Federal Reserve and FDIC reports—Next steps

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The Federal Reserve and the FDIC reports on their supervision of Silicon Valley Bank and Signature Bank provide insight into potential upcoming shifts in regulatory and supervisory focus.

The Board of Governors of the Federal Reserve System (Federal Reserve or Board) released the results of its review of the supervision and regulation of Silicon Valley Bank (SVB), which was led by Vice Chair for Supervision Michael S. Barr (the Board Report),[1] and the FDIC released the results of its review of the supervision of Signature Bank,[2] which was led by FDIC Chief Risk Officer E. Marshall Gentry (the FDIC Report).[3] Before the banks' failures on March 10 and 12, the Federal Reserve Bank of San Francisco (FRBSF) and the Board were the primary federal supervisor of SVB, a California state member bank,[4] and the FDIC was the primary federal supervisor of Signature Bank, a New York state nonmember bank.[5]

The Board Report, the FDIC Report, and the GAO Report[6] also released on Friday, contain some information about SVB and Signature Bank, which, until disclosed by the agencies, was confidential supervisory information (CSI). It does not contain any of SVB's or Signature Bank's responses. Each banking agency has the discretion to disclose its own CSI, and the decision to do so does not change the CSI status of any other examination or supervisory materials that were not included in the reports.

Board Report cover letter

Vice Chair for Supervision Barr's cover letter to the Board Report highlights already in-progress proposals planned to be released "soon" for comment: the Federal Reserve's holistic review of the capital framework; implementation of the Basel III endgame rules; the use of multiple scenarios in stress testing; and a long-term debt rule intended to improve the resiliency and resolvability of large banks.

Barr's cover letter provides his views on potential changes to bank supervision and regulation based on the lessons learned from SVB's failure. Barr describes certain of the changes as necessary, whereas others are recommended, providing insight as to his views on where the Federal Reserve should focus its supervisory and regulatory efforts. Given the hefty list of proposals Barr says are planned and are expected to be issued soon, the Federal Reserve will likely be limited in its ability to complete all of the policy and regulatory work for all the issues Barr outlines in his letter in the next couple of years.

Barr states that the Federal Reserve ***must, needs to*** or ***is going to*** take the following actions:

- Evaluate how to ensure that supervision intensifies at the right pace as a firm grows in size or complexity, and be attentive to the particular risks that firms with rapid growth, concentrated business models or other special factors might pose regardless of asset size that warrant additional supervisory attention.
- Change the general trend that the Federal Reserve does not require additional capital or liquidity beyond regulatory

requirements for a firm with inadequate capital planning, liquidity risk management, or governance and controls.

- Revisit the tailoring framework (for enhanced prudential standards, capital and liquidity), including to re-evaluate a range of rules for banks with $100 billion or more in assets, and the changes made to stress testing that reduced its coverage and timeliness for some firms.[7]
- Evaluate how the Federal Reserve supervises and regulates a bank's management of interest rate risk and liquidity risk, starting with the risks of uninsured deposits.

In contrast, he recommends that the Federal Reserve ***should***:

- Evaluate how a bank's management of interest rate risk is supervised and regulated, while acknowledging the obvious point that "interest rate risk is a core risk of banking that is not new to banks or supervisors."
- Introduce more continuity between the Federal Reserve's size-based supervisory portfolios, so that as a bank grows in size and changes its supervisory portfolio, the bank will be ready to comply with heightened regulatory and supervisory standards more quickly, rather than providing a long transition to comply with those heightened standards.
- Re-evaluate the stability of uninsured deposits and the treatment of held-to-maturity securities in the standardized liquidity rules and in a firm's internal liquidity stress tests.
- Consider applying standardized liquidity requirements to a broader set of firms.
- Require a broader set of firms to take into account unrealized gains or losses on available-for-sale securities, so that a firm's capital requirements are better aligned with its financial positions and risk.
- Consider setting additional minimum standards for incentive compensation programs and ensure banks comply with the existing standards.

Barr acknowledges that any of the above changes to the liquidity or capital rules would need to go through the notice and comment rule-making process, have appropriate transition periods, and would not be effective for "several years."

Board Report key takeaways

Here are key takeaways from the Board Report, along with some details from the Board Report for context:

- **Federal Reserve supervisory staff will be directed to escalate issues and act more quickly; this may be in the form of private or public enforcement actions.** According to the Board Report, the FRBSF and Board supervisory staffs did not fully appreciate the extent of the identified vulnerabilities of SVB or act with enough urgency when they did so. Despite SVB's risk management and control infrastructure falling short of the expectations of the enhanced prudential standards, the FRBSF supervisory staff, in consultation with the Board's supervisory staff, decided not to cite it for a violation of Section 252.33(b) of Regulation YY for the firm's lack of a Chief Risk Officer since April 2022 because the firm was actively searching for one with the appropriate skills and experience. The Board Report states that "in some instances, supervisors saw progress on remediation of supervisory findings or risk-management gaps as positive developments on a relative basis, rather than citing the gap that continued to exist relative to baseline expectations."
- **Federal Reserve Supervisory staff will be less likely to regard financial performance as a mitigating factor for supervisory concerns.** According to the Board Report, the supervisory approach to SVB gave unnecessary weight to the firm's apparent strong performance, overlooking concerns related to governance and risk management as a result. The Board Report acknowledges that the supervisory team, FRBSF leadership, Board staff and the large bank management group "did not yet recognize the building liquidity and interest rate risk" in 2022. The Board Report states that SVB's LFI Governance and Control rating was not lowered to "Deficient-1" despite a number of

fundamental and critical weaknesses that supported the downgrade, as “financial performance was still considered satisfactory, so the risk-management deficiencies did not threaten safety and soundness.”

- **There will be an increased focus on board and senior management’s ability to self-identify a firm’s weaknesses or deficiencies.** The Board Report notes that SVB management was not identifying issues, but that they “were reacting to supervisors identifying the issues.” SVB’s board of directors and risk management’s experience and capabilities were found lacking for a firm of its size and complexity and as a result, were unable to manage risks.
- **Incentive compensation and whether it is appropriately tied to performance with respect to risk management and controls will become an area of heightened supervisory focus.** The Board Report states that “stronger or more specific supervisory guidance or rules or incentive compensation” for firms of SVB’s size, complexity, and risk profile, or “more rigorous enforcement of existing guidance and rules,” may have mitigated the risks resulting from SVB’s incentive compensation arrangements and practices. Supervisors had concluded that SVB’s incentive compensation decisions were primarily based on its financial performance, “with minimal to no linkage to risk management and control factors.”
- **There will be an increased focus on the uninsured deposit bases of supervised institutions, including the size and concentration of the uninsured deposit base, the institution’s reliance on uninsured deposits for funding and what this means with respect to a firm’s liquidity models, stress testing, and risk management.** There was an underappreciation by directors, management, and supervisors of SVB of its highly concentrated business model and reliance on uninsured deposits. While “supervisors of SVB recognized a gradual increase in liquidity and market risks,” they did not “fully appreciate the risks associated with the concentrated deposit base” or with SVB’s investment portfolio strategy.
- **There will be a heightened focus on the adequacy of controls in light of growth or specialized business models at supervised institutions; controls will not be permitted to lag growth and the need for banks to have robust internal testing systems for liquidity and capital.** Risk management and controls had not kept pace with the rapid growth of SVB. The Board Report found that SVB failed its own internal liquidity stress tests and as a result “changed its own risk-management assumptions,” affecting its ability to manage the firm’s risks effectively.
- **The Federal Reserve will reevaluate transition periods in the application of increased regulatory and supervisory expectations to firms.** According to the Board Report, even after SVB triggered the threshold from regional banking organization supervision to large and foreign banking organization supervision, the FRBSF and Board supervisory staff continued to take an accommodative supervisory stance towards the firm. SVB was not subject to increased supervisory intensity before crossing the threshold and was given a long transition period while the new supervisory team built up its understanding of the firm.
- **The Federal Reserve will reassess the tailoring that resulted from the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), both as a technical matter, but also for the incentives it created for supervisory staff.** The Board Report asserts, based on interviews with supervisory staff, that during the 2018-2021 period, “supervisory practices shifted.” According to the report, certain members of the supervisory staff “mentioned changes in expectations and practices, including pressure to reduce burden on firms, meet a higher burden of proof for a supervisory conclusion, and demonstrate due process when considering supervisory actions. There was no formal or specific policy that required this, but staff felt a shift in culture and expectations from internal discussions and observed behavior that changed how supervision was executed… . Although the stated intention of these policy changes was to improve the effectiveness of supervision, the changes also led to slower action by supervisory staff and a reluctance to escalate issues.”
    - **Response by Quarles.** In response to these assertions, former Federal Reserve Vice Chair for Supervision Randal Quarles issued a public statement, stating that “[t]he report frankly acknowledges … that there was ‘no policy’ leading to a change of supervision, but rather that the staff ‘felt’ a shift in expectations on the basis of no communication at all, which is like the ancients asserting they could describe the world by interpreting the flights and cries of birds.”[8] He went on to say to a reporter that “he held town halls at each of the Fed’s regional branches, in which he told supervisory staff that he was not directing them to go easy on the banks.”

> He said “his policy goal was due process, to make sure banks understood what was required of them… . I communicated it generally, in sentences that were combined with, ‘do not be weaker in supervision, do not misunderstand what this is about.’” [9]

FDIC Report

The FDIC Report, similar to the Board Report, pointed to management failures on the part of Signature Bank, finding that the root cause of that bank’s failure was poor management. The bank’s management was found to be “slow to respond to FDIC’s supervisory concerns” and not prioritizing “appropriate risk management practices and internal controls,” with an approach that was “reactive, rather than proactive” in addressing risks and supervisory concerns.

With respect to its own supervisory approach, the FDIC Report was thematically consistent with the Federal Reserve, stating the need for supervisors to act more expeditiously to escalate outstanding concerns and the need for a firm to have risk management commensurate with the nature of its activities, including complexity, size, and concentration and reliance on uninsured deposits as a source of funding. At the time of its failure, Signature Bank had been assigned a CAMELS composite rating of 2, indicating that the FDIC supervisory staff considered the overall condition of the bank to be satisfactory. SVB, prior to its collapse, had most recently received a CAMELS composite rating of 3. The FDIC Report also noted its own difficulties in having adequate headcount and expertise in the supervision and examination teams. The FDIC’s supervision of Signature Bank faced resource challenges, with vacancies on the examination team and the adequacy of the skill sets of the supervisory team contributing to “timeliness and work quality issues and slowed earlier identification and reporting” of the bank’s weaknesses.

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[1] Board of Governors of the Federal Reserve System, *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank* (April 28, 2023), https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf.

[2] FDIC Chairman Martin Gruenberg stated in recent congressional testimony that the FDIC is also undertaking a comprehensive review of the deposit insurance system and will release a separate report that will include policy options for consideration related to deposit insurance coverage levels, excess deposit insurance, and the implications for risk-based pricing and deposit insurance fund adequacy. That report is expected to be released on Monday, May 1.

[3] Federal Deposit Insurance Corporation, *FDIC's Supervision of Signature Bank* (April 28, 2023), https://www.fdic.gov/news/press-releases/2023/pr23033a.pdf.

[4] SVB's state supervisor, the California Department of Financial Protection and Innovation, is conducting its own review of its oversight and supervision of SVB.

[5] Signature Bank's state supervisor, the New York State Department of Financial Services, released on April 28 its review of the supervision and closure of Signature Bank. *See* New York State Department of Financial Services, *Internal Review of the Supervision and Closure of Signature Bank* (April 28, 2023), NYSDFS Internal Review of the Supervision and Closure of Signature Bank - April 28, 2023.

[6] The Government Accountability Office (GAO) also released on April 28 its preliminary review of agency actions related to the March 2023 bank failures (the GAO Report). *See* United States Government Accountability Office, *Preliminary Review of Agency Actions Related to March 2023 Bank Failures* (April 28, 2023), https://www.gao.gov/assets/gao-23-106736.pdf. The GAO was asked by the House of Representatives Committee on Financial Services to review the events surrounding the bank failures and provide an interim report of its findings by April 28, 2023. There are additional reviews by the GAO forthcoming as the GAO plans to further examine the FRBSF and FDIC supervisory decision-making and other related issues, as well as how SVB's Category IV designation affected its supervision prior to its failure. In addition, under the Federal Deposit Insurance Act, the GAO is required to review and report to Congress on each systemic risk determination

made by the Secretary of the Treasury. The GAO also plans to examine the Bank Term Funding Program authorized under 13(3) of the Federal Reserve Act pursuant to its authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

[7] It will be interesting to see whether, in revisiting stress testing, the Federal Reserve will address its scenario design framework and the relationship between the severely adverse scenario and current economic conditions. In the 2022 and 2023 severely adverse scenarios, the Federal Reserve hypothesized “near zero” short-term interest rates and long-term interest rates falling to 3/4 percent before gradually rising to 1-1/2 percent (2022), and short-term interest rates falling to “near zero” and long-term interest rates falling by nearly 3-1/4 percentage points and then gradually rising to approximately 1-1/2 percent (2023). *See* Board of Governors of the Federal Reserve System, *2022 Stress Test Scenarios* (February 2022), at 5; Board of Governors of the Federal Reserve System, *2023 Stress Test Scenarios* (February 2023), at 6.

[8] Randal Quarles, *Statement of Randal Quarles Regarding the Federal Reserve Report on the Failure of Silicon Valley Bank* (April 28, 2023), STATEMENT OF RANDAL QUARLES (politicopro.com).

[9] Victoria Guida, *Quarles hits back at Barr’s SVB report* (April 28, 2023), POLITICO Pro | Article | Quarles hits back at Barr’s SVB report.