

Operational and Liquidity Risk Information Disclosure Practices by Malaysian Listed Banks

Sheila Nu Nu Htay and Syed Ahmed Salman

Institute of Islamic Banking and Finance, International Islamic University Malaysia, Malaysia

Abstract: Banking industry is a backbone of any country's economy. The crisis in banking sector will consequently cause the whole country's financial crisis. Due to the nature of banking industry, risk is inherent in its activities and it should be managed with due care. Market discipline theory highlights the important role of information disclosure because investors will be well informed about the performance of the company and able to monitor and discipline the management. Thus, researchers believe that among the different types of information disclosure, the most significant information disclosure for the banks is related to operational and liquidity risk management. However, the research in this aspect is limited, especially in Malaysian context. The research is to explore the operational and liquidity risk information disclosure practices by Malaysian listed banks. The sample period covers from 2002-2011 for 5 listed banks. The findings show that overall, the disclosure on both operational and liquidity risk information disclosure is increasing over the sample period. It is expected that this research will be the interest of the investors, industrial players and regulators because the findings show the disclosure pattern of risk information disclosure. Since, this study is an exploratory in nature, researchers do not observe the determinants which influence on information disclosure. The future research should focus on it.

Key words: Operational risk, liquidity risk, bank, performance, Malaysia

INTRODUCTION

The repeated occurrence of financial crisis and scandals not only have demotivated and discouraged the investors but also had negative impact on the investors trust. Today, investors are not only keen to know the true financial position of the banks but also are interested in knowing various risks that these banking institutions are exposed to. Besides, they also want to know the strategies and framework that these banks have adopted for managing and mitigating these risks. This is mainly because these investors would like to ensure that their investments are safe and properly managed. Incidents like 1997-1998 financial crisis, Collapse of Enron, 2007-2008 financial crises and European financial crisis have forced the regulators to come up with stringent rules and regulations that would force these banking institutions for disclosing vital information to the stakeholders.

Prior researchers such as Linsley (2011) and Banziger *et al.* (2012) highlight that more transparent, timely and comparable risk information disclosure are required to be disclosed due to the uncertainty inherent in the business activities. Since, risk information disclosure is essential in the banking sector, many countries and international organizations have provided the guidelines

on risk management and its disclosure. Therefore, the purpose of this study is to explore the disclosure practices of Malaysian listed banks on operational and liquidity risks.

Literature review: Basel defines operational risk, as the risk of loss resulting from inadequate or failed processes, people and systems or from external events. This definition includes legal risk but excludes strategic and reputational risk. Operational risk is a major cause of the financial loss in the banking sector (Hain, 2009). The important role of disclosing the operational risk management is supported by prior researchers, such as Helbol and Wagner (2006), Gregoriou (2009), Hain (2009) and Abu El Haija and Al Hayek (2012). According to them, the transparent disclosure on operational risk will enhance the investors trust and confidence to have the stability of the banking sector to minimize the probability of occurring financial crisis to reduce the cost of capital, agency costs, the expected cost of financial distress and political costs arising from regulatory actions. Therefore, Basel committee, Bank Negara Malaysia and Islamic Financial Services Board have provided the guidelines for the operational risk management information disclosure.

Basel defines liquidity risk as the risk arises from the inability of a bank to accommodate decreases in liabilities or to fund increases in assets. When a bank has inadequate liquidity, it cannot obtain sufficient funds, either by increasing liabilities or by converting assets promptly, at a reasonable cost. It can lead to insolvency and bankruptcy of the banks. Therefore, managing liquidity is crucial for viability of any banking organization (BCBS, 2008). Both the international banking standards and the Shari'ah guidance suggest that banks should have robust liquidity risk management policies, a responsive asset and liability committee, effective information and internal control systems and methods for managing deposits to reduce on-demand liquidity. Having good liquidity management is a key prerequisite for sustaining financial stability and helping to alleviate any liquidity shortage (Abdullah, 2010). Due to the importance of the sound liquidity management framework for the well-functioning of banking institutions, many standards and guiding principles has been initiated by Islamic Financial Services Board (IFSB), the Basel Committee on Banking Supervision (BCBS), Bank Negara Malaysia (BNM), etc. These guiding principles were to provide guidance on the supervision and management, as well as to develop the criteria for identifying, measuring, managing and disclosing risks. Having proper disclosure is a key factor for the better performance of liquidity. Prior researchers such as Welker (1995), Healy *et al.* (1999), Oliveira *et al.* (2001), Espinosa and Trombetta (2005), Shen *et al.* (2009) and Desrochers *et al.* (2010) find that the disclosure has a positive effect on liquidity.

MATERIALS AND METHODS

This study uses the secondary data which is collected from the relevant studies, books and internet resources. In addition, the annual reports from 5 banks (2002-2011) are used to examine the disclosure score of the operational and liquidity risks. The disclosure check list is developed referring to the prior researchers and the standards issued by Basel committee, Bank Negara Malaysia and Islamic Financial Services Board. The total number of operational risk disclosure items is 25 and liquidity risk disclosure items are 40.

RESULTS AND DISCUSSION

Findings; liquidity risk disclosure: Appendix 1 shows the list of the disclosure items for liquidity risk. Until 2004, the number of liquidity risk disclosure items increased gradually, however it started decreasing from 2005 followed by 2006. It is quite surprising that from 2007

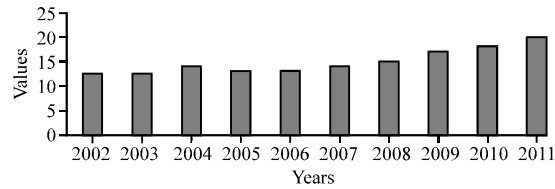


Fig. 1: Bank A; liquidity risk disclosure

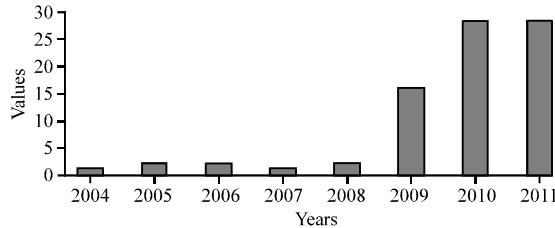


Fig. 2: Bank B; liquidity risk disclosure

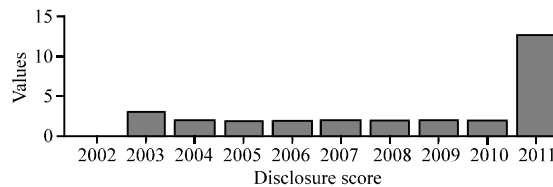


Fig. 3: Bank C; liquidity risk disclosure

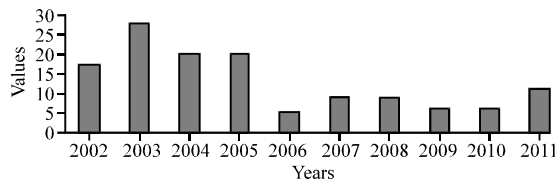


Fig. 4: Bank D; liquidity risk disclosure

which is the starting point of financial crisis, the quality of disclosure had increased and this trend followed till 2011 (Fig. 1).

The number of liquidity risk disclosure of bank B is not much until 2008 and then starting from 2009, it discloses more items significantly until 2011 (Fig. 2).

In regards to liquidity risk disclosure, during the period of 7 years (2004-2010) the disclosure quality remained constant at only 2 items but there had been a sudden increase in 2011 totaling 12 items (Fig. 3).

The quality of liquidity risk disclosure had decreased dramatically over the period of 10 years. During the period of financial crisis (2007/2008), though the number of disclosed items increased but later in 2009-2010 it again decreased (Fig. 4).

The trend of liquidity risk disclosure had increased over the period of 9 years that is from 6 disclosed items in 2002 to 16 disclosed items in 2010 (Fig. 5).

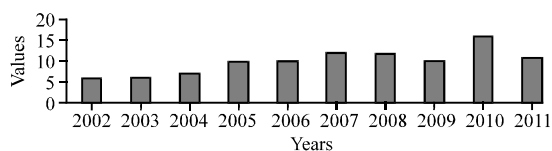


Fig. 5: Bank E; liquidity risk disclosure

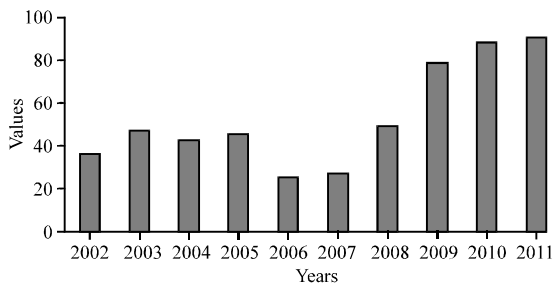


Fig. 6: Consolidated liquidity risk disclosure

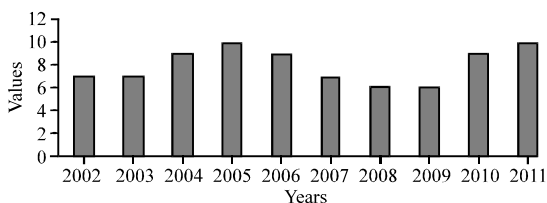


Fig. 7: Bank A; operational risk disclosure

When the consolidated liquidity risk disclosure is examined, there is low disclosure during 2006 and 2007. However starting from 2008, the total number of items disclosed steadily increased until 2011. In sum, it could be said that in terms of liquidity risk disclosure, it is not that much transparent and in detail (Fig. 6).

Findings operational risk disclosure: Appendix 2 shows the list of the disclosure items for operational risk. In regards to operational risk, bank A maintains this level till 2005 from 2006-2008, the disclosure score started going down gradually till it got stabilized in 2009. The industry started recovering from the financial crisis in 2010 and continued this upward trend in 2011 as well (Fig. 7).

In terms of operational risk disclosure number of disclosed items slightly dropped in 2010 and 2011. Over the study period, 2009 has the highest number of disclosure items (Fig. 8).

Regarding operational risk disclosure the numbers of disclosed items were constant for 4 years from 2003-2006. It is very astonishing fact that the level of quality disclosure had started increased from 2007. It is the period during which financial crisis had started (Fig. 9). Over the period of 5 years the number of disclosed items had increased from 4-14 as against 24 items (total numbers of expected disclosed items in a

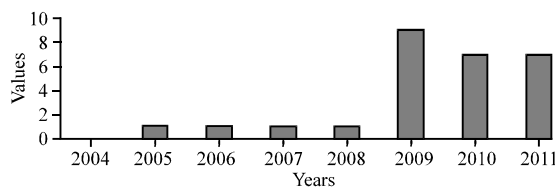


Fig. 8: Bank B; operational risk disclosure

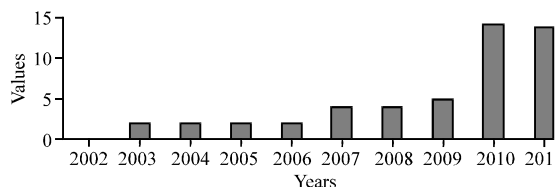


Fig. 9: Bank C; operational risk disclosure

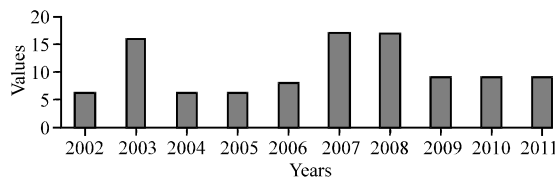


Fig. 10: Bank D; operational risk disclosure

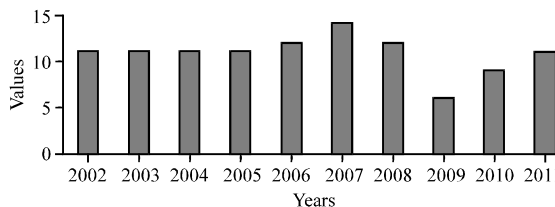


Fig. 11: Bank E; operational risk disclosure

year). In regards to the operational risk disclosure, the trend was quite volatile. With the 16 disclosed items in 2003, the numbers decreased drastically in 2004-2005 totaling 6 each but surprising factor is that during the financial crisis, it has the high number of disclosed items around 17 each. In post crisis period, the disclosure quality decreases and remains constant for 2009-2011 amounting to 8 items each (Fig. 10).

In the case of operational risk as compare to other banks, it maintains a good disclosure quality from the beginning. For the first 4 years (2002-2005), the number of disclosed items remains constant at 12 approximately. In 2006 and 2007, the trend has increased disclosing 12 and 14 items, respectively. It should be noted that in 2007 which was the starting point for financial crisis, it has the most number of disclosed items. However, the disclosed items for operational risk have decreased during 2008-2009 with 12 and 6 items, respectively. In 2010 and 2011, the disclosure quality has again started to increase with 9 and 11 items, respectively (Fig. 11).

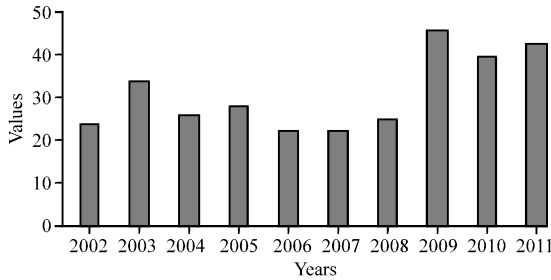


Fig. 12: Consolidated operational risk disclosure

Considering the disclosure on operational risk itself, the amount of information given in the operational risk section increased substantially over the 2002-2011 period (Fig. 12).

CONCLUSION

The risks are inherent in the banking business and they are inseparable. The success or failure of the banks depends on how well they manage their risks. This study tries to examine the disclosure quality of liquidity and operational risks of the banking sector in Malaysia. Transparency and disclosure is the heart of the sound banking system. However based on findings of this study, the disclosure levels are not high. Prior researchers have, also highlighted the important role of disclosure on the risk management. Thus, this study suggests that the regulators should relook the disclosure quality on risk exposure.

APPENDICES

Appendix 1: List of liquidity risk disclosure items

Description of disclosure items

Brief definition of liquidity risk

The exposure to liquidity risk and how they arise

The objectives, policies and process for accepting, measuring, monitoring and controlling the liquidity risk

The structure and organization of the entity's liquidity risk management functions including a discussion on independence and accountability

Strategy for managing liquidity involving effective board and senior management oversight

The scope and nature of the entity's liquidity risk reporting or measurement systems

The entity's policies for hedging or mitigating liquidity risk, including its policies and procedures for taking collateral

The entity's processes for monitoring the continuing effectiveness of hedging techniques

The entity's policies and procedures for avoiding excessive concentration of liquidity risk

How it manages the liquidity risk arises from financial liabilities maturing over time horizon

Expected cash outflow for its liabilities to be paid (for instance, demand customer deposits placed with a bank)

Expectation on some of its undrawn loan commitments

Information on holding the financial assets for which there is a liquid market and that are readily saleable to meet liquidity needs

Commitment to borrowing facilities (e.g., commercial paper facilities) or other lines of credit (e.g., stand-by credit facilities) that it can access to meet liquidity needs

Holding financial assets for which there is not a liquid market but which are expected to generate cash inflows that will be available to meet cash outflows on liabilities

Holding deposits at central banks to meet liquidity needs

Existence of having diverse funding sources

Existence of having significant concentrations of liquidity risk in either its assets or its funding sources

Methods/techniques used to measure/mitigate the liquidity risk

Detail explanation of any periodic changes in liquidity risk exposure, objectives, policies and process for managing the risk

The degree to which the liquidity risk management functions is centralized and decentralized

The frequency and type of internal liquidity reports

A summary of the liquidity risk management framework in addressing risk exposure for each category of funding (current accounts, unrestricted and restricted accounts), as well as on an aggregate basis

General information on policies to manage and mitigate liquidity risk, taking into account the ease of access to Shariah compliant funds and the diversity of funding sources

Maturity analysis of financing and various categories of funding (current account, unrestricted and restricted accounts) by different maturity buckets

An explanation of the utilization of stress testing in a liquidity risk management framework

Supervisory restrictions on the transfer of liquidity among group entities, if any

Contingency funding plan and intra-group financing strategies

Access to liquidity through fixed asset realizations and arrangements, such as sale and lease-back

Liquidity crisis management if any

The particular skills in treasury management and public relations

The quality of Management Information System (MIS)

Reliance on marketable assets or availability of standby lines of external funding

Summary quantitative data about its exposure to the risk at the end of the reporting period based on the information provided internally to key management personnel of the entity

Information disclosure on non-derivative financial liabilities

Financial liabilities according to their contractual maturity, based on undiscounted cash flows

Involvement of the board members in providing the strategy for liquidity risk management

Communication with the risk management committee with board of directors

Compliance with the regulatory requirement

Future plan for liquidity risk management

Appendix 2: List of operational risk disclosure items

Description on disclosure items

Definition of operational risk
Objectives and policies on operational risk management
Strategies and processes for operational risk management
The structure and organization of the operational risk management function
Strategies and processes for monitoring the continuing effectiveness of hedges to mitigate operational risk
The scope and nature of the operational risk reporting and/or measurement systems
Policies on hedging and/or mitigating operational risk
Contingency planning for operational risk
Business continuity planning for operational risk
Staff training for the awareness of operational risk management
The approaches for operational risk capital assessment for which the bank qualifies
Potential area exposed to operational risk
Stress tests done for the operational risk
Plan to prevent operational risk, for instance, segregation of the duty
Amount of Shari'ah non-compliant income (if any)
Disclosure of the Risk Weighted Asset (RWA) equivalent for operational risk
The identification of large exposures and risk concentration on operational risk
The organization (reporting framework) and responsibilities of an independent risk control unit
Involvement of board of directors and senior management in taking responsibilities for operational risk
Actual annual operational loss compared to the estimated amount
Operational risk reporting frequency to the top management
Documentation of risk management procedures
Independent review process on operational risk management
Communication with audit committee and operational risk management department
Compliance with the regulation on operational risk

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