OFFICE OF FINANCIAL RESEARCH

Financial Research Advisory Committee meeting
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Discussion Topic 4: The OFR's Role in Analyzing Operational Risks

Recent glitches at the New York Stock Exchange and NASDAQ, trading losses at Knight Capital, JPMorgan's London Whale, and the cascading events surrounding the 2010 Flash Crash have heightened attention to the importance of careful and robust operational design and internal governance in financial institutions and markets. The Basel Committee on Banking Supervision has defined operational risk as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events." These risks can be related to cybersecurity threats, technology changes, resiliency management, internal fraud, reliance on third-party systems and support, and recovery management.

A large number of federal agencies, including the Federal Reserve, Securities and Exchange Commission, Commodity Futures Trading Commission, Federal Deposit Insurance Corporation, and the Department of the Treasury, are focused on operational risks involving financial market participants. With respect to cybersecurity, the Treasury Department is leading an information sharing effort with financial services companies in conjunction with law enforcement agencies, regulatory agencies, and the intelligence community, to raise awareness and provide companies with timely information about emerging threats.

What should the OFR's role be in evaluating and analyzing potential financial stability concerns related to operational risks? More fundamentally, do operational risks have material implications for financial stability? Could failures in management of operational risks involving financial market utilities or financial institutions with large dollar-or-transaction volume impair financial market functioning? Could operational failures cause or amplify financial shocks and contagion?

To date, the OFR has focused limited resources on these issues. Efforts have been directed at mapping aspects of the "plumbing" of the financial system, supporting industry efforts to track the flow of intraday funding, and considering operational risks in the asset management industry. Given the serious nature of these threats, the OFR would like advice from the committee on the following questions:

1. What role, if any, should the OFR play in collecting data or assessing, measuring, and monitoring operational risks?

2. Are contagion risks arising from operational risks? If so, how can these risks be best understood and mitigated?

3. What types of metrics (e.g., frequency, cost) are needed to assess and quantify operational risks to financial stability? Are these data currently collected by federal agencies, and, if not, how could these data be collected?

4. What information should financial sector firms report to help regulators assess operational risks? How should these data be acquired to result in desired outcome(s)?

5. Where are the greatest operational risks in the financial system? Which activities and what size and types of firms face the largest risks? Which of these risks could pose the greatest threat to financial stability?