BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

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April 28, 2023

Re: Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank

Silicon Valley Bank (SVB) failed because of a textbook case of mismanagement by the bank. Its senior leadership failed to manage basic interest rate and liquidity risk. Its board of directors failed to oversee senior leadership and hold them accountable. And Federal Reserve supervisors failed to take forceful enough action, as detailed in the report.

Our banking system is sound and resilient, with strong capital and liquidity. And in some respects, SVB was an outlier because of the extent of its highly concentrated business model, interest rate risk, and high level of reliance on uninsured deposits; however, SVB's failure demonstrates that there are weaknesses in regulation and supervision that must be addressed. Regulatory standards for SVB were too low, the supervision of SVB did not work with sufficient force and urgency, and contagion from the firm's failure posed systemic consequences not contemplated by the Federal Reserve's tailoring framework.

Following SVB's failure, we must strengthen the Federal Reserve's supervision and regulation based on what we have learned. This report represents the first step in that process—a self-assessment that takes an unflinching look at the conditions that led to the bank's failure, including the role of Federal Reserve supervision and regulation. Individuals who were not involved in the supervision of SVB conducted the review, and I oversaw it.

The four key takeaways of the report are:

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

Before discussing specific supervisory and regulatory changes that we should consider, I would like to touch on broader issues exposed by the failure of the bank.

First, 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.

Second, as I have previously stated, a firm's distress may have systemic consequences through contagion—where concerns about one firm spread to other firms—even if the firm is not extremely large, highly connected to other financial counterparties, or involved in critical financial services.

Third, this experience has emphasized why strong bank capital matters. While the proximate cause of SVB's failure was a liquidity run, the underlying issue was concern about its solvency.

As risks in the financial system continue to evolve, we need to continuously evaluate our supervisory and regulatory framework and be humble about our ability to assess and identify new and emerging risks. That is why we need to bolster resiliency broadly in the financial system, and not focus solely on specific risk drivers. Some steps already in progress include the holistic review of our capital framework; implementation of the Basel III endgame rules; the use of multiple scenarios in stress testing; and a long-term debt rule to improve the resiliency and resolvability of large banks. We plan to seek comment on these proposals soon. Other possible steps based on what we have learned from the SVB report, SVB's failure, and its contagion, will follow later.

Stronger Supervisory Framework

Our first area of focus will be to improve the speed, force, and agility of supervision. As the report shows, in part because of the Federal Reserve's tailoring framework and the stance of supervisory policy, supervisors did not fully appreciate the extent of the bank's vulnerabilities, or take sufficient steps to ensure that the bank fixed its problems quickly enough.

In SVB's case, the firm's rapid growth but slow transition to heightened standards contributed to the slow identification of risks and slow pace of supervisor action. We need to evaluate how to ensure that supervision intensifies at the right pace as a firm grows in size or complexity.

Within our supervisory structure, we should introduce more continuity between the 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.

We also need to be attentive to the particular risks that firms with rapid growth, concentrated business models, or other special factors might pose regardless of asset size. As I have previously announced, the Federal Reserve has begun to build a dedicated novel activity supervisory group to focus on the risks of novel activities (such as fintech or crypto activities) as a complement to existing supervisory teams. As we do so, we will identify whether there are other risk factors—such as high growth or concentration—that warrant additional supervisory attention.

Once issues are identified, they should be addressed more quickly, both by the bank and by supervisors. Today, for example, the Federal Reserve generally does not require additional capital or liquidity beyond regulatory requirements for a firm with inadequate capital planning, liquidity risk management, or governance and controls. We need to change that in appropriate cases. Higher capital or liquidity requirements can serve as an important safeguard until risk controls improve, and they can focus management's attention on the most critical issues. As a further example, limits on capital distributions or incentive compensation could be appropriate and effective in some cases.

We need to develop a culture that empowers supervisors to act in the face of uncertainty. In the case of SVB, supervisors delayed action to gather more evidence even as weaknesses were clear and growing. This meant that supervisors did not force SVB to fix its problems, even as those problems worsened.

Last, we need to guard against complacency. More than a decade of banking system stability and strong performance by banks of all sizes may have led bankers to be overconfident and supervisors to be too accepting. Supervisors should be encouraged to evaluate risks with rigor and consider a range of potential shocks and vulnerabilities, so that they think through the implications of tail events with severe consequences.

Stronger Regulatory Framework

Our second area of focus will be to raise the baseline for resilience. Our experience following SVB's failure demonstrated that it is appropriate to have stronger standards apply to a broader set of firms. As a result, we plan to revisit the tailoring framework, including to re-evaluate a range of rules for banks with $100 billion or more in assets.

In addition, let me go through some specific rules that should be modified or re-evaluated.

We need to evaluate how we supervise and regulate a bank's management of interest rate risk. While interest rate risk is a core risk of banking that is not new to banks or supervisors, SVB did not appropriately manage its interest rate risk, and supervisors did not force the bank to fix these issues quickly enough.

In addition, we are also going to evaluate how we supervise and regulate liquidity risk, starting with the risks of uninsured deposits. Liquidity requirements and models used by both banks and supervisors should better capture the liquidity risk of a firm's uninsured deposit base. For instance, we should re-evaluate the stability of uninsured deposits and the treatment of held to maturity securities in our standardized liquidity rules and in a firm's internal liquidity stress tests. We should also consider applying standardized liquidity requirements to a broader set of firms. Any adjustments to our liquidity rules would, of course, go through normal notice and comment rulemaking and have appropriate transition rules, and thus would not be effective for several years.

With respect to capital, we are going to evaluate how to improve our capital requirements in light of lessons learned from SVB. For instance, we should 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.

Again, these changes would not be effective for several years because of the standard notice and comment rulemaking process and would be accompanied by an appropriate phase-in.

Stress testing is a key supervisory tool, and tailoring changes reduced its coverage and timeliness for some firms; we will be revisiting this approach.

Oversight of incentives for bank managers should also be improved. SVB's senior management responded to the incentives approved by the board of directors; they were not compensated to manage the bank's risk, and they did not do so effectively. We should consider setting tougher minimum standards for incentive compensation programs and ensure banks comply with the standards we already have.

Closing

Contagion from the failure of SVB threatened the ability of a broader range of banks to provide financial services and access to credit for individuals, families, and businesses. Fast and forceful action by the Federal Reserve, the Federal Deposit Insurance Corporation, and the Treasury Department helped to contain the damage, but weaknesses in supervision and regulation must be fixed.

In doing so, we should be humble about our ability—and that of bank managers—to predict how losses might be incurred, how a future financial crisis might unfold, and what the effect of a financial crisis might be on the financial system and our broader economy. Greater resilience will guard against the risks that we may not fully appreciate today.

This report is a self-assessment, a critical part of prudent risk management, and what we ask the banks we supervise to do when they have a weakness. It is essential for strengthening our own supervision and regulation. I am grateful to the staff who conducted the review and prepared the report.

I also appreciate that others will have their own perspectives on this episode. We welcome external reviews of SVB's failure, as well as congressional oversight, and we intend to take these into account as we make changes to our framework of bank supervision and regulation to ensure that the banking system remains strong and resilient.

Sincerely,

Michael S. Barr