FRB, FDIC DELIVER REPORTS AND TAKE SOME BLAME ON SILICON VALLEY BANK AND SIGNATURE BANK FAILURES; MORE REGULATION AHEAD

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On Friday 28 April 2023, the Board of Governors of the Federal Reserve System (the FRB) and the Federal Deposit Insurance Corporation (the FDIC) each released a report regarding a recent bank failure. The FRB report covered Silicon Valley Bank (SVB), which was placed into FDIC receivership on 10 March, and the FDIC report covered Signature Bank (Signature), which was placed into FDIC receivership on 13 March. The Government Accountability Office also released a report on April 28th stating that regulators identified problems at both banks in recent years but did not escalate supervisory concerns in time to prevent their failures.

The FRB also released a substantial number of supervisory documents relating to its supervision of SVB, including supervisory letters, reports of inspection and ratings letters, and CAMELS reports dating as far back as 2017. The FDIC published a separate report on the adequacy of deposit insurance in light of the failures, which also evaluates potential changes to the deposit insurance system, on 1 May.

On 1 May, First Republic Bank was placed into FDIC receivership and the FDIC is entering into a purchase and assumption agreement with JPMorgan Chase Bank, National Association, Columbus, Ohio, to assume all of the deposits and substantially all of the assets of First Republic Bank. This third significant bank failure in six weeks was not the subject of either report, but will serve to increase the FRB and FDIC's determination to strengthen regulation and supervision as outlined below.

FRB CONCLUSIONS REGARDING THE SVB FAILURE

The FRB's review identified four key takeaways on the causes of SVB's failure:

1. SVB's board of directors and management failed to manage risks;
2. FRB supervisors did not fully appreciate the extent of the vulnerabilities as SVB grew in size and complexity;
3. when supervisors did identify vulnerabilities, they did not take sufficient steps to ensure that SVB fixed those problems quickly enough; and
4. The FRB's tailoring approach in response to the Economic Growth, Regulatory Relief, and Consumer Protection Act (S. 2155) and a shift in supervisory policy impeded effective supervision by reducing standards, increasing complexity, and promoting a less assertive supervisory approach.

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The FRB review also noted that at the time of its failure, SVB had 31 unaddressed safety and soundness supervisory warnings—triple the average number of peer banks. Several broader issues raised by SVB's failure were highlighted by the FRB's review:

- The combination of social media, a highly networked and concentrated depositor base, and technology may have fundamentally changed the speed of bank runs. Social media enabled depositors to instantly spread concerns about a bank run, and technology enabled immediate withdrawals of funding. The technology enabling the movement of deposits is only getting faster, as the FRB is scheduled to roll out the FedNow service in July.
- A bank's distress may have systemic consequences through contagion—where concerns about one institution spread to other institutions—even if the institution is not extremely large, highly connected to other financial counterparties, or involved in critical financial services.
- Strong bank capital matters. While the FRB's review explains that the proximate cause of SVB's failure was a liquidity run, the underlying issue was concern about its solvency.

FDIC CONCLUSIONS REGARDING THE SIGNATURE FAILURE

Unlike the FRB, the FDIC report largely places the blame for the Signature failure on Signature's management and board of directors (which includes former Congressman Barney Frank, architect of the Dodd-Frank Act). The FDIC stated that its report “identifies clearly that 'the root cause of Signature's failure was poor management.'” Among the management issues identified in the report:

- 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.
- Signature's management did not prioritize good corporate governance practices, did not always heed FDIC examiner concerns, such as with respect to Signature's reliance on uninsured deposits, and was not always responsive or timely in addressing FDIC supervisory recommendations.
- Signature funded its rapid growth through an overreliance on uninsured deposits without implementing fundamental liquidity risk management practices and controls.
- Signature failed to understand the risk of its association with and reliance on crypto industry deposits or its vulnerability to contagion from crypto industry turmoil that occurred in late 2022 and into 2023.
- Signature's poor governance and inadequate risk management practices put Signature in a position where it could not effectively manage its liquidity in times of stress, rendering it unable to meet large withdrawal requests and ultimately unable to withstand the contagion effects of the SVB failure.

The FDIC's report asserts that the FDIC conducted targeted reviews and ongoing monitoring, issued supervisory letters and annual roll–up reports of examination, and made a number of supervisory recommendations to address supervisory concerns with Signature. The FDIC conceded that supervisors could have escalated supervisory actions sooner, that the examination work product could have been timelier, and that its

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communication with Signature's board and management could have been more effective. The FDIC also blamed understaffing and resource challenges that affected the timeliness and quality of its examinations of Signature.

The FDIC report highlights the contribution of Signature's focus on the crypto industry to its failure. The report states that Signature's strategy of rapid growth and expansion into the digital asset markets exposed it to greater susceptibility to liquidity, reputation, and regulatory risk due to the uncertainty and volatility of the digital asset space. The FDIC report further states that growth fueled by Signature's pursuit of digital marketplace players exposed Signature to depositor runs and contagion, particularly in regards to crypto-related entities such as FTX, Alameda Research, and Silvergate Bank. In the FDIC's view, pursuit of this strategy increased the volatility and susceptibility of Signature's more traditional depositor sources to event shocks and depositor runs. The FDIC found that Signature's management was not sufficiently prepared to ameliorate the risks posed by its concentration of deposits and lending relationships in the digital assets space and seemed unaware of the potential damage it could inflict on its more traditional customer base.

WHAT ADDITIONAL REGULATORY AND SUPERVISORY MEASURES TO EXPECT

These reviews provide a clear path for a tougher and more costly regulatory regime, particularly for banks with at least US$100 billion of assets. New regulatory proposals are expected in the coming months, though it may take years for the proposals to work their way through the notice and comment rulemaking process. The anticipated regulatory response includes:

- Focus on empowering supervisors to be more proactive in addressing concerns and more skeptical of bank management.
- Heightened focus on quickly growing banks and a more rapid implementation of enhanced regulatory requirements when banks cross asset thresholds.
- Heightened focus on banks with concentrated and novel business models (such as fintech or crypto-asset activities).
- Higher capital or liquidity requirements, as well as limits on capital distributions or incentive compensation, for banks with inadequate capital planning, liquidity risk management, or governance and controls.
- Revision of the FRB's tailoring framework for banks with over US$100 billion in assets to strengthen requirements for banks between US$100 billion and US$700 billion in assets.
- Heightened focus on interest rate risk management.
- Enhancements to regulatory requirements for liquidity risk management, particularly the risks of uninsured deposits and the treatment of held-to-maturity securities in the liquidity rules and stress tests. This likely will include applying the full Liquidity Coverage Ratio to banks with US$100 billion or more in assets.
- The FRB requiring a broader set of banks to include unrealized gains and losses on available-for-sale securities in capital. This will likely apply to banks with US$100 billion or more in assets and be phased in over several years.
- A more stringent version of the Basel III endgame rules.

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- Expanding the annual stress test to multiple scenarios rather than just the severely adverse and adverse scenarios.
- Enhanced oversight of bank incentive compensation to set tougher minimum standards and focus incentive compensation programs on encouraging the managing of risk.
- Continued regulatory scrutiny and aversion to banks engaged in crypto-related activities.

FDIC REPORT ON DEPOSIT INSURANCE

The FDIC released a report providing a comprehensive overview of the deposit insurance system and options for reform to address financial stability concerns stemming from recent bank failures. The report examines the role of deposit insurance in promoting financial stability and preventing bank runs. In the report the FDIC evaluates several options for deposit insurance reform, including:

5. Limited coverage: Maintaining the current deposit insurance framework, which provides insurance to depositors up to a specified limit (possibly higher than the current $250,000 limit) by ownership rights and capacities.
6. Unlimited coverage: Extending unlimited deposit insurance coverage to all depositors.
7. Targeted coverage: Offering different deposit insurance limits across account types, where business payment accounts receive significantly higher coverage than other accounts.

The FDIC states that each option should be viewed alongside other policy changes. The report finds that maintaining the current system of deposit insurance would not, by itself, address the run risk associated with high concentrations of uninsured depositors, even with an increase to the deposit insurance limit. The report states that fully insuring all deposits effectively removes run risks but may have large effects on bank risk-taking, the level of deposit insurance assessments on banks, and broader financial markets. The report concludes that targeted coverage would provide substantial additional coverage to business payment accounts without extending similar insurance to all deposits, yielding large financial stability benefits relative to its costs. A challenge to targeted coverage, however, is the need to delineate between business payment deposits and other deposits. Of the three options, the FDIC indicated that it believes targeted coverage best meets the objectives of deposit insurance of financial stability and depositor protection relative to its costs. The proposed options would require Congressional action, though the FDIC stated that some aspects of the report lie within the scope of the FDIC's rulemaking authority.

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