



Insights: Alert

# Regulators Offer Candid Assessment of the Root Causes for SVB and Signature Failures

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A toxic combination of poor risk management and poor regulatory supervision proved fatal for Silicon Valley Bank (“SVB”) and Signature Bank (“Signature”), according to a series of reports released on April 28, 2023 by federal and state regulators. The reports (by the Federal Reserve Board (“FRB”) for SVB and the Federal Deposit Insurance Corporation (“FDIC”) and New York Department of Financial Services for Signature) provide a unique window into the progressive deterioration of each bank, the confluence of events that resulted in failure and the deficiencies in regulatory oversight that contributed to their failure. The reports confirm that, while a “run on the bank” was the proximate cause of each bank’s failure, the root causes can be found in the significant deficiencies in bank management and bank supervision that preceded their demise. This alert will highlight the common themes in each report and provide a perspective on the way forward as the agencies (and legislators) contemplate changes to the regulatory environment.<sup>1</sup> (Note that the FRB was the primary regulator for SVB’s parent, SVB Financial Group. References to SVB in this alert refer to both entities.)

## **A Failure to Manage Risk**

For both SVB and Signature, the events leading up to failure were characterized by rapid growth without a corresponding increase in the rigor of each bank’s risk management function to address the increasing complexity of their business models. The deficiencies were compounded by a corporate governance structure that was inconsistent with the complexity, risk profile and scope of operations of each bank. At the management level, adverse findings often went unaddressed through multiple exam cycles and risk assumptions were merely adjusted in lieu of addressing risks. At the board level, directors failed to obtain adequate information from management about looming risks and failed to hold management accountable for effective risk management.

The FRB report captures the essence of the problems that led to the of SVB: “[SVB] was a highly vulnerable firm in ways that both its board of directors and senior management did not fully appreciate. These vulnerabilities – foundational and widespread managerial weakness, a highly concentrated business model, and a reliance on uninsured deposits -- left [SVB] acutely exposed to the combination of rising interest rates and slowing activity in the technology sector that materialized in 2022 and early 2023.” Similarly, the FDIC noted that “[Signature] management did not prioritize good corporate

governance practices, did not always heed...examiner concerns, and was not always responsive or timely in addressing...supervisory recommendations.” While conceding that Signature was adversely affected by fallout from the liquidation of Silvergate Bank and the unraveling of SVB, “poor governance and inadequate risk management practices put the bank in a position where it could not effectively manage its liquidity in a time of stress.”

The FRB and FDIC reports are replete with examples of the issues that surfaced at each bank, but, perhaps just as interesting, is the regulators' decision to lift the veil on the details of exam findings and CAMELS ratings that are rarely, if ever, made public. In the case of SVB, the FRB has taken the unprecedented step of releasing a wide range of examination reports and other supervisory communications for the period 2017-2022. The FDIC's Signature report also provides a specific narrative of critical exam findings, identifies CAMELS scores and catalogues outstanding regulatory concerns by topic and by required action.

While these materials generally support key elements of the regulators' after-the-fact assessment of the root causes of the SVB and Signature failures, it nevertheless remains difficult to align the conclusions in the two reports with the regulators' relatively sanguine assessment of each bank in the years preceding their demise. By way of example, the FDIC assigned a “2” rating to Signature management from 2017 through March 11, 2023, the day before Signature entered receivership. A “2” rating indicates “satisfactory management and board performance and risk management practices relative to the institution's size, complexity, and risk profile”. Yet, the report cites “poor management” as the root cause of failure. Similarly, FRB examiners maintained relatively high ratings for SVB in a number of areas despite mounting evidence of weaknesses, concluding, by the FRB's own admission, that the bank's strong financial performance and the absence of adverse risk events offset possible concerns about SVB's governance and risk management framework.

### **A Failure of Supervision**

In a remarkably candid self-assessment, the two reports catalogue a series of missteps in the supervisory process that contributed to the eventual failure of SVB and Signature. A theme common to the regulation of each bank was the failure on the part of examiners to appreciate the vulnerabilities of each bank as they grew in size and complexity. In addition, when the examiners identified vulnerabilities, they were often slow to seek remediation, choosing instead to be “deliberative and passive.” The regulatory ratings in place for each bank were maintained well past the point where the growth and complexity of each bank should have triggered a reassessment. Scarce regulatory resources were also a contributing factor to inadequacies in the supervision of each bank.

The regulation of SVB posed unique challenges for the FRB as the bank migrated from the FRB's examination protocols for a “regional banking organization” (“RBO”) to the more stringent examination standards for a “large and foreign banking organization” (“LFBO”). SVB transitioned to LFBO status in February 2021 when the firm crossed the \$100 billion asset threshold. However, the higher intensity of regulation required for an LFBO was slow to develop. According to the FRB report, the examiners did not anticipate SVB's growth, and the development of a new supervisory plan for SVB reflecting the more intense scrutiny applied to LFBOs and the staffing of a new examination team with experience in the

LFBO group did not occur until later in 2021. In the interim, the RBO examiners continued their close-out of pending exams and concluded their annual rating cycle. Once the LFBO examiners initiated their review of SVB, it quickly became apparent that the bank was ill-equipped to meet the enhanced prudential standards that apply to a larger and more complex institution.

However, in key areas, the level of scrutiny failed to intensify. The report notes that SVB's transition to LFBO status "did not materially increase the level of supervisory scrutiny of interest rate risk for some time." Perhaps most telling, the FRB admits that, as late as January and February 2023, the examiners had only limited concerns about SVB's liquidity position. In fact, although the regulators made significant supervisory findings regarding liquidity concerns in late 2021, SVB received a "2" CAMELS rating on liquidity in August 2022. The report now concedes that the severity of the 2021 findings would have supported a significant downgrade of the liquidity rating. Similarly, the examiners identified significant deficiencies in the risk management function but maintained a satisfactory rating until August 2022. The report notes that the bank's strong financial performance caused the examiners to downplay the potential threat to SVB's safety and soundness posed by these deficiencies, which included the lack of a qualified Chief Risk Officer until December 2022. The relative complacency of the examiners was amplified by the failure of SVB management to cultivate the strong risk management, internal audit and board oversight associated with the safe and sound operation of the bank.

Two other factors played into the relative weakness of the supervision of SVB and Signature. The onset of the COVID pandemic slowed the regular pace of regulatory supervision, resulting in the cancellation or delay of key examinations during a period of growth for each bank. In addition, both the FRB and the FDIC experienced a shortage of staff with the level of training and experience necessary to oversee a larger, more complex institution. The FDIC report on Signature cites significant vacancies in the large financial institution examiner ranks and notes that work quality suffered as examiners attempted to keep up with the demands of the exam cycle.

### **The Impact of Social Media**

An interesting side note in the SVB report is a reflection on the impact of social media on the events immediately preceding the receivership. The report acknowledges that the "combination of social media, a highly networked and concentrated depositor base and technology may have fundamentally changed the speed of bank runs." In the 2008 crisis, many banks slipped into a slow descent toward failure with only limited public recognition of performance issues and limited public knowledge of any regulatory concerns. However, recent events demonstrate that widely disseminated public perceptions of weakness may limit the ability of an institution to work through regulatory issues within a manageable timeline. In the future, regulators will likely pay close attention to social media commentary on the trajectory of a bank's fortunes and act with the knowledge that such commentary has the potential to rapidly compress the timeline for regulatory action.

### **The Role of Incentive Compensation**

The FRB report also provides commentary on the contribution of SVB's incentive compensation practices to the institution's failure. The report notes that the 2022 governance and risk management exam uncovered "major" weaknesses in SVB's incentive compensation program and in board oversight of the

program, including a failure to consider performance evaluations and a failure to hold management accountable for operational deficiencies. The exam also noted the bank's failure to consider risk management and risk control factors in the development of SVB's incentive program, which was tied solely to financial performance metrics like return on equity and total shareholder return. The report confirms public reports that, notwithstanding the bank's negative cash balance, SVB paid certain 2022 bonuses on March 10, 2023, the same day SVB failed.

### **Looking Ahead**

There is little doubt that recent events will have an impact on bank regulation for years to come. At a minimum, Congress and the regulatory agencies will be encouraged to close the gaps that were highlighted by the recent bank failures.

First on the list will certainly be a comprehensive review of the 2018 legislation that raised the asset size threshold for application of enhanced prudential standards from \$50 billion to \$250 billion. The legislation also provided the FRB with authority to apply the enhanced standards to banks between \$50-\$250 billion in total assets and, in 2019, the FRB adopted a "tailoring" approach to implementation of this authority. The tailoring rules generally reduced or delayed a higher level of regulatory oversight at banks like SVB in several important categories, including liquidity management, certain capital requirements and enhanced stress testing. By way of example, under the tailoring rules, SVB was subject to enhanced stress testing when it crossed the \$100 billion asset threshold, but SVB benefited from transition relief that would have delayed application of enhanced stress testing requirements until 2024, or more than two years after SVB crossed the \$100 billion asset threshold. It is likely that by means of new legislation, new regulations and new examination protocols, the agencies will adopt a more rigorous approach to the regulation of banks with \$50 billion or more in assets and that banks that venture into non-traditional banking activities will be subject to more intense scrutiny. In addition, the resources available to the regulators will increase to ensure that the agencies are adequately staffed with supervisory personnel that have the knowledge and training to examine larger and more complex institutions.

A second area of focus will be to address a perceived cultural shift that relaxed the intensity of supervisory activity. As noted in the FRB report, during the period after passage of the 2018 legislation, supervisory staff reported changes in expectations and practices that tended to place a higher burden of proof on the staff to justify a particular conclusion and to ensure a higher level of due process when recommending supervisory action. These changes resulted in "slower action by supervisory staff and a reluctance to escalate issues." It is likely that the pace and intensity of regulatory supervision will accelerate, that communication with regulators will be timelier, and that escalation of issues will occur more frequently.

The perennial debate over incentive compensation is also likely to be renewed as regulators consider whether the programs at the failed banks inappropriately incentivized excessive risk taking. The regulators have addressed incentive compensation practices in fits and starts in the years since the passage of the Section 956 of the Dodd-Frank legislation, which mandated the rollout of new rules to address perceived abuses. In 2010, the regulators issued the Interagency Guidance on Sound Incentive Compensation Practices, which created a framework for the design and implementation of compensation

arrangement that discourage imprudent risk-taking and that are consistent with the institution's safety and soundness. The regulators proposed more prescriptive regulations in 2016 that were never finalized, so the 2010 guidance remains the touchstone for agency review of incentive compensation arrangements. However, the regulators are almost certain to revisit the topic of incentive pay, and new rules are likely to emerge that mandate incentive pay deferrals and stricter clawback rules and that require the board and compensation committee to maintain a higher degree of vigilance over incentive pay practices.

Finally, a rethinking of the deposit insurance system is inevitable in light of recent events. The decision to protect uninsured deposits at SVB and Signature raises fundamental questions about the purpose and structure of a system that is essential to financial stability. The FDIC has publicly endorsed a “targeted” approach to deposit insurance that would provide higher cover limits for certain business accounts. But, ultimately, it will be left to Congress to consider deposit insurance reform.

If you have any questions regarding this alert, please reach out to your Kilpatrick Townsend contact.

**Links:**

[FRB Report on Silicon Valley Bank](#)

[SVB Supervisory Materials](#)

[FDIC Report on Signature Bank](#)

[NYDFS Report on Signature Bank](#)

[GAO Report](#)

**Footnotes**

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<sup>1</sup> The U.S. Government Accountability Office (“GAO”), an arm of Congress, also published a report on the March 2023 bank failures. The report generally tracks the broad conclusions of the regulatory agency reports by attributing the failures to poor risk management and poor supervision. A link to the GAO report appears below.

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