Takeaways From Recent Bank Failures

The Federal Reserve (Fed), the FDIC, and the U.S. Government Accountability Office (GAO) recently issued initial post-mortem reviews on the March 2023 bank failures. These insights also will likely apply to the April collapse of First Republic Bank. While blame lies primarily with each bank's management team's failure to adequately manage risk, the control lapses were well documented by banking supervisors for several years. The candid reports highlight the missed supervisory opportunities for early intervention and timely remediation. This article summarizes potential supervisory changes and focus areas for financial institutions to consider for upcoming reviews. Some changes mirror recommendations following the 2007 mortgage crisis that were never implemented. Given the balance of power in Washington and an upcoming election cycle, will these bank failures result in more effective oversight?

Background

Between March 10 and March 12, 2023, state banking supervisors closed California-based Silicon Valley Bank (SVB) and New York-based Signature Bank (SB). At the time of closure, SVB and SB were the 16th and 29th largest U.S. banks, respectively. The FDIC currently estimates the cost of resolving SVB to be $20 billion and SB to be $2 billion. A systemic risk exception was invoked to allow the FDIC to guarantee deposits in excess of $250,000. SVB was supervised[1] by the Fed and SB was supervised by the FDIC.

The combination of social media and technology fundamentally changed the speed of bank runs that would have been nearly impossible for banks or regulators to predict. Social media spread concerns with lightning speed and technology enabled the immediate withdrawal of funds. This deposit outflow was unprecedented in scale and scope. On March 9, SVB lost more than $40 billion in deposits and was expected to lose more than $100 billion more on March 10, representing 85% of the bank's deposit base. The Wachovia failure in 2008 included about $10 billion in outflows over eight days, while the Washington Mutual failure in 2008 included $19 billion over 16 days.

[1] Each insured bank in the U.S. is primarily supervised by one of three federal banking regulators: the Fed, the FDIC, or the Office of the Comptroller of the Currency. The Fed supervises state-chartered banks that are members of the Federal Reserve System, bank holding companies and any nondepository institution subsidiaries of a bank holding company, and savings and loan holding companies and any subsidiaries (other than depository institutions) of a savings and loan holding company. The FDIC supervises insured state-chartered banks that are not members of the Federal Reserve System, state-chartered savings associations, and insured state-chartered branches of foreign banks.

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I. Bank-Specific Shortcomings

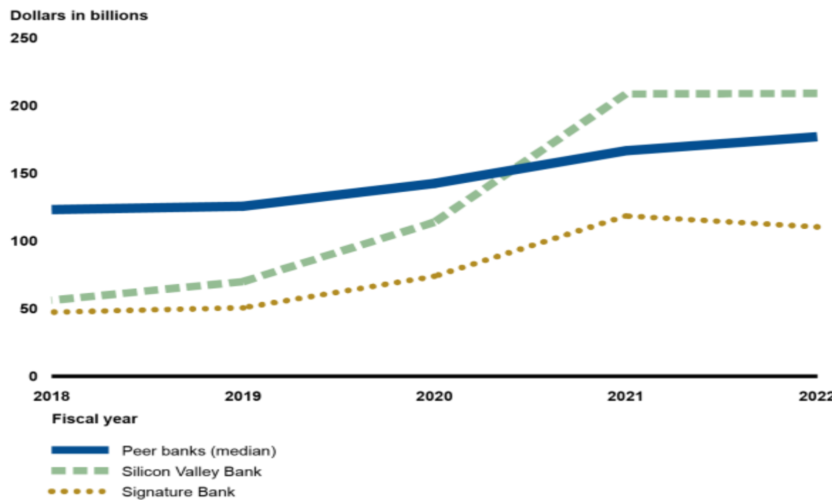
The Fed's Office of Inspector General commissioned a report, Summary Analysis of Failed Bank Reviews, in 2011 following the 2007 mortgage crisis to identify common themes related to the cause of failure and the role of Fed supervision, and the findings are eerily prescient.

Fed Report Findings	
2011 Report	**2023 Report**
Management pursuing robust growth exceeded the banks' risk management and funding strategies.	SVB's governance and risk management did not keep pace with the bank's rapid growth in size and risk.
Strategic choices proved to be poor decisions.	SVB remained steadfast in its commitment to protect against down rate interest scenarios but did not protect against a rising interest rate environment. SVB expected to benefit in a rising interest rate environment as it generally assumed that deposit betas would be low.
Incentive compensation programs inappropriately encouraged risk-taking.	The incentive compensation arrangements and practices at SVB encouraged excessive risk taking to maximize short-term financial metrics.

1. Rapid Growth

From December 2018 to December 2022, SVB's total assets more than tripled from $56 billion to $209 billion, and SB's total assets more than doubled from $47 billion to $110 billion. From 2019 through 2021, SVB and SB grew faster than a group of peer banks. Total assets of SVB and SB grew by 198% and 134%, respectively, compared to 33% for a group of peer banks.

Total Assets of SVB & SB & Median Total Assets for Peers, 2018–2022



Source: GAO analysis of S&P Capital IQ Pro data. | GAO-23-106736

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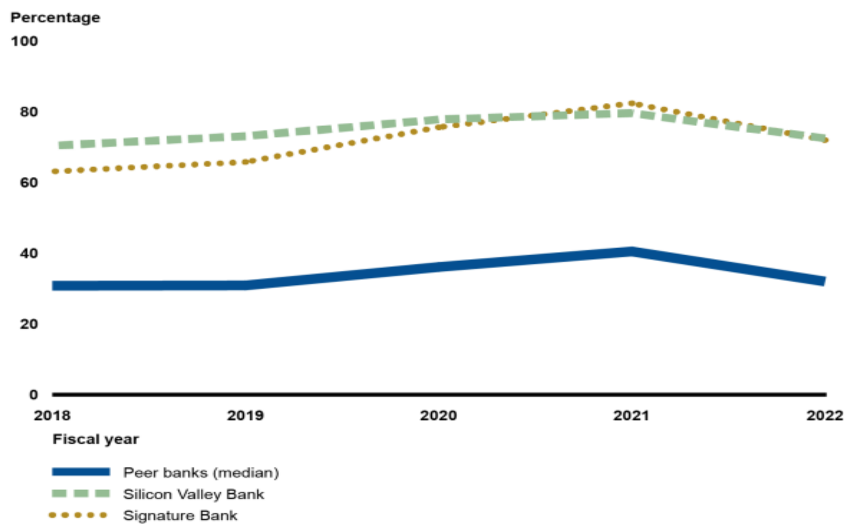
2. Uninsured Deposits/Less Stable Funding

Uninsured deposits can be unstable because these customers are more likely to withdraw their funds during times of stress. At the end of 2021, SVB and SB reported uninsured deposits to total assets at 80% and 82%, respectively. Since 2018, SVB and SB reported a significantly higher percentage of uninsured deposits to total assets than the median for a group of peer banks. In 2018 to 2022, SVB's uninsured deposits to total assets ranged from 70% to 80%, and SB's uninsured deposits to total assets ranged from 63% to 82%. During the same time period, the median uninsured deposits to total assets for a group of peer banks ranged from 31% to 41%—approximately half that of SVB and SB.

Uninsured Deposit to Total Assets for SVB & SB & Median Uninsured Deposits to Total Assets for Peers, 2018–2022



3. Weak Risk Controls

SVB's governance and risk management did not keep pace with the bank's rapid growth in size and risk, most notably liquidity, interest rate, and investment portfolio management. The Fed's 2021 exam findings concluded that the chief risk officer (CRO) did not have the experience necessary for a large financial institution, and she left SVB in April 2022. SVB operated without a CRO for eight months until the position was filled in January 2023. SB funded its growth through an overreliance on uninsured deposits without implementing fundamental liquidity risk management practices and controls and failed to understand the risk of reliance on crypto industry deposits or its vulnerability to contagion from the crypto industry.

Liquidity

Regulators have extensive requirements and expectations for the sound management of liquidity risk, which includes board and senior management oversight, establishment of liquidity risk tolerances, internal liquidity stress tests, and contingency funding plans. SVB liquidity risk management practices were fundamentally flawed and not suitable for a $200 billion bank and were a direct contributing factor to its failure. The FDIC concluded that SB management was unable to fully understand the bank's liquidity position in the days and hours before failure. In 2019, the FDIC found planning and control weaknesses preventing the bank from adequately identifying, measuring, and controlling liquidity risk.

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Interest Rate Risk

SVB's interest rate risk monitoring lacked back-testing, limited sensitivity testing, and did not have second line review and challenge for model assumptions. SVB's interest rate risk policy did not specify scenarios to be run, how assumptions should be analyzed, how to conduct sensitivity analysis, or articulate model back-testing requirements. There was no description of how limits were set and calibrated. Limits had not been reviewed for potential recalibration and the current level of the limits had been supported since at least 2018. SVB's policy did not specify the ongoing reporting requirements for threshold breaches over prolonged periods.

4. Customer Concentrations

SVB primarily served entrepreneur clients in technology, healthcare, and private equity. These clients were mostly financed by venture capital firms. SB conducted a significant amount of business with venture capital and digital asset companies. Ironically, SB added these business lines to offset a previous concentration in commercial real estate.

5. Incentive-Based Compensation Plans

The incentive compensation arrangements and practices at SVB encouraged excessive risk taking to maximize short-term financial metrics. SVB's compensation practices also did not adequately reflect longer-term performance, nonfinancial risks, or unaddressed audit or supervisory issues. Stronger or more specific supervisory guidance or rules on incentive compensation for firms of SVB's size, complexity, and risk profile—or more rigorous enforcement of existing guidance and rules—may have mitigated these risks. Cash bonuses were paid to several SVB executives and staff for their 2022 performance on March 10, 2023, the day SVB was taken over.

II. Supervisory Shortcomings

The purpose of federal banking supervision is to help ensure that banks operate in a safe and sound manner and comply with federal laws and regulations for the provision of banking services. Federal banking supervision also looks beyond the safety and soundness of individual banks to promote the stability of the financial system as a whole. Banking regulators have a comprehensive framework of measurements and progressive enforcement actions to address supervisory concerns.

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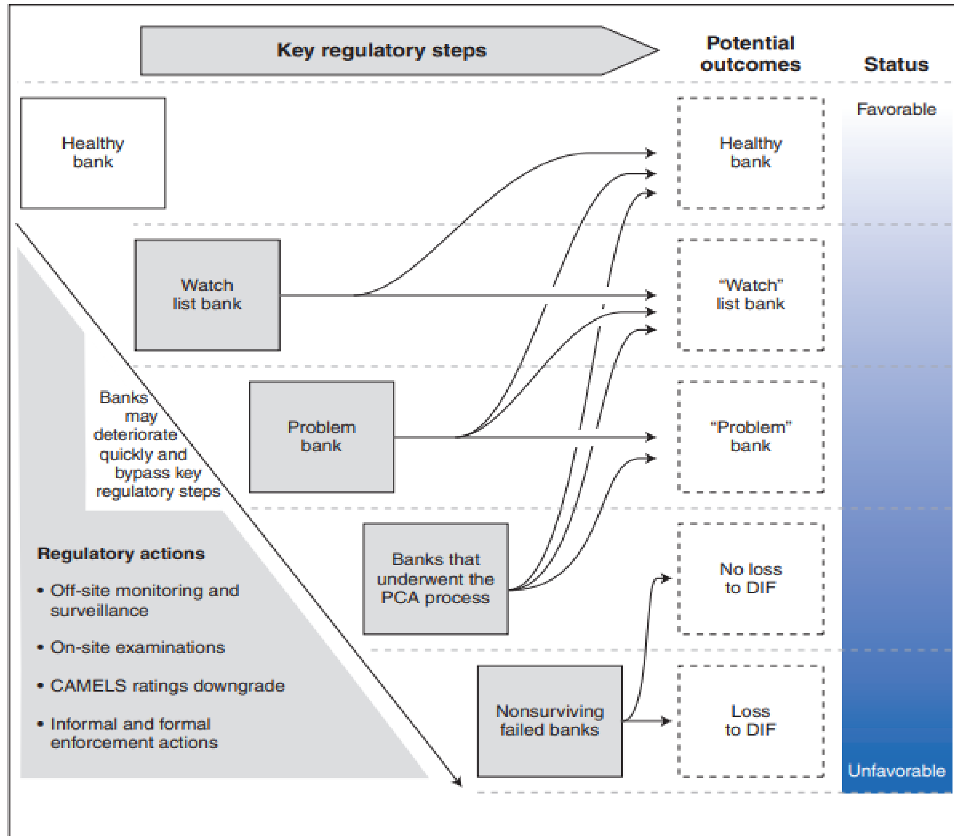
Key Regulatory Milestones Associated With Bank Deterioration



Source: GAO analysis of data from federal banking regulatory agencies.

1. Staffing & Resources

FDIC

The FDIC report highlighted challenges posed by persistent staffing shortages. SB growth warranted an increase in dedicated staff from three positions in 2017 to nine in 2023. However, the dedicated team had at least one vacancy 60% of the time and had 17 different staff assigned from 2017 to March 2023. FDIC officials acknowledged concerns about the skill set of the dedicated team, and new, more experienced members were added in 2022. Since 2020, an average of 40% of positions have been vacant or filled by temporary staff in the New York regional office. Several other regions also have a number of examiner vacancies.

"We concluded that the vacancies and adequacy of the skillsets of the dedicated team slowed earlier identification and reporting of SB weakness."

Fed

For the Federal Reserve System as a whole, resources did not grow with the banking industry. From 2016 to 2022, banking sector assets grew 37%, while supervision headcount declined by 3%. For SVB, supervisory resources declined despite the bank's rapid growth and increased risk. The Fed's dedicated teams staffing came from the community/regional

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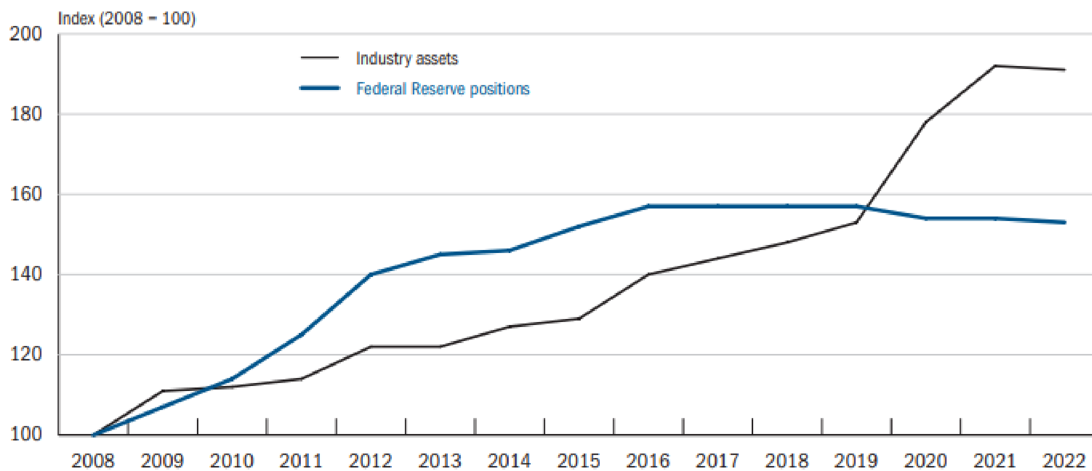
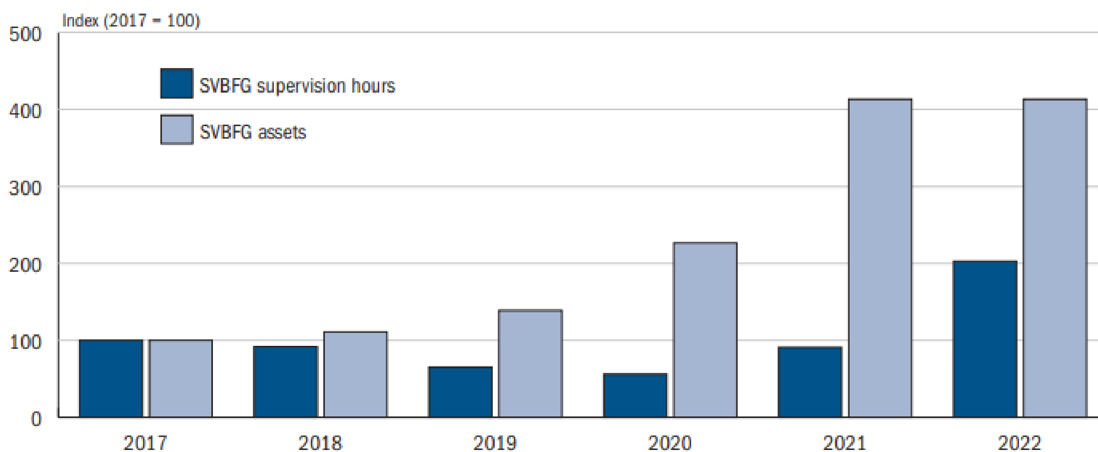
bank pool of examiners, who may have lacked experience with governance and risk-management practices of more sizable and complex institutions like SVB. Because the Fed's examiners concluded the inherent risk related to liquidity was low, staff conducted lighter reviews and material gaps in supervisory conclusion occurred. A subsequent, more thorough, and well-staffed examination by subject matter experts revealed foundational issues in November 2021. However, a different assessment in August 2022 noted: "Actual and post-stress liquidity positions reflect a sufficient buffer." Supervisors were unaware of management's changes to liquidity stress test assumptions that reduced the size of the modeled liquidity shortfall.

Supervision Staffing Relative to Banking Industry Assets



Source: Internal Federal Reserve staffing databases, FR Y-9C, and Call Report

SVB Supervision Hours Relative to Assets



Source: Internal Federal Reserve staff time databases and FR Y-9C

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While some changes have been made to improve the attractiveness of examination position, staffing issues continue to be a challenge for all industries. The FDIC's 2023 budget included a 6.5% increase and authorized 220 new positions. The Federal Reserve System is not subject to the appropriations process, and aside from the recording of transfers of Fed earnings as budget receipts, its financial operations have always been excluded from the federal budget. This has enabled the Fed to make decisions with relative independence from congressional and presidential influence. The Fed's 2022 budget did not include an increase in overall headcount and the budget for supervision was increased 7.2%.

B. Timeliness of Feedback/Enforcement

Regulators did not escalate supervisory actions in time to prevent the failures. Both SVB and SB were on regulators' radars at least five years ago. The GAO report noted: "While SVB management failed to take adequate and timely steps to mitigate risks, staff generally accepted SVB's planned actions to correct deficiencies."

"In retrospect, FDIC could have escalated supervisory actions sooner … examination work products could have been timelier and communication with SBNY's board and management could have been more effective."

C. Regulatory Framework

The Fed report cited changes in its supervisory approach as a result of the 2018 *Economic Growth, Regulatory Relief, and Consumer Protection Act* (EGRRCPA). The EGRRCPA raised the threshold from $50 billion to $250 billion for financial institutions to be subject to enhanced prudential standards. This law meant that SVB was subject to lower supervisory and regulatory requirements, including lower liquidity and capital requirements. These changes also may have led to slower action by supervisory staff and a reluctance to escalate issues. The EGRRCPA changes and related rulemakings had a significant impact on the level of requirements to which SVB was subject in 2018 and beyond. Had these changes not been made to the framework, SVB would have been subject to enhanced liquidity risk management requirements, full standardized liquidity requirements, enhanced capital requirements, company-run stress testing, supervisory stress testing at an earlier date, and tailored resolution planning requirements. The enhanced requirements that did apply to SVB were not immediately effective because of lengthy transition periods prescribed by the relevant regulations.

"A comprehensive assessment of EGRRCPA changes and related rulemakings show that they combined to create a weaker regulatory framework for a firm like SVB. These requirements may have resulted in SVB's having increased capital and liquidity that would have bolstered its resilience. The requirements may also have encouraged closer scrutiny of the firm's financial position, and SVB may have more proactively managed its liquidity and capital positions or maintained a different balance sheet composition."

III. Recommended Changes

Each of the three reports represents a first step in potential regulatory or oversight changes. The Dodd-Frank Act was unprecedented in scope, and some recommendations are only now being finalized by the SEC. Several other recommendations following the mortgage crisis were never implemented for various reasons. It is hard to predict the final

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outcome of these current self-assessments, and additional recommendations are likely to follow. The Fed's report notes: "These changes would not be effective for several years because of the standard notice and comment rulemaking process and would be accompanied by an appropriate phase-in."

GOA

1. Addition of Noncapital Triggers to Regulatory Framework

The 2007 mortgage crisis resulted in the failure of 300 insured depository institutions with losses estimated at $70 billion. A 2011 GAO report, Modified Prompt Corrective Actions Framework Would Improve Effectiveness, identified issues with the banking regulators' escalation of supervisory concerns. The prompt corrective action (PCA) framework was designed in 1991 following the savings and loan crisis, which resulted in the failure of more than 1,000 financial institutions. The PCA was intended to improve regulators' ability to identify and promptly address deficiencies at depository institutions and minimize losses to the Deposit Insurance Fund. The GAO's 2011 report noted that the PCA framework's effectiveness is limited because of its reliance on capital, which is a lagging indicator of bank health. Under PCA, issues may be discovered too late for banks to recover regardless of regulatory action imposed. Problems with a bank's assets, earnings, or management appear before those problems affect bank capital. The GAO tested other financial indicators, including measures of asset quality and liquidity, and found that they were important predictors of future bank failure. Suggestions never implemented from the 2011 report include:

- Incorporating an institution's risk profile into PCA capital categories
- Adding triggers – asset quality, asset concentration, or liquidity

These changes could compel regulators to act more quickly and consistently. While banking regulars implemented another recommendation to raise the PCA capital regulatory thresholds, it was never adopted due to the perceived disadvantages of this approach:

- Another trigger might duplicate other tools regulators already use in their supervision of banks, creating oversight inefficiencies
- The PCA trigger chosen might not be applicable to all banks
- Legislative changes would be needed to allow regulators to use the same authorities under the current PCA framework, such as the authority to dismiss bank officers and directors

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GAO Report Findings	
2011 Report	**2023 Report**
Actions to address early signs of deterioration were inconsistent and, in many cases, regulators either took no enforcement action or acted in the final days before an institution was subject to PCA or failed.	In the five years prior to 2023, regulators identified concerns with SVB and SB, but both banks were slow to mitigate the problems the regulators identified, and regulators did not escalate supervisory actions in time to prevent the failures.
Regulators generally were successful in identifying early warning signs of bank distress, but the presence and timeliness of subsequent enforcement actions were often inconsistent. While their off-site monitoring tools and CAMELS ratings often indicated deteriorating conditions more than a year before banks failed, regulators did not consistently take enforcement actions.	While the Fed's supervisory actions compelled SVB to replace the board chair, CRO, and treasurer and revise its incentive compensation program to incorporate risk management as a formal assessment criteria, its supervisory actions were inadequate given the bank's known liquidity and management deficiencies. The Fed did not recommend the issuance of a single enforcement action despite the bank's serious liquidity and management issues before the bank's failure.

FDIC

The FDIC report included 13 matters for further study. Most covered staffing challenges and internal processes. The following items are most relevant for financial institutions, but no additional insights were provided.

1. Enhanced examination guidance related to assessing liquidity risk management practices

2. Enhanced examination guidance related to supervising banks that are overly reliant on uninsured deposit funding or have concentrations in uninsured deposits

Fed

The Fed's report breaks down lessons learned into two buckets—supervision and regulation.

Supervisory Framework

The Fed recognizes the need for speed, force, and agility in its supervision. "Higher capital or liquidity requirements can serve as an important safeguard until risk controls improve, and they can focus management's attention on the most critical issues. As a further example, limits on capital distributions or incentive compensation could be appropriate and effective in some cases."

Regulatory Framework

1. Re-evaluate the rule for banks with more than $100 billion in assets. The Fed's tailored framework will likely be more stringent for banks with $100 billion or more in assets.

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2. Update liquidity rules starting with the risks of uninsured deposits. “Liquidity requirements and models used by both banks and supervisors should better capture the liquidity risk of a firm’s uninsured deposit base. For instance, we should re-evaluate the stability of uninsured deposits and the treatment of held to maturity securities in our standardized liquidity rules and in a firm’s internal liquidity stress tests. We should also consider applying standardized liquidity requirements to a broader set of firms.”

3. Better align capital requirements. “We should require a broader set of firms to take into account unrealized gains or losses on available-for-sale securities, so that a firm’s capital requirements are better aligned with its financial positions and risk.”

4. Closer review of incentive compensation. Current guidance on supervisory expectations for incentive compensation arrangements are included in the 1996 Interagency Guidelines Establishing Standards for Safety and Soundness and the 2010 Interagency Guidance on Sound Incentive Compensation Policies. Proposals were issued in 2011 and in 2016 to implement the incentive compensation provisions of the Dodd-Frank Act, but neither proposal was ever finalized.

In October 2022, the SEC issued a final rule creating standards for exchange-listed companies for the recovery of erroneously awarded executive compensation, known as a clawback policy. The New York Stock Exchange (NYSE) and the Nasdaq Stock Market (Nasdaq) recently filed their proposed listed standards. In January, the SEC provided additional clarity on application of the rule, which will be effective in 2024. For more details, see **FORsights**™ article, “Updates to SEC’s Executive Pay Clawback Rules.”

Conclusion

FORVIS has resources to assist financial institutions as they work to mitigate risk, avoid regulatory pitfalls, and grow with confidence. For more information, visit **forvis.com**.

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