles and responsibilities for Operational Risk Identification; Assessment and Measurement; Monitoring; Reporting and Control.

Operational Risk Mitigation / Control (/dictionary/operational-risk-mitigation--control/82574): It relates to the operational risk control environment of an institution characterized by the implementation of Operational Risk Control Strategies and regularly monitoring their effectiveness.

Operational Risk Monitoring (/dictionary/operational-risk-monitoring/82571): Operational Risk Monitoring relates to timely identification and correction of the irregularities in the processes and procedures associated with Operational Risk Management.