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FRB, FDIC and GAO Release Reports Reviewing Supervision of Silicon Valley Bank and Signature Bank

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Last Friday, the Federal Reserve Board ("FRB") and Federal Deposit Insurance Corporation ("FDIC") released reports evaluating their supervision of the failed Silicon Valley Bank ("SVB") and Signature Bank ("Signature"), respectively. On the same day, the Government Accountability Office ("GAO") released its preliminary review of the actions taken by relevant federal agencies, including the FRB and FDIC, relating to the bank failures. You can refer to our Financial Markets Resource Center for further background and resources.

Both of the FRB's and FDIC's reviews found that the issues underlying the bank failures were deficient governance and risk management practices, particularly with respect to managing liquidity risk in the face of the rapid growth of both banks. (SVB's total assets more than tripled from $56B to $209B between 2018 and 2022, while Signature's more than doubled from $47B to $110B during the same period, primarily due to large, uninsured deposits that they relied on to support their growth.) Such issues had been identified by the regulators in prior supervisory cycles but remained unresolved by SVB's and Signature's management. The releases of the FRB and FDIC reviews also include release of a great deal of supervisory material that is usually not public and closely guarded as confidential supervisory information.

The GAO's report included review of: (1) bank-specific factors that contributed to the bank failures; (2) the supervisory actions taken by regulators leading up to the bank failures; (3) the Secretary of the Treasury's invocation of the systemic risk exception that allowed the FDIC to guarantee SVB's and Signature's deposits in excess of $250,000; and (4) the FRB's establishment of the Bank Term Funding Program. The GAO's review found that FRB's and FDIC's supervision were

"inadequate" and "lacked urgency" in that the regulators failed to issue supervisory actions sufficient to force the banks to remediate their deficiencies prior to their failures, and that more decisive actions taken by the regulators could have helped the banks mitigate their weaknesses.

SVB was subject to regulation by the Federal Reserve and was supervised by examiners in the Federal Reserve Bank of San Francisco ("FRBSF"). The FRB's review found that SVB had been highly vulnerable prior to its failure, having failed its own internal liquidity stress tests and not having workable plans to access liquidity in times of stress. SVB's depositor base was primarily technology and venture capital companies, whose deposits dwindled as the interest rate environment became less favorable to investment in those sectors. Though FRBSF had found weaknesses in SVB's liquidity and management practices as early as 2018, FRBSF consistently gave SVB ratings of "satisfactory" regarding its overall condition between December 2018 and June 2022, and the highest and second-highest available Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk ("CAMELS") ratings for its liquidity and management practices, respectively, during such period. After SVB became subject to a new examination team and more rigorous supervisory requirements as a result of reaching over $100B in assets, in June 2022, FRBSF downgraded SVB's ratings and found that SVB's board did not provide effective oversight of the bank's risk management or hold the bank's management accountable for the bank's deficiencies. Notably, the FRB found that SVB "changed its own risk-management assumptions to reduce how [its interest rate risk was] measured rather than fully addressing the underlying risks" in order to focus on short-run profits.

In August 2022, FRBSF indicated the deficiencies in a supervisory letter to SVB and stated its intent to initiate an informal, nonpublic enforcement action that was to be designed to hold the bank's board and executives accountable. The action − a memorandum of understanding between SVB and its holding company − and a downgrade to SVB's CAMELS rating related to interest rate risk deficiencies dating back to 2020 were still being finalized in March 2023 when SVB failed. The FRB asserted that its supervisory failures of SVB were due in part to supervisory practices that "placed a greater emphasis on reducing burden on firms, increasing the burden of proof on supervisors, and ensuring that supervisory actions provided firms with appropriate due process," which "led to slower action by supervisory staff and a reluctance to escalate issues" – in essence, what bank examiners often cite as the "tone at the top."

As Signature was not a member of the Federal Reserve System, the FDIC was Signature's primary federal bank regulator. The FDIC's review found that Signature's "board of directors and management pursued rapid, unrestrained growth without developing and maintaining adequate risk management practices and controls appropriate for the size, complexity and risk profile of the institution." However, the FDIC had assessed Signature's overall condition to be "satisfactory" between 2018 and 2021, though it identified liquidity and management deficiencies at the bank during the same time period. The FDIC issued repeat matters requiring board attention and supervisory recommendations related to such deficiencies that remained unresolved. Signature's liquidity issues became exacerbated by its reliance on deposits by players in the digital asset (*i.e.*, cryptocurrency) market, which experienced a sharp decline in 2022. According to FDIC staff, "Signature's management was unable to fully understand the bank's

liquidity positions in the days and hours before failure" due to the bank's poor governance.

Despite Signature's significant and persistent deficiencies, the FDIC only issued an interim CAMELS rating downgrade to Signature on the day before it failed. The FDIC also stated that it had been considering escalating its supervisory actions against Signature, including a potential enforcement action, but any such action would have only taken place in Q2 2023. The FDIC cited a lack of resources for its supervisory failures – specifically, the FDIC noted that its New York Regional Office, which was responsible for examining Signature, was not able to adequately staff an examination team dedicated to Signature due to persistent staffing shortages within its examiner ranks. As a result, certain targeted reviews of Signature were not completed in a timely manner or at all due to resource shortages.

In its review, the GAO issued a recommendation that the federal banking regulators incorporate noncapital triggers into its prompt corrective action framework that would encourage earlier action by banks when their financial conditions are deteriorating. The GAO also noted that further reports and assessments relating to the bank failures will be forthcoming.

Additionally, in its review, the FRB stated that it is planning to re-evaluate its stress-testing approach as well as its supervision and regulation of banks' management, interest rate, and liquidity risk, and how to improve the Federal Reserve's capital requirements in light of lessons learned from SVB. The FRB noted that any such adjustments to the liquidity and capital requirement rules would be subject to normal notice-and-comment rulemaking and thus not effective for several years. The FRB outlined a number of policy and implementation issues that should be considered by policymakers to enhance the FRB's supervisory oversight program, including continuing to draw upon lessons learned from earlier bank failures. Such further issues for consideration revolved around four broad themes: (1) enhancing risk identification for both banks and their supervisors; (2) promoting resilience in period of rapid change and heightened uncertainty; (3) changing supervisor behavior such that supervisors move more decisively and focus on inherent risk; and (4) strengthening oversight processes by simplifying and tailoring the framework.

Some of those enhancements to the supervisory programs can be undertaken with just internal changes at the agencies relatively rapidly. For instance, changing supervisory processes and hoping for changes in examiner behavior can just be implemented as new policy at the agencies. However, changes to categorization under the tailoring rule will require notice-and-comment rulemaking and, as acknowledged by Vice Chair Barr in the FRB report, will take time. The agencies should, in most cases, however, be able to implement the enhancements suggested in the report through existing authority, and not necessarily require new legislation.