Unpacking the Lessons Learned from the collapse of Silicon Valley Bank

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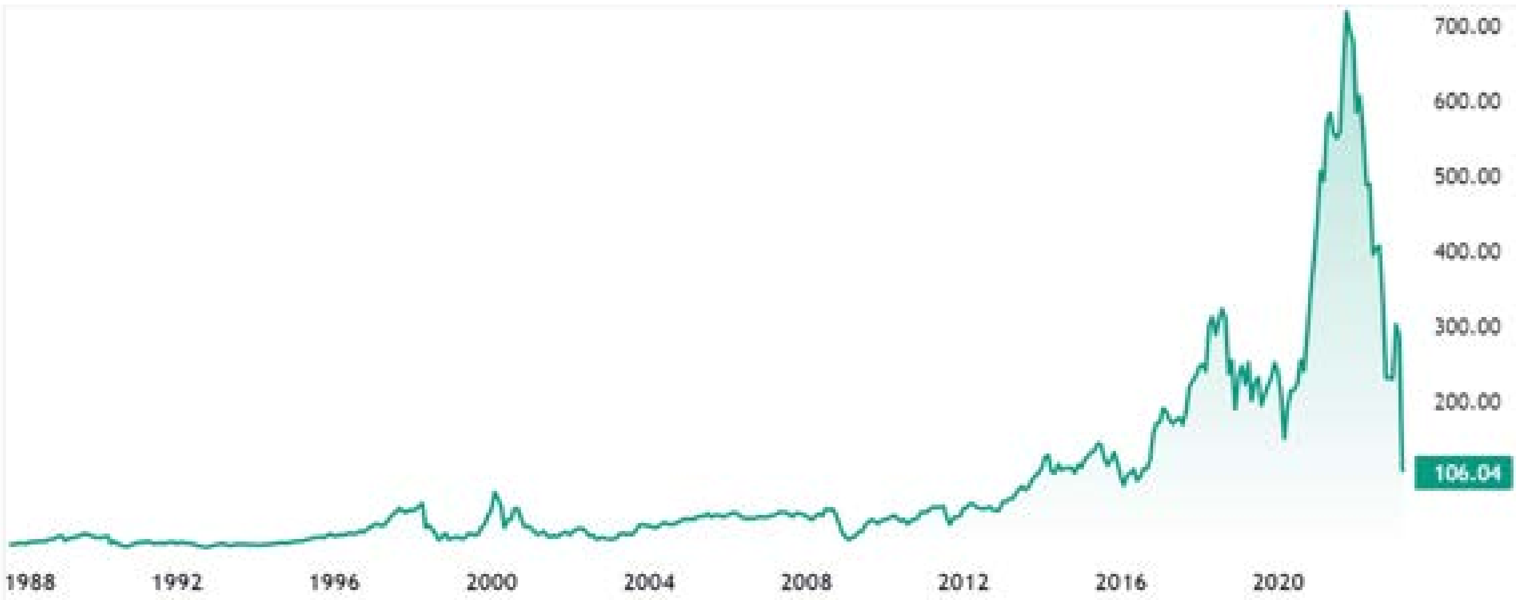
SVB: Charting the rise and then the fall…

Share price tells the story of a bank whom after decades of moderate performance, saw rapid deposit growth over a very short space of time, enterprise values at their peak over 7x historical averages. It also marks the incredible pace with which the firm went into decline and then collapse



Walking through the final days

Over the course of two weeks, SVB went from high growth, high potential scale challenger to the catalyst for a banking crisis the scale of which we have not seen since the GFC

- **24th of February** annual results released to market

- **1st of March** Moody's Investors Service communicate news to SVB of a likely ratings downgrade

- **8th of March** ….
  - The Bank's holding company announced it was conducting a capital raise
  - Bank announces a loss of approximately $1.8 billion from a sale of bond and mortgage back securities portfolios
  - Moody's downgrades SVB Financial - senior unsecured to Baa1 from A3

- **9th of March**
  - Investors and depositors reacted by initiating withdrawals of $42 billion in deposits from the Bank
  - Stock price plummets, 60% lower by the end of trade
  - At the close of business on March 9, the bank had a negative cash balance of approximately $958 million
  - Despite attempts from the Bank, with the assistance of regulators, to transfer collateral from various sources, the Bank did not meet its cash letter with the Federal Reserve

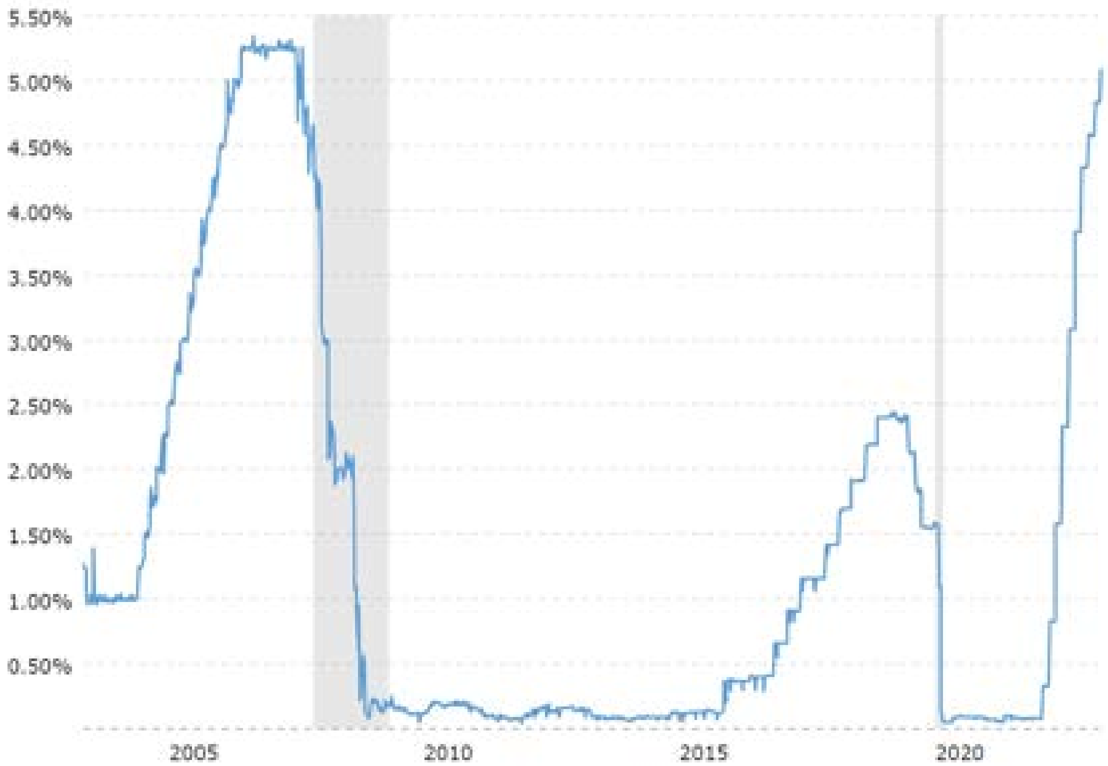
- **The bank is now insolvent.**

What went wrong?

…Let’s begin with the business model

A rate hike for the ages…

The pace and scale of recent interest rate hikes by central banks has been nothing but extraordinary, from being close to the lower bound to 5% in less than 18 months

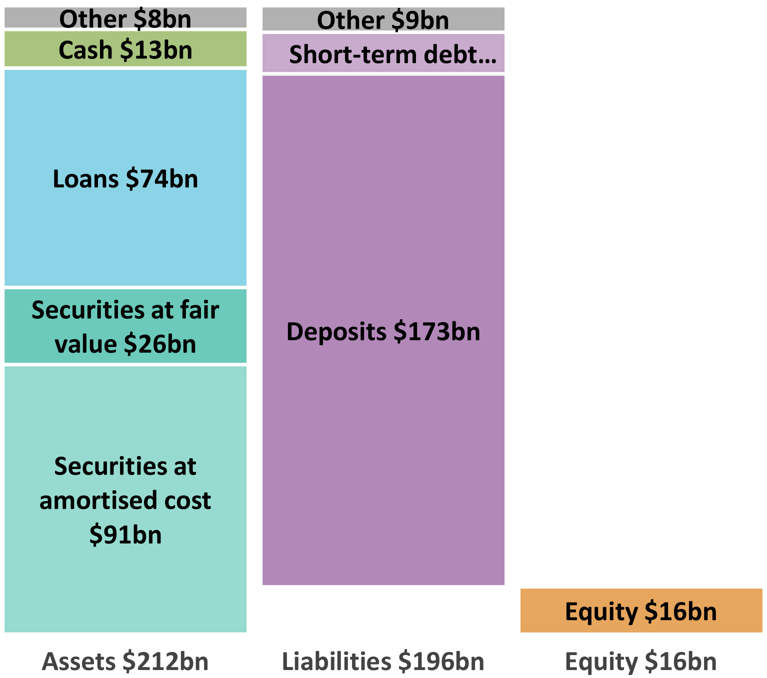


Fed Funds Rate – 20 year view

SVB: Business model as explained by the balance sheet

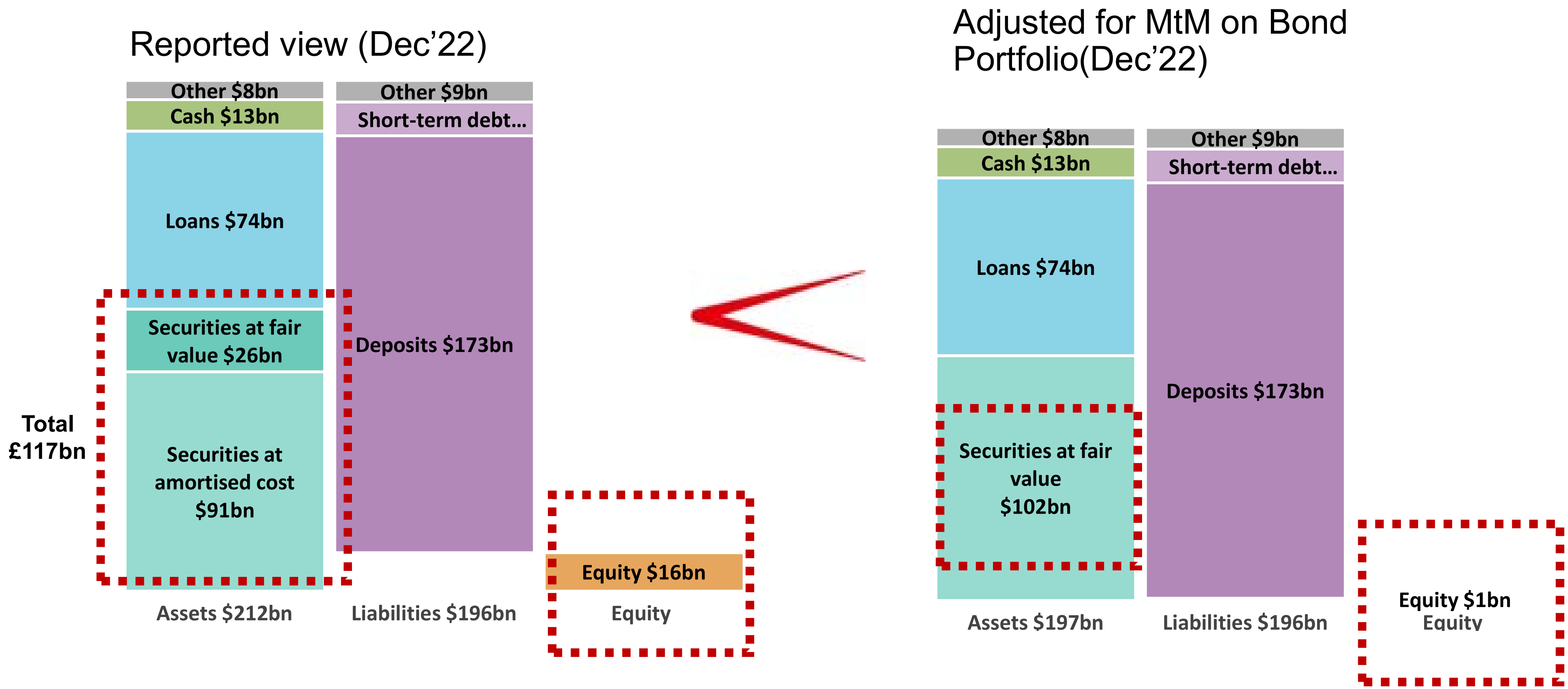
A conventional bank's business model is typically long term with some short-term assets, funded by a mix of short-term deposits, longer-term debt and a sliver of capital. When you get this delicate balance wrong, the business model has a tendency to upend...

Reported view (Dec'22)



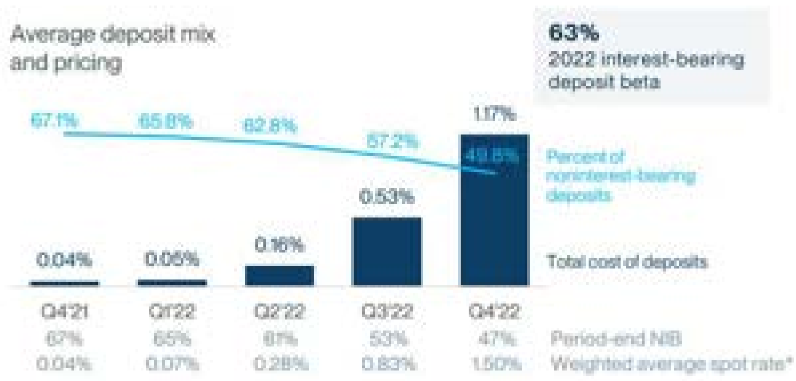
Assets: Losses hidden in plain sight

Mark to market valuation of bond portfolios would have led to a write down of assets and consequentially wafer thin net asset/solvency position



Deposits: early warning signs in mix and cost of funding

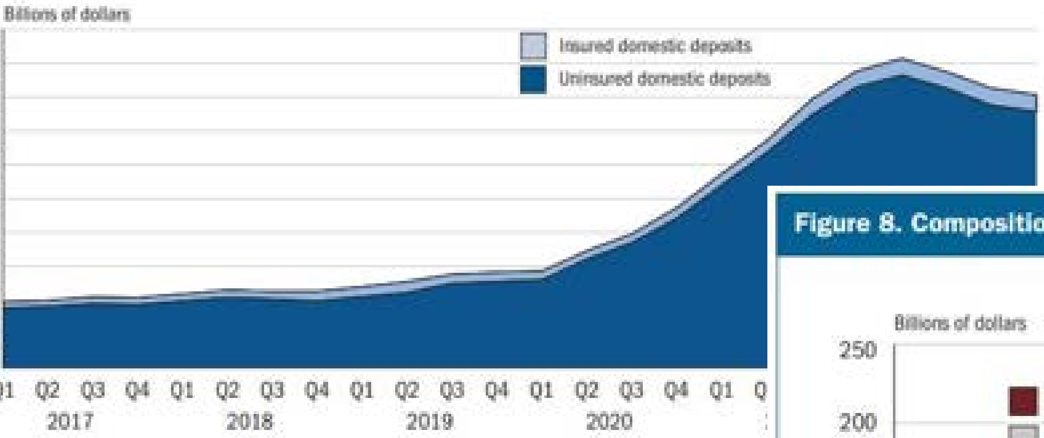
Over 12 months, deposits began to run down current accounts and move money into interest bearing accounts. In addition, savers began to demand higher rates to compensate for interest rate environment and inflation.



Accounting for debt securities

Accounting issues: SVB balance sheet

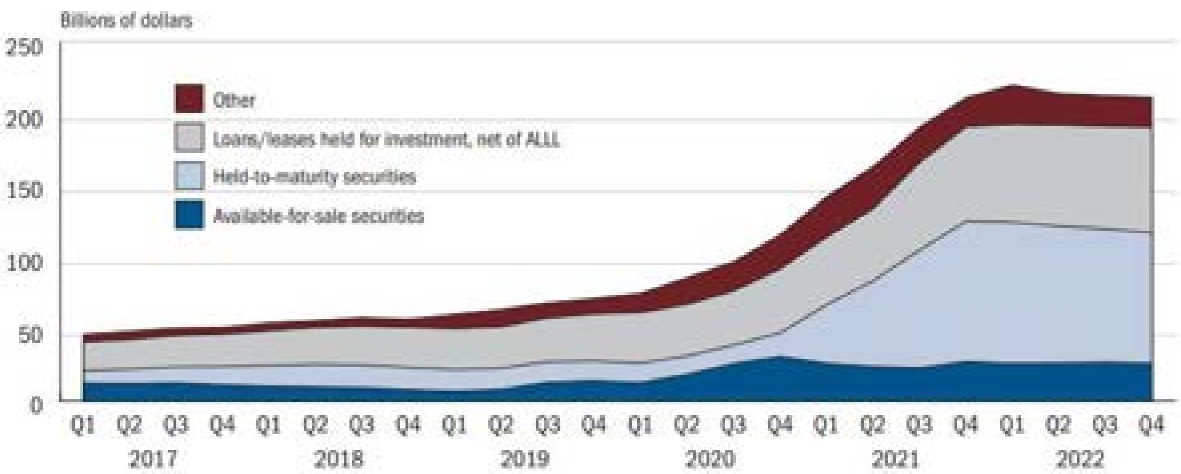
Figure 7. SVB deposit insurance coverage



Note: The key identifies areas in order from top to bottom.

Source: Call Report.

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: Charts from the Report, *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank*

Accounting issues: Held to Maturity

<u>Not consistent</u> with HTM

320-10-25-4: intent to hold the security for only an indefinite period. This includes because the firm:

- needs liquidity (for example, due to the withdrawal of deposits, increased demand for loans, surrender of insurance policies, or payment of insurance claims)

320-10-25-5: sets out 9 specific scenarios – eg:

- contractually be prepaid such that the holder of the security would not recover substantially all of its recorded investment
- Sold to meet regulatory capital requirements
- Convertible debt securities
- A documented policy to classify as HTM, but to transfer to AFS at a predetermined point

<u>Consistent</u> with Held-to-Maturity Classification

320-10-25-6: specific changing circumstances that affect intent, including:

- Change in statutory or regulatory requirements
- Significant increase by the regulator in the industry's capital requirements
- Significant increase in the risk weights of debt securities

320-10-25-9: sets out four general conditions: the event is

- isolated
- nonrecurring
- unusual for the reporting entity
- could not have been reasonably anticipated

320-10-25-10: *Other than extremely remote disaster scenarios (**<u>such as a run on a bank</u>** or an insurance entity), very few events would meet all four of those conditions*.

320-10-25-18: sets out other circumstances consistent with HTM (eg used in secured borrowing)

Accounting issues: disclosures

SVB FINANCIAL GROUP AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

	December 31,	
(Dollars in millions, except par value and share data)	**2022**	**2021**
Assets		
Cash and cash equivalents	$ 13,803	$ 14,586
Available-for-sale securities, at fair value (cost of $28,602 and $27,370, respectively, including $530 and $61 pledged as collateral, respectively)	26,069	27,221
Held-to-maturity securities, at amortized cost and net of allowance for credit losses of $6 and $7 (fair value of $76,169 and $97,227, respectively)	91,321	98,195
Non-marketable and other equity securities	2,664	2,543
Total investment securities	120,054	127,959
Loans, amortized cost	74,250	66,276
Allowance for credit losses: loans	(636)	(422)
Net loans	73,614	65,854
Premises and equipment, net of accumulated depreciation and amortization	394	270
Goodwill	375	375
Other intangible assets, net	136	160
Lease right-of-use assets	335	313
Accrued interest receivable and other assets	3,082	1,791
Total assets	$ 211,793	$ 211,308

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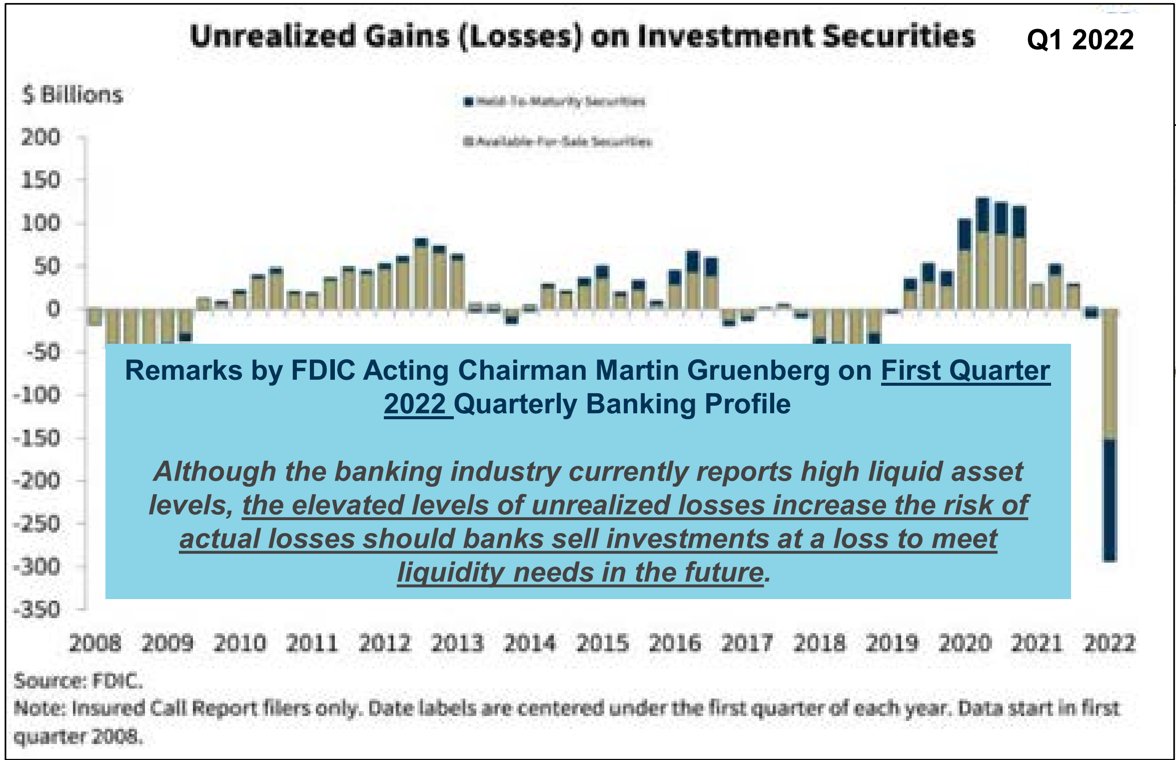
Accounting issues: public awareness – Q1/Q4 2022



Remarks by FDIC Acting Chairman Martin Gruenberg on First Quarter 2022 Quarterly Banking Profile

Although the banking industry currently reports high liquid asset levels, the elevated levels of unrealized losses increase the risk of actual losses should banks sell investments at a loss to meet liquidity needs in the future.

Remarks by FDIC Chairman Martin Gruenberg on the Fourth Quarter 2022 Quarterly Banking Profile

The combination of a high level of longer–term asset maturities and a moderate decline in total deposits underscores ***the risk that these unrealized losses could become actual losses should banks need to sell securities to meet liquidity needs.***

FDIC: Speeches & Testimony - 2/28/2023 - Remarks by FDIC Chairman Martin Gruenberg on the Fourth Quarter 2022 Quarterly Banking Profile

What went wrong?

…governance, risk management and regulatory climate

Cocktail for a banking failure

You will need:

- 3 parts **poor corporate governance**
- 2 parts **poor risk management**
- 1 part **lax regulatory supervision**

Corporate Governance

- Risk Committee – lack of FS and risk management experience

- Chief Risk Officer – absent for most of 2022

- Supervisory findings:

Table 7. Synopsis of SVBFG supervisory findings from the May 2022 letter on the governance and risk-management examination

Issue type	Issue synopsis
MRIA	Board effectiveness–The board's oversight over the firm's risk-management practices is not adequate and has contributed to an ineffective risk-management program. The lack of an effective risk-management program increases the potential that emerging risks may go undetected or root causes for internal controls deficiencies are not addressed.
MRIA	Risk-management program–SVB's existing risk-management program is not effective. The existing risk-management structure and framework does not provide the firm with appropriate mechanisms to operate a fully integrated risk-management program and impedes management's ability to identify emerging risks and address root causes of internal control deficiencies.
MRIA	Internal audit effectiveness–The internal audit (IA) department's methodology and programs do not sufficiently challenge management, provide the audit committee with sufficient and timely reporting, or ensure the timely analysis of critical risk-management functions and the overall risk-management program. The deficiencies in IA's processes and reporting negatively affected its ability to provide timely, independent assurance that the firm's risk management, governance, and internal controls were operating effectively.

Source: Federal Reserve communications with SVBFG, May 31, 2022.

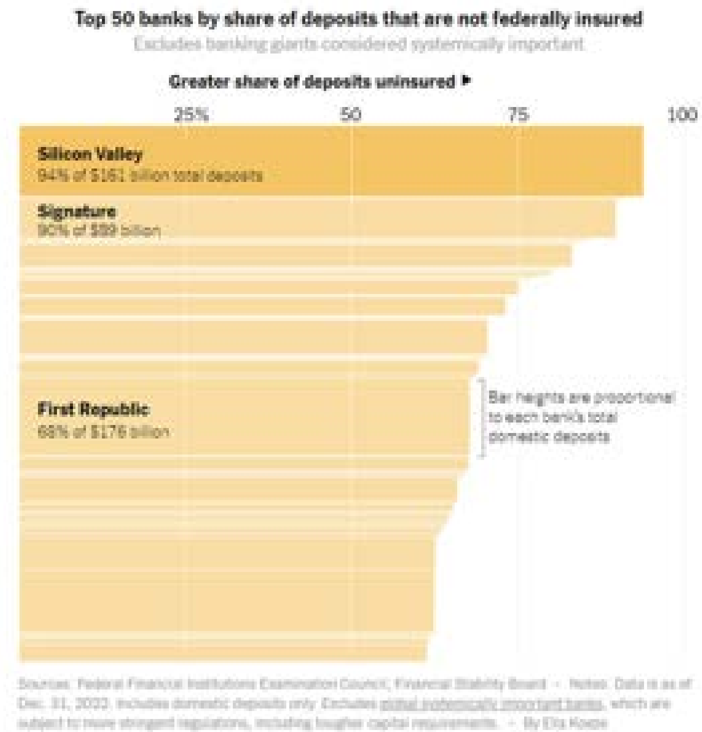
"The examination identified fundamental weaknesses in board effectiveness, risk management, and internal audit—three areas critical to the safety and soundness of financial institutions"

Risk management (or the lack thereof)

- Concentration risk
- Liquidity risk
- Interest rate risk

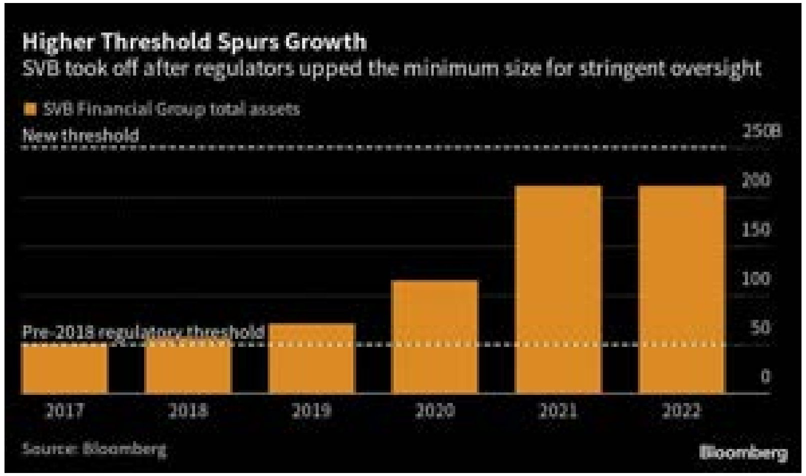
"In both cases, the bank changed its own risk-management assumptions to reduce how these risks were measured rather than fully addressing the underlying risks."

"The full board of directors did not receive adequate information from management about risks at Silicon Valley Bank and did not hold management accountable for effectively managing the firm's risks."



Lax regulatory culture

2018 rollback of Dodd-Frank



2019 'tailoring' rule

Deregulation highlights:

- Liquidity
- Capital stress Tests
- Resolution plan

SVB (absence of 2019 tailoring rules)

SVB (2019 tailoring rules)

Requirements for Domestic and Foreign Banking Organizations*

	Category I U.S. GSIBs	Category II ≥ $700b Total Assets or ≥ $75b in Cross-Jurisdictional Activity	Category III ≥ $250b Total Assets or ≥ $75b in nonbank assets, wSTWF, or off-balance sheet exposure	Category IV Other firms with $100b to $250b Total Assets	Other Firms $50b to $100b Total Assets
Capital	**TLAC/Long-term debt** **Stress Testing** • Annual company-run stress testing • Annual supervisory stress testing • Annual capital plan submission **Risk-Based Capital** • GSIB surcharge • Advanced approaches • Countercyclical Buffer • No opt-out of AOCI capital impact **Leverage capital** • Enhanced supplementary leverage ratio	**Stress Testing** • Annual company-run stress testing • Annual supervisory stress testing • Annual capital plan submission **Risk-Based Capital** • Advanced approaches • Countercyclical Buffer • No opt-out of AOCI capital impact **Leverage capital** • Supplementary leverage Ratio	**Stress Testing** • Company-run stress testing every other year • Annual supervisory stress testing • Annual capital plan submission **Risk-Based Capital** • Countercyclical Buffer • Allow opt-out of AOCI capital impact **Leverage capital** • Supplementary leverage ratio	**Stress Testing** • Supervisory stress testing (two-year cycle) • Annual capital plan submission **Risk-Based Capital** • Allow opt-out of AOCI capital impact **Leverage capital**	**Risk-Based Capital** • Allow opt-out of AOCI capital impact **Leverage capital**
Liquidity (Holding Company)	**Standardized** • Full daily LCR (100%) • Proposed full daily NSFR† (100%)	**Standardized** • Full daily LCR (100%) • Proposed full daily NSFR† (100%)	**Standardized** • If wSTWF < $75b: Reduced daily LCR and NSFR† (85%) • If wSTWF ≥ $75b: Full daily LCR and proposed NSFR† (100%)	**Standardized** • If wSTWF < $50b: No LCR • If wSTWF ≥ $50b: Reduced monthly LCR and proposed NSFR† (70%)	

Source: [Tailoring Rule visual (federalreserve.gov)]

What does this mean for the future of banking?

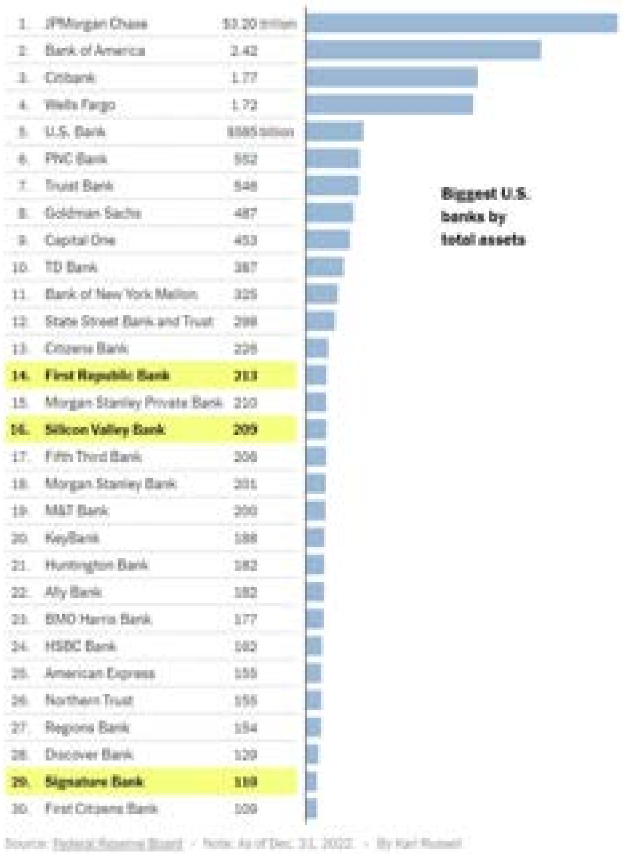
Defacto bail out of banks constitute moral hazard?

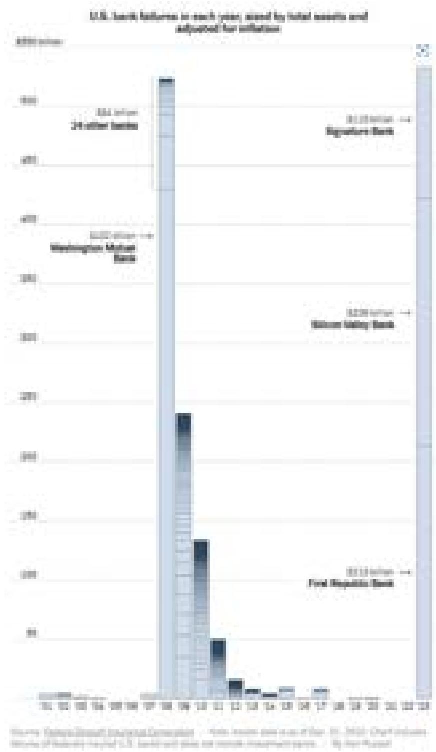
Encourage risky behaviour?

What is a systemic bank?

Areas for focus for regulators:

- **Changes to deposit guarantee scheme**
- **Liquidity coverage ratio / stress testing / outflow rates**





Next up...

BOOK YOUR PLACE

Silicon Valley Bank failure and social media risk

27 July 2023

12:30 - 13:30

Zoom

Book now

This webinar considers any new lessons learned from the failure of Silicon Valley Bank, and how speed of contagion risk in banking is amplified through social media news transmission.

Link: [Silicon Valley Bank Failure and social media risk (icaew.com)]

Questions

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From 1 November 2023, ICAEW's revised Continuing Professional Development (CPD) Regulations bring in new CPD requirements, including a minimum number of hours and an ethics requirement.

This webinar could contribute to up to 1 hour of verifiable CPD, so long as you can demonstrate that the content is relevant to your role.

Find out more about how these changes affect you at icaew.com/cpdchanges.

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