The Strategic Under-Reporting of Bank Risk

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Summary

- Documenting strategic under-reporting of trading book VaRs through banks' internal risk models
- Analyzing how incentives – proxied by bank equity – affect this under-reporting behavior
- Empirical results indicate:
  - Banks do strategically under-report risk depending on their equity capital (lower equity => more exceptions)
  - Banks with large trading books and low recent stock market performance under-report more
  - Many alternative stories, robustness checks

Comments I

- Number of banks in the analysis is very low possibly causing problems:
  - Small N large T setting
  - One bank driving the results? (Robustness check)
- The difference in incentives most evident between low vs high equity banks
  - Log transformation not clear enough to capture
  - Sample split, interaction term, distance to min. cap. req.

Comments II

- Including country level controls? (US vs. Canada)
- Use of banking crisis dummy as an alternative distress measure
- Any evidence of under-reporting before financial crisis? Is this behavior crisis-specific?
- Limits to asset class composition controls, possible measurement error in equity =>IV/AB?

Minor issues

- Some robustness tables can be consolidated
- More information on AB difference estimator needed (one- or two-step estimation, standard errors, validity of the tests)
- Considerably lower coefficient of Tier 1 capital can be highlighted (in line with Acharya et al. (2013))
- All variables should be included in summary stats

Conclusion

- Very important addition to literature on unreliability of self-reporting by banks
- It may be difficult to generalize as it mainly focuses on the crisis period and a very limited number of banks
- But results are in line with previous literature suggesting a consistent pattern