Discussion of: Haste Makes Waste: Banking Organization Growth and Operational Risk by Frame, McLemore and Mihov

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Introduction

- **Message:** Rapid asset growth is associated with higher operational risk losses (legal settlements, fraud, system failures etc.) for large US banks.
- *Magnitude:* 1 sd increase in asset growth $\rightarrow$ 24% rise in op risk losses
- Lots of additional analysis to shed light on mechanisms, e.g.,:
  - $\rightarrow$ Nonlinearity: relationship driven by positive asset growth
  - $\rightarrow$ Effects hold whether growth is organic or driven by M&A activity
  - $\rightarrow$ Stronger relation if execs have high-powered incentives or few independent directors

General reactions

- Very nicely executed paper on important topic in banking/regulation.
  - → Operational risk is large and fat-tailed. New risk factors emerging all the time.
  - → Hard for regulators to measure/monitor *ex ante*
  - → Useful to have measures of where risk may lie (e.g., allocating supervisory resources)
- Basic story is *very* plausible/believable
  - → Also fits with other work (e.g., Fahlenbrach et al. 2017: loan growth → loan losses)

Comments

1. Relationship to other evidence on drivers of operational risk?
2. Dynamics
3. Scale vs scope

Relationship to other evidence on drivers of operational risk?

- How should this paper change our views of *other* drivers of bank op risk?

- Prior research (also using Y-14Q data):

  1. Operational risk higher for large banks (Curti et al., 2021)
     This paper: scaled op risk losses *negatively* correlated with bank size

  2. Op risk higher in economic downturns (Abdymomunov et al., 2020)
     This paper: op risk losses move *positively* with GDP growth (albeit not significant)

Relationship between op risk losses and bank size

Curti et al., (2021, JMCB):

TABLE 3

OPERATIONAL LOSSES AND BHC SIZE

	(1) LtA	(2) Ln(Loss)	(3) Ln(Freq)	(4) Ln(Sev)
Ln(Assets)	0.918**	1.207***	1.007***	0.043***
	(0.047)	(0.000)	(0.000)	(0.002)
.....				
N	1,314	1,314	1,314	1,314
Adj R^2	0.080	0.712	0.824	0.193

This paper:

Panel A: Asset Growth

	(1) LtA	(2) LtA	(3) LtA	(4) LtA	(5) Ln(Loss)
Asset Growth	5.256***		5.120***	3.403**	0.579**
	(0.003)		(0.004)	(0.016)	(0.043)
Ln(Assets)		−2.358**	−2.296***	−1.438*	0.265
		(0.012)	(0.007)	(0.077)	(0.308)
.....					
N Obs	1644	1644	1644	1644	1644
Adj R^2	0.04	0.04	0.05	0.07	0.70

How to understand/reconcile results?

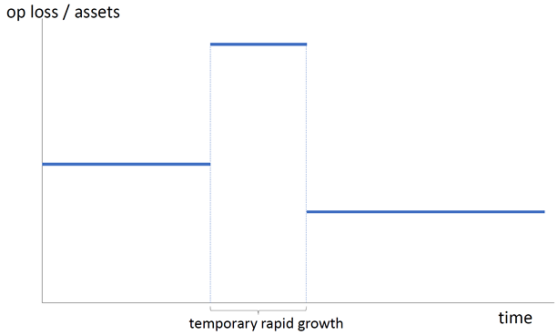
1. Asset growth was an omitted variable in prior studies?

2. Differences in methodology?
   - → E.g., this paper: bank FEs, no time FEs. Curti et al: time FEs, no bank FEs
   - → Different sample period? Different set of controls?
   - → If driven by modelling choices, which approach is "right"?

Goal: Comprehensive, internally consistent picture of op risk drivers for US banks

Dynamics

- Impulse response from positive (temporary) shock to asset growth?
  - → Higher op risk losses in short term (mechanism in paper)
  - → Lower op risk in long term? (bank is now larger)
- Richer lag structure to capture dynamics? (building on fig. 2)



Scale vs scope?

- Seems lots of potential op risk from expanding the *scope* of bank activities
  - → New products
  - → New geographies
  - → New customers
- Consistent with Chernobai et al. (2021, JME): expansion into investment banking
- Any way to get at this more directly?
- Also: did tighter post-crisis regulation mediate bank growth↔op-risk relationship?

Summing up

- Operational risk certain to remain a key risk for banks
- This paper is an important step towards better understanding these risks