Economic, Financial, & AI Regulation

A Case Study on the Federal Reserve & Silicon Valley Bank

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Full Case Study

On March 10, 2023, the California Department of Financial Protection and Innovation decided to shut down Silicon Valley Bank after the institution faced a bank run following financial difficulties. Months later, the Board of Governors of the Federal Reserve System released a report titled *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank*, which assessed several aspects of the bank's failure. This case study highlights the most critical points regarding the Federal Reserve's role in the failure of SVB and the significance of understanding this instance of financial regulatory failure.

Overview of Silicon Valley Bank

Silicon Valley Bank (SVB) operated as a subsidiary of Silicon Valley Bank Financial Group (SVBFG). As a state member bank, SVB was supervised by the Federal Reserve System, particularly through the Federal Reserve Bank of San Francisco.

- In 2021, SVB transitioned from being categorized in the Regional Banking Organization (RBO) portfolio to the Large and Foreign Banking Organization (LFBO) portfolio since it had more than $100 billion in assets
- Just prior to the bank's failure, SVB held over $200 billion in assets
- SVBFG's customer base was heavily concentrated in VC-backed technology and life sciences companies, which linked SVBFG's funding growth directly to VC deal activity
- The majority of SVB's deposits were uninsured (94% of SVBFG's total deposits were reported as uninsured in 2022) and SVBFG invested these deposits primarily in securities with longer-term maturities

Issues Facing Silicon Valley Bank

VC Activity Booms & Busts

- SVBFG's funding growth was directly linked to VC deal activity. As VC activity boomed in 2021-22, SVBFG's clients received investment proceeds, which were then deposited at SVB. However, as VC activity fell sharply at the end of 2022, slower funding led to slower inflows into SVBFG client accounts.

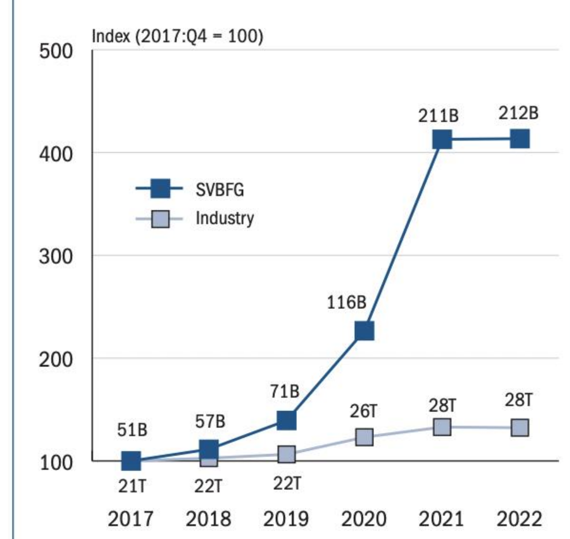
LFBO Categorization

- "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."

Regulatory Issues

- There were regulatory issues involved with the transition of SVBFG to the LFBO portfolio. When SVB became subject to heightened supervision after this transition, supervisors found serious problems at the bank. Supervisors did not act quickly enough and did not fully acknowledge the extent of SVBFG's weaknesses.

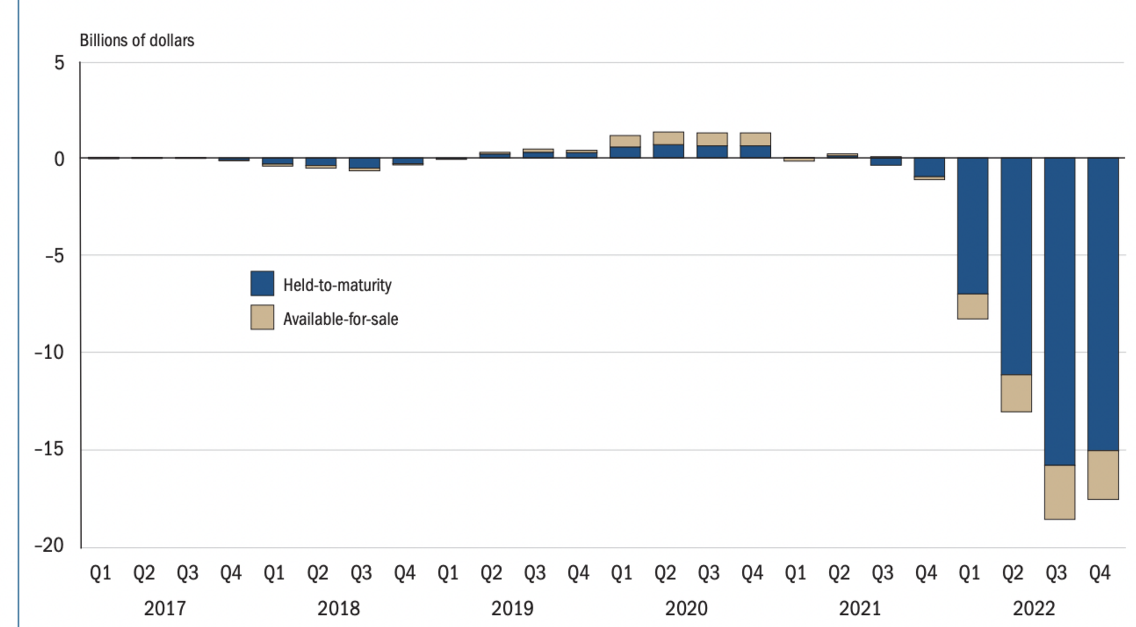
Figure 3. SVBFG and banking industry total assets



Note: The key identifies lines in order from top to bottom. All values indexed to 100 at year-end 2017. Values are as of year-end. Values are in billions of dollars for SVBFG and in trillions of dollars for the industry. Industry aggregate includes all top-holder firms.

Source: FR Y-9C and Call Report.

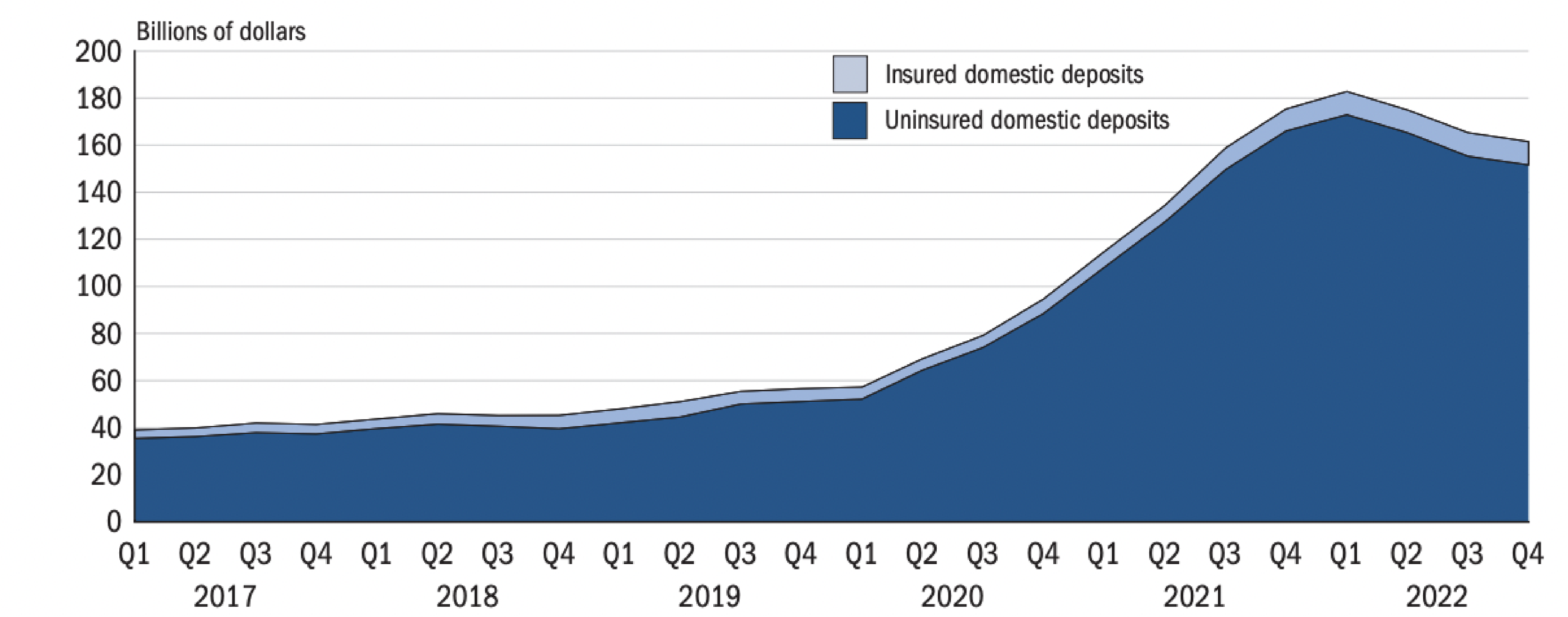
Figure 9. Estimated unrealized gains (losses) on SVBFG's investment portfolio securities



Note: Estimated unrealized losses on securities calculated as: (held-to-maturity fair value less held-to-maturity amortized cost) + (available-for-sale fair value less available-for-sale amortized cost). Estimates do not reflect losses related to available-for-sale securities that were transferred to held-to-maturity and do not reflect hedging impacts or tax consequences.

Source: FR Y-9C.

Figure 7. SVB deposit insurance coverage



Note: The key identifies areas in order from top to bottom.

Source: Call Report.

The Federal Reserve's Role

While there were concerns raised involving SVBFG's board of directors and internal management, the Federal Reserve also played a role in the failure of SVB. SVBFG did not maintain sustainable practices and "was focused on short-term measures of risk and managing to profitability rather than understanding the longer-term risk exposure".

The report highlights three weaknesses in the Federal Reserve's supervision:

1) **Governance and Risk Management**

"SVBFG's growth far outpaced the abilities of its board of directors and senior management," and that "they failed to establish a risk-management and control infrastructure suitable for the size and complexity of SVBFG when it was a $50 billion firm, let alone when it grew to be a $200 billion firm."

2) **Liquidity Risk Management**

Since SVB's liquidity ratings were deemed "Strong-1" and the liquidity risk appeared minimal due to a growing deposit base, the annual CAMELS and BHC exams were not as extensive as they should have been.

3) **Interest Rate Risk and Investment Portfolio Management**

There are a few distinct metrics that measure interest rate risk, including earnings at risk (EaR) or net interest income (NII) as well as economic value of equity (EVE), which is a long-term measurement of liabilities. Similar to the liquidity ratings of SVBFG, there were also noticeable and fundamental risk management weaknesses.

"SVBFG management was focused on a short-term view of IRR through the NII metric and ignored potential longer-term negative impacts to earnings highlighted by the EVE metric."

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