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Lessons from SVB's Sudden Failure

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(with credit to Randall Guynn for the slides)

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Outline

– What happened?
– Causes
– Debate over Diagnosis and Prescriptions

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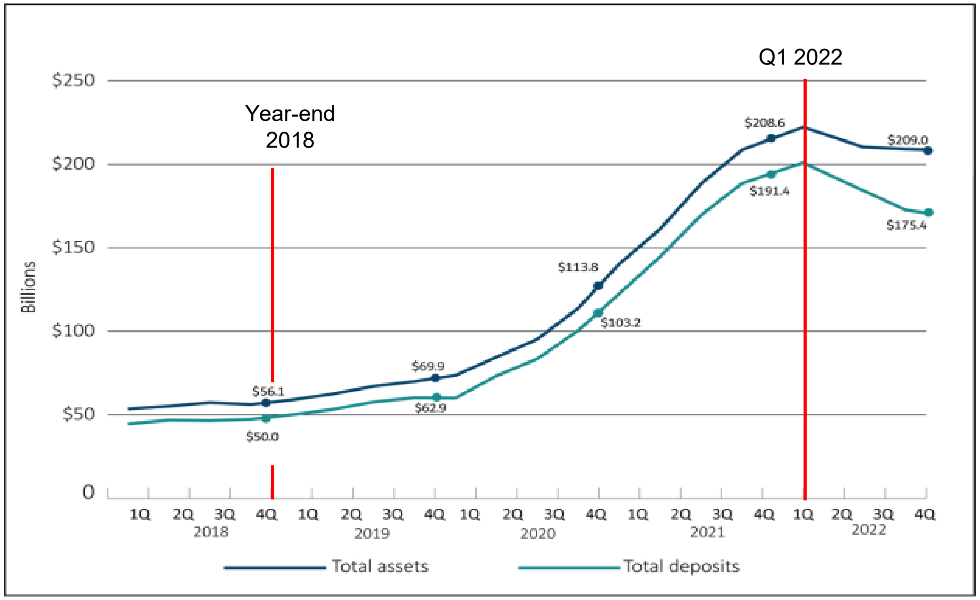
SVB – What happened?

— Rapid growth in deposits during COVID-19

- Deposits grew from $50 billion at year-end 2018 to a peak of $175 bn at the end of Q1 2022.

Figure 1. SVB's Total Assets and Deposits, 2018–2022



Source: OIG analysis of SVB and FRB San Francisco data, 2018–2022.

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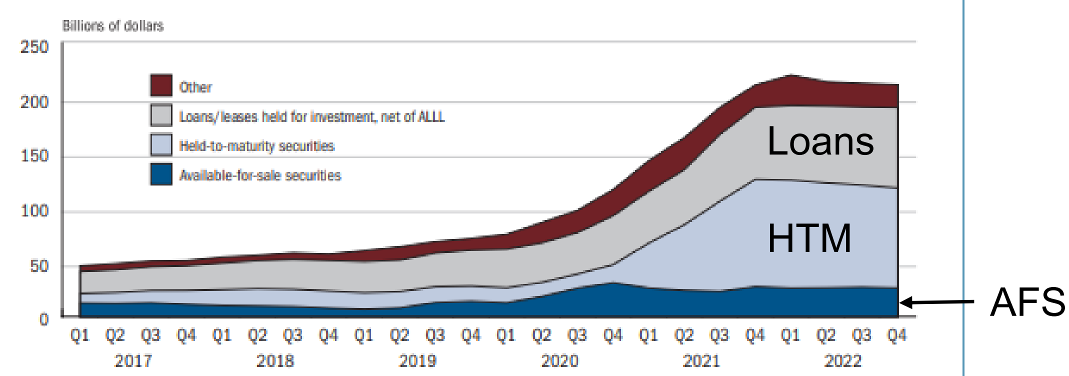
SVB – What happened?

- Exceptionally high interest rate risk.
  - SVB invests ~95% of its HTM and > 25% of its AFS portfolios in bonds with maturity of > 10 years.
  - Duration grows from 3.9 at 4Q 2019 to 6.1 at 4Q 2022. For every 1% increase in interest rates, fair value of portfolio would decrease by 6.1%.
  - All publicly disclosed in call reports and periodic reports on Form 10-K, 10-Q

Figure 8. Composition of SVBFG assets



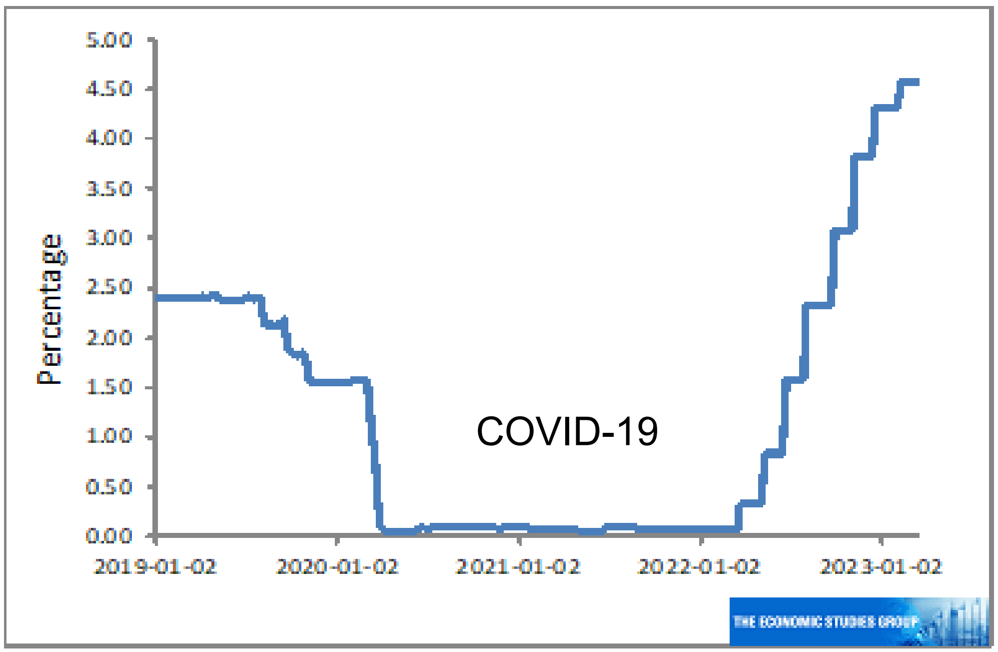
Note: The key identifies areas in order from top to bottom. ALLL is allowance for loan and lease losses.

Source: FR Y-9C.

Source: Barr Report on SVB (April 28, 2023); SVBFG's Annual Reports on Form 10-K for 2019-2022.

SVB – What happened?

- Increased interest rates
  - In early 2022, Fed starts increasing interest rates to battle what it had first called "transitory" inflation.



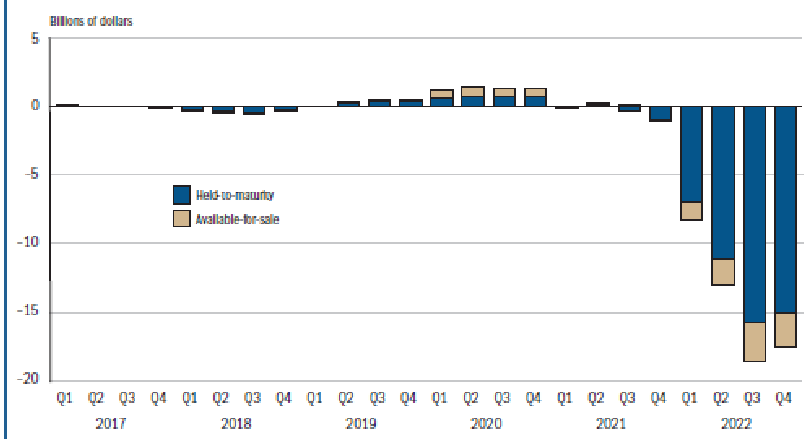
Source: The Economic Studies Group, CUNY Graduate Center.

SVB – Deeper dive on what went wrong on interest rate risk

– Extreme sensitivity to increases in interest rates

- As predicted by duration figures, fair value of SVB's HTM and AFS portfolios fell faster than the increase in interest rates.

Figure 9. Estimated unrealized gains (losses) on SVBFG's investment portfolio securities



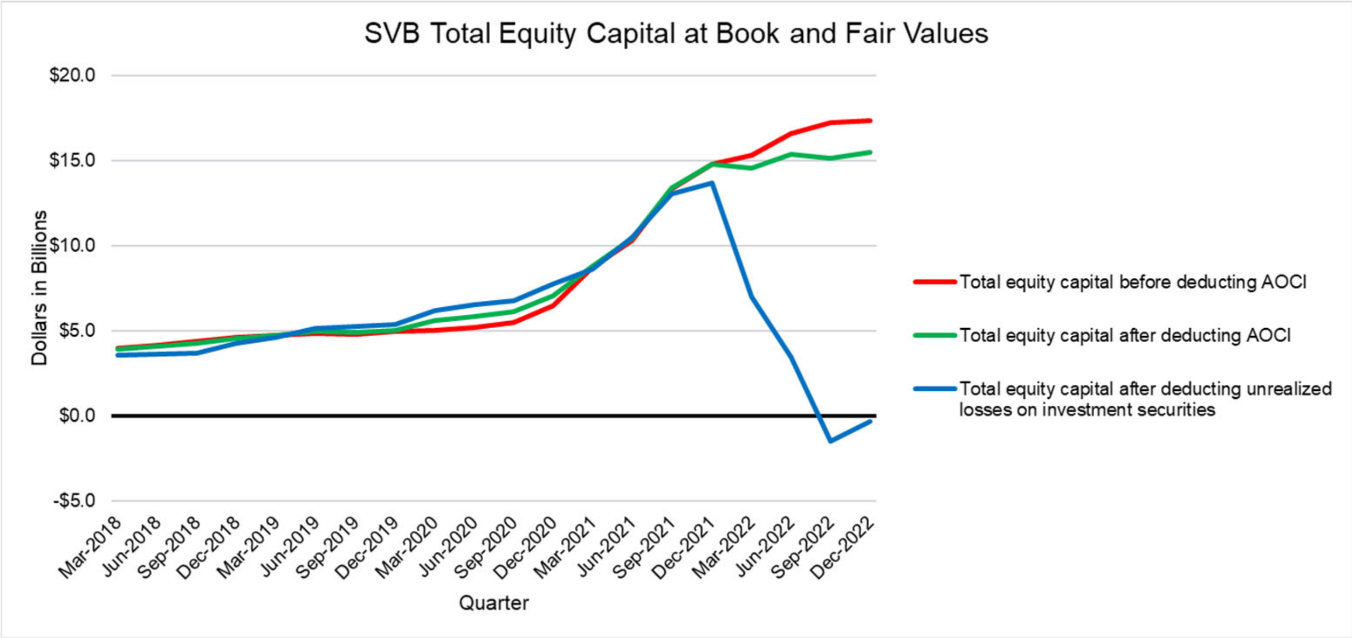
Note: Estimated unrealized losses on securities calculated as: (held-to-maturity fair value less held-to-maturity amortized cost) + (available-for-sale fair value less available-for-sale amortized cost). Estimates do not reflect losses related to available-for-sale securities that were transferred to held-to-maturity and do not reflect hedging impacts or tax consequences.

Source: FR Y-9C.

Source: Barr Report on SVB (Apr. 28, 2023)

SVB – What happened?

– By 9/30/2022, SVB was insolvent on a fair value basis
  - Remained insolvent on fair value basis through 3/9/2023.
  - Assuming it had unrealized losses in its loan portfolio, it may have been even more deeply insolvent.

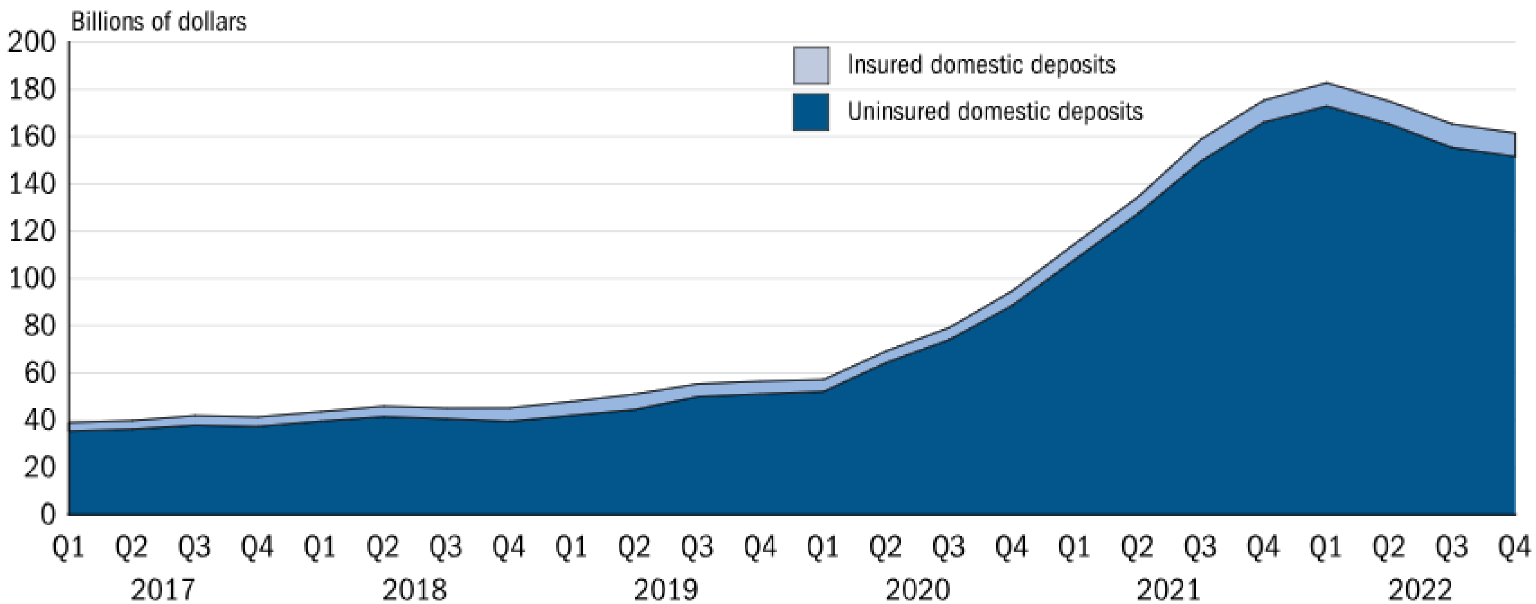


Source: Davis Polk based on SVB's call reports for at each date

SVB – What happened?

– Exceptionally high run risk
  - ~95% of deposits are uninsured. Deposit base highly concentrated in tight knit community of venture capital fund and technology and life-sciences portfolio companies.

Figure 7. SVB deposit insurance coverage



Source: Barr Report on SVB (April 28, 2023).

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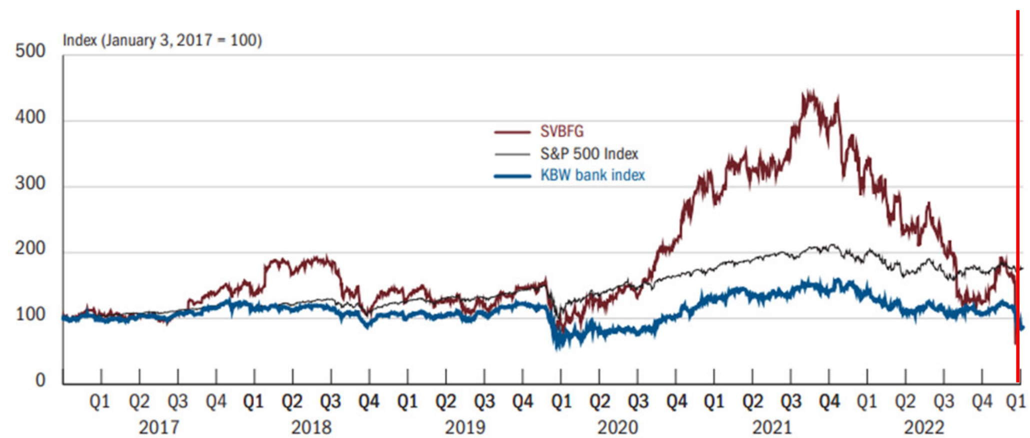
SVB – What happened?

– Announces $1.8 billion loss on AFS securities

- On March 8, SVBFG announces t $1.8 billion loss on the sale of AFS securities in preparation for new capital raise. On the same day, Silvergate Capital announces the voluntary liquidation of Silvergate Bank.

Figure 10. SVBFG stock price performance



Note: All values indexed to 100 on January 3, 2017.

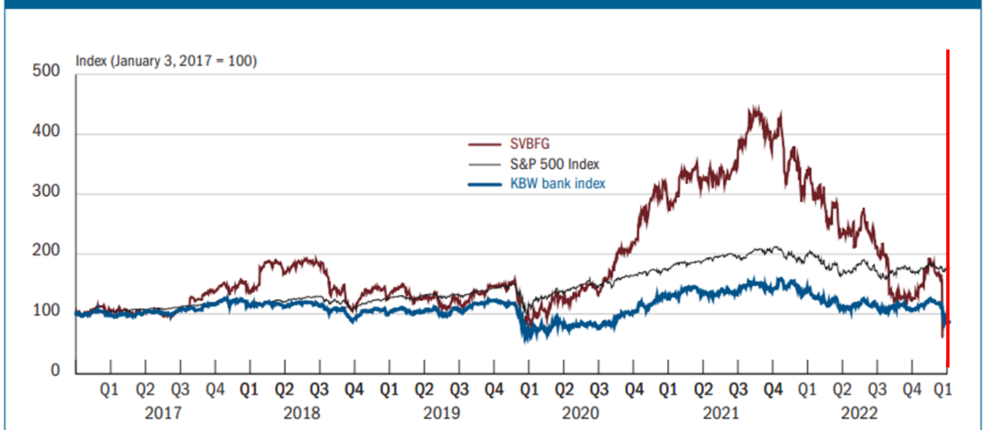
Source: Bloomberg Finance L.P.

Source: Barr Report on SVB (Apr. 28, 2023)

SVB – What happened?

– Depositors panic
  - By March 9, SVB's depositors withdraw $42 billion in deposits and submit orders for an additional $100 billion in withdrawals requests after hours.
  - Panic was made far worse by extreme uncertainty over whether majority of deposits had been swept into third-party MMFs or were really just uninsured deposit claims at money market rates

Figure 10. SVBFG stock price performance



Note: All values indexed to 100 on January 3, 2017.

Source: Bloomberg Finance L.P.

Source: Barr Report on SVB (Apr. 28, 2023)

SVB – What happened?

— Systemic Risk Exception
  - On March 10, SVB is put into an FDIC receivership.
  - On Sunday afternoon, Signature Bank fails and is put into an FDIC receivership.
  - On Sunday evening, after unsuccessfully trying to sell SVB to a regional bank, FDIC announces it will protect all uninsured depositors of SVB and Signature Bank against losses.
  - Pursuant to systemic risk exception to least-cost test.

— Was bailout truly necessary?
  - Fear of massive defaults on payroll obligations throughout economy.
  - But what if fear was based on imperfect information?
  - What if fear was unfounded because most of the deposits had been safely swept off SVB's balance sheet into had access to MMFs, but depositors and the FDIC did not know it?
  - If this were the case, simple solution would be to mandate disclosure obligations on banks to eliminate uncertainty and reduce need for bailouts in the future?

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Agenda

–What happened?

–Causes

–Debate over Diagnosis and Prescriptions

SVB – Causes

— Barr Report

- On April 28, Barr Report
  - Primary cause of SVB's failure was managements failure to properly manage interest rate risk and liquidity risk
  - Identifies supervisory deficiencies as secondary cause
  - But instead of criticizing supervisory staff for missing obvious red flags, Barr Report blame:
    - Tailoring mandated by S.2155; and
    - Less-assertive supervisory culture instituted by this predecessor as VCS, Randy Quarles.

SVB – Causes

— OIG Report

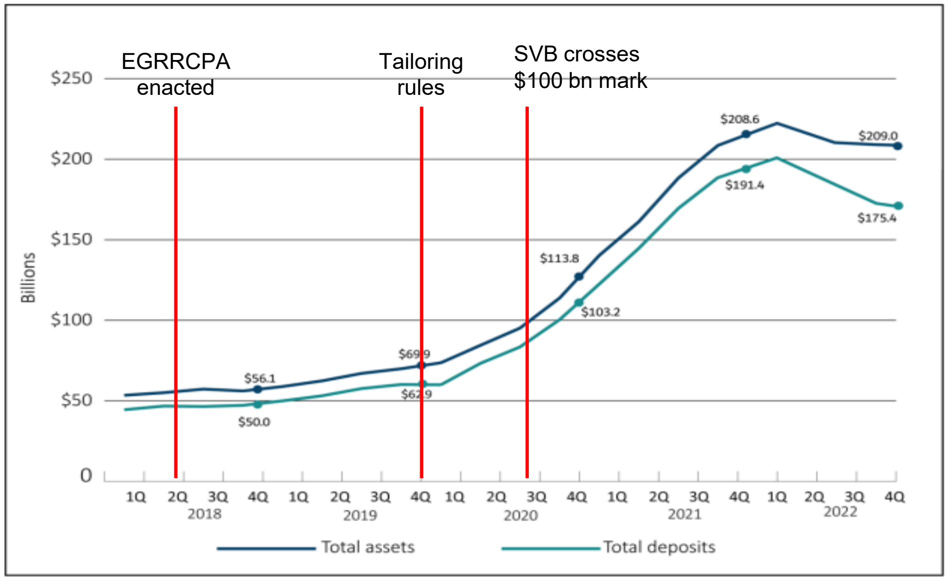
- On September 25, the Federal Reserve's Office of Inspector General (OIG) issued a separate report on SVB
  - Agreed primary cause for SVB's failure was failure of SVB management to properly manage interest rate risk and liquidity risk.
  - Disagreed that tailoring was a secondary cause.
    - Tailoring was only responsible for supervisory deficiencies until SVB crossed $100 billion mark in June 2020. No impact after June 2020.
  - Disagreed that less assertive supervisory culture under VCS Quarles was a secondary cause.
  - Instead, attributed supervisory failures to the supervisory's staffs failure to focus on SVB's salient (i.e., most important) risks, instead of relatively trivial risks and process.

SVB – Causes

– Tailoring Rules Mandated by EGRRCPA

- SVB crossed $100 billion threshold in mid-2020, nearly three years before it failed.

Figure 1. SVB's Total Assets and Deposits, 2018–2022



Source: OIG analysis of SVB and FRB San Francisco data, 2018–2022.

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SVB – Causes

— **B3E Capital Proposal / GLAC Proposal**
- SVB failed because it was not subject to sufficiently high going-concern and gone-concern capital requirements.
- To avoid similar failures in the future, we need to increase going-concern capital requirements by 16% and extend gone-concern subordianted LTD requirements to non-GSIB LBOs.

— **Would that have helped?**
- SVB would have failed even if it been subject to the higher going-concern capital requirements proposed by the B3E proposal or proposed new gone-concern capital requirements.
- It failed because it was exposed to extraordinarily high interest rate risk and liquidity risk that was not properly managed by SVB management or overseen by the California and Fed supervisory staff.
- While banks should be subject to strong capital requirements, the lesson from SVB is that even strong capital is not a substitute for good risk management and supervisory oversight.

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Agenda

– What happened?

– Reports

– Debate over Diagnosis and Prescriptions

SVB – Lessons Learned

— Why is it important to identify the true root causes for the supervisory deficiencies?

- Unless the root causes are diagnosed correctly, the wrong medicine might be prescribed.
  - Like prescribing high blood pressure medicine for patient with low blood pressure.
  - Not only would that medicine not raise the patient's low blood pressure, but it could also lower it to fatal levels.
- Root causes according to Barr Report
  - Deficiencies caused by regulatory tailoring framework mandated by EGRRCPA
    - If this diagnosis is correct, medicine might be to repeal the tailoring framework
    - But if, as the OIG Report concluded, EGRRCPA had a much more limited effect, and the deficiencies were instead caused by a lack of supervisory tailoring to SVB's salient risks, that medicine would be unnecessary and ineffective.
    - Moreover, that unnecessary and ineffective medicine could have the side effect of creating a powerful economic incentive for regional banks to become $1 trillion banks or larger to spread the cost over a larger scale and avoid becoming uncompetive with the U.S. GSIBs

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SVB – Lessons Learned

- Why is it important to identify the true root causes for the supervisory deficiencies? (cont'd)
  - Root causes according to Barr Report (cont'd)
    - Deficiencies caused by former VCS's excessive focus on due process, transparency and public accountability, which resulted in a less-assertive supervisory culture.
      - If this diagnosis is correct, medicine might be for Senate to block any future VCS candidates that focus excessively on due process, transparency or public accountability.
      - But if, as the OIG Report concluded, deficiencies were not caused by less-assertive supervisory culture instituted by former VCS, and deficiencies were instead caused by lack of supervisory tailoring to SVB's salient (i.e., most important risks), that medicine would be misdirected and ineffective.
      - It would have the side effect of deflecting attention from determining how the supervisory staff could have failed to identify or taken forceful action against SVB for its salient (i.e., most important) risks – namely its extreme run risk and interest rate risk

SVB – Lessons Learned

- Why is it important to identify the true root causes for SVB's failure
  - Root causes according to advocates for the B3E and GLAC proposals
    - Insufficient going-concern and gone-concern capital
      - If this diagnosis is correct, then going concern capital requirements should be increased and gone-concern capital requirements extended from GSIBs to other large banks.
      - But if SVB's failure was not caused by a lack of sufficient going-concern or gone-concern capital but the failure to manage interest rate risk and liquidity risk and the failure of supervisors to focus on the most important risks, then the prescription should be to improve risk management and the supervision of risk management.
      - Focusing on increased capital requirements could divert supervisory attention away from better risk management of interest rate risk and liquidity risk.

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