Operational Risk and Reputation in Financial Institutions: Does Media Tone Make a Difference?

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The chairman of TSB has reaffirmed his confidence in chief executive Paul Pester after a parliamentary committee called for him to be fired, even as he revealed the bank's recent IT problems had prompted more than 100,000 complaints.

The Treasury select committee earlier this month took the unprecedented step of declaring it had lost confidence in Mr Pester, who they accused of providing misleading figures and hindering its investigation into the outage that left hundreds of thousands of customers unable to access their bank accounts.

Last week, the select committee published a presentation produced by IBM days after it was brought in to help with the IT problems, which suggested TSB had not carried out enough tests and could have done more to reduce the risks of the data migration. Criticism of the bank has been compounded since the IT problems began by its perceived sluggishness in responding to customer complaints and compensation claims.

Financial Times 28th June 2018
https://on.ft.com/2Nm1Lp3

Closer to home the recent Bank of America /Countrywide class action lawsuit: Financial Times 9th May 2018
https://on.ft.com/2NqbHOC

- Operational risk (OR) event announcements reveal potential weaknesses in the governance, risk and compliance frameworks (and cultures) of financial organizations. Weaknesses that can result in reputation damage.
- How the media reports announcements may affect the level of reputation damage. Prior (non OR) research on the effects of textual tone on investor's behaviour reveals mixed results:
    - Investors tend to ignore positive tone (cheap talk);
    - Investors tend to value negative tone.

Our Contribution

- A relatively large sample size for this type of event study (305 announcements from 90 firms in 18 countries, 113 are from the USA and 218 banks).
- Content analysis of the textual tone of OR event announcements thanks to our access to the first reported story on each event.
- Use on-line media to capture first announcement (can be faster than print).
- Study post financial crisis only (2010-2014).
- Use ORIC data www.oricinternational.com/ (public data set with over 16,000 risk events).
- Consider shareholders and creditors (CDS spread).

Financial Sentiment Tones

We use financial sentiment tones proposed by Loughran and McDonald (2011) from their comprehensive research into 10-K filings of U.S. firms.

$$Net\ Negative\ Tone = \left(\frac{Negative\ Words - Positive\ Words}{Total\ Financial\ Sentiment\ Words}\right) * 100$$

$$Uncertainty\ Tone = \left(\frac{Uncertainty\ Words}{Total\ Financial\ Sentiment\ Words}\right) * 100$$

$$Litigous\ Tone = \left(\frac{Litigious\ Words}{Total\ Financial\ Sentiment\ Words}\right) * 100$$

Where:

$$Total\ Financial\ Sentiment\ Words$$

$$= Negative\ Words + Positive\ Words + Uncertainty\ Words + Litigous\ Words$$

Research Hypotheses

Variable	Equity Return	CDS Spread	Explanation
Negative Tone	-	+	Negative tone is bad
Uncertainty Tone	+	-	Investor optimism dominates pessimism
Litigious Tone	-	+	Risk of litigation is bad
Loss Disclosed	Weaker	Weaker	Objective information mitigates tone
Firm Recognizes	Weaker	Weaker	Quick confession mitigates tone
Simultaneous Regulatory Announcement	Weaker	Weaker	A credible source of information mitigates tone
Event is Settled	Weaker	Weaker	Fast settlement mitigates tone

Findings: Equity Related Reputation Damage

- Univariate analysis supports hypotheses 1-3, especially in the event window (+1,+5) (Table 4 in the paper).
- Multivariate analysis (Table 6, Panel A):
  - No evidence of pre-announcement (-10,-1) leakage causing reputational damage, but leakage can increase the extent of coverage;
  - FT and WSJ attention causes less damage;
  - Again support for hypotheses 1-3, especially in the event window (+1,+5);
  - A 14% (12%) increase in negative (litigious) tone decreases RCAR by -0.54% (-0.51%);
  - A 7.5% increase in uncertainty tone increases RCAR by 0.47%.

Findings: Debt Related Reputation Damage

- Univariate analysis supports hypotheses 1-3. In the event window (+1,+5) reputation effects are as high as 2.4bps (Table 5 in the paper).
- Multivariate analysis (Table 6, Panel B):
  - Again no evidence of pre-announcement (-10,-1) leakage;
  - FT and WSJ attention causes less damage, except on the day of the announcement (where the effect is around 1.1bps);
  - Again support for hypotheses 1-3, especially in the event window (+1,+5);
  - A one standard deviation increase in negative (litigious) tone increases the CDS spread by 0.69 (0.74);
  - An increase in uncertainty tone decreases spread by 0.69%.

Interactions with Loss Disclosure and Recognition

- Loss disclosure mitigates the (positive) effects of uncertainty tone. In the (+1.+5) event window a one standard deviation increase in uncertainty tone is associated with a 0.59% less favourable impact on RCAR (Table 7).
- But there is no evidence of any mitigation on either negative tone or litigious tone. (relationships are as expected, but insignificant).
- Findings are replicated for the CDS spread analysis.
- Firm recognition of the loss event reveals very similar results (Table 8). Recognition reinforces the adverse financial sentiment of equity and debt investors who become more certain about the (adverse) significance of the OR event.

Interactions with Regulatory Announcement and Settlement

- Regulatory announcements mitigate the positive effects of uncertainty tone and negative effects of litigious tone for both equity returns and CDS spreads (Table 9).
- The regulatory effect on uncertainty is strong (e.g. 0.94% less RCAR in the +1,+5 window compared to 0.59% for firm recognition).
- For litigious tone regulatory announcements can increase RCAR by 1.16% (one standard deviation increase in the +1,+5 event window) and CASC by 1.78bps.
- Similar, though stronger, results for final settlements (Table 10). For litigious tone: RCAR is 2.84% more favourable and CASC 1.98bps (+1,+5) event window.
- Relationships as expected for uncertainty tone, but not significant.

Cultural and economic differences

- To take account of the cultural effects of language differences we divided our sample into Anglo-Saxon (233 events) and non-Anglo-Saxon (72 events).
- Our results are much stronger in the Anglo-Saxon sub-sample, by between 3.5 and 6 times (Table 11).
- The interaction variable results are similar, except that net negative tone is significantly mitigated by both firm recognition and loss amount disclosure in the Anglo-Saxon sub-sample, this applies to the equity and debt regressions.
- The results are also stronger in market-based economies like the UK and USA (Table 12). This is probably because market based economies have more efficient capital markets that are more responsive to information and sentiment.

Final thoughts and recommendations

1) Textual tone matters, especially in market based, Anglo-Saxon economies like the UK and USA.
2) On-line media tone may be less predictable and more far reaching than established multinational news media like the FT and WSJ, this could further increase reputation effects.
3) But it is possible to mitigate the effects of the media – providing that this is done <u>promptly.</u>
4) Firms should confess and provide objective information on the likely loss amount to help mitigate the effects of media tone. This means monitoring media coverage and taking immediate action to mitigate negative or litigious tone.
5) Regulators have a key role to play as a credible source of information, but they must also act promptly.

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