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Something Missing: Omissions and Surprises in the Federal Reserve's SVB Report

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For those interested in substantive policymaking in light of the failure of SVB, the facts are important. Some proposed policy responses would have significant implications for the role of banks in the U.S. economy and long-term economic growth. The proper policy response will depend on a clear understanding of the causes of SVB's failure.

Set forth below are significant issues raised by the failure of SVB that were outside the scope of the Federal Reserve's initial report or within its scope but unaddressed. Each seems ripe for further investigation.

Out Of Scope by Design

Several topics were defined as out of scope for the Federal Reserve's report, which by its own account covers "the Federal Reserve's supervisory and regulatory responsibilities with respect to the Federal Reserve's safety-and-soundness objectives."

Thus, the report was not designed to cover, among other things:

- Actions by the Federal Reserve as lender of last resort or market liquidity provider;
- Actions by the Federal Home Loan Bank System;
- The impact on bank balance sheets of the Federal Reserve's policy of quantitative easing followed by rapid increases in rates;
- Actions by the Federal Deposit Insurance Corporation, including resolution of SVB;
- The systemic risk exception approved by the FDIC, Federal Reserve Board and Treasury.

Those topics presumably await review by others.

Out Of Scope by Oversight Or Choice

There are other topics that the self-identified scope of the report would presumably include, but were not covered.

INTERNAL COMMUNICATIONS AND DOCUMENTS

While the Federal Reserve has been rightly lauded for producing confidential supervisory information, that information includes only formal examinations and correspondence with SVB but not, with a single exception, internal communications (e.g., emails or memoranda).[1] Furthermore, although the report notes that the Board staff that prepared the report had access to all "internal communications" relating to SVB, none is quoted.

Similar gaps exist with respect to the Board's oversight of Reserve Bank staff. As the report notes, the Federal Reserve Act requires the Board to "at least once each year, order an examination of each Federal Reserve Bank."

[1] The exception is the slides from a Feb. 14, 2023 briefing of the Board on the Impact of Rising Rates and Supervisory Approach. Even in this case, no transcript of the briefing, including any questions or guidance from the Board to the staff, is provided.

The report includes a chart showing that all the ratings for the FRB-SF from 2019 to 2022 were Strong or Effective. But no materials were released with respect to either the Board's assessment of the FRB-SF or the assessment framework that was used.

ISSUES

Misallocation of Resources

The report does not consider the possibility that a proper focus on SVB's fatal weaknesses might have been delayed by examiner emphasis on other issues, including matters of little or no material risk to the bank's safety and soundness.

Consider the May 3, 2021 examination report, the first issued after SVB moved from regional bank to large bank supervision at the Federal Reserve, after two years of rapid asset growth. It contained the following list of MRAs and MRIAs.

- Internal Controls: Customer Due Diligence and Suspicious Activity Monitoring
- Disaster Recovery Testing
- Model Risk Management
- Information Systems/Cybersecurity Risk Reporting
- Firewall Management
- Systems/Technology Second Line of Defense [compliance]
- Audit Committee MIS [management information systems]
- Vulnerability Remediation
- Risk Governance – Disaster Recovery
- Risk Definition/Taxonomy
- Identity Access Management
- Technology Risk Management
- IT Asset Management
- Vendor Management
- Data Protection
- Data Governance
- Formalization and Maturity of Internal Loan Review
- Ownership of LOD [lines of defense] Lending Controls

None of those MRAs or MRIAs relates to financial condition, much less to interest rate or liquidity risk, which were the key problems at SVB.

About six months later, on Nov. 2, 2021, the FRB-SF did issue a supervisory letter following a targeted liquidity examination which at first blush appears to touch all the bases: poor scenario design for internal stress tests; a poor contingency funding plan; and a lack of deposit segmentation. It included two MRIAs and four MRAs. What is notable about the letter, however, is that it is almost exclusively focused on process. There is no mention of the outcome of the ILSTs, no independent assessment of the firm's actual liquidity risk and no suggestion that the firm need to reduce its risk as opposed to reform its processes.

SVB was issued seven other MRIAs and nine MRAs in 2022 and 2023. None was related to liquidity. Most notably, these subsequent actions included a Nov. 15, 2022 letter and accompanying MRA that expressed concern about interest rate risk, noting that "[c]hanges in NIM, NII and earnings are directionally inconsistent with internal projects and IRR simulations, calling into question the reliability of IRR modeling and the effectiveness of risk management practices." Again, this MRA is focused solely on *process*, not actual risk, and the report does not make clear what transpired as a result, noting only that "[t]he supervisory team issued a supervisory finding in

November 2022 and planned to downgrade the firm's rating related to interest rate risk, but he firm failed before that downgrade was finalized."[2]

These documents would seem to warrant an analysis of how examination priorities were set by Board or Reserve Bank management and whether they were unduly focused on governance, process and immaterial risks. The report omits any such discussion and provides no relevant records.

More broadly, the underlying documents seem at war with a central contention of the report that the preceding Vice Chair for Supervision set a tone of laxity. In fact, the examination materials reflect a highly energetic focus on the governance and procedural topics listed above, just not on matters of actual financial risk.

Internal Federal Reserve Governance

A key question about SVB's supervisory history is why, even after the FRB-SF recognized an interest rate risk problem (albeit only as related to risk management *processes*), a response was delayed. For example, a draft Memorandum of Understanding had been pending for more than seven months at the time of SVB's failure. The report states:

> Governance issues related to the Board's delegated authority may play a role. For example, the Board has delegated to the Reserve Banks supervisory authority for firms like SVBFG, including the authority to issue supervisory ratings, but in practice, Reserve Bank supervisors typically seek approval from or consensus with Board staff before making a rating change. Enforcement actions for banks with assets greater than $100 billion are not delegated to Reserve Banks but require approval by Board staff. The lack of clarity around governance processes and the need for consensus often lead to a lengthy process. A related complication is that the Board provides substantive input to the supervisory process, including the ratings for firms subject to delegated authority, and also acts in an oversight capacity over the Reserve Banks. This creates conflicting incentives for the Reserve Banks that could be an additional force that pushes toward consensus around supervisory judgments. [3]

Elsewhere the report notes that "the evolution of supervision in the LFBO portfolio involves a structure where Board staff both participates in the supervisory process with the Reserve Bank and provides formal oversight. This creates a potential conflict that may lead Reserve Bank staff to defer to Board staff with oversight responsibilities."[4]

This commendably candid acknowledgement of bureaucratic dysfunction would seem to warrant significant reflection, but it is omitted from the key takeaways of the report and not included in any recommendation. The result is that the report concludes that examiners should have taken more timely action, but is then silent on the internal organizational problems that seem to have been a primary obstacle to such action.

Furthermore, the quoted language speaks about Federal Reserve practices only generally and provides no facts with respect to what *actually occurred* with respect to SVB. One reason for the delay appears to have been that it encompassed not only liquidity risk but also information technology, third-party risk management and internal audit. Again, documents related to Board actions were not included along with the report.

Distraction

Similar to the point of misallocation of resources, the report does not appear to consider how SVB management might have been distracted from core risk management by a multiplicity of examiner mandates to establish policies and procedures for virtually every aspect of the business. The report includes in Figure 18 on p. 50 an internal risk management gap assessment produced by SVB management, apparently in response to examiner mandate. **This list of items, attached as an appendix, is a must-read for anyone wishing to understand the**

[2] Report at ii.
[3] Report at 9-10.
[4] Report at 43-44.

current state of bank examination. The tasks are primarily related to documentation, governance and process, and none was directed at actually reducing the financial risks at SVB. Yet the report does not consider the possibility that a mandate to, for example, establish "Risk ID and Risk acceptance governance standards" and a "centralized GRC tool" and a "framework or methodology for addressing compliance risk culture" might have left management and the board of directors less time to focus on actual financial risk.

Furthermore, the report explicitly notes that it "is not a comprehensive review of all supervisory activity. For example, there was substantial supervisory activity during this period in areas like information technology (IT) that is not a focus of this review."[5] Thus, the report gives only a partial view of the tasks mandated for management or board action by the examination teams. A comprehensive list would provide further insight, and likely spark greater concern.

The report includes evidence of how a focus on process and immaterial items prevented identification of actual risk. The report states, "After the firm transitioned to the LFBO portfolio, the supervisory team discussed conducting an IRR [interest rate risk] exam during 2022 but decided to defer this to the third quarter of 2023 in order to prioritize governance and liquidity exams."[6] The report suggests that the LFBO exam teams decided to prioritize governance and liquidity because sensitivity to interest rate risk "had been rated satisfactory for many years".[7]

The report contains no takeaways or recommendation on this topic. It therefore does not determine whether examiners at the FRB-SF were unusually focused on immaterial matters, or whether this was a broader issue across the Federal Reserve System or beyond.

Horizontal Review

One subtle but surprising omission from the report is any sense of how the key risks that undid SVB were managed and examined at other banks within the Federal Reserve System, at national banks, and at state nonmember banks.[8] This omission from the Federal Reserve's self-examination is remarkable given that the Federal Reserve consistently emphasizes so-called "horizontal reviews" in its examination of banks.

The omission is notable because by all and innumerable accounts, the business model at SVB was an extreme outlier both in terms of its interest rate risk and depositor concentration.[9] With respect to interest rate risk, this disclosure from the report is illustrative:

> SVBFG's risk appetite statement (RAS) set by the board, which sets limits within which the bank controls the risk, only included the NII metric and not the EVE [economic value of equity] metric. Further, the NII metric was included only as a down 100 bps 12-month ramp instead of a range of plausible shocks. Ramp scenarios gradually adjust rates and are less stressful than an immediate rate shock.[10]

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[5] Report at 27 (emphasis added).
[6] Report at 66.
[7] Report at 66.
[8] There is a section of the report that discusses several horizontal exams, including a horizontal capital review that covered CECL, Internal Audit, and several idiosyncratic elements, specifically, Risk Identification, Scenario Design, and Capital Plan. The report also mentions a supervisory planning meeting at which IRR management was listed as a "watch list" item for cross-portfolio discussion groups, but there is no indication that it was a risk actually targeted in a horizonal exam. Report at 69-70. The section of the report that discusses the Horizontal Liquidity Review that included SVB but was not complete at the time of the firm's failure discusses the preliminary SVB findings, but does not directly compare its performance to peer firms. Report at 59.
[9] According to the report, SVBFG's tech-focused business model made it an outlier relative to its peers in terms of growth, funding mix and composition of the balance sheet (table 1). As of year-end 2022, SVBFG's securities portfolio as a share of total assets was more than double the large banking organization (LBO) peer group, and SVBFG's HTM portfolio, as a percentage of total securities, was also nearly double that of the average LBO. SVBFG's uninsured deposits as a percentage of total deposits were more than double the LBO average. Report at 22.
[10] Report at 62.

Especially given that EVE is generally considered the most important measure of interest rate risk, it would be good to know whether other Reserve Banks or the OCC would have tolerated such an outcome at a bank of SVB's size, or any size. (Anecdotal evidence suggests that they would not.)

More generally, a crucial question unanswered in the report is whether other banks simply managed their interest rate and liquidity risk better than SVB (and First Republic, which was a state nonmember bank), or whether examiners at the OCC and the other Federal Reserve Banks did a better job examining national and other state banks and thereby restrained banks from taking risk like SVB.[11] The answer cannot be divined from the report, because the question is never asked.

Tailoring

Notably omitted from the report is documentary evidence to support its key takeaway: "The Board's tailoring approach in response to the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) and a shift in the stance of supervisory policy impeded effective supervision by reducing standards, increasing complexity, and promoting a less assertive supervisory approach."

***Assertiveness**.* As noted above, the examination materials released along with the report appear to rebut any suggestion that examiners were not assertive; they seem to have been quite assertive about certain topics, though mostly the wrong ones. There is certainly no evidence presented in the report of examiners being discouraged from pursuing their concerns about interest rate or liquidity risk. Reading the report and underlying materials in full, the greatest obstacle to timely resolution of problems looks to have been bureaucracy and misplaced priorities.

The closest example of a lack of assertiveness in the report is the following: "For example, staff informed SVBFG about a forthcoming MOU concerning information technology in 2021, but staff subsequently dropped the matter because they felt it would not be pursued by policymakers at that time." Of course, in hindsight, information technology was not the greatest risk facing SVB.

***Complexity**.* The report and underlying materials certainly demonstrated how a multitude of competing priorities and bureaucratic delays deterred examiners from focusing on actual risk,[12] but it does not include evidence to suggest that those complexities were attributable to a change in law as opposed to self-inflicted.

***Reduced Standards**.* The report mentions the 2018 tailoring statute, EGRRCPA, 38 times. There is little in the report, however, to link its passage to outcomes in the report.

Capital. As explained in a recent note,[13] there does not appear to be any evidence that application of pre-EGRRCPA capital standards would have found SVB wanting. The report does not provide evidence to the contrary.

***Liquidity**.* With respect to liquidity *regulation*, the report notes that SVB would have needed an additional $8 billion in high-quality liquid assets (HQLA) to pass the pre-EGRRCPA liquidity coverage ratio (LCR) requirement. As noted in the report, SVB could have easily avoided the full LCR requirement and instead been subject to the modified LCR requirement by managing down its foreign exposures.[13] In addition, as described in a recent note, SVB could also have come into compliance by simply investing slightly more in Treasury securities or Ginnie Maes and investing a little less in Freddie Mac or Fannie Mae securities.[14]

With respect to *supervision* of liquidity, the report acknowledges forthrightly:

> Supervisors continued to assess SVBFG's inherent liquidity risk profile favorably in the August 2022 CAMELS and LFI ratings letter, stating "…actual and post-stress liquidity positions reflect a sufficient

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[11] Silvergate, Moonstone and Signature appear categorically different, as crypto banks, a problem that seems to be solving itself.

[12] Report at 98.

[13] Covas, Francisco, "How Did Regulatory Tailoring Affect SVB's Capital Requirements?" *Bank Policy Institute* (May 3, 2023) https://bpi.com/how-did-regulatory-tailoring-affect-svbs-capital-requirements/.

[14] BPI Staff, "Did S. 2155 Allow SVB's Failure? *Bank Policy Institute* (May 1, 2023) https://bpi.com/did-s-2155-allow-svbs-failure/.

> buffer…". Supervisors primarily relied on the comparatively large percentage of the balance sheet held in cash reserves and investment securities, and SVBFG's estimated coverage relative to the U.S. LCR reduced requirements as drivers of the favorable liquidity position assessment.[15]

And consistently:

> Supervisory engagement with SVBFG in January and February 2023 occurred through continuous monitoring meetings, and the supervisory record shows supervisors had limited concerns on the liquidity position. Only concerns with liquidity risk management practices were communicated to SVBFG, not the substantive liquidity positions.[16]

The report does not include information to suggest that had EGRRCPA not been enacted, examiner judgment would have been better.

SVB's Failure To Prepare To Monetize Its HQLA

The report states that one of SVB's most serious deficiencies was its lack of a plan to monetize its HQLA, as required by the enhanced prudential standards related to ILST. It also states that SVB's remediation plan "cited the need to expand capacity and options for repo funding, including increased bilateral relationships, FICC direct membership, tri-party, and the Federal Reserve's Standing Repurchase Agreement facility, among other sources. These efforts were not complete by March 2023." [17]

This raises a series of questions unexplored in the report: Did examiners consider SVB's proposed remediation to be acceptable? Can a bank say that its monetization plan in its ILST is to use the SRF or primary credit from the discount window? Did examiners encourage SVB to pledge more collateral to the discount window? In the section on lessons learned under "Promote Resilience," the report includes an oblique suggestion that it is reconsidering these issues – "Requirements for stronger operational capacity to access alternative forms of funding in stress could help cushion shocks"[18] – but no more.

The Period Two Weeks Before Failure

On March 8, SVB made what turned out to be a disastrous decision to sell its entire AFS portfolio and recognize a $1.8 billion loss. That loss spooked the markets, triggered a run the next day, derailed a planned equity raise and doomed the firm. A key question is why SVB decided to sell those securities rather than pledge them to the discount window or otherwise borrow against them.

While there must have been communications among SVB, the FRB-SF (both as examiner and lender) and Board staff, the report says nothing about the incident other than noting its occurrence in a chronology.

SVB's Removal Of Interest Rate Hedges

The report notes:

> In early 2022 …. [t]he bank began positioning its balance sheet to protect NII against falling interest rates but not rising ones... Rising rates were seen as an opportunity to take profits on hedges, and the bank began a strategy to remove hedges in March 2022, which were designed to protect NII in rising rate scenarios but also would have served to constrain NII if rates were to decrease.[19]

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[15] Report at 55.
[16] Report at 59.
[17] Source: SVBFG internal materials.
[18] Report at 96.
[19] Report at 63.

The report does not disclose whether examiners at the Reserve Bank or the Board were aware of this decision. In terms of interest rate risk generally, the report describes SVB's practices at length but includes only two paragraphs on the Federal Reserve's oversight, focused mostly on ratings assigned.

Board Oversight Of The FRB-SF

Board staff consistently gave FRB-SF examination staff high ratings:

> In 2022, Board S&R staff noted, with respect to the SVBFG transition, that supervisory planning had been effective and necessarily agile as the dedicated supervisory team had focused the supervisory plans on key knowledge gaps, primarily risk management, board effectiveness, and internal audit. Board S&R staff also noted that the DST [dedicated supervisory team] demonstrated superior ability and that the SVBFG transition from RBO to LFBO had required the team and FRB leadership to navigate a complex supervisory profile.[20]

In light of the facts in the report, a finding that the FRB-SF had "superior ability," would seem to warrant further analysis, but the report includes no reflections on the process that yielded this high opinion of FRB-SF and no takeaways or recommendations. As noted, the report also did not attach the actual assessments, so the paragraph above is the sole detail provided.

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[20] Report at 31.

APPENDIX

Figure 18. SVBFG internal risk management gap assessment

Risk Management Gap Assessment: Executive Summary (1/2)

LFI Components	Summary of Gaps	Related RTP Workstreams (WS #) / Other Programs
Risk Appetite Statement I	• Given the lack of a formal **Risk Appetite Standard**, evaluation of the risk appetite statement ("RAS") and risk tolerance is not formalized for **annual review or ad hoc changes** due to emerging risks or strategic changes (e.g., acquisitions). *[Gap 1]* • **Enterprise-level risk tolerances** are not cascaded down to the line of business for all key applicable risks. *[Gaps 2, 3]*	• Risk Appetite and Limits Framework (WS 4)
Strategic Plan II	• The **strategic planning framework** does not have a defined process to review the impact of the business lines' strategic plans on SVB's risk profile, nor is there a mechanism to track the firm's progress against its strategic objectives. *[Gap 4]* • **Effective challenge by the 2nd LOD**, while present, does not demonstrate the outcome of its exercise. *[Gap 4]* • **Business unit strategic planning** is not supported by a documented process to demonstrate responsibilities, criteria and guidelines for approval. *[Gap 5]*	• Corporate Strategic Planning Process (WS 10)
Risk Identification and Assessment III	• The **Issues Management** process currently lacks mechanisms to track, escalate, report, determine root causes, ensure effective change management, and manage data quality on issues throughout the enterprise. *[Gaps 6, 7]* • The **Risk ID and Risk Acceptance** governing standards have not been implemented, and there is inconsistent application of the **Risk Taxonomy** across financial and non-financial risks. **Risk and Control Inventories ("RCI")** are at varying levels of maturity and data does not always map back to the Risk Identification Framework/Standard. *[Gaps 8, 9, 11]* • The scope of the **Compliance Monitoring and Testing program's risk assessments** do not consider the non-banking entities of SVBFG. *[Gap 9]* • SVB does not currently utilize a **centralized GRC tool** to manage and report on risk assessments across the enterprise. *[Gap 10]* • The governing risk management process for **New & Modified Products & Services** has not yet been finalized, leading to an inconsistent approach throughout the enterprise. *[Gaps 12, 13]*	• Issue Management (WS 9) • Risk Identification (WS 5), Risk Acceptance (WS 6) • GRC Platform (WS 8) • New & Modified Products & Services (WS 11) • Compliance-specific remediation will take place under regulatory remediation activities underway
Roles and Responsibilities IV	• Many **foundational standards of 2nd LOD** (e.g., issues management, risk ID, risk acceptance etc.) are not fully developed, and the execution and documentation of **2nd LOD's effective challenge** responsibilities are conducted inconsistently across 2nd LOD functional areas. *[Gap 14]* • The business units currently do not maintain clearly defined **roles and responsibilities** for key risk programs related to **1st LOD risk management.** *[Gap 15]* • There is **no framework or methodology** for assessing compliance **risk culture**. *[Gap 15]*	• Governance, Accountability & Culture (WS 1)

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Risk Management Gap Assessment: Executive Summary (2/2)

LFI Components	Summary of Gaps	Related RTP Workstreams (WS #)/ Other Programs
Governance and Escalation V	• There is a lack of governance process around **enterprise policies and procedures**, and no central repository to ensure awareness as to the existence of policies. *[Gap 16]* • The **Management-level Risk Committees** program governance, while established, does not clearly define a standard structure for hierarchy, information flow, and charter requirements. *[Gap 17]* • ERM has not implemented a **Risk Reporting Governance Program** and oversight framework, leading to disparate reporting practices across the enterprise. *[Gap 18]* • **Business Unit Quarterly Risk Reporting (QRR) and Monthly Reporting** lacks a structured risk framework around establishment of thresholds, limits and tolerances to conform with the Risk Appetite Standard. *[Gap 19]*	• Governance, Accountability & Culture (WS 1) • Management Committee Governance (WS 3) • Risk Reporting (WS 7)
Resources and Infrastructure VI	• While the 2nd LOD is currently actively hiring to meet its identified resource needs, it does not have a defined framework for identifying and assessing its resource needs. *[Gap 20]* • While the 1st LOD is currently actively hiring to meet its identified resource needs, it does not have a defined framework for identifying and assessing its resource needs. *[Gap 21]*	• Workforce Planning (WS 2)
Internal Control Framework VII	• There is no enterprise-wide **Internal Control Framework,** including no enterprise-wide standard for the various control testing programs, leading to limited standardized control data across the enterprise. *[Gap 22]* • **The Risk and Control Self-Assessment (RCSA) Program and related internal control testing** of key controls is inconsistent given the disparate scope of testing programs, and not at a state of maturity appropriate for a firm of SVB's size. *[Gap 22]* • Risk assessments for the Compliance Monitoring and Testing program considered a limited set of factors and conduct testing on inherent rather than residual risk. *[Gap 23]*	• ERM Controls Monitoring (WS 12) • Technology Risk Management (WS 13) • Compliance-specific remediation will take place under regulatory remediation activities underway
Talent and Incentive Management VIII	• HR has not established an enterprise-level **Talent Management framework** to govern the end-to-end employee lifecycle for Covered Employees, including **performance reviews** to monitor and enforce prudent risk-taking behaviors. *[Gaps 24, 25]* • The **Incentive Compensation plan design** does not include a process to ensure risk management and compliance objectives and practices are taken into consideration for Covered Employees. *[Gap 26]* • There are no documented processes to evidence standardized practices across the enterprise for **Succession Planning** and **maintaining job descriptions** for key employees. *[Gaps 27-30]*	• MRIA 1 • Workforce Planning (WS 2)

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Source: SVBFG internal material, August 29, 2022.