Discussion of “Business Complexity and Risk Management: Evidence from Operational Risk Events in U.S. Bank Holding Companies” by Chernobai, Ozdagli, and Wang

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The views expressed are solely those of the author and do not necessarily reflect those of the Federal Reserve Bank of New York, or the Federal Reserve System.

July 23, 2018
Quick Summary

Research Question: Does organizational complexity increase operational risk for banks?

How do they answer it:
- Empirically examine operational risk events for BHCs over '90s and early '00s
- Examine event frequency by previous diversification into "non-bank" activities
- Diff-in-Diff framework
  - Previous diversification ˜exposure to treatment of GLBA (predicts increases in non-bank activities)

Answer: more complexity → more op. risk events

Why it's important:
- Regulatory capital requirements ∝ complexity
- Complexity and managerial failures versus strategic risk-taking
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  - diseconomies of scope
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▷ Accidents happen? are these unforeseen mistakes or the results of choices
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1. How to interpret increase in Op. Risk. events
2. The “Natural Experiment” compared to ideal
How to interpret increase in Op. Risk. events

The “Natural Experiment” compared to ideal

- gradual increase in complexity of some firms
- I imagine bank lobbying helped lead to GLBA
- other correlates of pre-diversification and/or operational risk management
- implicit assumption that supervision (fines/seletion from unobservable to observable events) orthogonal
Comments

1. How to interpret increase in Op. Risk. events
2. The “Natural Experiment” compared to ideal
3. Ex-ante versus ex-post nature of analysis
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- “management failure” is a bit muddied or overly broad for me: from inaction through to reduced effort from agency problems.
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- Q: are diversifying managers worse off, do we think this is suboptimal for them in some way?
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- growth into non-bank activities appears related to culture, risk aversion, local opportunities “failures in operational risk management indicate deficiencies in other risk management areas”, “[...] show that banks with higher non-interest income ratios have higher contributions to systemic risk, “these restrictions were abolished for reasons unrelated to the operational risk of banks”
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- parallel trends should, most importantly, be in outcomes (LHS), rather than only complexity (RHS) - what I think of as the first stage here
- growth into non-bank activities appears related to culture, risk aversion, local opportunities
- put controls on equal footing with treatment: interact with after in order for strongest answer to, e.g. "is this just big banks, or risky banks, or ..." - allow for time varying relationship
3. Ex-ante predictions

- Some concern about degrees of freedom in analysis.
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1. choice of years - why before/after 1996-1999, not 1989 or 1999?
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2. what ex-ante measures would we expect to predict treatment, e.g. banks that hadn’t grown would grow into nonbanking (for diversification) seemed just as reasonable to me.
Some hopefully useful suggestions

- Model of story you have in mind with assumptions stated clearly could help, even just verbally

IMHO: I think this paper has a broader audience to aim for

- ⊿ jargon, regulatory definitions
- ⊿ Banks as one (highly regulated, hence "ideal") laboratory to study complexity of firms in general
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Recap

- Big question, high-level conceptual issue for the organizational structure of firms
- More could be done in clarifying how best to interpret results
- Paper shines an important light on Op. Risk, documenting heterogeneity in experience by US banks as they expanded into non-banking activities