Risk reporting by UK banks, 1995-2010: an exercise in futility?

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Abstract
This paper reports on risk reporting by the six largest UK-based 'high street' banks for all years between 1995 and 2010. Using a sentence, frequency-based and qualitative content analysis instrument, the study reports that volumes and frequency by risk category increased substantially over the sixteen years of the study. The qualitative interrogation of risk disclosures, enabled by the content analysis instrument, showed that almost all risk reporting included a discussion, by risk category, of mitigation and also that the proportion of 'bad news' rose over the longitudinal period, perhaps reflecting the market's demand for realistic risk reporting rather than 'copy-and-paste' disclosure. A volumetric regression of risk reporting volume (all companies) with newspaper mentions of risk by year over time produced a correlation of 72% showing an association between reporting and the intensity of discussion of risk in the press and, by proxy, in society. Notwithstanding such a quantitative and qualitative increase in risk reporting, including in liquidity risk reporting, many of the banks in the sample suffered from the occurrence of risk events, including liquidity failures. Accordingly, the paper discusses the findings in the context of subsequent failure, and challenges the belief that risk reporting in its present form is fit-for-purpose and capable of conveying truth to shareholders and others affected by bank risk.

1. Introduction
This paper reports on risk reporting by UK banks using a content analysis instrument capable of resolving the volumes, categories (types of risks disclosed) and information contents of risk disclosures in banks' annual reports from 1995-2010 inclusive. In noting several changes over a period that spanned a number of regulatory and societal challenges to banks, findings are discussed in terms of the banks’ responses to a changed political and social milieu. Specifically, this paper reports that the frequency, number of categories, volumes and information richness of risk disclosures have increased over time in banks' annual reports but that these changes bore no apparent relationship to the unfortunate period in which risk events were realised between 2007 and 2009.

These findings are discussed in the context of the purported purpose and potential materiality of risk disclosures. Following a range of initiatives emphasising the increased importance of risk management and disclosure in banks (such as FRS13 and the Basel provisions), many banks, including several in the UK, effectively failed because of liquidity problems.

It seems evident, then, that risk disclosures (at least as presently conceived) are incapable of adequately conveying the reality of risk, both in terms of the probability of risk events and their impact when they materialise. Notwithstanding increased regulation and disclosure, a banking 'crisis' was occasioned by a failure of a number of risk factors in UK banks. What purpose, then, do risk disclosures serve and what, if anything, is to be celebrated by a longitudinal increase in disclosure?

The remainder of this paper is structured as follows. In section 2, the prior literature on risk disclosure is reviewed with a particular emphasis on those reporting on risk disclosures in banks. Section 3 discusses the method used to interrogate the risk disclosures in UK banks between 1995 and 2010 and also
discusses the changes to bank risk regulation that has occurred over that time period. Section 4 reports on the main findings, whilst section 5 considers the implications of the findings, discussing then in the context of disclosure materiality and usefulness.

2. Background and literature review
A number of papers have commented on the increase in risk as an issue in society and business. Some (e.g. Linsley & Shrives, 2006) partly attribute this to the publication of what became an influential text in this area: Ulrich Beck’s ‘Risk society: towards a new modernity’ in 1992 (Beck, 1992). A series of corporate failures and near-failures have served to intensify an awareness of risks in business, and partly in response to this, a range of regulatory and advisory initiatives have been published: some industry specific and others concerned with internally controlling for risks alongside other corporate governance measures. Beck’s arguments included the observation that modernity (presumably including the rise of modern capitalism) has given rise to an increased complexity of society resulting in a greatly enhanced general risk awareness. Greater societal and economic complexity, often beyond the ability of the uninitiated to comprehend, creates a future orientation in which, it is thought, conveyance of risk narrative and mitigation messages serve to allay fear and palliate concern. In this regard, risk narratives are a way of maintaining quiescence and compliance, even though the messages’ conveyance may bear little relationship to the actual risks described: as long as the conferring public is satisfied that it does, that is deemed sufficient.

Risk reporting in accounting documents, most notably in annual reports, is a curious phenomenon inasmuch as the issues being described are often intrinsically unknowable. In the conventional form of risk assessment, in which risks are assessed in terms of their probability (of realisation) and impact (the loss if it were realised), it is common for either or both of these measures to be unknown or even unknowable. Lajili and Zeghal (2005) found that risk assessment analyses in risk disclosures lack uniformity, clarity and quantification. Yong, et al., (2005) was among several studies that reported very low levels of quantitative information in risk disclosure – almost all studies found that the information was overwhelmingly narrative-based. What, then, can be the purpose of risk reporting other than as a boiler-plating exercise designed to tick a compliance box or to palliate the concerns of a particular stakeholder (perhaps a regulator)?

The consumption of risk information was discussed by Campbell and Slack (2008), who reported on the perceptions of investment analysts. The content of risk reporting in UK banks was described by analysts as ‘generic’, ‘meaningless’ and ‘proforma driven’ whilst the authors (page 21) commented that disclosures were often “too simplistic for analysts on the one hand but perhaps too complex for the individual non-specialist investor on the other [hand].” Typical analyst views reported by Campbell and Slack (2008) were that risk reporting was ‘stating the obvious’, ‘mostly common sense’, ‘completely useless’, unchanged ‘from year to year’ and ‘boiler-plating’. It wasn’t that risk was unimportant in banking, because manifestly it was. It was just that the risk reports in annual
reports were of limited use because of the limitations of reporting on unknown and sometimes unknowable outcomes. Reflecting on this, Dobler (2008: 185) argued that one reason why risk disclosure was often considered immaterial was 'because it is subjective and partly non-verifiable'.

The importance of risk management to banks is uncontested, even if the usefulness and materiality if risk disclosures are sometimes questioned. The failure of the Royal Bank of Scotland (RBS) in 2008 was caused, according to the 2011 FSA report of the failure (FSA, 2011), in part by significant weaknesses in RBS’s capital position, over-reliance of short-term wholesale financing (causing a high level of liquidity risk), underlying asset quality, eroded market confidence, a seemingly botched acquisition of ABN-Amro and a structural vulnerability to a series of exogenous systemic events in UK markets and elsewhere. The report said that, the company was ‘too focused on revenue and profit at the expense of balance sheet risk’ (FSA, 2011: 249).

At a time when there were a range of manifest and imminent risks, that risk disclosures, inasmuch as they had any purpose at all, should have described with meaning, risk reporting clearly failed to discharge their putative role as meaningful disclosures in the annual report. The combination of boiler-plating disclosure and market mistrust of those disclosures combined, certainly in the case of RBS, to produce an unhappy combination in which the purpose and utility of risk disclosures were effectively undermined.

Notwithstanding these qualitative concerns, a number of studies have sought to analyse risk disclosures and to hypothesise on their purposes or their possible correlates. Many of these predate the banking problems that arose from 2007 to 2009. To varying degrees, these have used content analysis to examine risk disclosures volumetrically and qualitatively. These are summarised in Table 1.

The prior studies that specifically examined risk reporting in banks included Yong, et al. (2005), Poshakwale and Courtis (2005), Helbok and Wagner (2006), Linsley, et al., (2006), Bischof (2009) and Oliveira, et al., (2011a). In most cases the selection of banks in these studies was attributed to the strategic role that banks play in society and the unique way in which a wide range of specific risks that banks face.

More general studies have analysed risk reporting in a cross section of companies, sometimes specifically excluding banks and financial institutions from their samples. Linsley & Shrives (2006) found associations between risk disclosure, company size and structural risk exposure, but failed to find associations with a number of financial measures. Some studies (Othman and Ameer, 2009; Taylor et al., 2009. Oliveira, et al., 2011b) found a relationship between disclosure and some international accounting and/or reporting standards, such as FRS13 on derivatives and other financial instruments. The prominent prior studies, by date, are outlined in Table 1.

<table>
<thead>
<tr>
<th>Study</th>
<th>Countries</th>
<th>Sample</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beretta and Bozzolan (2004)</td>
<td>Italy</td>
<td>85 annual reports of non-financial listed companies (2001)</td>
</tr>
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</table>
Table 1. Empirical studies on risk disclosure.

As with other voluntary disclosure studies, longitudinal studies analysing reporting over several years are in the minority. Whilst cross-sectional studies can address inter-sectoral effects, they are clearly incapable of describing behaviour over time. In the interests of gaining a more complete picture of how risk reporting may respond to events over time for a single strategic sector of the UK economy (the major banks), this study adopted a longitudinal period capable of examining disclosure behaviour over a substantial time period.

3. Method

This paper presents a detailed content analysis of risk disclosures. Not only does this paper report on a contiguous longitudinal period over sixteen years (1995-2010), it also develops a content analysis method capable of examining volumetric, frequency by type and also a qualitative interrogation of the information content of risk disclosures.

Six UK-based banks were selected for the content analysis. They were Lloyds TSB, NatWest, RBS, HBOS (and the earlier BOS), HSBC and Barclays. Together, these six companies comprised the majority of banking market value in the UK. In each case, the main annual report and accounts filed in the UK was used for the content analysis. The annual report was employed because of this document being the basis for discussion in those regulatory provisions applicable to the
conveyance of risk information and it is also the document most widely and regularly distributed to shareholders and over the contents of which the company has almost total editorial control. It is based on the assumption that if a company were going to convey its risk management details to shareholders, the annual report would be only logical and practicable choice.

In each case, the risk disclosure sections were carefully analysed in order to establish risk disclosure data by overall frequency, frequency by category and by year, and also a volumetric sentence analysis. A coding matrix was employed capable of resolving disclosures by risk category (frequency of mention and also using sentences as a volumetric measurement) and some qualitative assessments, notable for this study being the textual and quantitative richness of the information (by category) being disclosed. This qualitative assessment involved assigning a value of 1, 2 or 3 depending upon the level of detail. This is shown in Table 2.

<table>
<thead>
<tr>
<th>Qualitative disclosure level</th>
<th>Definition</th>
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<tbody>
<tr>
<td>1</td>
<td>Disclosing with mention only or mention with minimal discussion</td>
</tr>
<tr>
<td>2</td>
<td>Disclosing with description of risk and exposure</td>
</tr>
<tr>
<td>3</td>
<td>Disclosing with description of management or mitigation of that risk</td>
</tr>
</tbody>
</table>

Table 2. The definitions of quality levels of qualitative disclosure

In order to include an external ‘societal’ variable capable of serving as a proxy for the intensity of societal opinion, a longitudinal analysis of newspaper hits (selected national daily and Sunday broadsheets) was conducted using Lexis Nexis. Over the sixteen years of the content analysis study, this was capable of providing an indication of the level of discussion in society about risk in banks. The citation frequency was calculated by summing the number of mentions of a number of selected risk terms. The terms searched for were those detailed in Table 3 and the usage was excluded if it did not refer to that risk in the context of banks or financial services (to maintain the sector relevance of each usage count).

4. Findings
This section describes aggregated data from the cohort of the six banks, for the purposes of illustrating the response of the banking sector to the changed risk environment over the sixteen years of the study. It is beyond the scope of this paper to disaggregate this data to report by company, and also unnecessary, as (a) there was broad agreement between the companies on risk reporting patterns, and (b), the motivation for this paper concerned issues relating to the banking sector as a whole. This meant that aggregated data was capable of addressing the issues under consideration.

Over the sixteen years of the study, the number of sentences on all matters of risk (in all six companies) rose from 1075 sentences in 1995 to 9941 sentences in 2010 (Figure 1). In all but one year, there was an annual increase in this
volume. The volumetric increase over the period is nine-fold since 1995 and five-fold since 2000.

A similar record is evident in the number of categories of risk disclosure discussed in the annual report. Figure 2 shows the average number of categories of risk disclosed by year among the six sample companies. In 1995, the average number of risk categories discussed in an annual report was eight. In each year over the longitudinal period, the total increased (excepting three years when it remained the same as the previous year), reaching a mean of twenty-five categories per annual report in 2010.

Within this trend are some noteworthy examples of the growth of risk categories disclosed. The Royal Bank of Scotland, for example, rose from six risk categories
disclosed in 1995 to thirty in 2010 (a five-fold increase with a modal figure of seventeen categories in each of 2003, 2004 and 2005.

Together, figures 1 and 2 describe a narrative of a greatly enhanced risk reporting regime in UK banks. This is likely to be the result of a number of causes including increased investment in information systems capable of generating risk assessment and mitigation data, increased stakeholder (especially shareholder and analyst) information demands, and a general trend among all large corporations towards increased transparency and higher levels of voluntary disclosures.

The relative ‘popularity’ (all companies, all years) of the different categories of risk disclosure is shown in Table 3. It is evident that credit risk, perhaps not surprisingly for banks, is the most frequently-disclosed risk category with almost 15,000 sentences disclosed in total over the sixteen years and six companies. Content coded as ‘risk management’ was second with just over half the number of sentences as that devoted to credit risk. Unlike specific risk categories, ‘risk management’ narrative generally designed to inform and, perhaps, reassure readers of the annual reports. Inasmuch as risk is a strategic matter for a bank, the general robustness and rigour of risk management systems would be potentially material to investors.

<table>
<thead>
<tr>
<th>Ranking number</th>
<th>Risk categories</th>
<th>Number of sentences</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Credit risk</td>
<td>14,958</td>
</tr>
<tr>
<td>2</td>
<td>Risk management (generally)</td>
<td>7,996</td>
</tr>
<tr>
<td>3</td>
<td>Market risk</td>
<td>5,530</td>
</tr>
<tr>
<td>4</td>
<td>Insurance and Investment risk</td>
<td>4,393</td>
</tr>
<tr>
<td>5</td>
<td>Liquidity and funding risk</td>
<td>4,176</td>
</tr>
<tr>
<td>6</td>
<td>Capital management risk</td>
<td>3,887</td>
</tr>
<tr>
<td>7</td>
<td>Legal and Regulation risk</td>
<td>3,443</td>
</tr>
<tr>
<td>8</td>
<td>Risk related to derivatives</td>
<td>3,441</td>
</tr>
<tr>
<td>9</td>
<td>Interest rate risk</td>
<td>2,510</td>
</tr>
<tr>
<td>10</td>
<td>Operational risk</td>
<td>2,243</td>
</tr>
</tbody>
</table>

Table 3. Volumetric ranking of the ten most popular risk disclosure categories, all companies, all years.

One of the causes of the problems that UK banks experienced in the period 2007-2009 was linked with liquidity. It is interesting to note that liquidity risk was volumetrically the fourth most disclosed risk category overall (fifth including the general ‘risk management’ disclosures). Because of its important role in the near-failures of several banks, including, for example, RBS, this category was volumetrically examined over time. Figure 3 shows the volumetric trend in liquidity risk disclosure over time. The graph shows a switch-point occurring in the mid decade around 2006, shortly before the liquidity difficulties in the banks became apparent. In the early years, the totality of liquidity risk reporting (all companies) was fewer than 100 sentences. By the mid 2000s, just before the liquidity problems in UK banks emerged, this volume had increased to around 300 sentences in total (all six companies). In 2007, just prior to when some of
the banks fell into liquidity problems, this had risen to around 500 sentences and during the 'crisis', it peaked at over 700 sentences (all companies). There is evidence, then, that banks felt the need to make more volumetric disclosures on matters of liquidity risk prior to the unfortunate events of 2007–2009 occurring.

Figure 3. Volumetric trend in liquidity risk disclosure, all companies.

In addition to frequency and volumetric increases, this study also included a qualitative interrogation using the 1, 2 and 3 scores as discussed above. The aggregated findings by year are shown in Figure 4. Disclosures scored at 3 significantly outnumbered those scored at 1 and 2. A disclosure scored at 3 is one that not only explains risk and places it in context, but which also provides a ‘description of management or mitigation of that risk’. This means that, in all years, the normal and most usual form of a risk disclosure was one in which risks were discussed and with readers then provided with a commentary on how that risk was being mitigated. This form was presumably intended to allay fears and provide reassurance, especially to readers who had a financial exposure to the company such as shareholders and creditors.

Figure 4. Qualitative interrogation by sentence, by year, all companies.
The final interrogation on the data for the purposes of this paper was on the news direction of each risk disclosure. This was seen as relevant not so much for gathering the news direction itself but in the belief that bad news reporting is more likely to be a fuller and more truthful disclosure. It is likely that higher levels of bad news are a proxy for greater transparency inasmuch as there is likely to be greater level of cost associated with the disclosure.

The ‘bad news’ disclosures are shown in Figure 5. Again, the graph shows a substantial and marked increase over time from under 1% of disclosures in 1995 and 1996 to almost 10% in 2010 with each year representing a year-on-year increase on the last. There are a number of possible reasons for this trend. The most obvious is that there was more bad news to actually report (such as under-performance against specific targets) but a second plausible explanation is a felt-need to be seen as credible. Investors fed with continual saccharin good news are likely to disbelieve the reporting and seek more credible explanations from the companies through other channels. This, representing an increased cost to management, could be partly obviated by the disclosure of ostensibly plausible information – i.e. that containing some bad news.

In any event, such an increase in bad news reporting suggests a concerted effort, over time, to be perceived as credible, transparent and reliable.

In order to gauge the extent to which risk disclosures might respond to the wider discussion of risk in society, the frequency of news hits was plotted and regressed against the aggregated volumetric risk disclosure data (Figure 6). A correlation of 0.722 was found with switch points approximately synchronously around 2006. The newspaper hits were approximately level between 1998 and 2006 but then witnessed a rise as the result of increased discussion in the media about the risks facing businesses, arising largely from the banking liquidity issues that started to emerge in 2007 with Northern Rock.
Figure 6. Correlation between number of sentences disclosed (all risk categories, all companies) and number of risk citations (all risk categories) in newspapers. (R square = 0.722, p=0.000).

Discussion
In the absence of countervailing narrative, these findings would suggest an industry responsive to market demands for more information, with more frequent disclosure, more realistic disclosure (evidenced by the increase in bad news reporting) and increasingly detailed information in terms of information richness. Furthermore, the evidence from the high correlation with newspaper hits superficially suggests an industry responsive to, or at least reflecting, the concerns and conversations occurring in society.

The more salient discussion to be had given these findings and the failure, nevertheless, of several UK banks included in this study, is on the materiality of risk reporting and, thereby, the purpose of risk reporting in annual reports. In addition to the evidence of limited usefulness reported on from interviews with information users (Campbell & Slack, 2008) it is hard to escape the conclusion that, notwithstanding the increases in quantity and quality of risk reporting, investors did not foresee the looming crisis, and management did not report salient facts on the true state of the risks facing their companies. This failure to disclose, in turn, may be the result one or both of two contingencies: management understanding the risks and concealing them, or, management being ignorant of the true nature of the risks (and thereby necessarily failing to disclose).

It is beyond the scope of this paper to provide a full discussion of bank risks and the causes of banking failures, but what seems likely, given the findings in this paper, is that the levels of risk reporting, albeit at a longitudinal high in terms of volumes, types and quality, were grossly inadequate. Were the banks to have provided genuinely accurate and material risk information in, say, 2006 or 2007, the effect would have been to reduce company values and degrade investor confidence.

There is ample scope, then, for a systemic questioning of the purposes of risk reporting. Inasmuch as it is distrusted by analysts and seemingly incapable,
notwithstanding a large increase over time, of foreshadowing significant risk events, then what is the purpose of risk disclosure in annual reports? As with any omission once present, it would certainly be of concern to users were it to suddenly disappear, but it is difficult to find a rationale for the presence of risk disclosure beyond an amorphous notion that it is ‘expected’ by readers, even if it is untrusted.

This also raises issues, we argue, about the information value of other voluntary narrative in corporate reporting. If there is a market penalty for ‘too much’ or ‘too honest’ reporting, and if ‘too little’ or ‘too poor’ is unfit for purpose, is there a balanced position at which voluntary information is optimal for producers and consumers alike (perhaps a notional ‘disclosure equilibrium’)? Although notionally conceivable, in reality this would seem to be unlikely, and this, in turn, represents a challenge to the purpose of voluntary reporting. If voluntary reporting is little more than a ‘comfort blanket’ to some annual report users, then it is an ineffective one, certainly as far as risk reporting is concerned – a placebo where a more effective medicament is required.

References.


