Dear Federal Reserve, FDIC, and OCC,

I would like to make the following comments regarding the operational risk framework:

As defined in the bank capital rules, operational risk includes a wide range of risks, including fraud, system failures, business disruptions, improper business practices, and litigation. Operational risk is present across banking products, activities, processes, and systems, and has resulted in substantial financial losses for several large banks.

Examples of banks experiencing severe operational losses abound:

-Multiple banks have suffered substantial losses due to rogue trading, including Barings Bank in 1995 (which failed), Société Générale in 2008, and JP Morgan in 2012 due to the trades of the "London Whale."

-Large US banks also experienced dozens of billions of dollars in operational losses from legal settlements relating to the improper origination, securitization, and foreclosure practices in the lead up to the 07–08 financial crisis. See https://www.justice.gov/opa/pr/federal-government-and-state-attorneys-general-reach-25-billion-agreement-five-largest; https://www.justice.gov/opa/pr/justice-department-federal-and-state-partners-secure-record-13-billion-global-settlement; https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-$9-3-Billion-Settlement-With-Bank-of-America-Corporation.aspx; https://www.justice.gov/opa/pr/bank-america-pay-1665-billion-historic-justice-department-settlement-financial-fraud-leading; https://www.justice.gov/opa/pr/justice-department-federal-and-state-partners-secure-record-7-billion-global-settlement; https://www.justice.gov/opa/pr/credit-suisse-agrees-pay-528-billion-connection-its-sale-residential-mortgage-backed; https://www.justice.gov/opa/pr/morgan-stanley-agrees-pay-26-billion-penalty-connection-its-sale-residential-mortgage-backed; and https://www.justice.gov/opa/pr/deutsche-bank-agrees-pay-72-billion-misleading-investors-its-sale-residential-mortgage-backed.

-Some banks have experienced substantial losses from legal settlements relating to the violation of sanctions put in place by the United States. See, for example, https://www.justice.gov/opa/pr/bnp-paribas-sentenced-conspiring-violate-international-emergency-economic-powers-act-and; and https://ofac.treasury.gov/recent-actions/20181005.

-Wells Fargo has suffered substantial operational losses due to a fake-accounts scandal.

Economic downturns and reductions in asset values tend to expose previous operational failures and fraud (Povel et al. 2007, Stewart 2016). For example, the fall in the asset values of mortgage-backed securities during the 07-08 financial crisis precipitated the litigation around mortgage securitization and origination that led to substantial operational losses for large U.S. banking organizations. Similarly, the fall in asset values exposed Bernie Madoff's Ponzi scheme in 2008. And substantial operational losses due to litigation followed from Enron and Worldcom scandals, which were precipitated by a stock market downturn in the early 2000s.

Empirical academic research also confirms that operational losses tend to increase upon economic downturns. Using a summary measure for the macroeconomic environment, Abdymomunov et al. (2019) find that operational losses increase by 16.5% for a one standard deviation decrease in the macroeconomic measure. Similarly, Allen and Bali (2007) find that operational risk is cyclical and relates to measures of the macroeconomy and systemic risk. Chernobai et al. (2011) find that operational risk is higher for firms with higher credit risk. Hess (2011) finds that measures of operational risk for several business lines increased meaningfully after the 07-09 financial crisis. Cope and Carrivick (2013) find that operational loss frequency and severity increased due to the 07-08 financial crisis. And Aldosoro et al. (forthcoming) find that operational losses peaked during the 07-09 financial crisis and that operational losses increase after periods of excessively accommodative monetary policy. Relatedly, Berger et al. (2022) find that operational losses increase the systemic risk posed by large U.S. banking organizations.

Given that operational losses tend to increase following economic downturns and reductions in asset values, which can often also result in credit and trading losses for banking organizations, it is critical to account for operational risk in the capital framework, together with credit risk and market risk, to ensure the safety and soundness of large banking organizations and bolster U.S. financial stability.

Also, operational risk is the main source of risk for several of these activities – including corporate finance, payment and settlement, agency services, asset management, and retail brokerage – as these activities generally result in limited balance sheet footprint (and therefore limited credit risk and market risk requirements). So, while these activities may not result in substantial credit or trading losses, they can result in meaningful operational losses.

For these reasons, ensuring that large U.S. banking organizations are subject to a robust operational risk capital requirement is critical to ensuring their safety and soundness and contributes to U.S. financial stability.

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