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Silicon Valley Bank failure – A different view of the Federal Reserve OIG report

October 18, 2023 | Client Update | 17-minute read

The Federal Reserve OIG issued a report on SVB's failure. Media reports have described it as nearly identical to the Barr Report. The report is more critical of the supervisory staff. It does not blame regulatory tailoring for reduced supervisory intensity, except when SVB had assets between $50-$100 billion. Nor does it blame supervisory deficiencies on a less-assertive supervisory culture instituted by former Vice Chair for Supervision Quarles.

Key takeaways

Diagnosing the true reasons for the failure of Silicon Valley Bank (SVB) and the contagion it fostered is critical to prescribing the right medicine to reduce the risk of similar failures and contagion in the future. That is why recognizing the key differences between the OIG Report[1] and the Barr Report is so important.[2] The Barr Report was essentially a self-assessment by the supervisory staff of the root causes of SVB's failure, including deficiencies in risk management and the staff's own supervision of SVB. The report was prepared under extreme time pressure with little time to weigh the evidence or reflect on the root causes for the deficiencies. In contrast, the OIG Report was a more independent review with more time to weigh the evidence and reflect on the root causes of the deficiencies in risk management and supervision.

If, as the Barr Report alleges, the Federal Reserve's implementation of the tailoring requirement in the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)[3] was a major factor in the staff's failure to detect or take prompt action to remediate SVB's deficiencies in managing its liquidity and interest rate risks, then it would be appropriate to question whether that regulatory tailoring should be modified or eliminated consistent with the congressional mandate. But if, as the OIG Report alleges, only the Federal Reserve's understanding or misunderstanding of how EGRRCPA was supposed to apply to firms between $50 billion and $100 billion was responsible for any deficiencies in supervising SVB and only during the period when its assets fell within that range, then flattening regulatory tailoring among large banking organizations with assets of $100 billion or more (LBOs) would be a serious mistake. Such flattening would do nothing to reduce the risk of future bank failures and related contagion. But it would create powerful economic incentives for LBOs that are not global systemically important banking organizations (non-GSIB LBOs) to become larger so that they have the scale to bear the increased costs of that flattening of regulatory tailoring and remain competitive. Thus, flattening regulatory tailoring would produce no benefits in terms of increased financial stability, but would produce significant costs in terms of a less diverse, more concentrated banking system.

Similarly, if as the Barr Report alleges, the former Vice Chair for Supervision's excessive focus on due process, transparency and public accountability led to a less-assertive supervisory culture that prevented the supervisory staff from detecting or taking forceful action against SVB's failure to manage its risk of runs by uninsured depositors or the interest-rate risk of its long-dated securities portfolio, then it might be appropriate to question whether the supervisory staff should be subject to any due process, transparency or public accountability obligations at all. But if, as the OIG Report alleges, the root causes of the supervisory deficiencies did not include an excessive focus on due process, transparency or public accountability or a less-assertive supervisory culture instituted by the former Vice Chair for Supervision, but rather a number of other factors including the ***failure to tailor*** supervision to SVB's ***salient risks***, then it would be a mistake to weaken such protections based on the Barr Report. This difference between the two reports may

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be explained by the greater independence of the OIG Report from the supervisory staff and the additional time the OIG had to gather and weigh evidence and reflect on the root causes of the deficiencies in the supervision of SVB and the related contagion it fostered.

Bank supervision is critically important for the stability of the banking sector. By necessity, much of it happens behind a veil of secrecy because of the doctrine of confidential supervisory information. As a result, in those few instances where the crucial work of the supervisory staff becomes public, it behooves us to ask whether the supervisory staff has the right kind of tools, resources, training and management and is subject to effective oversight by the full Board of Governors, in addition to the Vice Chair for Supervision.[4] The recommendations in the OIG Report about the need for a new supervisory committee at the Federal Reserve are also based in this concept of oversight. One of the recommendations in the OIG Report is that bank examiners be more "empowered" and that they have the ability to act in a more agile way. Questions about tools, resources, training, transparency and public accountability are also key to these recommendations.[5]

It also behooves us to look carefully into the information provided by the agencies. For that reason, we think that a deep dive into the differences, missed by most commentators, between the OIG Report and the Barr Report on the SVB failure is warranted. There are both common elements and very different perspectives that we believe are worth considering.

Barr Report

Less than six weeks after the failure of SVB, Federal Reserve Vice Chair for Supervision Michael Barr published a report on the lessons from the failure of SVB. The Barr Report concluded that SVB's failure was primarily the result of mistakes made by SVB's "senior management … to manage basic interest rate and liquidity risk" and the lack of effective oversight by SVB's board of directors.[6] A recent report by a group of bank regulatory experts at the Center for Financial Stability led by Sheila Bair (CFS Report), the Chair of the Federal Deposit Insurance Corporation (FDIC) during the 2008 Great Financial Crisis,[7] was even more blunt: "the fundamental mismanagement of [SVB] … violated basic 'Banking 101' principles of asset and liability management."[8] While acknowledging that supervisors did not fully appreciate the extent of SVB's vulnerabilities as it grew in size and complexity and did not take sufficient steps to ensure that SVB fixed those problems quickly enough,[9] the Barr Report blamed the staff's omissions on two root causes:

- The tailoring mandated by EGRRCPA;[10] and
- A shift in supervisory practices under the direction of the previous Vice Chair for Supervision, including pressure to reduce burden on firms, meet a higher burden of proof for supervisory conclusions, and demonstrate due process when considering supervisory actions, that resulted in a less-assertive supervisory culture.[11]

Agreement on the primary causes of SVB's failure

The OIG Report agreed with the Barr Report and the CFS Report that the primary cause of SVB's failure was rooted in basic risk management mistakes by its senior leadership and deficient oversight by its board of directors. In particular, it identified the following circumstances and risk management deficiencies as the primary causes of SVB's failure:

- A concentrated business model with a funding structure that was primarily concentrated in private equity and venture capital firms and their portfolio companies, with a depositor base consisting of nearly half of the venture-backed technology and life sciences companies in the United States.[12]
- Rapid and unchecked growth, with total assets growing from just over $50 billion at the start of 2018 to approximately $210 billion at year-end 2022 and total deposits increasing from just below $50 billion at the start of 2018 to about $175 billion at year-end 2022.[13]
- High concentrations of uninsured deposits, which represented approximately 94% of its total deposits at year-end 2022 and the failure of SVB's management to appreciate the risks associated with this concentration and its assumption that SVB's depositors would remain at SVB because of their perceived loyalty and the strength of those customer relationships.[14]
- Concentration in SVB's investment portfolio in long-dated, fixed-rate debt securities, which exposed SVB to the risks associated with the value of those securities declining significantly in a sustained rising interest rate environment.[15]
- Failure of SVB management to fully appreciate or understand the risks associated with the bank's rapid growth and concentrations.[16]
- Ineffective risk management, as evidenced by:

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- a lack of several foundational liquidity risk management elements;
- the removal of its chief risk management officer in April 2022 based on concerns about her experience and qualifications for the position and failure to replace her until January 2023;
- a securities portfolio classified as hold to maturity (HTM) with a ratio of HTM securities to total assets that was almost six times higher than its peers;
- failure by SVB management to heed the early signs of interest rate risk when interest rates started to rise in 2022, which adversely affected the value of SVB's investments in long-dated, fixed rate, debt securities;
- an erroneous projection that the rising rates in 2022 would reverse direction in 2023; and
- the decision to remove its interest-rate hedges to boost net income at year-end 2022 based on that erroneous projection.[17]

– Management's ineffective communication of its plan to raise capital and other market events in early March 2023, leading to significant deposit outflows, as evidenced by:
  - The public announcement by Silicon Valley Bank Financial Group (SVBFG), SVB's parent bank holding company, on March 8, 2023 that it had sold substantially all of its available for sale (AFS) investment securities at a loss of $1.8 billion and planned to raise additional equity capital of $2 billion on the same day that Silvergate Capital Corporation announced that it would be winding down operations and voluntarily liquidating Silvergate Bank;
  - The erroneous assumption of SVB management that its depositors would remain at the bank based on their perceived loyalty and the strength of those customer relationships; and
  - The concern of SVB clients about SVBFG's announcement, which caused them to begin to speculate about the bank's solvency on various social media platforms.[18]

Different perspective on the supervisory deficiencies that were contributory causes to SVB's failure

The OIG Report is more pointed in its criticism of supervisory staff than the Barr Report.[19] It also described the impact of EGRRCPA as being significantly ***more limited*** – i.e., it was limited to reducing the intensity of supervision of SVB during the short period when SVB had assets between $50 billion and $100 billion. In sharp contrast to the Barr Report, the OIG did ***not*** attribute any of the staff's supervisory deficiencies to a less-assertive supervisory culture promoted by former Vice Chair for Supervision Randal Quarles as a result of his excessive focus on due process, transparency and public accountability. Consistent with the OIG Report, the CFS Report states that "enhanced [supervisory] standards should not have been needed for supervisors to catch and remediate the fundamental mismanagement of [SVB] which violated basic 'Banking 101' principles of asset and liability management."[20]

The OIG Report identified the following supervisory deficiencies as contributory causes of SVB's failure:

– The failure of the Federal Reserve's supervisory unit for regional banking organizations (RBOs)[21] to keep pace with SVB's growth and complexity, because of the following factors:[22]
  - After EGRRCPA's enactment, firms with assets under $100 billion, including SVB, were no longer subject to enhanced prudential standards (EPS), compounded by:
    - The Board's belief that EGRRCPA required it to reduce the regulatory and supervisory standards applicable to banking organizations with assets between $50 billion and $100 billion;[23] and
    - The supervisory staff's belief that they were supposed to supervise banks with assets between $50 billion and $100 billion in the same way they would supervise smaller banks;[24]
  - Supervisory management allocated an insufficient number of RBO examiner resources and hours to supervise SVB, as evidenced by:
    - The decrease in examiner hours dedicated to examining SVB from 2018 to 2020, even as its assets grew rapidly;[25] and

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- The supervisory staff's belief that examination team hours should be consistent with the hours recommended by SR 19-9: Bank Exams Tailored to Risk (BETR), even though BETR had been developed for community banks and does not contemplate additional hours for rapidly growing banks with substantial concentration risks like SVB;[26]

▪ RBO examiners assigned to SVB did not have sufficient expertise with supervising a large, complex institution and their perspectives of SVB were based on their knowledge of smaller firms, making certain weaknesses not as apparent, resulting in their failure to:

  - detect SVB's lack of appropriate liquidity risk management in its exam in March 2019;[27]
  - downgrade SVB's management rating and issue a memorandum of understanding as part of its IT exam in February 2021;[28] and
  - downgrade SVB's management rating in May 2021 in order to send SVB management a stronger message about management's need to proactively identify and manage risk.[29]

▪ RBO Supervision's decision to pause onsite examinations at the start of the COVID-19 pandemic in 2020.[30]

- Better tailoring of RBO Supervision's examination approach and planning activities, including by increasing examiner resources and hours, enhancing expertise, and conducting more robust examination work, could have helped examiners identify issues sooner or have a greater appreciation for the severity of the issues.[31]
- Failure to transition SVB from the RBO portfolio to the large and foreign banking organizations (LFBOs) portfolio in a timely manner.[32]
  ▪ The supervisors did not develop a plan to prepare SVB for its transition to the LFBO portfolio or to being subject to EPS;
  ▪ The Federal Reserve's supervisory unit did not begin the process to fully staff its Designated Supervision Team (DST) for SVB until the bank formally transitioned to the LFBO portfolio in the second quarter of 2021 — i.e., when it crossed the $100 billion threshold based on a four-consecutive-quarter average;[33] and
  ▪ Failure by the Board to provide guidance for the Federal Reserve's supervision staff on transitioning an institution from the RBO portfolio to the LFBO portfolio.[34]
- This was coupled with a failure to downgrade SVB's supervisory ratings to unsatisfactory until August 2022.[35]
- Delays in forming the DST and ineffective coordination between RBO Supervision and LFBO Supervision resulted in gaps in supervision and an inaccurate picture of SVB's condition as it transitioned to the LFBO portfolio.[36]
- Earlier involvement of LFBO Supervision could have better prepared the institution for portfolio requirements and provided LFBO Supervision with a more accurate assessment of SVB's condition.[37]
- Despite significant warning signs, LFBO examiners did not sufficiently scrutinize the risks from rising interest rates on SVB's HTM investment securities portfolio.[38]
  ▪ LFBO Supervision failed to take actions to mitigate the risks from rising interest rates because the LFBO unit was excessively focused on risk management and associated processes.[39]
  ▪ Even after the Board placed SVBFG on its holding company watch list for high interest rate risk in June 2022,[40] SVB's examination team did not focus its attention on the potential risk of unrealized losses on SVB's long-dated, fixed rate, investment securities as a result of rising interest rates.[41]
- LFBO Supervision "should have heeded the warning signs and taken immediate actions to closely scrutinize the risks of rising interest rates on SVB's investment securities portfolio and the sufficiency of the bank's liquidity."[42]
  ▪ LFBO Supervision "missed an opportunity to take stronger supervisory action sooner to communicate the urgency of the issues by proceeding with the downgrades they initially proposed and discussed."[43]
- "While … examiners should focus on an institution's risk management and associated processes, [they] should pay close attention to an institution's financial conditions and any imminent and pressing potential threats to the institution's viability."[44]

Neither the OIG Report nor the Barr Report mention that there were many months without a Vice Chair for Supervision in place, which may have contributed to supervisory deficiencies with respect to SVB.[45]

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OIG recommendations

The OIG made several recommendations for the Director of the Division of Supervision and Regulation to remediate the supervisory deficiencies identified above, including the following:

- "Assess the current RBO supervisory planning process and implement measures to tailor supervisory plans to better promote a timely focus on salient risks;"[46] and
- "Assess the current LFBO supervisory planning process and implement measures to tailor supervisory plans to better promote a timely focus on salient risks."[47]

In other words, the supervisory staff's ***failure to tailor*** its supervision of SVB to focus on SVB's ***salient risks*** was one of the root causes of SVB's failure. In the case of SVB, the salient risks would presumably have included the risk of a sudden and significant outflow of deposits because of SVB's high concentration of uninsured deposits from a concentrated pool of depositors—i.e., private equity funds and venture capital funds and their high-tech and life sciences portfolio companies—and its high interest rate risk arising from its concentration of investments in long-dated, fixed-rate debt securities.

According to public statements by former Vice Chair for Supervision Randal Quarles immediately after publication of the Barr Report, that is precisely the approach he claims he urged in a series of town hall meetings with supervisory staffs of the Board and Reserve Banks, including the FRB San Francisco.[48] He claims he told the supervisory staff in those town hall meetings to "stop distracting both the institutions and ourselves with excessive attention to routine administrative matters and focus on what's really important—like interest rate and liquidity risk."[49] He reportedly claimed, "I would often use the phrase, 'And if they won't do what's really important, smite them hip and thigh.'"[50] He said the Barr Report on "Silicon Valley Bank—which notes that 31 supervisory findings were issued to the bank [in August 2022]—is evidence that his advice was not heeded."[51]

As noted above, much of bank supervision, by necessity, happens behind a veil of secrecy because of the doctrine of confidential supervisory information. Without public access to a transcript of those town hall meetings or at least the talking points used in them, there is no way for the public to assess whether his directions to the supervisory staff anticipated the recommendations in the OIG report about tailoring supervision to a firm's salient risks or whether they promoted a less-assertive supervisory culture as the Barr Report alleged.[52] Assuming that such a transcript or talking points exist, they could only be obtained if the Board voluntarily chose to disclose them or Congress compelled disclosure.

Responses by the Director of the Division of Supervision & Regulation

Michael Gibson, the Director of the Division of Supervision & Regulation, accepted the OIG's findings and recommendations on behalf of the Board and committed to implement the recommendations in a timely manner.[53] In particular, he stated that the "Federal Reserve is completing a comprehensive review of the RBO supervisory program,"[54] including by incorporating "practices to ensure collaboration between the RBO and LFBO portfolios."[55] The OIG committed to follow up on the Director's commitments to ensure that the OIG's recommendations are fully addressed, although did not say whether that follow up with be transparent and public or whether it will be kept opaque.[56]

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[1] The report was conducted pursuant to Section 38(k) of the Federal Deposit Insurance Act, which requires the inspector general of a failed bank's appropriate federal banking agency to conduct a review of the agency's supervision where the estimated loss to the Deposit Insurance Fund (DIF) is more than $50 million. As a state member bank, SVB's appropriate federal banking agency was the Federal Reserve. The loss to the DIF from SVB's failure has been estimated at $16.1 billion. Testimony of Martin J. Gruenberg, Chairman of the FDIC, Hearing Before the Committee on Banking, Housing, and Urban Affairs, United States Senate (May 18, 2023).

[2] While this client update discusses differences between the OIG Report and the Barr Report, it should not be construed as an agreement with, or endorsement of, the findings or factual assertions in either document.

[3] EGRRCPA, § 401(a).

[4] *See also* California Department of Financial Protection and Innovation, Review of DFPI Oversight and Regulation of Silicon Valley Bank (May 8, 2023); Federal Deposit Insurance Corporation, FDIC's Supervision of Signature Bank (Apr. 28, 2023). Based on some of the reports by other agencies, it is an open question whether supervisory staff has the appropriate resources, training and compensation for today's environment.

[5] We note that the Office of the Comptroller of the Currency is much more transparent about the organization, hierarchy and assignments of its supervisory staff than the Federal Reserve.

[6] Michael Barr, Vice Chair for Supervision, Cover Letter to Barr Report (Cover Letter) at 1.

[7] In addition to former FDIC Chair Sheila Bair, the group of experts included Joyce Cheng, Charles Goodhart, Lawrence Goodman, Barbara G. Novick and Richard L. Sandor.

[8] *Supervision and Regulation after Silicon Valley Bank*, Center for Financial Stability, at 2 (October 16, 2023)

[9] Cover Letter at 1.

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[10] EGRRCPA, § 401(a).

[11] Barr Report at 11; Cover Letter at 1.

[12] OIG Report at 11.

[13] *Id.* at 12 and Figure 1.

[14] *Id.* at 13.

[15] *Id.*

[16] *Id.*

[17] *Id.* at 14-15.

[18] *Id.* at 15.

[19] Neither the Barr Report nor the OIG report makes clear how the supervisory staff at the Federal Reserve is managed or organized.

[20] *Supervision and Regulation after Silicon Valley Bank*, Center for Financial Stability, at 2 (October 16, 2023)

[21] The RBO Supervision unit is responsible for banking organizations with total assets between $10 billion and $100 billion. Board of Governors of the Federal Reserve System, *Understanding Federal Reserve Supervision*, *available at* https://www.federalreserve.gov/supervisionreg/approaches-to-bank-supervision.htm.

[22] OIG Report, at 31.

[23] *Id.* Prior to EGRRCPA becoming law in 2018, RBO Supervision applied to banking organizations with total assets between $10 billion and $50 billion. Board of Governors of the Federal Reserve System, Supervision and Regulation Report, at 8, Box 1 (November 2018).

[24] OIG Report, at 31.

[25] *Id.* at 32 and Figure 2.

[26] *Id.* at 32-33.

[27] *Id.* at 24.

[28] *Id.* at 25.

[29] *Id.*

[30] *Id.* at 30, 34.

[31] *Id.* at 34-35.

[32] *Id.*

[33] *Id.* at 25.

[34] *Id.* at 39.

[35] *Id.* at 22, Table 2. A bank's supervisory rating is considered unsatisfactory if either its composite or management rating is 3 or less.

[36] *Id.*

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[37] *Id.*

[38] *Id.* at 41.

[39] *Id.* at 43. The CFS Report also calls out "a lack of sufficient attention by supervisors and monetary policy makers to the interplay of bank stability with monetary tightening." CFS Report at 2.

[40] OIG Report at 26-27.

[41] *Id.*, at 27.

[42] *Id.*

[43] *Id.* at 26.

[44] *Id.* at 43.

[45] Randal Quarles left the role in October 2021 and Michael Barr assumed office in July 2022.

[46] *Id.* at 35.

[47] *Id.* at 44.

[48] Victoria Guida, ***Quarles hits back at Barr's SVB report***, PoliticoPro (April 28, 2023).

[49] *See* Kyle Campbell, ***For Fed supervision, cultural shortcomings are nothing new***, American Banker (May 8, 2023).

[50] *Id.*

[51] *Id.*

[52] Barr Report at 11; Cover Letter at 1.

[53] OIG Report Appendix B at 48-51.

[54] *Id.* at 49.

[55] *Id.* at 50.

[56] *Id.* at 45.

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