What Do the Silicon Valley Bank and Signature Bank Failures Mean for Bank Supervision?

By Carol Beaumier and Michael Brauneis

On April 28, 2023, four reports[1] were issued on the failures of Silicon Valley Bank (SVB) and Signature Bank (Signature). These reports explored the reasons and assigned responsibilities for the failures, faulting bank management and to varying degrees the regulators themselves and, in one instance, citing as a contributing factor the rollback during the prior administration of certain Dodd-Frank Act provisions that would have subjected regional banks to stress-testing requirements. The Government Accountability Office (GAO) report also examined how the Treasury Department, the Federal Reserve and the Federal Deposit Insurance Corporation managed the SVB and Signature failures and attendant industry risk.

Why do these reports matter?

These reports do not mark the end of the discussion on the SVB and Signature failures; to the contrary, they signal that we are about to enter a new stage of the review where the reports themselves will be scrutinised and lawmakers and regulators will debate who should be punished (beyond the shareholders who have already lost their investments) and what laws and policy changes should be enacted to prevent a recurrence of the events of March 2023. The circumstances will also inevitably lead to more debate on "too big to fail" – a concept the United States has been trying unsuccessfully to refute for nearly four decades since the collapse of Continental Illinois Bank in 1984.

Closing out this stage of the review will take time and will be further complicated by the bank failure that occurred on May 1 and any subsequent failures. However, the effect of the SVB and Signature failures on bank supervision has been immediate and boards of directors and

[1] Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank, Board of Governors of the Federal Reserve System, April 28, 2023, www.federalreserve.gov/publications/files/svb-review-20230428.pdf; FDIC's Supervision of Signature Bank, Federal Deposit Insurance Corporation, April 28, 2023, www.fdic.gov/news/press-releases/2023/pr23033a.pdf; New York State Department of Financial Services Internal Review of the Supervision and Closure of Signature Bank, New York State Department of Financial Services, April 28, 2023, www.dfs.ny.gov/system/files/documents/2023/04/nydfs_internal_review_rpt_signature_bank_20230428.pdf; Preliminary Review of Agency Actions Related to March 2023 Bank Failures, United States Government Accountability Office, www.gao.gov/assets/gao-23-106736.pdf.

management of banks, especially mid-sized and regional banks, need to be prepared for increased scrutiny, if they aren't already facing it.

What can boards of directors and management expect?

Setting the strategy for a bank is the purview of the board and management. Examiners generally do not insert themselves into strategic decision-making. Examiners do, however, challenge directors and management on how well they understand the risks of their strategy and whether they have an adequate framework for managing the risks. Boards and management should expect these discussions to take on added importance in upcoming examinations, especially if any of the following apply:

- The bank's asset portfolio (whether measured by asset category or borrower characteristics) base is highly concentrated.
- The bank operates within a narrow business model (e.g., specialising in serving cryptocurrency organisations and/or offering banking-as-a-service to fintech clients).
- The bank has experienced significant growth, particularly without a commensurate investment in risk management.
- The bank's funding sources are concentrated and/or potentially unstable (particularly including, but not limited to, the bank relying on high levels of brokered and/or otherwise uninsured deposits).
- The bank's cost of funding is increasing without a corresponding ability to increase return on assets and with net interest margin eroding as a result.
- The bank's balance sheet is highly vulnerable to changes in interest rates or a prolonged period of high interest rates, particularly including the extent to which unrealised losses due to interest rate swings exceed the bank's tangible common equity.
- The bank cannot quickly produce reliable data to measure its financial risks.
- The bank's contingency funding plan is not well-developed or is untested.
- The bank's risk management processes and tools are not subject to adequate independent testing (i.e., internal audit, model validation).
- The board is unable to demonstrate its understanding and oversight of risk by, among other things, including risk experts on the board or hearing from independent experts, holding executive sessions with the bank's chief risk officer, requiring comprehensive risk reporting from management, and evidencing challenge of management's decisions.

Boards and management should take stock of their current risk management practices and immediately take steps to address any gaps. These steps may include strengthening policies and procedures; improving the early identification and measurement of risks, including making better use of available tools; stress testing (whether or not a regulatory requirement) and scenario planning; and ensuring there is continual, effective challenge of risk-management decisions.

Where the board and management identify problems relating to prior risk decisions (e.g., a balance sheet vulnerable to high interest rates or an overreliance on uninsured or other unstable funding), they should develop credible remediation plans that recognise that not all poor risk decisions can be redressed quickly or that current circumstances may require external support, such as raising additional capital or seeking a merger/acquisition partner. Whatever the course of action taken, the alternatives that the board and management considered and the rationale for the decisions taken should be documented to evidence proper oversight and make clear that the board and management fully understand the current risks.

Boards and management should also expect examiners to be less tolerant of delays in responding to previously identified issues, whether these were identified internally or through the regulatory examination process. Self-identification of a problem is always better and when that does occur boards and management should require (without being asked by examiners) and closely monitor remediation plans. Comprehensive remediation plans are also required for examiner-identified issues, and, in fact, will often be mandated.

Banks that are unable to respond timely and effectively to address identified gaps, particularly those that have been outstanding for some time, should expect rating downgrades and enforcement actions that may include a requirement to curtail certain activities until they are appropriately managed. In fact, it seems likely in the current environment that examiners will move more quickly to downgrade ratings even if the underlying problems were not flagged as potential concerns in prior regulatory exams.

In addition to addressing known problems, boards and management should be able to demonstrate that they are considering what could happen next. For example, credit problems in the industry are likely to exacerbate as borrowers deal with an extended period of higher interest rates. Also, values of underlying collateral in asset classes like commercial real estate have fallen significantly between the time many of those loans were made and when they will need to be refinanced. Banks should be modeling the potential impact on their credit portfolios, reevaluating their credit administration practices, and preparing, if necessary, to add resources to support problem loan identification and collections. And they should be doing this now before their examiners tell them to do it.

The bottom line

The regulators are under pressure, which means pressure for the industry. We've seen this many times before. It's not revelatory; it's just human nature. Tougher examinations are ahead. Risk management, board and management responsiveness, and proactivity will be critical areas of focus.

How Protiviti can help

Protiviti's financial services practice can assist financial institutions with the following:

- **Surge staffing support** – Banks of all sizes are seeing an increase in customer-service calls and other operational activities. As smaller banks make and field calls to reassure customers that their money is safe, larger banks must manage a surge in new account onboarding requests.

- **Liquidity and capital** – Board members across the industry are seeking reassurance that what happened to SVB, Signature, Credit Suisse, etc., won't happen to their institutions. We've built a proprietary risk scorecard and industry-benchmarking database to help address this concern. We can also help banks with strategy and implementation of remediation activities if the initial risk diagnostic reveals concerns that need to be addressed.

- **Reporting and data** – Helping banks design more holistic key risk and performance indicator dashboards to measure financial risk (e.g., interest rate, market, credit, etc.) and build the data infrastructure to make this information available on a real-time basis.

- **Regulatory compliance** – We see the regulatory environment heating up in two main ways:

    - As noted above, U.S. regulators are under the microscope because of the banks that failed under their supervision and are dramatically ramping up the intensity of exams. We help banks prepare for these reviews and manage and resolve the issues (up to and including formal enforcement actions) that result from them.

  - Over the medium-term, we expect supervisory policies to swing back in the direction of the original enhanced prudential standards passed as a part of Dodd-Frank and relaxed in the 2018 regulatory-relief bill. Given the fractured political environment in Washington, we don't necessarily expect significant new legislation in this area, but regulators have a number of levers they can pull to functionally raise the standards that banks are held to even if Congress does not act.

- **Merger and acquisition integration** – As banks are forced into mergers, have to sell assets, or are liquidated, a significant amount of integration work is created that the acquirer often does not have sufficient capacity to manage.

About the Authors

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