Did S.2155 Allow SVB's Failure?

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The Federal Reserve's recent report on the failure of SVB places blame for its supervisory failures on passage of S. 2155, the so-called tailoring bill. The report suggests that the tailoring of pre-existing capital, liquidity and resolution planning rules allowed SVB to take more risk and avoid more supervision than it otherwise would have. That is a false and misguided narrative. This note briefly explains why tailoring had no meaningful effect on SVB's liquidity and capital positions or its resolution planning.

Liquidity

According to the report, liquidity problems centered on SVB's reliance on uninsured deposits as a source of funding and its inability to rapidly convert its high-quality liquid assets (HQLA) into cash. **Had SVB been subject to the pre-S.2155 liquidity framework, neither of these problems would have been changed.**

- **Existing requirements:** SVB was required to do internal liquidity stress tests at least quarterly and report results to examiners. It also had to submit a detailed liquidity monitoring report to the Fed each month.
- **Had regulatory tailoring not been implemented,** SVB's internal liquidity stress test requirement would have been at least monthly, it would have been subject to the liquidity coverage ratio and net stable funding ratio and the liquidity monitoring report would still have been required monthly.
  - **Would it have passed?** The Fed notes that SVB would have passed the NSFR and stated that SVB would have needed $8 billion more in high-quality liquid assets to have passed the LCR in December 2022.[1]
  - **Less frequent tests:** The report does not discuss any consequences from less frequent ILSTs, indicating that the Fed judged that it didn't contribute to the failure. In fact, SVB was failing its own ILSTs, and the Fed's finding is that its examiners did not respond appropriately.

How would SVB have come into compliance with the LCR?

- **SVB was awash in liquid assets.** Fifty-eight percent of SVB's assets (at the end of 2022) were liquid, more than double the average percentage among its large peers. In particular, more than half of its assets were Treasury securities and agency MBS.
- **SVB would have come into compliance by investing a little more in Treasuries or Ginnie Maes and a little less in Fannies or Freddies.** That shift would have done nothing to change the firm's interest rate risk or ability to monetize its assets.[2]
- **Alternatively, as noted in the report, SVB could have come into compliance by reducing its foreign exposure below $10 billion.** In that case, SVB would have been subject to the modified LCR rather than

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[1] The report also notes that SVB would have had a modestly larger shortfall of $14 billion in February 2023 once SVB was encountering serious funding difficulties. None of the analysis reported here would change materially if we focused on the February 2023 figure, but the more relevant issue is whether SVB would have been better prepared for the challenges it encountered.

[2] Each dollar diverted would have increased its HQLA eligible for the LCR by $1.67. Why? 1) The reduction in agency MBS would not have reduced its HQLA because it had more agency MBS than it could count toward the LCR. 2) The increase in Treasuries or Ginnies would have increased HQLA directly. 3) The increase in level 1 HQLA would have allowed more agency MBS to count within the 40 percent limit. SVB could have and presumably would have boosted its HQLA by that amount while sticking to its business model by diverting just 7.7 percent of its investments in Fannie and Freddie MBS toward longer-term Treasuries or Ginnies.

the full LCR, and the Fed estimates SVB would have passed the modified LCR.[3]

Would SVB have been better able to convert its assets into cash quickly? Probably not.

SVB was already failing its internal liquidity stress test and contingency funding plan requirements in part because it did not have a sound plan for converting its assets into cash, and the Fed recognized that it dropped the ball by not acting on that information. There is no reason to think that adding the LCR's monetization requirement would have changed the outcome, as there is a similar requirement in place for its ILSTs.

Capital

The report notes that absent the adoption of the 2019 tailoring rule, SVB would have been an advanced approaches bank and, therefore, required to include unrealized gains and losses on available-for-sale (AFS) securities to be reflected in regulatory capital. Additionally, SVB would have been subject to supervisory stress tests beginning in 2020. **However, none of these changes would have materially affected SVB's stress capital buffer nor forced the firm to raise capital.** In addition, and similar to the LCR, SVB could have managed its assets to stay below $10 billion in total consolidated on-balance-sheet foreign exposure to avoid becoming an advanced approaches bank, and therefore could have continued applying the AOCI filter.

- **Basel:** In 2013, the U.S. regulatory agencies implemented the Basel III capital standards, which required all advanced approaches banks to include most elements of AOCI in regulatory capital. At that time, banks with consolidated assets of $250 billion or more, or with on-balance-sheet foreign exposures of at least $10 billion, would have been subject to the advanced approaches rules.
- **Even if SVB had not been eligible for the AOCI filter**, its CET1 capital ratio would have been above 10 percent, well above its 7 percent requirement.

Subject to supervisory stress tests

The report notes that if the tailoring rules had been absent, SVB would have been required to undergo annual and mid-cycle company-run stress tests and to explore its own idiosyncratic scenarios in these tests. Moreover, prior to the tailoring rules, the supervisory stress tests comprised two scenarios, with one scenario featuring a significant increase in inflation and a corresponding sharp rise in long-term interest rates.

However, the **stress tests were not designed to capture the types of vulnerabilities that led to SVB's failure.** Although capital and liquidity factors were interconnected in SVB's failure, the amount of unrealized losses on its investment securities portfolio did not create a capital problem until it became evident to the market that the firm was unable to raise liquidity from its assets.

Resolution planning

The report notes that, absent EGRRCPA and related regulatory tailoring, SVB would have been subject to holding company-level resolution planning requirements, and therefore seems to imply, without articulating how, such requirements would have made SVB more resilient. This is unlikely for two reasons. First, and as the report notes, SVB *was* subject to bank-level resolution planning requirements, and more than 98 percent of the firm's assets were held in the bank. Therefore, it is unlikely that a holding company-level plan would have differed meaningfully from the bank-level plan. Second, and more importantly, resolution planning requirements are not designed to reduce a firm's risk of failure, but instead to facilitate an orderly resolution once a bank has failed or is soon to fail. It may be worth examining how the agencies handled the SVB resolution after its failure became

[3] SVB would have been subject to the full LCR and NSFR because it had $10 billion in total consolidated on-balance-sheet foreign exposure, not because of its asset size. As noted in the report, if SVB had been subject to the pre-S.2155 regime, "SVBFC may have proactively managed its asset size and on-balance sheet foreign exposure to avoid becoming subject to these additional requirements." (p.13). If SVB had reduced its foreign exposure below $10 billion, it would have been subject to the modified LCR – specifically, its LCR would have been divided by 70 percent.

nearly unavoidable on March 8, including how resolution planning requirements could have supported a more orderly resolution, but the report explicitly declines to address developments after that date.

Conclusion:

Subjecting SVB to enhanced capital requirements and stress testing, including pre-tailoring requirements, would not have forced the firm to raise additional capital or alter its behavior. **Ultimately the removal of these requirements did not play a factor in the eventual failure of SVB.**