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ALERT MEMORANDUM

Recent Government Bank Failure Reports Point to Increased Regulation and Examination Scrutiny

May 8, 2023

On April 28, several banking regulators and the Government Accountability Office released reports analyzing the factors that contributed to the failures of Silicon Valley Bank and Signature Bank, at the same time suggesting possible areas of forthcoming supervisory focus and regulatory change. The **"FRB Report,"** led by Federal Reserve Board Vice Chair for Supervision Michael Barr, analyzes the supervision and failure of SVB Financial Group and Silicon Valley Bank. The **"FDIC Report,"** led by the Federal Deposit Insurance Corporation's Chief Risk Officer, and the **"NYDFS Report,"** led by the New York Department of Financial Services Office of General Counsel, each examine the supervision and failure of Signature Bank. The "**GAO Report**" focuses on how the responsible bank regulatory agencies regulated and supervised Silicon Valley Bank, SVB Financial Group and Signature Bank, as well as how the agencies responded to the March 2023 turmoil in general. The California Department of Financial Protection and Innovation, the state regulator for Silicon Valley Bank, has announced that it will release its own report in early May.

These reports offer the public a detailed look into the bank supervisory process, including through the release of dozens of pages of confidential supervisory information, and provide important insights into regulatory and supervisory changes that may be on the horizon. In this Memorandum, we briefly summarize the reports before turning to our expectations for potential regulatory and supervisory developments.

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Key Takeaways

— **The Reports**[1] **provide a detailed regulatory self-assessment.** The Federal Reserve Board ("**FRB**"), Federal Deposit Insurance Commission ("**FDIC**"), and New York State Department of Financial Services ("**NYDFS**") identify a number of ways in which supervision fell short and could be improved. In particular, supervisors sometimes failed to identify or escalate issues in a timely manner, and bank management was sometimes slow to remediate important issues identified by supervisors. Staffing shortages and the COVID-19 pandemic exacerbated some supervisory issues, but the Reports attribute supervisory shortcomings to a variety of factors (including, in the FRB's case, the tone set by prior FRB leadership). The Reports also include significant amounts of confidential supervisory information ("**CSI**"), such as supervisory letters, reports of examination and exam ratings, which the agencies have the discretion to disclose and which the FRB argued was in the public interest.

— **Supervisory staff will more quickly escalate and take action on identified issues, and will more aggressively scrutinize firms that are growing rapidly.** Each Report clearly faults a lack of urgency of supervisory action with respect to Silicon Valley Bank ("**SVB**"), SVB Financial Group ("**SVBFG**") and Signature Bank ("**Signature**"), particularly in light of their rapid growth. We expect that supervisory staff will more quickly escalate and act on supervisory concerns going forward. This, in turn, is likely to lead to higher numbers of exam findings (Matters Requiring Attention ("**MRAs**") and Matters Requiring Immediate Attention ("**MRIAs**")) and more frequent (and quicker) enforcement actions against regulated entities. Supervised entities' pleas of strong financial performance or progress on remediation are likely to be discounted heavily if supervisory findings remain unaddressed and unclosed. Vice Chair Barr also suggests alternative tools, such as additional capital and liquidity requirements or restrictions on capital distributions or on incentive compensation, in appropriate cases to address issues with capital planning, liquidity risk management, or governance or controls. In addition, Vice Chair Barr states that the FRB should evaluate how intensity of supervision can keep pace with a firm's growth in size or complexity, and should introduce greater continuity between supervisory portfolios (e.g., from the Regional Banking Organization ("**RBO**") supervisory portfolio to the Large and Foreign Banking Organization ("**LFBO**") portfolio) so that a firm that grows into a new supervisory portfolio will be ready to comply with the relevant requirements without an extended transition period.

— **Regulatory focus on interest rate risk, liquidity requirements, capital and resolution-related requirements will increase.** Possible measures the FRB will consider include applying standardized liquidity requirements to more firms; changing the treatment of uninsured deposits and held-to-maturity securities in liquidity requirements; strengthening capital requirements, including through finalizing the Basel III "End Game" and revisiting the treatment of unrealized gains or losses on available-for-sale securities; requiring more frequent and widespread stress testing; and applying long-term debt and other enhanced resolution-related requirements to more firms.

— **The "tailoring framework" will be revisited.** The FRB Report is critical of the bank regulatory tailoring that was implemented under the prior Vice Chair for Supervision in response to the 2018 Economic Growth, Regulatory Relief, and Consumer Protection Act ("**EGRRCPA**").[2] The FRB Report characterizes the tailoring

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[1] The FRB Report, FDIC Report, NYDFS Report and GAO Report are referred to together as the "**Reports**." FRB, Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank (Apr. 2023); FDIC, FDIC's Supervision of Signature Bank (Apr. 2023); GAO, Preliminary Review of Agency Actions Related to March 2023 Bank Failures (Apr. 2023); NYDFS, Internal Review of the Supervision and Closure of Signature Bank (Apr. 2023).

[2] Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, § 401, 132 Stat. 1296, 1356 (2018).

approach and related supervisory developments as having "combined to create a weaker regulatory framework for a firm like SVBFG" and "impeded effective supervision by reducing standards, increasing complexity, and promoting a less assertive supervisory approach." Vice Chair Barr states that the FRB will specifically re-evaluate the rules for banks with $100 billion or more in assets.

— **There will be a more acute supervisory focus on uninsured deposits and a new appreciation for the possible speed of deposit runs in light of new technology.** The Reports observe that the pace of deposit runoff at SVB and Signature was unprecedented and attribute it to a combination of factors, including high levels of uninsured deposits, concentrated depositor bases, and new technology and behaviors. An FDIC report on options for insurance reform[3] released on May 1 (the "**Deposit Insurance Report**") concludes that trends in uninsured deposits and technological changes have increased the risk of bank runs and analyzes options for reform to the U.S. deposit insurance system.

— **There will be stronger emphasis on oversight by bank boards and management, as well as increased scrutiny with respect to incentive compensation.** Each of the Reports find considerable fault with the boards and management of SVBFG and Signature. Effective, proactive bank governance and board oversight, and the role of incentive compensation in incentivizing risk management, are likely to be key areas of regulatory and supervisory focus for the foreseeable future. There is also likely to be legislative pressure to impose penalties on SVB and Signature management and legislative proposals to claw back compensation in similar situations.

— **There will be increased supervisory pressure on operational readiness.** The Reports characterize SVB and Signature as being insufficiently prepared to access the discount window or other sources of liquidity in their final days, which exacerbated an already difficult situation. The regulators are likely to place increased emphasis on financial institutions' operational readiness for liquidity shortages.

Additional analysis on these takeaways can be found beginning on page 9 under the heading "Regulatory and Supervisory Implications of Recent Reports."

[3] FDIC, *Options for Deposit Insurance Reform* (May 1, 2023).

Summary of the FRB Report

The FRB Report identifies three critical weaknesses at SVBFG: (1) governance and risk management; (2) liquidity risk management; and (3) interest rate risk and investment portfolio management. SVBFG's practices "did not keep pace with its rapid growth in size and risk."[4] The FRB Report also identifies weaknesses in Federal Reserve regulation and supervision, including missed key issues and delays in taking action.[5]

The FRB Report was prepared by Federal Reserve System staff upon request by Vice Chair Barr. It covers "the regulations applicable to firms such as SVB[,]… a review of the supervisory regime; and an evaluation of whether supervisors had sufficient tools to address the weaknesses at SVB." However, it expressly does not address events that occurred after March 8, 2023, including the closure of SVB and FDIC receivership.[6]

Key takeaways from the FRB Report

The FRB Report focuses on four key takeaways:

— *SVB's board of directors and management failed to manage risk effectively*

- The FRB Report emphasizes that SVB's failure was directly tied to failure by the board and management to effectively oversee inherent risks in the business model and balance sheet strategies. The board did not receive adequate information, did not hold management accountable, put short-run profits above effective risk management, and did not take resolution of supervisory issues seriously enough.[7] The FRB Report also criticizes the compensation program for senior management.[8]
- The board and management did not address vulnerabilities resulting from the bank's highly concentrated business model and reliance on uninsured deposits, which left it exposed to rising interest rates and technology sector slowdown. For example, despite having failed internal liquidity stress tests after becoming subject to enhanced prudential standards under Regulation YY, management did not fully develop additional funding capacity and instead used less conservative stress testing assumptions. The Report also criticizes management's failure to assess and manage interest rate risk, noting that in 2022 management removed interest rate hedges that protected against rising interest rates in order to maintain short-term profits.[9]

— *Supervisors did not fully appreciate the extent of the vulnerabilities as SVB grew in size and complexity*

- At the time of SVB's failure, SVBFG had 31 open supervisory findings, about triple the number observed at peer firms.[10] Numerous MRAs and MRIAs covered governance and risk management, liquidity, interest rate risk management and technology.[11]
- Many of the MR(I)As were recent, however—issued between May and December 2022, more than a year after SVBFG moved from the RBO supervisory portfolio to the LFBO portfolio.[12] Between 2017 and 2021, SVBFG had consistently received ratings of "Satisfactory-2" across the board (other than for liquidity, which had received a "Strong-1" rating), despite observed weaknesses in governance, building interest rate and liquidity risks and risk limit breaches.[13]

[4] FRB Report at 45.
[5] See, e.g., FRB Report at 51.
[6] FRB Report at vii.
[7] See, e.g., FRB Report at i.
[8] FRB Report at 74 to 75.
[9] FRB Report at 3.
[10] FRB Report at 6.
[11] See FRB Report at 18.
[12] See, e.g., FRB Report at 7 ("When SVBFG moved to the LFBO portfolio, supervisors recognized that SVBFG's risk management was not robust and proceeded to build evidence, issue MRIAs, and downgrade SVBFG. Governance and Controls were ultimately rated "Deficient-1," but not until August 2022.").
[13] FRB Report at 7 and 39.

— *When supervisors did identify vulnerabilities, they did not take sufficient steps to ensure that SVB fixed those problems quickly*

- The FRB Report characterizes supervisors as slow to downgrade supervisory ratings and to insist on remedial action by the board and management. It characterizes the supervisory approach as "too deliberative and focused on the continued accumulation of supporting evidence in a consensus-driven environment."[14]
- In 2021, as SVBFG moved from the RBO portfolio to the LFBO portfolio, supervisors were hesitant to issue a downgrade, despite multiple supervisory findings. The firm's first rating as an LFBO was also delayed by six months to August 2022, as the FRB had granted the Federal Reserve Bank of San Francisco ("**FRBSF**") team a waiver due to SVBFG's growth and transition to the LFBO portfolio.[15]
- Interest rate risk deficiencies identified in 2020, 2021 and 2022 CAMELS exams were only communicated as advisories or verbal observations, not formal MR(I)As.[16]
- Once supervisors decided to take informal enforcement action against SVB, it took over seven months to develop a memorandum of understanding, which had not yet been delivered at the time of SVBFG's failure.[17]
- SVBFG's Chief Risk Officer ("**CRO**") left the organization in April 2022. Despite the regulatory requirement for a bank holding company ("**BHC**") to appoint a CRO with appropriate experience to manage the risks of a large, complex firm,[18] the position remained unfilled for eight months while a committee of senior risk officers oversaw risk management. Supervisors did not issue an MRIA for violating this regulatory requirement because SVBFG was actively searching for an appropriate CRO.[19]

— *The Board's tailoring approach in response to the EGRRCPA and shift in the stance of supervisory policy impeded effective supervision by reducing standards, increasing complexity, and promoting a less assertive supervisory approach*

- The FRB Report describes the FRB's view of how EGRRCPA, the 2019 tailoring framework and related rulemakings led to a less stringent regulatory framework for SVBFG.[20] In addition to making other changes, the FRB raised the thresholds for the application of enhanced prudential standards. It also raised the threshold for supervision under the LFBO portfolio from $50 billion in total assets to $100 billion in total assets "to track the new EGRRCPA thresholds."[21] This created a delay of at least three years for applying heightened supervisory expectations to SVBFG.[22]
- SVBFG met the criteria for a Category IV firm under the tailoring framework rule as of June 2021 by crossing the $100 billion asset threshold.[23] However, a number of Category IV capital and liquidity requirements were not yet applied due to applicable transition periods in the rules, including for supervisory stress testing, the stress capital buffer, the liquidity coverage ratio and the net stable funding ratio.[24] Moreover, in interviews for the FRB Report, staff stated that they did not increase the

[14] FRB Report at ii.
[15] FRB Report at 8.
[16] FRB Report at 9. The "CAMELS" exam rates a bank based on **C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to market risk.
[17] FRB Report at 8. The FRB released the draft MOU as part of its release of certain documents in connection with the review of the supervision and regulation of SVB and SVBFG.
[18] See 12 C.F.R. § 252.33(b).
[19] FRB Report at 49.
[20] FRB Report at 91.
[21] FRB Report at 11.
[22] FRB Report at 11.
[23] See FRB Report, page 87, for a table of the key requirements for SVBFG and SVB both (i) as a Category IV firm and (ii) hypothetically in the absence of the 2019 tailoring rule and related rulemakings.
[24] FRB Report at 12-13.

intensity of supervision leading up to SVBFG entering Category IV due to concern from policymakers and FRB senior leadership that supervisors would prematurely "pull forward" the requirements of the enhanced prudential standards.[25]

- The FRB Report describes a shift in supervisory practices – although there was no formal policy change – in which staff felt that expectations and practices led to pressure to reduce burdens on firms, meet higher burdens of proof for supervisory conclusions and demonstrate due process in supervisory actions. This is characterized as having led to slower action by supervisors and a reluctance to escalate issues in some cases.[26]
- The COVID-19 pandemic led to certain pauses in RBO portfolio examinations, which led to stale information and may have made SVBFG's transition to the LFBO supervisory team more abrupt.[27]

Implications for Federal Reserve oversight

The FRB Report concludes by identifying four broad themes with respect to supervisory oversight that may warrant further consideration by policymakers:

(1) *enhancing risk identification* by supervisors;

(2) *promoting resilience* of banking institutions, particularly in periods of rapid change and heightened uncertainty;

(3) *changing supervisory behavior* to promote more timely decision-making and remediation; and

(4) *strengthening processes*, by simplifying and improving the efficiency of the oversight program and tailoring framework.

Release of supervisory materials

In connection with the FRB Report, the FRB also released certain CSI, stating that this was in the best interest of the public due to the exceptional nature of the recent bank failures.[28] The FRB may waive confidential treatment for its own CSI. The supervisory material covers: (1) supervisory letters since 2019, which detail the deficiencies and requisite remedial obligations described in the FRB Report; (2) holding company reports of inspection and ratings letters since 2017; (3) CAMELS reports since 2017; and (4) certain other supervisory memoranda. However, the FRB did not release any of SVB's responses to these materials.

New FRB regulatory and supervisory priorities: takeaways from Vice Chair Barr's letter accompanying the FRB Report

Vice Chair Barr characterizes the FRB Report in his introductory letter as "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."[29]

In his letter, Barr states that the FRB will focus on "improv[ing] the speed, force, and agility of supervision," including by:

- Evaluating how supervision can keep pace with a firm's growth in size and complexity.
- With respect to banks moving from one supervisory portfolio to another, increasing the continuity of supervision in a way that pushes firms to comply with heightened regulatory and supervisory standards more quickly.
- Improving the speed at which banks and supervisors address identified supervisory / regulatory issues (and giving supervisors greater

[25] FRB Report at 35.
[26] FRB Report at 36.
[27] FRB Report at 38.
[28] See Silicon Valley Bank Review – Supervisory Materials (Apr. 28, 2023).
[29] Vice Chair for Supervision Michael S. Barr, Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank (Apr. 28, 2023) ("**Vice Chair Barr's letter**").

ability and grounds to impose restrictions on noncompliant banks).

- Identifying factors beyond asset size (e.g., growth and concentrated business models) that indicate risk. The FRB recently created a new supervisory group focused on novel risks.
- Focusing on the culture of supervision, "empower[ing] supervisors to act in the face of uncertainty," and "guard[ing] against complacency."

The FRB also will focus on "rais[ing] the baseline for resilience" through a stronger regulatory framework, including by:

- "Revisit[ing] the tailoring framework, including to re-evaluate a range of rules for banks with $100 billion or more in assets."
- Evaluating the regulation and supervision of a bank's management of interest rate risk.
- Evaluating how the FRB supervises and regulates liquidity risk, including with respect to uninsured deposits and held-to-maturity securities.
- Evaluating whether a broader set of banks should be subject to the standardized liquidity requirements.
- Bolstering capital requirements, including by requiring more firms to account for their unrealized gains and losses on available-for-sale securities, a requirement that was rolled back in 2019.
- Revisiting the applicability of stress testing and potentially expanding it.
- Exercising greater oversight of incentive compensation for managers, including, potentially, through new standards.

Summary of the FDIC Report

The FDIC Report points to poor management as the root cause of Signature's failure.[30] It criticizes Signature's board and managers for focusing on "growth, deposits, and profits" over "the responsibility to ensure sound risk management," for being "sometimes disengaged from the examination process" and "generally dismissive of examination findings," and for taking a "check-the-box" approach when addressing examination findings to "assuage the examiners."[31] It identifies rapid growth, overreliance on uninsured deposits, a failure to understand the risks of being associated with the cryptocurrency industry and weaknesses in liquidity risk management and contingency planning as the key factors leading to Signature's liquidity crisis and eventual failure.[32]

The FDIC Report primarily places the blame on Signature's management, but also points to supervisory issues as a contributing factor. Consistent with the FRB Report, it suggests that supervisory actions could have been escalated sooner and communications and work product could have been timelier. For example, the FDIC typically expects an examination team to complete a targeted review and meet with management within 50 to 60 days and to issue a Supervisory Letter 45 days later. The FDIC Report identifies 24 instances where it took 100 or more days to complete an exam and meet with bank management, and 18 instances where it took more than 45 days to issue the Supervisory Letter after meeting with bank management—including 12 that took more than 100 days.[33]

In addition, the FDIC Report states that communication with the Signature board and management could have been more effective. In contrast to the FRB Report, the FDIC Report identifies staffing challenges as a main reason for these issues.[34]

The FDIC did not release in-depth exam report materials or copies of other CSI, although it summarizes the findings from Signature's annual examinations and

[30] FDIC Report at 2.
[31] FDIC Report at 9.
[32] FDIC Report at 2.
[33] FDIC Report at 32.
[34] FDIC Report at 32; see also FDIC Report at 40.

other supervisory letters. The FDIC Report concludes with a 13-item list of "Matters for Further Study," which focuses on potential internal improvements at the FDIC. The items include, among other things, considering whether supervisors should have enhanced supervisory guidance in respect of banks "that are overly reliant on uninsured deposit funding or have concentrations in uninsured deposits" and with respect to assessing liquidity risk management.[35]

FDIC Report on *Options for Deposit Insurance Reform*

Separately, the FDIC released a report on deposit insurance reform. Noting the recent debate over deposit insurance, the Deposit Insurance Report sets out considerations related to reform of the deposit insurance system. The report describes three broad options for reform:

- **The "Limited Coverage" Option**:[36] The Limited Coverage option is the model for deposit insurance that currently exists. The amount of coverage and which account types are covered could be changed.
- **The "Unlimited Coverage" Option:** Under the Unlimited Coverage option, *all* deposits would be insured by the FDIC.
- **The "Targeted Coverage" Option:** The Targeted Coverage option would provide for higher levels of coverage for certain types of accounts (e.g., business payment accounts) than others.

The Deposit Insurance Report describes advantages and drawbacks for each option in relation to factors such as moral hazard and simplicity of resolution, but does not recommend a particular option. While the report describes Targeted Coverage as the "most promising option to improve financial stability relative to its effects on bank risk-taking, bank funding, and broader markets," it also notes "unresolved practical challenges" including determining which accounts should receive additional coverage and "preventing depositors and banks from circumventing differences in coverage."[37]

The Deposit Insurance Report highlights that congressional action would be necessary to implement any of the proposed options, which makes the near-term prospects for adoption of any of the options uncertain.[38]

Summary of the NYDFS Report

The NYDFS Report identifies overreliance on uninsured deposits as a key liquidity risk leading to Signature's failure, consistent with the FDIC Report.[39] It also emphasizes the speed of the run, accelerated by social media and Signature's association with the cryptocurrency industry.[40]

The NYDFS Report provides significant detail regarding the challenges Signature had in measuring available liquidity and pending withdrawals, and in identifying appropriate collateral to pledge to FRBNY to raise liquidity. For example, it says that Signature did not have existing arrangements in place to pledge available collateral to the FRBNY, and Signature "struggled over the weekend to identify readily pledgeable assets," instead proposing to pledge assets that it knew were ineligible or could not be valued or pledged in the immediate future.[41]

The NYDFS Report does not spend as much time as the FDIC and FRB Reports on supervisory shortcomings. However, it does point to lengthy delays in the issuance of supervisory findings, identifying a "cumbersome review process" requiring "several rounds of reviews,

[35] See FDIC Report at 40-41.
[36] Deposit Insurance Report at 49-53.
[37] Deposit Insurance Report at 67.
[38] Deposit Insurance Resort at 6 ("The proposed options require an act of Congress, though some aspects of the report lie within the scope of FDIC rulemaking authority.").
[39] NYDFS Report at 41.
[40] NYDFS Report at 6 and 32.
[41] NYDFS Report at 34-36.

with no established internal deadlines for completion." The NYDFS Report suggests keeping subject matter experts involved at all stages of the examination process and setting internal deadlines, as well as rebuilding staff resources to speed up timelines.[42]

The NYDFS did not release in-depth exam report materials or other CSI.

Summary of the GAO Report

The Government Accountability Office ("**GAO**") Report focuses on the actions of the regulators and perceived inadequacies in the supervisory framework, noting the GAO has had "longstanding" concerns with the escalation of supervisory actions.[43] While noting that the regulators identified liquidity and risk management issues, it criticizes the regulatory process for being too slow to address these risks in a timely manner. For example, the GAO Report discusses how FRBSF staff began work on an informal enforcement action—a memorandum of understanding—for SVB in July 2022, but FRBSF and FRB staff's continued review resulted in the enforcement not being finalized before SVB's failure in March 2023. The GAO Report also notes that FRBSF staff accepted SVB's planned actions to remedy supervisory issues, despite the bank's management having "failed to take adequate and timely steps to mitigate risks."[44]

The GAO Report also characterizes the FDIC as being too slow to escalate supervisory actions and allowing identified deficiencies to go unremedied. It goes so far as to say that the "FDIC lacked urgency despite [Signature]'s repeated failures to remediate liquidity and management issues," and states that the agency "did not pursue more forceful supervisory actions in a timely manner."[45]

In addition, the GAO Report reiterates its 2011 recommendation that regulators add additional noncapital triggers to the prompt corrective action framework. This recommendation is based on the belief that capital is a "lagging indicator of bank health" and that noncapital indicators might result in more timely action.[46]

Regulatory and Supervisory Implications of Recent Reports

The Reports provide important indicators of possible changes to the supervision and regulation of insured depository institutions ("**IDIs**") and BHCs that could be implemented or proposed in the near term. Below, we share our expectations for potential regulatory and supervisory developments.

Banking supervisors will focus on improvements to their own supervisory processes and cultures.

In their respective Reports, each of the FRB, FDIC and NYDFS assesses the ways in which its supervisory processes may have contributed to the failures of SVBFG and Signature. A common theme that emerges is that, while supervisors often identified pertinent issues, they had difficulty escalating and compelling resolution of these issues in a timely fashion.[47] The Reports highlight a new focus on increasing the speed at which supervisors can operate.[48] In his letter, Vice Chair Barr also suggested that supervisors could be given new tools to incentivize banks to remediate supervisory and regulatory issues. For example, inadequate risk controls could trigger the imposition of

[42] NYDFS Report at 42.
[43] GAO Report, cover page.
[44] GAO Report at 22.
[45] GAO Report at 26.
[46] GAO Report at 27.
[47] See, e.g., NYDFS Report at 44 ("DFS needs to establish clear escalation procedures for examination findings that remain outstanding and criteria on when further action must be taken to ensure compliance with an outstanding regulatory finding") and FDIC Report at 42 (the FDIC will study further "the [supervisory recommendations ("SR")] and [matters requiring board attention ("MR")] escalation process for situations involving repeat recommendations, and define paths for progressive enforcement when bank management is unable or unwilling to effectively address chronic problem areas").
[48] See NYDFS Report at 7 ("Signature's collapse underscores the speed at which the modern financial system moves. Inefficiencies led to delays in issuing examination findings to the Bank. DFS's policies and procedures need to be updated to insure that DFS addresses risks at banking organizations in real-time.").

"[h]igher capital or liquidity requirements" or "limits on capital distributions or incentive compensation," which would represent a significant change to current practice.

The FRB Report additionally points to EGRRCPA and the tenure of the former Vice Chair for Supervision, Randal Quarles, as sources of a shift in supervisory culture.[49] Vice Chair Barr highlighted "develop[ing] a culture that empowers supervisors to act in the face of uncertainty" as an important priority, stating that SVB's supervisors "delayed action to gather more evidence even as weaknesses were clear and growing."[50] In a statement reacting to the Report, former Vice Chair Quarles firmly pushed back on the idea that there was a "shift in the stance of supervisory policy" during his tenure.[51]

The FRB will revisit the "tailoring framework."

EGRRCPA's changes to the thresholds for applying enhanced prudential standards under the Dodd-Frank Act and to the standardized capital and liquidity rules, as well as the resultant tailoring framework, receive close attention in the FRB Report. Vice Chair Barr suggests that the FRB will revisit the enhanced prudential standards that apply to BHCs that have between \$100 billion and \$250 billion in assets. The White House has put forth a similar view.[52] By way of background, EGRRCPA generally raised the threshold for the application of enhanced prudential standards from a \$50 billion threshold to a \$250 billion threshold. However, it gave the FRB the discretion to impose enhanced prudential standards on BHCs with \$100 billion to \$250 billion in total assets if the FRB determines that this would (i) prevent or mitigate risks to U.S. financial stability or (ii) promote the safety and soundness of a BHC or BHCs. In either case, the FRB must impose these standards taking into account the attributes (e.g., riskiness, complexity) of a specific BHC or of BHCs in general.[53] Consequently, the FRB should not need Congressional approval to impose additional standards on BHCs that have between \$100 billion and \$250 billion in total assets (but would need legislative approval to lower either or both of these thresholds).[54]

There are by no means consensus views on how or if the tailoring framework should be recalibrated. For example, the FDIC's Vice Chairman Travis Hill has recently stated that "[t]he reasons for SVB's failure are quite straightforward and easy to explain, and [the EGRRCPA-related] rule changes had nothing to do with them."[55] Having gone through an extensive notice-and-comment period about the tailoring framework in 2019, the banking sector – which also generally supported the concept of more tailored regulations – will not be eager to revisit this topic.[56] Political dynamics are highly likely to affect the debate over tailoring as well.[57]

[49] See FRB Report at 11 ("In the interviews for this report, staff repeatedly 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.").

[50] Vice Chair Barr's letter at 3.

[51] Randal Quarles, "Statement of Randal Quarles Regarding the Federal Reserve Report on the Failure of Silicon Valley Bank" (Apr. 28, 2023) ("The report frankly acknowledges at the very outset, on page 11, 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.").

[52] Fact Sheet, White House, President Biden Urges Regulators to Reverse Trump Administration Weakening of Common-Sense Safeguards and Supervision for Large Regional Banks (Mar. 30, 2023) (the "**White House Fact Sheet**").

[53] See 12 USC § 5365.

[54] It is worth noting that the FRB Report does not argue for a return to the \$50 billion application threshold, which was the default prior to EGRRCPA. Among other things, this would require legislative change, the prospects for which are uncertain.

[55] Travis Hill, Vice Chairman, FDIC, Remarks at the Bipartisan Policy Center on the Recent Bank Failures and the Path Ahead (Apr. 12, 2023) (the "**Vice Chair Hill Remarks**").

[56] See Press Release, Bank Policy Institute ("**BPI**"), "BPI Statement on SVB Reports" (Apr. 28, 2023).

[57] See, e.g., Press Release, House Financial Services Committee, "McHenry Statement on Regulator, GAO

Regulators will re-emphasize bank liquidity requirements.

Vice Chair Barr asserted that the Federal Reserve would "consider applying standardized liquidity requirements to a broader set of firms." The standardized liquidity requirements – which are promulgated jointly among the FRB, FDIC and OCC – include the liquidity coverage ratio ("**LCR**") and the net stable funding ratio ("**NSFR**"). Before the EGRRCPA-related changes, the full LCR and NSFR would have applied to every BHC with total assets above $50 billion or more. Currently, the LCR and the NSFR start to apply at a 70% level to Category IV BHCs – which have total assets of at least $100 billion – but only if those BHCs also have $50 billion or more in weighted short-term wholesale funding. One implication of Vice Chair Barr's statement could be that the regulators propose that all BHCs with over $100 billion in total assets comply with a 70% LCR or perhaps even the full LCR.

Regulators also may revisit the components of the LCR. The NYDFS Report suggests that the LCR's "outflow assumptions" – namely, how fast different kinds of deposits are expected to run during times of stress – did not match the behavior of Signature's depositors, whose withdrawals generally moved much faster than the assumptions would indicate.[58] By way of explanation, the NYDFS Report argues that the LCR's assumptions "have not kept pace with customer behavior or technological advancements in media and mobile banking in the years since its finalization."[59] The FDIC and FRB Reports also emphasize the rapidity of deposit outflows.[60] The FRB Report notes that SVB had $40 billion in deposit outflows on March 9, with $100 billion more expected when the bank failed on March 10 (by contrast, in 2008, Wachovia experienced $10 billion in outflows over eight days).[61] The outflows from SVB corresponded to approximately 85 percent of SVB's deposit base.[62] Just as the LCR's assumptions were based in part on data from the 2008 financial crisis,[63] the current turmoil could inform further revisions to the LCR.

Prudential and supervisory (non-standardized) liquidity requirements should receive renewed attention as well. The NYDFS Report notes more broadly that "it remains the case that all regulators would do well to revisit their liquidity risk assessment frameworks to account for changes in technology, account accessibility, and customer behavior," also suggesting that Signature's failure indicates that certain kinds of deposits may not be as stable as they appear.[64] Vice Chair Barr similarly suggests that there will be a reevaluation of "the stability of uninsured deposits and the treatment of held to maturity securities" in both the standardized liquidity rules and in internal liquidity stress tests.[65]

Indeed, there likely will be targeted supervisory focus on internal liquidity stress tests and how institutions respond to their results. The FRB Report notes that in July 2022, SVBFG initially became subject to the FRB's enhanced prudential standards, at which point it "repeatedly failed its own [internal liquidity stress testing]."[66] Management's response was to (i) use less conservative stress testing assumptions and (ii) develop a plan to increase SVBFG's funding capacity, an initiative that was incomplete as of March 2023.[67] The

Reports Regarding Recent Bank Failures" (Apr. 28, 2023) ("While there are areas identified by Vice Chair Barr on which we agree—including enhancing attention to liquidity issues, especially when a firm is rapidly growing—the bulk of the report appears to be a justification of Democrats' long-held priorities. Specifically, the section on tailoring is a thinly veiled attempt to validate the Biden Administration and Congressional Democrats' calls for more regulation"). Cf. Press Release, Senate Committee on Banking, Housing, and Urban Affairs, "Brown Statement on Fed and FDIC Reviews" (Apr. 28, 2023) ("We must address gaps in the Fed and FDIC's supervisory structure and we must strengthen the rules weakened by the prior administration").

[58] NYDFS Report at 45.
[59] NYDFS Report at 45.
[60] See, e.g., FDIC Report at 16 (describing the events leading up to the failure of Signature, including the role of social media and other means of communication).
[61] FRB Report at 4.
[62] FRB Report at 4.
[63] NYDFS Report at 45.
[64] NYDFS Report at 46.
[65] Vice Chair Barr's letter at 3.
[66] FRB Report at 3.
[67] FRB Report at 3.

FDIC and NYDFS also raised concerns about Signature's liquidity risk management, including with respect to liquidity stress testing, noting "that the liquidity risk management concerns raised during the 2019 examination remained unresolved."[68]

SVBFG's pro forma LCR results

If SVBFG had been subject to pre-EGRRCPA standards, in the twelve months from the end of March 2021 to the end of February 2022, its LCR would have fluctuated from a low of 73.2% (September 2022) to a high of 99.3% (March 2022).[69] In other words, it would have had a shortfall during this time period relative to the full LCR requirement. Under post-EGRRCPA standards, SVBFG was not subject to the LCR as of the time of its failure, but based on its weighted wholesale short-term funding, it would have been subject to the 70% LCR beginning in October 2023.[70] The FRB Report also suggests that SVBFG would have exceeded the 100% requirement under the NSFR Rule.[71]

Recent developments in the banking sector have renewed regulators' priorities on capital and resolution-related initiatives.

Existing regulatory (and resolution-related) capital requirements have been under scrutiny even prior to the SVB and Signature failures. Vice Chair Barr suggests that the FRB will continue to place emphasis on completing the Basel III "End Game" and the "holistic review of capital standards" he announced in December 2022,[72] as well as on reviewing whether multiple stress testing scenarios should be used[73] and whether resolution-related requirements for large banks should be modified (the "**Large Bank ANPR**").[74] The Large Bank ANPR, released in October 2022, focused on Category II and III BHCs. However, SVBFG's recent experience raises the question of whether Category IV BHCs also will be addressed in a forthcoming proposed rule, on which the White House called for "expeditious" progress. Indeed, the White House Fact Sheet echoes many of the capital-related priorities from Vice Chair Barr's letter.

We also expect to see discussion of the effectiveness and proper role of resolution planning. EGRRCPA-era changes as well as resource constraints at the FRB and FDIC had resulted in tailored application of BHC resolution plans.[75] The FDIC also had put a moratorium on IDI resolution plans while it further calibrated resolution planning standards (the moratorium has largely been lifted).[76] As a firm that became a Category IV BHC in June 2021, SVBFG should have submitted its first BHC resolution plan in July 2024.[77] SVB submitted its first IDI resolution plan in December of 2022, and while that plan was still under review at the time of SVB's failure, initial review by the FDIC indicated that the plan would not have met the FDIC's standards.[78] As for Signature (which did not have a BHC), its IDI resolution plan would have been due in June 2023.[79] SVBFG's and Signature's failures have generated questions about the utility of resolution planning[80] as well as calls for renewed emphasis on resolution planning.[81]

[68] NYDFS Report at 30.
[69] FRB Report at 88.
[70] FRB Report at 12.
[71] FRB Report at 83.
[72] See Michael Barr, Vice Chair for Supervision, FRB, Why Bank Capital Matters (Dec. 1, 2022).
[73] See id.
[74] 87 Fed. Reg. 64170 (Oct. 24, 2022). Please refer to our alert memorandum here.
[75] Please refer to our client memorandum here.
[76] See Press Release, FDIC, "FDIC Announces Lifting IDI Plan Moratorium" (Jan. 19, 2021).
[77] See 12 CFR § 243.4.
[78] See GAO Report at 36-37.
[79] GAO Report at 37.
[80] See, e.g., Vice Chair Hill Remarks ("I suspect there are better ways to explore issues that might arise in different resolution scenarios than through detailed, formal plans.").
[81] See, e.g., White House Fact Sheet (suggesting reinstatement of the EGRRCPA-related loosening of BHC resolution planning requirements for Category IV banks).

Regulators are likely to place greater emphasis on banks' contingency and emergency planning.

The more operational aspects of liquidity management and contingency planning are in the spotlight as a result of SVBFG's and Signature's failures. The FRB Report presents an extensive list of actions that SVBFG did not take to prepare for a liquidity crisis, including running operational tests of capacity to borrow (i.e., test transactions); establishing adequate access to repo funding; signing up for the Federal Reserve's Standing Repurchase Agreement Facility; and pledging enough collateral to the Federal Reserve's discount window.[82] The FRB notes that while these sources of liquidity may have not prevented the crisis, "the lack of preparedness may have contributed to how quickly [SVBFG] failed."[83]

Similarly, Signature had not arranged to be able to pledge collateral directly to FRBNY in order to access the discount window.[84] In addition, while Signature had been aware for months that certain loans it wished to pledge as collateral to the FRBNY did not qualify as acceptable collateral, Signature management nevertheless "continued to try to include these loans in collateral calculations just hours before the institution failed."[85] We expect supervisors to place immediate emphasis on emergency access to liquidity as well as more general operational planning for crises.[86]

The practices of boards of directors and senior management – as well as incentive compensation – are likely to draw additional regulatory, supervisory and enforcement attention.

The FRB, FDIC and NYDFS Reports are unequivocal in placing responsibility on the leadership of the failed banks. The conclusions of these Reports are likely to be used to justify further heightened regulatory and supervisory expectations for boards and management. As of 2021, the FRB had finalized its board effectiveness guidance for domestic BHCs with over $100 billion in total assets,[87] but the proposed companion guidance for senior management effectiveness has not yet been finalized.[88] Given the calls from President Biden and legislators for increased accountability for the leaders of failed banks, additional guidance or rules on incentive compensation also may be forthcoming, including the possibility of legislative action on clawbacks on compensation and penalties for management and boards of failed banks.[89] Incentive compensation rules required by the Dodd-Frank Act were never finalized by the six regulatory agencies tasked with implementing them, and the recent turmoil in the banking sector may provide renewed momentum.[90]

This is an important moment for banks to assess and, as needed, strengthen their leadership and governance. Some of the Reports characterized the leadership of SVBFG and Signature as passive or reactive rather than proactive, demonstrating the risks for boards and management that do not meet supervisory

[82] FRB Report at 60.
[83] FRB Report at 60.
[84] NYDFS Report at 33-34.
[85] FDIC Report at 12.
[86] See, e.g., NYDFS Report at 43 ("While examiners routinely require stress testing of certain key financial assumptions and controls, operational functions are not similarly tested. DFS will consider whether banks need to conduct table-top exercises demonstrating their operational readiness to collect and produce accurate financial data at a rapid pace and in a stress scenario.").
[87] See SR 21-3 / CA 21-1, Supervisory Guidance on Board of Directors' Effectiveness (Feb. 26, 2021).
[88] 83 Fed. Reg. 1341 (Jan. 11, 2018).
[89] Press Release, Senator Elizabeth Warren, "Warren, Hawley, Cortez Masto, Braun Introduce Bipartisan Bill to Claw Back Compensation From Failed Bank Executives" (Mar. 29, 2023); Press Release, Senator Jack Reed, "Reed-Grassley Bill Would Allow Failed Bank Executives' Pay to be Clawed Back, Bar Them from Financial Industry" (Apr. 19, 2023); Press Release, White House, "Statement from President Joe Biden on Holding Senior Bank Executives Accountable" (Mar. 17, 2023). See also NYDFS Report at 46.
[90] See FRB Report at 72-75.

expectations.[91] It is also a good time for banks to specifically assess incentive compensation arrangements to ensure these incentives appropriately consider risk management responsibilities and outcomes, not just financial performance. SVBFG's program was found to have major weaknesses on this front.[92]

There is likely to be close attention to a firm's rate of growth as an indicator of risk and to the length of "transition periods" for the application of regulatory and supervisory standards.

Both SVBFG and Signature grew rapidly in the period between 2019 and 2022 and significantly faster than their peers. A concern clearly expressed by the Reports is that a bank's growth may outpace a supervisor's ability to provide sufficient oversight or for bank management to maintain appropriate risk management practices.[93] In light of recent events, the FRB may work to shorten the time that BHCs are given to transition to higher levels of supervision and regulation. Under the tailoring framework, BHCs that move from one "category" to a higher category typically are given a transition period to comply with this more stringent level of regulation. For example, although SVBFG became a Category IV institution in June 2021, many enhanced prudential standards would not have applied to it immediately (SVBFG's first supervisory stress test would have taken place in 2024, for instance).[94] The FRB Report places strong and repeated emphasis on the transition time and delays associated with SVBFG's graduation from the RBO portfolio to the LFBO portfolio,[95] leaving little doubt that the transition of supervisory portfolios will be an important area of emphasis for the FRB in the future. Growth *rates*, in particular, are likely to draw increased focus, which is something that both Vice Chair Barr's letter and the White House have emphasized.[96]

Conclusion

There is currently substantial momentum around regulatory change related to the banking turmoil, but much of this will take time to effectuate. Vice Chair Barr's letter notes that notice and comment around new rules and transition to any heightened requirements could take several years. The pace of this regulatory change would be complicated if there is a change in presidential administration as of 2025, though an impending election also may create additional impetus for rules to be finalized expeditiously. In contrast, there are fewer barriers to changing supervisory and examination practices, and we expect a change in the tone of supervision reflecting the regulators' experiences with SVB and Signature to become apparent immediately.

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[91] See FRB Report at 3 (the SVBFG board of directors "often treated resolution of supervisory issues as a compliance exercise rather than a critical risk-management issue"); FDIC Report at 9 ("Management was described by FDIC supervisors as reactive, rather than proactive, in addressing bank risks and supervisory concerns… When [Signature] did take action to address examination findings, [Signature's] actions were more 'check-the-box' or done to assuage the examiners…").

[92] FRB Report at 74.

[93] FRB Report at 45 ("A consistent theme across each area is that SVBFG's practices did not keep pace with its rapid growth in size and risk. The board of directors' and risk management's experience and capabilities were lacking for a firm that grew to over $200 billion in assets.").

[94] FRB Report at 13. It is interesting to note that while the FRB Report places considerable emphasis around SVBFG's transition into Category IV, SVBFG actually was not that far off from Category III, the application for which begins at $250 billion in total assets (or several other risk-based indicators). Per the GAO Report, the GAO also intends to release a report addressing the effects of the Category IV designation on SVBFG, which may address these topics as well. See GAO Report at 19.

[95] See, e.g., FRB Report at 44.

[96] See White House Fact Sheet.