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Risk Management Disclosure: Evidence from the UK Banks

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Abstract

There is now greater demand for increased corporate disclosures for stakeholders particularly Risk Management Disclosure (RMD). This study examines the extent of change in RMD in the annual financial reports of UK banks over a period of six years (2011-2016). A content analysis approach has been undertaken on a sample of reports from five UK Banks. The results reveal that the quantity of RMD has been increasing significantly in the selected banks due to regulations and increased pressures by stakeholders after the financial crisis. The need for more sound regulation regarding risk information disclosure is required to safeguard against agency cost and crisis.

Keywords: Risk Management Disclosure; Banks; Disclosure Quantity

1. Introduction

Corporate disclosure satisfies various information needs, it allows shareholders to hold administration to account (Elshandidy, Shrives, Bamber, & Abraham, 2018; Marshall & Weetman, 2002); it also provides support to various stakeholders to help them make decisions about their relationship with the corporation (Elshandidy et al., 2018; Marshall & Weetman, 2002). Recently, disclosures have become a regulatory mechanism because, as Lee (2011) notes, recent corporate governance failures led to the increasing requirement for regulations, and regulatory bodies have faced the challenge of developing mechanisms that can satisfy the purpose of ensuring corporate accountability. RMD is considered a significant factor in rebuilding trust in corporate reporting (Elzahar & Hussainey, 2012). Due to regulatory pressure companies, particularly banks, in the most industrialised countries are required to increase the volume of RMD in their annual reports (Pérignon & Smith, 2010). Banks have been under significant scrutiny since the financial crisis in 2007-2008. In addition, the trust of the stakeholders, particularly customer and investors has been shaken due to uncertainty in the market (Elbannan & Elbannan, 2015). This study aims to provide an overview of the extent of change in RMD practices of the UK banks. Only a limited number of studies have addressed the matter of how banks in the UK are improving their RMD practices and have explored whether or not changes are well reflected in their annual reports after the financial crisis. Therefore, this study attempts to answer the following research question: to what extent have RMD practices in the UK banking sector changed between 2011 and 2016? This study is important because the previous research on disclosure suffers from various limitations that lead to inconsistencies in the existing findings (Holm & Scholer, 2010) and several attempts have been made in the literature to measure corporate RMD. For instance, measuring change over time is significant in any research and it seems to have been ignored in existing literature as most of the extant studies explore results for just one year (Adams, 2002; Brammer & Pavelin, 2006; Elzahar & Hussainey, 2012; Pérignon & Smith, 2010).

Moreover, existing studies have not conducted a longitudinal analysis of corporate disclosure activities in the UK, therefore, longitudinal research on a yearly basis (2011-2016) may provide deep insights into changes in corporate RMD practices (Brammer & Pavelin, 2006). This study finds that RMD is still underexplored in the banking sector, therefore, it intends to expand the scope of prior research within the UK context in order to overcome the limitations inherent in prior research. The current study contributes to the fields of disclosure and

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risk management, by providing updated evolving disclosure practices. The next section gives an overview of previous literature, which is followed by a section on methodological choices made in the study and a section on the main findings of the study. The final section summarises the main conclusions of the study.

2. Literature Review

Many authors have defined risk, for instance, Lupton (1999) refers to risk as a phrase for a hazard, danger or harm. Dobler (2008) defines risk as an 'uncertainty- or goal based' viewpoint. The uncertainty based viewpoint describes risk as 'randomness of the uncertainty of future outcomes that can be expressed numerically by a distribution of outcomes' (p. 187). A stakeholder-based approach to risk reinforced the enhanced demand for voluntary disclosure because a corporation has various stakeholders, not just shareholders, who have the right to attain information regarding the effect of the corporation's activities (Lajili & Zéghal, 2009; Marshall & Weetman, 2002; Sierra-García, Zorio-Grima, & García-Benau, 2013). In particular, studies have emphasised the value of corporate RMD to stakeholders (Brown, et al., 2009) and note that it enables corporations to exhibit accountability for their financial stability. Despite the expansion and improvement of corporate RMD practices, its capacity for meeting the information requirements of a variety of stakeholders is still debatable (Elshandidy et al., 2018; Pérignon & Smith, 2010). Such dissatisfaction with RMD has led to a requirement for improved stakeholder reporting, and hence enhanced the need for more research into the quantity of RMD in order to give some clarity about business sustainability, which is a concern of a variety of stakeholders. Solomon (2010) states that potential institutional investors recognise to the benefits of corporate disclosure, including RMD. Hence, there is a positive association between an increased quality and quantity of disclosures and increased ownership by investors. Another piece of research shows that controlled disclosure delivers appropriate information for potential investors (Markarian, et al., 2007). However, corporate risk disclosure can be considered a way of ensuring good corporate governance that promotes transparency in governance performance. This view is referred to as governance by disclosure, where information disclosure is vital to develop transparency (Gupta, 2008). The demand of stakeholders regarding risk management related information has been increasing therefore corporations are required to validate their activities by reporting on risk management rather than communicating only about economic and environmental dimensions (Cormier et al., 2011). Moreover, mitigating risks is crucial for the long-term sustainability of organizations and, so, RMD has become an essential issue. Dobler (2008) mentions that protecting the corporation from adverse risks is part of the corporate governance of the corporation and it should be responsible for poor RMD practices, which was one of the causes of the financial crisis 2007-08. Brown et al., (2009) also state that disclosure has received some attention in recent years as a part of increased accountability and transparency processes across the world and it is now a very important issue for further study.

Elshandidy et al., (2018) explain that for the purpose of annual decision making, corporations are required to provide disclosures to external users regarding their economic situation and financial support. Linsley & Shrives (2006) state that the risk disclosure informs the reader about 'any opportunity or prospect, or of any hazard, danger, harm, threat or exposure, that has already impacted upon the company or may impact upon the company in the future' (p. 389). Weaknesses in current practices of RMD in annual reports has drawn considerable attention from regulators, researchers and managers. In terms of banks, few studies have examined risk disclosure, for example, Tadesse (2006) argue that in countries where risk disclosure is regulated, there are fewer chances of a financial crisis particularly because the banking system is less likely to be in financial turmoil because of proper financial reporting. However, on the contrary, Linsley & Shrives (2005) found that companies avoid giving a complete picture of the risks they encounter and the levels of disclosure are low and largely consist of general statements. Although there is now a trend to provide risk disclosure due to financial regulations, the usefulness of such information to stakeholders is still questionable. Tadesse's (2006) study suggests that the financial crisis can be avoided in the banking sector if corporations provide more comprehensive, timely, credible and informative disclosures. Recent literature found interesting results by investigating RMD. For example, Elzahar & Hussainey (2012) found that large firms are likely to disclose more risk related information. Pérignon & Smith (2010) concluded that the quality of RMD did not show a sign of improvements over time and there is little information about future volatility. However, Elshandidy et al., (2018) found 'a lack of clarity and consistency around the

conceptualization of risk'. In addition, Miihkinen (2013) found that shifts in stock markets affect the relevance of firms' risk reports. Based on the previous literature it can be observed that there is an association between increased reliable disclosure including RMD and good stakeholder relationship with the company.

3. Theoretical Background

The previous and on-going financial crises emphasise the importance of disclosure and transparency. Stefanescu (2011) argued that poor levels of disclosure and a lack of transparency were amongst the causes of the latest financial crisis. Disclosures by a corporation to their stakeholders are an essential means by which corporations become transparent and are essential for better performance on the market (Elzahar & Hussainey, 2012). In addition, theoretical perspectives such as stakeholder theory and agency theory stress that corporations achieve accountability through more disclosures. Solomon (2010) describes disclosure as the whole collection of information created by the corporation. Many researchers believe that improvement in transparency depends on the quantity of disclosure. Developments in transparency are the focus of the regulatory authorities in the UK. The Cadbury report (1992) argued that 'the lifeblood of markets is information and barriers to the flow of relevant information represents imperfections in the market. The more the activities of companies are transparent, the more accurately will their securities be valued' (p. 33).

Conyon et al., (2011) note that banks also suffer from information asymmetry and agency issues, just like other institutions. Where managers have a chance to take self-interested decisions because of a strategic advantage based on information they have, this is called the principal-agent problem. Improved disclosure also helps to reduce agency costs such as information asymmetry and conflicts of interest. Berger, (2011) suggests that financial and non-financial information should be disclosed in accordance with the high standard of accounting. However, the study claims that the readability of risk disclosures is very difficult in annual reports. Markarian, et al., (2007) states that when interests between the agent and principal are not the same, a problem arises when agents have easy access to more information than the principal. However, many authors have suggested ways to diminish problems with agency, for instance, Healy & Palepu (2001, p. 410) suggest that agency problems can be eliminated by making a reliable disclosure. Moreover, Fontes et al (2018) define that disclosure of information helps to reduce information asymmetry. In addition, Markarian, et al., (2007) argue that according to stakeholder point of view, disclosed information can be helpful for sound decision making. Furthermore, Solomon (2010) argues that ample disclosure helps to deter fraud.

Solomon, (2010) argues that better and more fully developed disclosures potentially diminish agency problems because improved information is exchanged between the corporations to the stockholder, which results in decreases in the unevenness of information. From a theoretical viewpoint, the cause of asymmetry in the information is that managers have more knowledge about a corporation's affairs, monetary position and activities than potential investors. This is the same case with stakeholders, where inadequate information creates difficulties not only for shareholders but for stakeholders as well. Watson et al., (2002) argue that the stakeholder theory claims that firms increase the confidence of investors and the public when firms disclose more to their various stakeholders. Therefore, this theory presents a helpful framework through which to evaluate the corporation's RMDs practices (Snider et al., 2003) and allows the evaluation of the extent of change in RMD. Therefore, corporate disclosure is about influencing the expectation of various stakeholders regarding the future prospects of the firm (Brammer and Pavelin, 2006). In addition, RMD in annual reports has various advantages for corporations. For example, Linsley et al, (2008) argue that it can be helpful for enhancing the corporation's risk management capability. Dickinson (2001) suggests that external shareholders can scrutinise a corporation's risk management system through transparent risk disclosure and that access to a corporation's reports can be a way to treat all shareholders and stakeholders equally. However, Linsley & Shrives (2006) have identified the main reason for not disclosing in annual reports, firstly, due to questions of the commercial sensitivity of information, managers do not want to disclose information because this kind of information could give an advantage to competitors.

4. Methodology

Content analysis techniques have been used increasingly in social sciences and many authors have used this approach to evaluate RMD practices (Beretta & Bozzolan, 2004; Elshandidy, Fraser, & Hussainey, 2015; Elzahar & Hussainey, 2012; Linsley & Shrives, 2006; Zéghal & El Aoun, 2016). Krippendorff (1980: 21) defines content analysis as ‘a research technique for making replicable and valid inferences from data according to their context’. The unique attribute of the content analysis approach is that data is coded and examined in a reliable and organised way (Krippendorf, 1980). Milne & Adler (1999) define content analysis based on some questions such as ‘Where? What? And how?’ in which ‘where’ represents a selection of documents for analysis, for instance, annual reports; ‘what’ represents categories and definition of data to research, and finally, ‘how’ represents coding and process of data calculating scores. For this study, the argument presented by Krippendorff (2012) that claims the amount of disclosure is an indication of the significance that is positioned on the item (RMD) being revealed by the reporting company is vital. To investigate such trend, a variety of literature on RMD studies used the annual report as the main investigation tool for corporate disclosure (Buckby, Gallery, & Ma, 2015; Dobler, Lajili, & Zéghal, 2011; Marshall & Weetman, 2002; Miihkinen, 2013). The data in the annual report was considered a secondary source of data (Belal & Owen, 2015) that is used in this research to examine the corporate RMD practices of UK companies over a period of six years between 2011 and 2016. According to Unerman (2000), annual reports are important to demonstrate how the company solves conflicts within the company and how interests of stakeholders are managed. Therefore, in this regard, the annual reports are used as the reliable source for examining RMD information.

4.1 Sample selection

The research sample consists of five large UK banks. The reason for choosing these banks is that they cover a broad range of business activities and have a significant reputation. Brammer & Pavelin (2006) explain that the examination of those samples that are considered large allows for a more comprehensive investigation and discovery. The annual reports of the selected companies are examined to be able to study the extent of RMD between 2011 and 2016. The significance of choosing this period was to examine the impact the previous financial crisis (2007-2008) (Elbannan & Elbannan, 2015; Ntim, Lindop, & Thomas, 2013) might have had on the volume of RMD. This time frame can allow the researcher to assess the extent of change of RMD in banks over a significant period of time. Banks were extremely affected by financial crisis and moreover, banks are an important institution for the economy, therefore poor disclosure could affect the whole economy (Linsley, Shrives, & Crumpton, 2006; Zéghal & El Aoun, 2016). The banks that are included in the sample are HSBC, Barclays, Royal Bank of Scotland, Lloyds Banking Group, Standard Chartered Bank. These banks have the largest assets in the UK. The annual reports have been collected from the website of each bank, from the years 2011 to 2016.

4.2 Data collection

The content analysis consists of researching the quantity and content of disclosure on risk management of the UK banks’ annual reports during the financial year 2011 to 2016. The focus of the study was only on risk information disclosed in the annual reports under the heading of corporate governance, risk and risk management section. In addition, Linsley & Shrives (2006) suggest that content analysis can be performed by taking the number of words, pages and the sentences. For this study, the number of pages dedicated to risk management was measured because counting pages is an accurate method and can capture comprehensive RMD practices, including narratives, graphs, and images. This cannot be achieved by using words and sentences alone (Beck, Campbell, & Shrives, 2010; Campbell & Abdul Rahman, 2010). The total number of the pages giving risk management related disclosures were counted throughout the annual report.. The data for content analysis was collected from the banks’ annual reports and all data was coded. After the coding, the data was interpreted and analysed. Then the coded data was summarised and patterns and trends of corporate RMD were identified.

5. Results and Discussion

Figure 1 indicates an increasing trend in the disclosure of RM practices over the study period, where such an increasing trend over time emphasises the increased awareness of corporate RMD by UK banks. Tricker (2012) argues that UK corporations are increasingly realising the significance of risk management and risk reporting practices. Specifically, HSBC bank has developed its disclosure of risk management significantly in its annual reports, by including risk management as a special heading. Overall, all the banks studied increased their RMD, which could be due to an increased pressure to be transparent with a wide array of stakeholders. In addition, regulatory pressure forced corporations in the UK to increase the levels of risk management coverage. However, despite the pressure from different sources, some banks gave less information than HSBC. The importance of disclosure can be observed from the example of HSBC bank, because this bank has the most assets, more than any other bank in the UK sample.

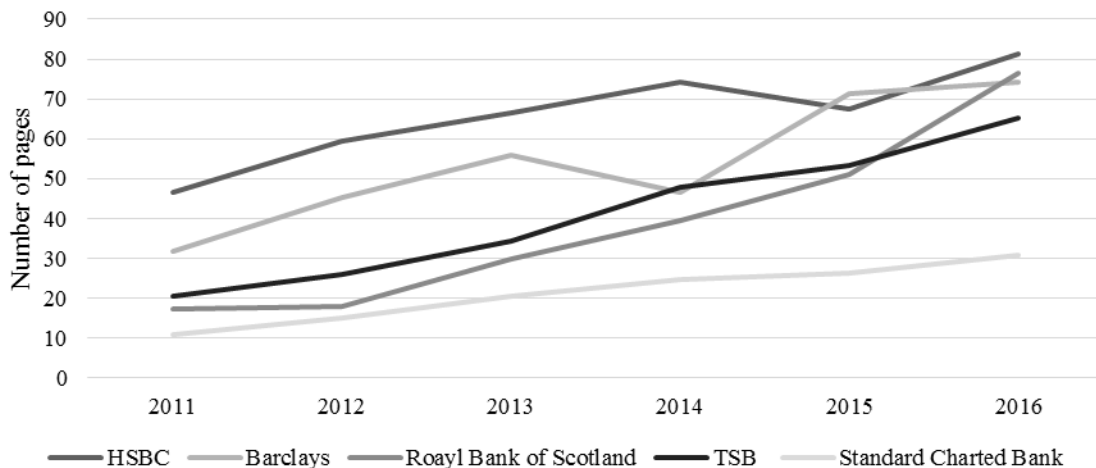

Fig. 1. Disclosure within and between UK banks

Therefore, this may align with the idea taken from stakeholder theory that better and more disclosure increases confidence amongst investors and the general public (Watson et al., 2002). This increase is associated with the general increase in corporate reporting as guided by the recommendations set by professional accounting bodies and standard setters such as the International Financial Reporting Standards and Financial Reporting Council. In addition, increased corporate risk disclosure can be attributed to the adoption of the relevant codes of best practice, following the release of the Combined Code (2003, 2010) of corporate governance in the UK. However, one significant factor is the financial crisis of 2007-08, which impacted on the extent of disclosure. Particularly, in the last three years of the study period, there was a significant increase in RMD.

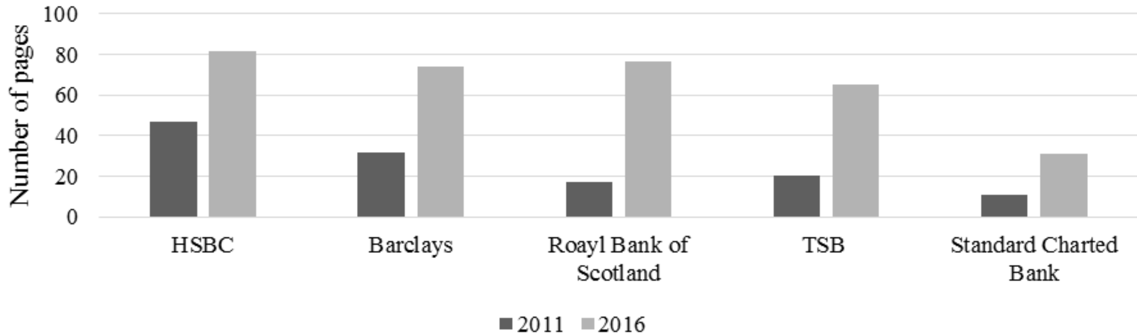

Fig. 2. Difference in RMD between the year 2011 and 2016 in the UK banks

Figure 2 depicts the level of RMD in UK banks in the first and last years of the study period (2011 and 2016). From the above figures, a significant difference and increase in the level of disclosure regarding corporate risk management practices can clearly be seen. Where UK banks have disclosures, these had doubled in 2016 when compared with 2011. Figure 3 presents the percentage increase in RMD in the UK banks. Specifically, RBS and TSB group have increased their level of RMD significantly, by 340% and 220% respectively. The theoretical concepts that lie behind agency theory are supported by the data – increased levels of disclosure indicate that more disclosure diminishes conflicts of interest between shareholders and managers; increased disclosure may also support the claim of stakeholder theory that stakeholders' requirements are being met to achieve the approval and confidence of various stakeholders in the firm.

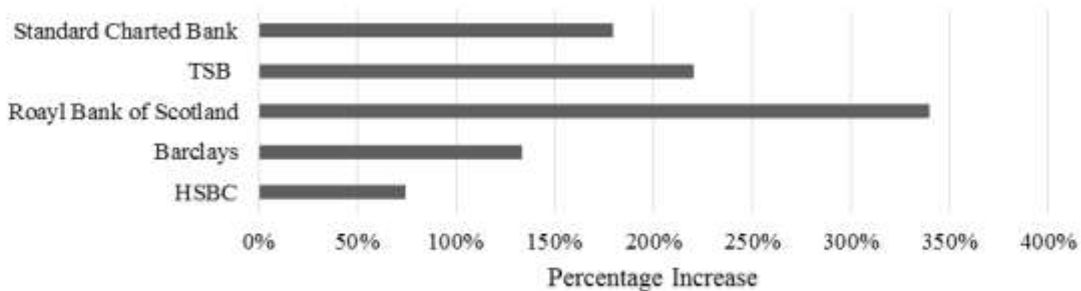

Fig. 3. Percentage increase of RMD between the year 2011 and 2016 in the UK banks

Therefore, these results may align with stakeholder and agency theory perspectives that better disclosure increases the confidence of investors and the public. According to Tricker (2012) information disclosure is a function of corporate governance in the sense that agents have more access to the information within the corporation than shareholders and that credible disclosure can provide value to the corporation by eradicating agency cost, as firms use disclosure to reduce such costs.

6. Conclusion

This study examined the extent of change in RMD practices between 2011 and 2016 seen in the annual reports of UK banks. Content analysis has been used in this study to measure the extent of disclosure by measuring the number of pages in the annual reports of the selected banks. From the content analysis, it can be concluded that UK banks have improved their RMD practices significantly, this is consistent with the findings of previous studies (Buckby et al., 2015; Elzahar & Hussainey, 2012; Linsley & Shrives, 2006; Linsley et al., 2006; Pérignon & Smith, 2010). There are several factors for the enhancement of practices in the area of disclosure. These include successive regulations issued after a series of corporate scandals and financial crises by regulatory bodies that enforced regulations for more corporate RMD practice. The perspectives of stakeholder theory were also linked with increased disclosures because, according to those theories, management discloses to ensure the firm's accountability to its various stakeholders. To support this argument the research of Mäntysaari (2012) argued that businesses are turning their attention towards protecting shareholder's interest as well as providing accountability and making disclosures to various stakeholders regarding corporate governance's activities for managing their relationship with them. In addition, corporate governance plays a significant role in shaping how corporations mitigate agency issues and respond to the requirements and interest of stakeholders and accordingly, in determining the quantity of RMD in their annual reports. There is a significant relationship between RMD quantity and corporate governance.

The policymakers and regulators need to increase pressures on the banks by creating further regulations that promote better accountability by strengthening changes in the corporate laws relating specifically to governance; by ensuring that mechanisms of compliance exist; and by benchmarking and inspecting their implementation. Board members should consider the importance of transparency in corporate governance structures by adopting rigorous RMD strategies. In addition, voluntary disclosures on risk management should be enhanced to gain the confidence of stakeholders.

This study suffers from some limitations. The practice of content analysis might be considered subjective research, yet it is vital to state that subjectivity cannot absolutely be eradicated. A further limitation of this study is sample size, only five banks were used in this study and therefore, the small sample cannot provide broad conclusions. One way to further enhance the sample might be to focus on non-financial companies or on a mixture of financial and non-financial companies to draw a comparison of both. In this study non-financial companies were excluded because they make a different type of risk disclosure (Bessis, 2002). However, future researchers could also examine the risk disclosure performance of non-financial companies, because they play a significant role in stock exchange as well. In addition, future researcher might also consider examining the quality of the risk disclosures.

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