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ACCEPTED MANUSCRIPT

What do a bank's legal expenses reveal about its internal controls and operational risk?

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Highlights

- Consistent strong performance in banking requires a good system of internal control.
- High legal expense is indicative of weak internal control.
- Bank legal expense is not shown on regulatory reports.
- We find legal expense (measured by a proxy) is a strong determinant of loan losses and stock returns.
- Bank regulators should require reporting of legal expense on call reports to identify weak internal control.
- An analysis of litigation patterns is crucial in this process
- Current reporting requirements are inadequate and improvements are easy to implement.
- Current reporting leads to mispricing of bank securities.

Abstract

Excessive (substantially above peer) litigation against a bank is indicative of operational risk because it often suggests failure to maintain a strong system of internal control. We examine the relation between bank performance and weak internal control using legal expense as a proxy. We find that legal expense is a strong determinant of loan losses and stock returns. Bank regulators should require reporting of legal expense on call reports to help identify institutions with weaknesses in internal control. Current reporting creates unnecessary information asymmetries because investors are not well informed about operational risk, leading to mispricing of bank securities.

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1. Introduction

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