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WHAT WE'RE LEARNING FROM THE COLLAPSE OF SVB AND SIGNATURE

— THOUGHT LEADERSHIP

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With the sales of Silicon Valley Bank to First-Citizens Bank and Trust Co. and Signature Bank to Flagstar Bank, N.A., much of the panic that embroiled the U.S. banking sector over the past few weeks appears to have subsided. The extraordinary measures taken by private[1] and public[2] actors to shore up the liquidity positions of community and regional banks and stem the further flight of deposits seem to have achieved their desired effect, at least insofar as no U.S. banks have failed since Signature's collapse. The FDIC ultimately did not take the emergency step of temporarily guaranteeing deposits of all U.S. banks, and the Fed ostensibly had enough confidence that the banking system could weather another interest rate hike in late March.

As the dust begins to settle on this latest banking crisis, important questions loom – what precisely caused the failures of SVB and Signature? Was this a case of bank mismanagement, poor regulatory supervision, the byproduct of a once-in-a-generation aggressive rate tightening cycle, a consequence of Trump-era deregulation, or perhaps some combination of the above? More importantly, how do we prevent another crisis like this from unfolding in the future?

While there is much to unpack in terms of what contributed to the velocity and severity of the recent panic, *lawmakers and regulators should avoid an unthinking reaction such as simply restoring prudential requirements as they existed* prior to the passage of the 2019 "tailoring" rules, lest they create false assurances that the banking system is more resilient than it actually is.[3] Already, the White House has released a briefing urging regulators to reinstate requirements that were rolled back in the previous Administration.[4]

Clearly, the crisis shows that even "mid-sized" banks like SVB and Signature carry more systemic risk than policymakers had anticipated, as evidenced by the drastic measures taken to stem the contagion from their collapse. However, even the full panoply of liquidity, capital and stress testing rules applicable to global systemically important banks likely would not have prevented the failures of SVB and Signature, nor mitigated their systemic impact. In this article, we propose that any "re-tailoring" proposal should be properly calibrated to account for the particular rate and liquidity risks behind the failures of SVB and Signature, and more attention should be paid to the new systemic risks arising from technological advances in payment systems and the rapidly modernizing ecosystem of commercial banking.

Title IV of S.2155 and the 2019 Tailoring Rules

In 2018, U.S. lawmakers passed S.2155 (the Economic Growth, Regulatory Relief, and Consumer Protection Act), which among other changes increased the threshold – from $50 billion to $250 billion – at which banking organizations would be automatically subject to enhanced prudential standards.[5] The Fed, acting

1 Joint Statement by the Department of the Treasury, Federal Reserve, FDIC, and OCC (March 16, 2023), available at https://www.fdic.gov/news/press-releases/2023/pr23020.html (announcing $30 billion in deposits to support First Republic Bank).

2 For example, the launch of the Bank Term Funding Program and the "systemic risk" exceptions for SVB and Signature announced on March 12, 2023.

3 Bills have already been introduced to repeal Title IV of S. 2155 (The Economic Growth, Regulatory Relief, and Consumer Protection Act).

4 White House Release: President Biden Urges Regulators to Reverse Trump Administration Weakening of Common-Sense Safeguards and Supervision for Large Regional Banks (March 30, 2023).

5 Under S. 2155, the Fed retained discretion to apply enhanced prudential standards to banking firms with more than $100 billion in net assets. The bill also increased the threshold for stress-testing requirements

under the statutory mandate, adopted tailoring rules in 2019 significantly relaxing the requirements for Category III firms (between $250 billion and $700 billion in total assets, or greater than $75 billion in short-term wholesale funding) and Category IV firms (between $100 billion and $250 billion). Both SVB and Signature qualified as Category IV firms shortly before their collapse.

Among other tweaks, the 2019 tailoring rules –

- reduced the Liquidity Coverage Ratio (LCR) requirement from 100% to 85% for most Category III firms and eliminated the LCR requirement entirely for most Category IV firms;[6]
- allowed Category III firms and Category IV firms to opt out of including accumulated other comprehensive income (AOCI) in common equity tier 1 capital, which would have imposed capital charges for unrealized losses on available-for-sale securities and certain other exposures; and
- eliminated capital and liquidity stress testing requirements for Category IV firms.

Some Contrarian Prudential Math

If we suppose for the sake of argument that SVB and Signature were subject to the full LCR prior to their collapse, then 100% of the value of their U.S. treasuries and agency debt securities would have qualified as level 1 high-quality liquid assets (HQLA). Deposits of partially uninsured wholesale customers, in turn, would have been subject to a 40% outflow assumption under the LCR.[7] To maintain a 100% LCR,[8] a bank receiving $10MM in deposits from a single corporate client would be required to hold $4MM of HQLA against such outflows, which it could have held in the form of U.S. treasuries or agency debt securities *irrespective of their maturity.*

While there is some technical disagreement as to whether the LCRs of SVB and Signature would have satisfied regulatory minimums,[9] the salient point is that both banks held vast quantities of liquid and high-quality assets as intended by the LCR rule.

And therein lies the crux of the problem: by assuming a rough and rudimentary calculation of liquidity outflows over a 30-day stress horizon, the LCR can grossly underestimate the true extent of liquidity flight in a modern bank run. By all accounts, both SVB and Signature experienced a failure-inducing flight of depositors *within a matter of hours*, not over a 30-day period.[10] Both banks were sufficiently "liquid" in terms of their holdings of HQLA under the LCR rule, yet collapsed due to a crisis of confidence that set off a tsunami of redemptions, ultimately forcing their supervisors to shut them down.

There is an argument that, without the 2019 tailoring rules, perhaps SVB and Signature would not have grown as quickly as they did, as well as a claim that periodic liquidity reporting would have provided advance warning to supervisors that the banks' liquidity positions were swiftly deteriorating. Neither of these arguments are compelling, however, since both banks' rapid growth was primarily due to an influx of cheap funding (particularly non-interest bearing deposits) rather than an absence of regulatory constraints, and even daily LCR reporting could not have kept up with the speed of their collapse.

from $10 billion to $250 billion, and increased the threshold for mandatory risk committees from $10 billion to $50 billion.

6 Category III firms with greater than $75 billion in short-term wholesale funding (STWF) would have still been subject to a 100% LCR and daily reporting, while Category IV firms with greater than $50 billion in STWF would have been subject to a 70% LCR w/ monthly reporting.

7 The outflow assumption would be even lower (25%) for uninsured operational deposits.

8 We recognize that the average LCR is typically higher for most large banks, and supervisors and bank management would have been alerted as ratios progressed closer to 100%.

9 One study points out that SVB's reliance on Level 2a HQLA would have been capped at 40% of total HQLA and therefore failed the LCR, but also correctly identifies that SVB could have easily shifted its holdings in Level 2a HQLA to long-dated Level 1 HQLA. Greg Feldberg, *Lessons from Applying the Liquidity Coverage Ratio to Silicon Valley Bank*, Mar. 27, 2023, at https://som.yale.edu/story/2023/lessons-applying-liquidity-coverage-ratio-silicon-valley-bank.

10 According to Vice Chair Michael Barr's testimony to the Senate Banking Committee on March 29, 2023, SVB had approximately $100 billion in pending withdrawals as of Friday morning, March 10, 2023.

Similarly, it is true that without the ability to opt out of AOCI, SVB and Signature would have had to take earlier capital charges on losses in their securities portfolios, but it's also true that capital ratios are point-in-time measures of solvency reported on a quarterly basis and would not have reflected unrealized losses in the first quarter of 2023. Furthermore, stress testing occurs on an annual basis, and neither the 2022 nor 2023 "severely adverse" scenarios accounted for the rapidly-rising rate environment that triggered losses on SVB's and Signature's books and ultimately induced depositors to flee. Relying on the Fed to predict with perfect clairvoyance what causes the next series of bank failures and expecting heightened capital charges to avert such a crisis is, in our view, tantamount to barring a barn door with duct tape.

Re-Tailoring with a Twist

Given the widespread contagion that followed the failures of SVB and Signature, there is merit to the argument that these were not simply "mid-sized" banks without systemic importance that should have been scoped out of most of the enhanced prudential standards. However, any proposal to undo the 2019 tailoring rules should refrain from simply restoring the Dodd-Frank Act-era rules *status quo ante*, and should account for risks that came to light over the course of the past few weeks. Some options to be considered include re-calibrating the LCR to incorporate a haircut for longer-dated HQLAs (*i.e.*, factoring in duration risk) or raising the outflow assumptions on large uninsured deposits.

More importantly, any rulemaking proposal should be thoughtful about the incremental benefits to be obtained from undoing the tailoring rules relative to other options, lest they encourage complacency and create new blind spots in the oversight of systemic risk.

Thoughts Toward the Future

While much of the recent banking panic can be traced to known risks that have historical precedents – non-diversified funding channels, over-reliance on uninsured deposits, poor interest rate risk management – new risks have also emerged that warrant further attention. More than ever before, consumers and businesses can effect payments and withdrawals 24x7 through digital interfaces including websites, chatbots and smartphone apps. Payments settlement systems are also growing ever-faster[11], smarter and more convenient. By all accounts, such technological innovations were aggravating factors in the precipitous collapses of SVB and Signature, both of which received so many pending transfers in the overnight and weekend hours leading up to their collapse that supervisors determined they could not successfully re-open for business.

While the benefits of convenience are obvious and manifold, technological upgrades undoubtedly accelerate the speed with which bank failures occur and can drastically shorten the window within which regulators can restore confidence, organize orderly sales and minimize losses to the Deposit Insurance Fund (and ultimately taxpayers). Furthermore, the speed with which information moves today – including via social media –means that even a false rumor of insolvency can quickly snowball into a true catastrophe of bank failure.

Banking in the year 2023 is increasingly digital, and payments are increasingly frictionless. As the banking system and customer behaviors continue to evolve, lawmakers and regulators should consider the resulting systemic risks and modernize their toolkits and playbooks accordingly.

11 For example, same-day automated clearing house (ACH) transactions debuted in the United States in 2016 and have steadily increased in scale through phased releases. The Federal Reserve has also announced recently that instant payments through the FedNow Service will become operational in July of this year.

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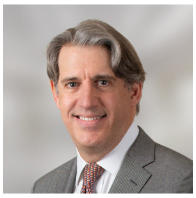

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