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

Ahmed Barakak
Simon Ashby
Paul Fenn
Cormac Bryce

Discussion by Brian Clark (RPI)[1]

July 24, 2018

Operational Risk Research Conference - Charlotte

---

[1] Disclaimer: The statements made and views expressed herein are solely those of the authors and do not necessarily represent official policies, statements, or views of the Office of the Comptroller of the Currency

Summary of the Findings

- The paper investigates equity and bond (CDS) market reactions to operational risk announcements

- Focus on the textual tone of the media announcements:
  - Negative tone $\Rightarrow$ adverse reputational effects
  - Litigious tone $\Rightarrow$ adverse reputational effects
  - Uncertainty tone $\Rightarrow$ positive reputational effects
  - Alternative sources of information mitigate the reputational effects of textual tones (e.g., loss amount disclosure, third-party announcements)
  - The effects also vary by global macro factors (Anglo-Saxon countries, market-based economies)

- Overall, reputational effects of media tone matter most when there is more uncertainty and less information disclosed by the media

Comment 1: Measuring Reputational Effects

- The authors measure reputational losses as follows:

$$RCAR(x, z)_i = CAR(x, z)_i + |\frac{OperationalLossAmount_i}{MarketCapitalization_i}|$$

- How can the reputational loss exceed the total market loss?
  - Shouldn't *CAR* be reflective of the $ ops loss plus the reputational loss?
  - In other words, *CAR* should include the ops loss (assuming the announcement of the loss is new information)
  - Why is setting missing announcement values to $0 conservative?
    - Wouldn't it imply that all of the market reaction was purely reputational?

Comment 1: Measuring Reputational Effects (cont.)

- The loss-adjusted reaction is a reasonable start, but:
  - The big question is how to distinguish between uncertainty about the loss amount and reputation?
  - Suggestion:
    - Look at a sample of losses that were announced and the amount was fully known on one day.
    - The difference between the market reaction and the known loss amount should be a relatively clean measure of reputational losses.
    - Of course, the down side is that the really interesting losses (usually legal) take time to cure and settle

- Other issues:
  - *CAR* estimation:
    - Fama-French? Momentum?
    - Size anomalies for large banks (Gandhi & Lustig, 2015 *Journal of Finance*)
  - Do you control for events that are more likely to be correlated (e.g., fraud) or systematic (i.e., multiple banks in the same suit - LIBOR)
  - The CDS spreads are not loss-amount adjusted...so how are the changes in spreads capturing reputation effects?

Comment 2: Motivation and Hypotheses Development

- The hypotheses for the main effects are straight forward for negative and litigious tones

- However, H_2 seems to be less clear. Why would "Investors interpret good news as bad news?"

  H_2: *The uncertainty tone in operational risk event announcements is positively associated with loss-adjusted abnormal stock returns and negatively associated with abnormal CDS spreads following the announcements*

- Motivation:
  - Page 3 mentions that this is the first to study equity and bond market reactions in the same paper
  - Suggestion: I think you could leverage this point more in your analysis. The current analysis treats the markets separately.
    - Is there a wealth transfer from equity to bond markets or vice-versa?

Other Comments

- Might want to consider separating legal losses:
  - More uncertainty when considering the first announcement
  - Litigious is obviously different for legal losses
  - Or consider tracing announcements for legal losses over time to see how market perception changes

- Introducing the cross-country macro factors (Anglo-Saxon, market vs. bank based economies, etc.) is confusing until the end of section 4
  - Suggestion: You may consider discussing the language aspect of why "Anglo-Saxon" countries are different than the others. It seems more of a language issue than a cultural issue anyhow.

Summary

- Overall, the paper was interesting to read

- There are a lot of results in there that seem robust and generally intuitive

- I look forward to reading the next version

References I