Bank Opacity and Systemic Risk: The Mitigating Role of Risk Disclosure Regulation on Analysts' Forecast Accuracy

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Abstract:

This paper examines the impact of Bank Opacity on European Financial Stability. Based on a panel dataset of capital market-oriented European Banks covering the period 2002-2018, it can be shown that Bank Opacity has a significant influence on the institution-specific contribution to the ΔConditional Value at Risk and Marginal Expected Shortfall. The policies introduced by accounting standard setters and regulators for the risk disclosure of banks have a positive impact on the mitigation of Bank Opacity and reducing Systemic Risk. Both the risk reporting in accordance with IFRS 7 and the measures introduced by the Basel Committee in the form of the Basel Pillar 3 Regulation lead to an increase in transparency (reduction of Bank Opacity) and thus to an improvement in financial market stability.

Abstract (german):

Im Rahmen dieses Beitrages wird der Einfluss von Bank Opacity auf die europäische Finanzmarktstabilität untersucht. Auf Basis eines Panel Datensatzes von kapitalmarktorientierten europäischen Banken über den Zeitraum 2002-2018 kann festgestellt werden, dass die Bank Opacity einen signifikanten Einfluss auf den institutsspezifischen Beitrag zum ΔConditional Value at Risk und Marginal Expected Shortfall besitzt. Die durch Standardsetter und Regulatoren eingeleiteten Maßnahmen zur Offenlegung von Bank Risiken besitzen einen positiven Einfluss auf die Reduzierung der Bank Opacity und des Systemischen Risikos. Sowohl die Risikoberichterstattung nach IFRS 7 als auch die vom Baseler Ausschuss eingeleiteten Maßnahmen in Form der Basel Pillar 3 Regulation führen zu einer Erhöhung der Transparenz (Reduzierung der Bank Opacity) und somit der Verbesserung der Finanzmarktstabilität.

Keywords: Systemic Risk, Bank Opacity, Risk Disclosure, Regulation, IFRS7, Basel

Introduction

Due to their business model as financial intermediaries, banks are generally considered to be non-transparent with negative consequences for overall financial stability (Morgan, 2002). This is mainly due to the risk behaviour which is difficult to analyse for the capital market addressees (Jungherr, 2018)especially in times of crisis (Flannery et al., 2013). Market discipline - as a regulatory disclosure paradigm - attempts to generate greater transparency in the risk management activities of credit institutions, particularly through the extended disclosure requirements codified by the Basel Committee in Basel Pillar 3 (Basel Committee on Banking Supervision, 2015, 2009a, 2009b, 2004). It follows the theoretical idea that market participants monitor the risk activity of banks and discipline them accordingly (Bliss and Flannery, 2002; Stephanou, 2010).[1]

High-quality financial reporting is a key success factor for functioning market discipline and regulation (Acharya and Ryan, 2016). In particular, IFRS 7 of the IASB, which is to be applied for the first time in the 2007 financial year, represents a key standard for risk reporting by banks (Bishop, 2009)[2]. The risk reporting of banks is thus subject to the dualistic disclosure regime of two enforcement bodies with theoretically two report contents: Banking supervision with Pillar 3 Regulation and the Accounting Standardsetter with the annual risk report.[3]

While empirical studies in recent history have focused primarily on the evidence for Bank Opacity and its determinants of influence (Fosu et al., 2018) the direct effect of opacity on the systemic risk of the financial system and interaction with banking regulation remains largely unexplored. Although individual studies establish a causal connection between financial market stability in the form of the insolvency risk (Fosu et al., 2017) or the influence of regulatory interventions, especially regulatory forbearance, on Bank Opacity (Gallemore, 2020). However, a holistic view of systemic risks and disclosure regulation is not yet available in the literature. In addition, the majority of studies focus on the following topics, with the exception of (Iannotta, 2006) on the US capital market. The present paper attempts to close this gap and focuses on the european market, which has had a uniform regulatory and supervisory

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[1] The theory distinguishes two forms of market discipline: *Direct market discipline* describes the possibility for shareholders and stakeholders as market participants to influence the behaviour of credit institutions (Stephanou, 2010). This includes in particular shareholders, creditors and depositors of sight deposits and lenders (European Central Bank, 2005) *Indirect market discipline* refers to the influence of a bank's risk activity on the market prices of the debt securities issued on the primary and secondary markets (Kwan, 2002). According to the ECB, supervisors, rating agencies and central banks can thus be enabled to derive implications for the financial situation of the institution and to take corrective action (European Central Bank, 2005).

[2] IFRS 7 was subject to a fundamental revision, particularly in the course of the amendment of IFRS 9 (IASB, 2017, 2014; see Novotny-Farkas, 2016).

[3] See in particular the comments of Bishop et al. (2019).

framework since 2014 through the Capital Regulatory Directive (CRD-IV) and the Single Supervisory Mechanism (SSM).

Research Design

The aim of this paper is to examine the impact of Bank Opacity on European financial stability and the possible influence of accounting and banking regulation on disclosure. To measure disclosure quality we follow a market-based approach, assuming that the capital market anticipates regulatory measures (Leuz and Wysocki, 2016). For this purpose, the analysts' forecasts will be used to measure the bank opacity in line with previous studies (Fosu et al., 2018, 2017).

On the basis of a panel data set of capital market-oriented European banks over the period 2002-2018, it can be determined that Bank Opacity has a significant influence on the institution-specific contribution to the ΔConditional value-at-risk and Marginal Expected Shortfall. The measures introduced by standard setters and regulators for the disclosure of bank risks have a positive influence on the reduction of Bank Opacity and systemic risk. Both the risk reporting in accordance with IFRS 7 and the measures introduced by the Basel Committee in the form of the Basel Pillar 3 Regulation lead to an increase in transparency (reduction of Bank Opacity) and thus to an improvement in financial market stability. The results are robust, both through variations in the panel data model and by using dynamic panel data models (GMM) to control for endogeneity.

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