
CORPORATE GOVERNANCE „ACTORS” CAPABILITY AND RISK INFORMATION TRANSPARENCY – EMPIRICAL STUDY ON EUROPEAN BANKING SYSTEM

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Abstract:

The purpose of our empirical study is to assess the relationship between corporate governance „actors” capability and risk information transparency in European banking system. The research methodology used for achieving our goal is based on correlation tests and regression analyses for identifying and assessing the relationships between the “risk information disclosure index” developed and the experience and education of both board of directors and audit committees’ members. The results of the performed analysis reveal significant positive influences of governance actors’ capability on the level of risk information disclosure, thus confirming our assumptions that the higher the educational degrees and professional expertise, the higher the level of disclosure. Irrespective of prior studies, which were focused on various corporate governance features, our paper comes to add value to research literature by testing the same characteristic, namely “capability” from two of the most important actors’ perspective: board of directors and audit committee. Moreover, we also had the chance to enrich the literature with this empirical study not only by focusing on a specific field - the banking one, which was little explored on this topic before, but also by considering a particular area of disclosure – the risk information one, thus revealing how corporate governance actors’ capability affected financial institutions’ transparency in case of E.U. banking system.

Key words: *corporate governance, transparency, risk information, banking system, European Union*

1. Introduction

Basing on the agency theory, a good corporate governance system providing more transparent disclosing information appears to be a key issue in ensuring stability to the financial sector and sustainability to economy, as whole. Thus, poor corporate governance in banking environment leads to lose of confidence in the ability of managing properly its assets and liabilities. Consequently, depositor might withdraw their economies, while other creditors might end their financing, which could in turn trigger a liquidity crisis in banking environment, leading to a systemic risk. In this context, risk information disclosure plays an essential role in banking environment, being of interest for market participants in their decision-making process. It might

reduce the information asymmetries, clarifying interests' conflicts, making corporate insiders accountable for their actions and not least protecting shareholders. Thus, disclosure and transparency play an important role in ensuring market discipline in banking environment.

Good quality, timely and relevant information needs to be available to all market participants and regulators so that as set quality, creditworthiness and the condition of financial institutions can be adequately assessed. Thus, only through enhanced disclosure, active participants might impose market discipline earlier and more effectively, and great importance in this respect has both the regulatory environment (Nier and Baumann, 2006) and supervisors' information, especially for banks that were not forthcoming in their prior disclosures (Jordan et al., 2000; Bliss and Flannery, 2002). However, what an entity discloses in its annual reports and financial statements is considered as a "litmus test" of its corporate governance quality (Bokpin and Isshaq, 2009), thus leading to the general assumption that disclosure and quality of corporate governance system are two closely related concepts - the higher the level of transparency, the better the quality corporate governance practices.

Basing on this background, our paper proceeds as it follows: Firstly, we briefly review prior literature concerning possible relationships between "capability", as a measure of quality of corporate governance and banks' level of risk information disclosure, which stood at the basis of our research hypotheses. Than, we provide information about the sample of banking institutions that became the subject of our analysis, providing as well details about variables' measurement. After explaining the research methodology used, consisting of correlation and regression analysis, we provide our research findings and discuss their implications, closely related to previous studies focused on the similar goals.

2. Literature Review And Hypotheses Development

Risk information disclosure stood as a topic of research in many studies, which approached this concept from various perspectives, all off these actually deriving from the general accepted idea that in the light of market discipline and as a part of good corporate governance, banking institutions are expected to be transparent as regards risk taken. In the latest years, on the background of financial instabilities that affected various regions of the world, many policy initiatives recognized the importance of market discipline in safeguarding the overall financial stabilities. Because banking activity is by its nature a risky one, these initiatives often addressed risk taken by credit institutions, being focused on enhancing their transparency.

Thus, focusing on possible consequences of transparency, research literature provides evidences about the relationship between the level of risk information disclosure and various issues like feature predictions (Liu, et al., 2004; Linsley, et al. 2006), equity capital level (Wu and Bowe, 2010; Nier and Baumann, 2006), volatility of a bank's stock price (Baumann and Nier, 2004; Poshakwale and Curtis, 2005) or corporate governance structure (Htay, et al., 2011). When investigating the impact of

corporate governance structure on risk information disclosure on banking system, by testing for statistically significant correlations, authors concluded that higher risk management information disclosure can be achieved if board leadership structure, higher proportion of independent directors, institutional ownership, block ownership, board size and lower director ownership are separated.

Consequently, the continuously improving regulatory environment, gave researchers a lot of possibilities to approach risk information disclosure topic, but there are many unexplored, yet. Basing on this background, we designed our analysis focusing on assessing possible relationships between good-quality corporate governance, by measuring its “capability”, and transparency, thus aiming to enrich research literature on this topic.

a. Board of directors’ capability

Board capability is appreciated as an important issue of a good corporate governance mechanism, prior studies suggesting various ways of assessing it, such as:

- ✓ knowledge and skills to adequately monitor an organization (Nicholson and Kiel, 2004)
- ✓ legitimacy and abilities to link the firm to key stakeholders or other important parties (Ong and Wan, 2008)
- ✓ professional accounting and financial expertise to report in a more straightforward manner (Raghunandan, et al., 2001; Carcello and Neal, 2000)
- ✓ experience measured in terms of diverse backgrounds (mainly in other firms and industries) and directorships in other “unconnected” companies (Westphal and Milton, 2000), hoping that it should improve board monitoring and decision making.

Board’s capability was included in prior studies focused on the relationship between corporate governance and transparency, basing on the premise that knowledge and skills ensure better monitoring, thus leading to higher disclosure. Thus, according to earlier findings (Haniffa and Cooke, 2002; Chiang and He, 2010), board members with higher-level educational degrees are expected to have better general knowledge, while those who hold dual positions are assumed to have better business knowledge and experience, and consequently, they should be able to ensure more disclosure of company information.

Since professional expertise proved to ensure both better supervision, and fair and proper disclosure of company information, we hypothesize that:

H_{1a}: There is a positive association between the educational degrees of board membership and the extent of risk information disclosure

H_{1b}: There is a positive association between the professional expertise of board membership and the extent of risk information disclosure

b. Audit committee' capability

According to the agency theory, the establishment of an audit committee serves as a mean of reducing information asymmetry and managerial opportunism, by improving disclosure quality (Chung et al., 2002) through a proper information flow between firm owners (shareholders and potential shareholders) and managers (Ho and Wong, 2001), thus protecting the investors (McDaniel et al., 2002), especially in the financial reporting environment where there are disparate information levels (Barako, et al., 2006). By monitoring board activities, audit committee plays an essential role in ensuring an accurate assessment of the top management decisions and performance and a continuous communication to external auditors (Rashidah and Fairuzana, 2006). Consequently, it ensures a reliable financial reporting by reducing the incidence of errors and other irregularities, as well as the likelihood of accounting fraud, by attesting external financial reporting (Peasnell et al., 2001). Thus, it maintains the quality of control systems and financial accounting information disclosure. Moreover, it contributes at enhancing the breadth of relevance and reliability of annual reports and improving information quality conveyed to external parties (Abbott, et al., 2004; Carcello and Neal, 2000).

Just, the existence of an audit committee proved to be not enough in order to ensure quality to disclosure (Forker, 1992). That is why, prior studies tried to assess its effectiveness through the independence and expertise of its members. As regards the expertise of audit committee members there have been considered their degrees in finance and accounting, prior studies' expectations related to a positive influence on the level of disclosure being confirmed (Mangena and Tauringana, 2007; Akhtaruddin and Haron, 2010; Mangena and Pike, 2005)

In conclusion, audit committee in general became an effective monitoring tool to control agency problem and improve disclosures, thereby reducing information asymmetry and agency costs, while its independence and membership expertise proved to be its essential features coming to help the principals to better monitor the agents' activities and reduce benefits from withholding information.

Based on these earlier evidences the following hypotheses are examined:

H_{2a}: There is a positive association between the educational degrees of audit committee membership and the extent of risk information disclosure

H_{2b}: There is a positive association between the professional expertise of audit committee membership and the extent of risk information disclosure

3. Empirical design and results

In this survey we aimed to identify possible associations between "capability" of corporate governance and the level of risk information disclosure through annual reports in case of banking institutions. The main reason of focusing our research on a qualitative characteristic of governance structures was its major role in ensuring a good quality corporate governance mechanism. Thus, the aim of our study is to provide an

answer to the research question “*Do corporate governance capability affect risks’ transparency?*” by assessing the relationship between the level of education and experience of governance structures’ members and the level of risk information disclosure.

The research methodology used for achieving our goal is based on econometric analysis using statistical tools - correlations for identifying possible relationships and regressions for assessing them - all of these being performed using SPSS software.

3.1. Sample selection and variable measurement

For achieving our goal, we need a representative sample for data collection. In this respect, we decided to consider all 27 European Union countries and all the financial institutions listed on their main stock exchanges, according to the information provided on their website for September 2011. Thus, initially, our sample consisted of 261 financial institutions, coming from various regions of the world. After excluding those financial institutions that are conducting only financial consultancy, without any banking activity (13), that did not have an English version of their website (46) or did not provide an English version of their annual report (13), our final sample consisted of 189 banking institutions. Data collection was based on information provided by banks’ websites throughout their annual reports.

Because the main purpose of our study is to identify possible associations between corporate governance dimensions and the level of transparency, two sets of dependent and independent variables for performing the correlation analysis were needed.

The dependent variable consisted of *the risk information disclosure index (RID)* developed, based on disclosures required by international regulations dealing with financial instruments, considering as well the “Disclosure checklist” used by Big Four for assessing the level of applicability of IFRS. For developing the disclosure index each item of the checklist was scored using binary classification, each issue from the list being treated a dummy variable, where “1” indicates that the annual report discloses the information and ‘0’ indicates that there is not disclosed any information about that issue.

The checklist developed for computing the disclosure index consisted of 18 items divided into two main categories: qualitative and quantitative risk disclosures that briefly presented as follows. Qualitative disclosures refers to general information such as risk exposures for each type of financial instrument, management's objectives, policies and processes for managing those risks, changes from the prior period. Quantitative disclosures comprise besides general disclosures (summary quantitative data about exposure to each risk at the reporting date, concentrations of these risks, disclosures about credit, liquidity and market risk and how these risks are managed) specific information on each risk, as follows:

- *credit risk*: the maximum amount of exposure (before deducting the value of collateral), description of collateral, information about credit quality of

financial assets that are neither past due nor impaired, as well as for those whose terms have been renegotiated;

- *liquidity risk*: a maturity analysis of financial liabilities and a description of approach to risk management
- *market risk*: a sensitivity analysis of each type of market risk to which the entity is exposed, the methods and assumptions used in preparing the sensitivity analysis, changes from the previous period in the methods and assumptions used, and the reasons for such changes.

The *independent variables* consisted of assessing an important characteristic of both board of directors and audit committee's members, namely "*capability*" that prior studies found to have significant influences over the level of disclosure. Thus, their way of measurement and the predicted direction of influence over risk information disclosure index are presented in Table 1.

Table 1. Independent variable description

Independent variables		Variables description	Predicted sign
Board education	B_Edu	the proportion of members with high level of education (ex. PhD degree) to the total number of directors	+
Board experience	B_Exp	the proportion of members with cross-directorship to the total number of directors	+
Audit committee education	AC_Edu	the proportion of members with high level of education (ex. PhD degree) to the total number of members	+
Audit committee experience	AC_Exp	the proportion of members with prior experience in audit field	+

Source: own projection

3.2. Data analysis and hypotheses test results

For performing the correlation analysis, the first step of our analysis whose results are detailed in Table 2, we calculated Pearson coefficient that is usually used for measuring the strength of linear dependence between two variables, giving a value between "1" describing the perfect direct relationship and "-1" revealing an indirect one, "0" value meaning that there is no linear correlation between variables.

When formulated our first hypothesis we presumed that board members with higher-level educational degrees are expected to have better general knowledge, thus being able to better fulfill their monitoring duties and consequently to ensure more information disclosure. Also, basing on the premise professional expertise ensures both better supervision, and fair and proper information disclosures, we appreciated that board membership holding positions in other boards will have better business knowledge and experience.

Table 2. The correlation matrix between variables

		B_Edu	B_Exp	AC_Edu	AC_Exp
RIDI (Risk Information Disclosure Index)	Pearson Correlation	.439**	.416**	.494**	.372**
	Sig. (2-tailed)	.000	.000	.000	.000
	N	189	189	189	189

***. Correlation is significant at the 0.01 level (2-tailed).*

Source: calculations made using SPSS software

Pearson coefficient values reveal the existence of a positive correlation between variables tested, having a high probability of significance of 99% (Sig. <0,01) and a medium intensity: 0,439 in case of board education (B_Edu), respectively 0,416 for board experience (B_Exp), which is explained in around 20% of cases, according to the linear regression results presented in Table 3.

Consequently, our first hypothesis (H_{1a} and H_{1b}) will be accepted, leading to the conclusion that *the higher the educational degrees and the professional expertise of board membership, the higher the level of disclosure.*

Table 3. Linear regression analysis results

	Unstand. / Stand. Coeff.		Beta	t	Sig.	R.Sq.	Adj.R.Sq.	F value
	B	Std error						
Risk Information Disclosures								
(Constant)	9.084	.281		32.315	.000			
B_Edu	.113	.017	.439	6.675	.000	.192	.188	44.551
(Constant)	6.150	.727		8.462	.000			
B_Exp	.074	.012	.416	6.263	.000	.173	.169	39.227
(Constant)	7.134	.473		15.088	.000			
AC_Edu	.057	.007	.494	7.762	.000	.244	.240	60.254
(Constant)	9.731	.234		41.538	.000			
AC_Exp	1.960	.358	.372	5.477	.000	.138	.134	29.992

Source: calculations made using SPSS software

Similar, in case of audit committee's members experience and expertise, correlation analysis results reveal a significant positive association, too, having an intensity level close to a medium value in case of education (0,494) and a pretty lower one for experience (0,372), both of them with the highest probability of significance (99% - Sig. <0).

Thus, *the extent of risk information disclosure proved to be positively associated with the educational level and experience of an audit committee membership*, our second hypothesis H_{2a} and H_{2b} being accepted, too.

In conclusion, "capability" as a measure of good quality corporate governance has positive significant influence on the level of risk information disclosure in case of European listed banking institutions, our analysis' results being thus consistent with prior research findings.

4. Conclusions, limitations and perspectives

Banking environment faced up a continuous evolution marked by globalization and deregulation that might negatively affect its soundness thus being more sensitive to financial crisis. During the financial meltdown which began in the late 2007, both capital market and the bank regulatory authorities have called for enhanced transparency, basing on the assumption that inappropriate and improperly timed information disclosure may make the banking system sensitive to systemic shocks. The main consequences of inadequate disclosure, resulting in poor transparency and the absence of effective market discipline, might consist of weak monitoring and supervision, thus leading to financial crisis. Closely related to financial crisis it has been stated that transparency can only help to prevent a financial crisis and it should not be seen as a cure for systems already under stress.

Most recently corporate failures and accounting scandals proved to have been caused by the lack of good corporate governance, that have adversely affected public confidence in the reliability of corporate and financial reporting. All these situations gradually lead to “a wake-up call” to the need for better corporate governance and transparency among entities all over the world. Also, analyzing possible relationships between corporate governance features and transparency became one of the most attractive, dynamic and challenging research subject in academic environment.

Thus, many studies focused on corporate governance mechanism analyzed its components closely related to performance measures or information disclosures, often concluding that a weak corporate governance system negatively affects both value and disclosure level, while a strong governance mechanism improves efficiency and encourages transparency, thus leading to the following “*motto*”: “*The higher the level of transparency, the better the quality corporate governance practices*”.

Basing on this background, our study was aimed to provide a comprehensive analysis of the relationship corporate governance – transparency in banking environment, by trying to find answers, justified throughout empirical analysis, to the following research questions “*How does capability of governance structures affect risk information transparency in banking system?*”

Irrespective of prior studies, which had similar goals, our paper comes to add value to corporate governance literature from multiple perspectives. Firstly, our analysis was conducted on a sample made exclusively of banking institutions, the financial system being little explored on this topic before. Than, if prior studies analyzed such relationships considering various features of one corporate governance “actor”, we had the chance to enrich the research literature with this empirical study by analyzing the same feature (capability) in case of various actors (board of directors and audit committee). Moreover, we focused on a particular area of disclosures – the risk information one, specific to our sample made, thus, the disclosure index developed ensuring as well originality to our research.

The results of the performed analysis reveal positive relationships between capability of corporate governance structures analysed and the level of risk information

disclosure that proved to be statistically significant. Thus, all hypotheses developed were accepted by asserting that *the higher the educational degrees and the professional expertise of board and audit committee membership, the higher the level of disclosure.*

Finally, we appreciate our study as having multiple theoretical and practical implications, being a useful source of information and reflection to interested practitioners, regarding corporate governance influences over banks' transparency. Furthermore, we consider the literature review of our paper as providing an overview image of what has already been studied related to corporate governance's impact on transparency, as a useful synthesis for both research and academic environment.

In the end, being aware of our study's limitations, coming from the sample of banks, the limited number of factors and the fact that only one year data were considered for analysis, we are appreciating these as a challenge that give us outlooks for future research.

5. References

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