Insight

A Mea Culpa From the Fed on the Failure of Silicon Valley Bank

THOMAS KINGSLEY | MAY 1, 2023

Executive Summary

- The Federal Reserve (the Fed) has released a hotly anticipated report examining the collapse of Silicon Valley Bank (SVB).
- The Fed correctly identifies SVB's management failings and the Fed's own weak supervision as key factors in the bank's fall.
- The Fed errs, however, in identifying largely unrelated bank deregulation and the bank capital requirement framework as additional factors, neither of which would have prevented SVB's collapse.

Context

Early March saw the collapse of Silicon Valley Bank (SVB), America's 16th largest bank, after depositors attempted to withdraw $42 billion in a single day. While the bank's sudden failure took many by surprise (including apparently its regulatory supervisors), it quickly became apparent that the bank's abrupt liquidity crisis was the result of a few key factors: weak risk controls and basic business failures by SVB's management; a lack of oversight by state and federal banking supervisors; and the challenges posed by the macroeconomic environment and in particular the Fed's quantitative tightening.

When on March 13 the Fed announced that Vice Chair for Supervision Michael Barr would lead a review "of the supervision and regulation of [SVB]," the primary question became the degree to which the Fed would acknowledge these factors and in particular its own complicity in the circumstances that led to SVB's downfall. On April 28 the Fed released the SVB report and was unflinching in its assessment of its own failures. But where the Fed acknowledged the failings of SVB's management and the failings of its supervisors, the Fed differs on its view as to the third key factor: rather than inflation and the Fed's own tightening of financial conditions, in its view blame must be attributed to 2018 midsize bank regulatory reform.

Included in the Fed's Report

The Fed's review of the supervision and regulation of SVB finds four key takeaways:

– Silicon Valley Bank's board of directors and management failed to manage their risks;

– Federal Reserve supervisors did not fully appreciate the extent of the vulnerabilities as Silicon Valley Bank grew in size and complexity;

– When supervisors did identify vulnerabilities, they did not take sufficient steps to ensure that Silicon Valley Bank fixed those problems quickly enough; and

– The Board's tailoring approach in response to the Economic Growth, Regulatory Relief, and Consumer Protection Act and a shift in the stance of supervisory policy impeded effective supervision by reducing standards, increasing complexity, and promoting a less assertive supervisory approach.

SVB management failures

In what is inarguably the least controversial aspect of the report, the Fed focuses first on the misconduct of SVB's management. The first sentence of Chair Barr's memo notes that "[SVB] failed because of a textbook case of mismanagement by the bank." The report touches on the unique vulnerabilities of SVB, including its highly concentrated business model and the fact that its deposits were largely uninsured by the Federal Deposit Insurance Corporation (FDIC). The Fed also notes SVB's exposure to interest rate risk, and repeated changes to risk management tolerances rather than addressing the underlying risk, without dwelling in much detail on the macroeconomic context of the interest rate risk. Perhaps the most damning and interesting revelations from the Fed note that SVB's own board was in part kept uninformed of the bank's weakness and the disclosure that it had been failing its own internal liquidity stress tests.

SVB supervisory failures

The Fed notes that in many ways SVB presented a series of textbook risks. Despite this, over periods of mismanagement and liquidity strain, the bank was rated "satisfactory" for management and "strong" for liquidity. The Fed notes unsparingly, "the Federal Reserve did not appreciate the seriousness of critical deficiencies in the firm's governance, liquidity, and interest rate risk management."

The report provides some justification for these failings, noting that as explosive growth at SVB led to it moving between banking supervisory categories relating to size and supervision either failed to keep up, or chose to err on the side caution, applying a "too deliberative" approach to enhanced supervisory requirements. SVB had 31 open supervisory findings at the time of its collapse, about three times the number of its peers.

Midsize bank regulatory reform

In May 2018, Congress passed the Economic Growth, Regulatory Relief, and Consumer Protection Act (S.2155), a landmark financial services deregulatory bill aimed at scaling back and addressing some of the most burdensome aspects of the Dodd-Frank Act. The Act sought to reform the prudential regulatory landscape, including reform of banking capital requirements, and was primarily aimed at community and mid-size banks. The liquidity and capital requirements at these banks were eased, with several capital requirements and liquidity ratios becoming optional, and stress testing becoming biennial.

At the hearing announcing the proposal, the Fed Chair for Supervision Randal Quarles (Michael Barr's predecessor) noted that "the character of regulation should match the character of a firm." Enhanced tailoring in regulatory approach was a welcome indication that the Fed would apply (and have access to) higher degrees of nuance, recognizing that not all banks are the same or face the same risk. As Quarles noted, mid-size banks do not exhibit "meaningful complexity."

It is disappointing then that the Fed has taken a diametrically opposed stance, noting that S.2155 resulted in lower supervisory and regulatory requirements. This is a position lacking in nuance, a factor the Fed appears to recognize in noting that "higher supervisory and regulatory requirements may not have prevented the firm's

failure.” Depositors at SVB attempted to withdraw 25 percent of the bank’s balance sheet in about ten hours. There simply does not and cannot exist a bank capital requirements framework that would have mitigated this risk. While some commentators may view this as an indictment of bank deregulatory reform under President Trump, the result would fundamentally have been the same; what is interesting is the degree to which the Fed acknowledges that its response to S.2155 may have “led to slower action by supervisory staff and a reluctance to escalate issues.”

Other findings and recommendations

By far the bulk of the report’s recommendations relate to strengthening the Fed’s role as supervisors, with a particular focus on changing supervisor behavior and strengthening internal processes. It is, however, both surprising and unwelcome that Chair Barr notes that the Fed is considering higher capital requirements in response to SVB’s collapse, as it is in no way clear that higher capital requirements would have prevented the fall of SVB. The Fed already has a “holistic” review of bank capital requirements underway, and it is to be expected that nerves about SVB may impact this assessment, even if to do so unduly would be inappropriate, unfair, and fail to serve its purpose.

It is also curious to note that Chair Barr remarked on the role of social media in SVB’s bank run, although the modern technological implications of this sudden loss of investor confidence are not considered elsewhere in the report.

Not Included in the Fed’s Report

Inflation and the Fed’s quantitative tightening

Chair Barr was at pains to stress the overall strength and resilience of the banking sector, noting that SVB represents “an outlier” due to its unique vulnerabilities (while acknowledging the concomitant supervisory failings). Is it appropriate, however, to call SVB an outlier in light of the failure of Silvergate and Signature Bank, and demonstrated weakness at First Republic and Credit Suisse, and others? While there appears to be little evidence of the widespread contagion that led to the 2007–2008 banking crisis, rendering a collapse of the financial services sector unlikely, there clearly are, if not systemic, at least system-wide factors at play.

By far the most obvious of these are the ongoing challenges posed by inflation. The Fed’s own interest rate increases and quantitative tightening, while laudable in driving down inflation, directly created the interest rate risk faced by SVB. The Fed seems loath to recognize its role in this affair as steward of the macroeconomic environment. While the horse has bolted on SVB, the markets would derive enormous confidence from a discussion as to the risks interest rate hikes and quantitative tightening pose to all banks and financial institutions and what actions might be required to prevent further bank runs in contracting liquidity conditions.

The role of the FHLB

Of increasing concern is the role of the Federal Home Loan Bank (FHLB) network. The FHLB is a network of 11 regional banks across the United States that are privately capitalized and do not receive government funding but are overseen by the Federal Housing Finance Agency and has a public purpose mandate, founded by the government during the Great Depression to provide banks with low-cost funds that could be used to finance mortgages. Often called the lender of next to last resort, the FHLB is the only entity paid out ahead of the FDIC in bank resolution – and is effectively taxpayer subsidized.

After the collapse of SVB, it became clear that the FHLB network had made $30 billion in loans to SVB, Silvergate, and Signature Bank shortly before each collapsed. Aside from raising questions as to the meticulousness of due diligence performed by its loan origination teams, it is fundamentally difficult to square these loans with the FHLB's purpose of boosting the country's mortgage market.

The federal response to SVB's collapse

While the Fed's report details what led to the collapse of SVB, it is silent as to the government response. Although this was not necessarily in-scope for the review, the administration and the federal banking regulatory agencies took actions in response to SVB's fall that were simply disproportionate, and numerous questions remain. Why trigger the systemic risk exception over a firm not deemed systemically risky? Can a bank have different systemic risks in operation and in receivership? Why provide a federal guarantee for funds not covered by the FDIC, setting a dangerous precedent, and promote the discussion of a nationwide guarantee on all deposits? Why create a new Bank Term Funding Program fund (paid for out of the Exchange Stabilization Fund, an unrelated facility to mitigate currency risk) to lend against the face value of long-term bonds, rather than their current market price, appearing to bail out any other firm that makes similarly poor investment decisions?

Why, indeed, do anything at all? Poor-performing firms in other industries aren't rescued, and the administration's response itself led to decreased market confidence, as the "crisis" appeared so much worse than it actually was.

Conclusions

In what is generally an unflinching and unsparing report on its own failures, as a supervisor the Fed so nearly gets it right. While the degree of supervisory detail and transparency is welcome (rarely are we allowed so deeply under the hood of the supervisory process) the Fed fails to stick the landing. Where the Fed's report is at its weakest is when it strays from its review of its own internal processes. Focusing on largely unrelated bank deregulation and the bank capital requirement framework, neither of which meaningfully impacted the fall of SVB, is a disappointing finding. That the Fed needs to examine its supervisors and oversight framework is clear, but using SVB as scapegoat and rationale for higher capital requirements is at best lazy thinking.