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Fraud recovery and the quality of country governance

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ABSTRACT

Using supervisory data from U.S. financial institutions on fraud-related losses in foreign markets, we find that losses in countries with poor governance have lower recovery rates. Our results are robust to accounting for potential endogeneity and reverse causality concerns, among numerous robustness checks. The association is driven by intuitive governance dimensions such as control of corruption, rule of law, regulatory quality and government effectiveness. In addition, country governance plays a particularly important role in fraud recovery for firms with poor risk management quality. Overall, this paper presents unique and novel evidence tying country governance quality to firm-level risk realizations.

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1. Introduction

The quality of country institutions has first-order effects on economic growth and financial development. For instance, Acemoglu et al. (2001) estimate a large impact of institutions on income per capita, explaining cross-country differences in income levels. Similarly, La Porta et al. (1997) and Djankov et al. (2007) show that investor protections play a crucial role for the size and breadth of capital markets. Furthermore, country institutions have pervasive implications for corporate policies, organization and structure (e.g., Stulz, 2005; Antras et al., 2009; McLean et al., 2012). Despite such evidence, the existing literature provides little insight on the direct channels through which country institutions improve operational environment, and help corporate businesses mitigate business and operational risk realizations. Our study takes a step towards filling this important void by presenting novel cross-country evidence on the link between the quality of country governance and wealth recovery from financial fraud.

While country institutions have been related to fraud occurrence (e.g., Callen and Long, 2015; Bertrand et al., 2007; Olken, 2007), and more generally the incidence of crime (e.g., Soares, 2004), a direct link between the quality of country governance and wealth recovery in relation to such externalities has not been established. In a recent incident, the Bangladesh Central Bank lost millions of U.S. dollars to fraud. The Bank traced most of the stolen money to the Philippines and recovered some through cooperation with local authorities. However, a full recovery from the attack is deemed unlikely with weak anti-money laundering laws being a particularly difficult obstacle. The dizzying scope of the heist underscored the sometimes global nature of financial fraud, and highlighted the crucial role of country institutions for the recovery of wealth lost in crime.[1]

In this study, we examine fraud events incurred by U.S. financial institutions that can be traced to foreign markets, focusing on how much can be recovered. Our research design ensures that the home country institutions regulating the operational environment and administering the legal protection of businesses can be held

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[1] See *Wall Street Journal*: "Bangladesh Central Bank Found $100 Million Missing After a Weekend Break" (S. Al-Mahmood, March 10, 2016); "Bangladesh Central Bank Says It Recovered Some Funds Allegedly Stolen by Hackers" (K. Burne and S. Al-Mahmood, March 8, 2016).

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constant (by focusing on U.S. financial institutions only). This allows us to center on the role of governance quality in the countries where fraud occurs. To explore this question, we use supervisory operational loss data from 2002 to 2012 related to fraud cases in international markets. Such losses are reported to the Federal Reserve System by large U.S. bank holding companies (BHCs) for stress testing purposes. Our main findings can be summarized as follows.

We document a significant association between fraud recovery rates and country governance: recovery rates are higher in countries with good governance relative to countries with poor governance. Country governance is statistically and economically significant, even after controlling for other country, bank, and fraud event characteristics. A one standard deviation improvement in our country governance index is associated with a 0.5 percentage point increase in the recovery rate, which is meaningful given an unconditional average recovery rate of 3.3 percentage points in our sample.

Our results are robust to accounting for potential endogeneity and reverse causality concerns. Using an instrumental variables approach, we follow Acemoglu et al. (2001) and Acemoglu and Johnson (2005) to exploit European settler mortality rates in colonies between the seventeenth and nineteenth centuries as an instrument for country governance. European settlers adopted different policies in different colonies, with different associated governance institutions that arguably persisted to the present. Acemoglu et al. (2001) show that European settlers were more likely to set up strong institutions that protected private property rights in colonies with favorable environments for settlement. In contrast, in places where Europeans faced high mortality rates, they were more likely to set up extractive institutions to exploit the native populations. The advantage of the instrumental variables approach is that it provides a plausible framework to identify the effects of country governance; conditional on controls, settler mortality more than 100 years ago should have no effect on fraud recovery outcomes today, other than through its effect on country governance and quality of property rights institutions. We confirm our baseline results using European settler mortality rates as an instrument for the quality of governance institutions.

We then investigate the governance dimensions driving this relationship. In particular, we examine the six individual component indices on which our main measure is based: control of corruption, regulatory quality, rule of law, government effectiveness, political stability, and voice and accountability. Arguably, such governance dimensions capture disparate aspects of governance and thus might have unequal influence on fraud recovery. While the capacity of the government to effectively formulate and implement sound policies should matter more, political stability and the democratic process are likely less important. Consistent with this conjecture, we show that the positive association between country governance quality and recovery rates is driven by governance dimensions such as control of corruption, regulatory quality, rule of law and government efficiency.

Finally, we investigate the link between banks' internal risk management practices and fraud recovery in an international context, and examine potential interactions between firm-level risk management and the quality of country governance. Leveraging a risk management rating from the Federal Reserve System, we find significant relationships. Good country governance has stronger positive effects on recoveries for banks with poor practices. Conversely, banks with poor risk management face incrementally lower recoveries in countries with poor governance.

Our paper contributes to several research streams. First, our paper extends the large and growing literature linking country institutions and legal protections to economic activity and outcomes. For example, La Porta et al. (2006) examine the effect of securities laws on stock market development, finding strong evidence that laws mandating disclosure and facilitating private enforcement through liability rules benefit stock markets. Similarly, La Porta et al. (1997) show that countries with poor investor protections, measured by the character of legal rules and the quality of law enforcement, have smaller and narrower capital markets. Djankov et al. (2007) examine the cross-country determinants of private credit, showing that both creditor protection through the legal system and information-sharing institutions are associated with more private credit. Nenova (2003) shows that the value of control-block votes varies widely across countries. Differences in the legal environment, law enforcement, investor protection, takeover regulations, and power-concentrating corporate charter provisions help explain the majority of such variation. Davydenko and Franks (2008) show that bank debt recovery rates across countries are sharply different, reflecting different levels of creditor protection. Our study complements this stream with unique evidence on the relationship between country governance quality and the recovery of corporate wealth lost in financial fraud.

In addition, while we do not take a direct stand on whether country institutions affect multinational firms' geographical structure and foreign investment, our study supports prior literature that documents such effects. For example, Habib and Zurawicki (2002) and Uhlenbruck et al. (2006) argue that investors engage in less foreign direct investment in countries with weak governance (e.g., high corruption) to reduce operational inefficiencies created by weak country governance. Lin et al. (2016) provide firm-level evidence that U.S. multinational companies (MNCs) are more likely to have operations in countries with better country governance (e.g., property rights). The authors also argue that investment in countries with better governance enhances the value of U.S. MNCs because investors are willing to pay more for firms' assets when expropriation risk is lower. Col and Errunza (2015) provide confirmatory evidence that acquisition targets that operate in countries with weak governance receive significantly lower premiums. Related to these studies and consistent with the existence of a link between country governance and MNC geographic structure and investment choices, our research provides some of the first empirical evidence on a direct mechanism through which laws and institutions improve operational environment and help corporations mitigate business and operational risks.

Our study also contributes to a large literature in accounting, banking and finance focusing on fraud. Choi (2007), Griffin et al. (2001) and Thompson and Sale (2003) provide evidence on the frequency and the cost imposed by fraud. Burns and Kedia (2006) and Efendi et al. (2007) examine the characteristics of firms involved in fraud. Palmrose and Scholz (2004) document the impact of fraudulent financial reporting on firm value. Dyck et al. (2010) identify the most effective mechanisms for detecting corporate fraud. Karpoff et al. (2008a) and Karpoff et al. (2008b) focus on the costs borne by firms and managers upon fraud detection. La Porta et al. (2003) provide evidence that related loans are more likely to default and have lower recovery rates when they do. Our study complements this strand of literature with evidence on fraud recovery by banking institutions in an international context. In addition, we provide unique evidence that a strong legal environment and country governance facilitate fraud recovery primarily at institutions with poor risk management practices.

Our findings have potential supervisory policy implications regarding exposure of financial firms to foreign markets. In general, fraud accounts for substantial losses at financial institutions, reducing profitability and even posing risks to the firms' financial stability. Based on a sample of 30 U.S. bank holding companies over the period [2000–2013], Abdymomunov et al. (2015) document that fraud accounts for more than 5% of operational risk losses at large U.S. banking organizations. In dollar terms, this amounts to

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