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What was the San Francisco Fed's role in SVB collapse?

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One of the biggest questions to come out of the Silicon Valley Bank debacle is: Where were the regulators?

That will be the focus of hearings on Capitol Hill this week into the failure of SVB — whose assets and deposits will be acquired by First-Citizens Bank & Trust, according to an announcement Sunday — and New York's Signature Bank.

SVB's regulators for safety and soundness were the Federal Reserve, primarily the San Francisco Fed, and the California Department of Financial Protection and Innovation, known as DFPI.

Although hindsight is 20-20, there were some big red flags waving at SVB. Some short sellers, who bet on stocks they think will fall, and other investors saw warning signs. One author who posts under the name CashFlow Hunter on SeekingAlpha.com pretty much nailed it in a Dec. 19 post titled "SVB Financial: Blow Up Risk."

The Fed reportedly stepped up its oversight of SVB and issued six warnings last year. But it failed to take decisive action before the state regulator seized the bank and turned it over to the Federal Deposit Insurance Corp. on March 10.

Hoping to prevent contagion, the government agreed to guarantee all deposits in SVB and Signature Bank, which failed on March 12, and provide a lifeline in the form of emergency loans to other banks.

Fed Chairman Jerome Powell seemed to acknowledge regulatory lapses in a press conference last week, when he said, "Clearly we do need to strengthen supervision and regulation."

Both the Fed and DFPI said they are reviewing their oversight of SVB and will issue reports in early May. Until then, both declined to discuss their supervision of the bank.

More details could come out when Senate and House committees hear from Fed, FDIC and U.S. Treasury executives on Tuesday and Wednesday, respectively. In the meantime, here are answers to some questions about why the Santa Clara bank collapsed and regulators' role.

What went wrong at SVB?

Although SVB mainly served venture-backed tech and biotech startups, it wasn’t done in by its own loan portfolio. Its problem stemmed from an old-fashioned maturity mismatch between assets (such as loans and securities) and liabilities (such as deposits).

From December 2019 to December 2021 – when tech was booming and companies were flush with cash from venture capital and initial public offerings – SVB’s deposits tripled, to $189.2 billion.

Because its customers didn’t need a lot of loans, the bank invested a big chunk of these deposits in long-term bonds backed by government-backed mortgages and Treasury bonds. Although these bonds had almost no default risk, they had gobs of interest-rate risk.

When interest rates rise, the market value of existing bonds falls. The longer the maturity, the bigger the drop. If you hold the bond until it matures, you’ll get the face value, but if you have to sell before maturity, you’ll generally lose money.

SVB purchased most of these bonds when interest rates were near historic lows because they yielded a bit more than short-term securities. When the Fed started ratcheting up interest rates in March 2022 to fight raging inflation, the bonds lost value.

Around the same time, the tech boom turned to a tech bust, and cash-burning companies started demanding their deposits back.

To meet withdrawals, the bank announced on March 8 that it had sold bonds at a $1.8 billion loss and planned to sell $2 billion in stock. The next day, its shares fell 60%, sparking a lightning-speed run on the bank. SVB was seized the following day.

What were the red flags?
A big one: About 96% of its deposits at the end of last year were uninsured – the highest of any bank with more than $50 billion in assets, according to S&P Global.

The average for all U.S. banks is a little below half, said Amit Seru, a finance professor at Stanford’s Graduate School of Business,

Another was its bulging bond portfolio. In 2021, the bank had taken steps to “hedge” or reduce its interest rate risk, but by the end of 2022, it had virtually no hedging in place, according to the Wall Street Journal.

Also, the bank was also without a chief risk officer for eight months last year.

Why did SVB have so many uninsured deposits?
It generally required its loan customers to keep all of their banking deposits at SVB, said Joe Horowitz, managing general partner at Icon Ventures. This was a common practice at all the banks his firm works with, he said, because the banks were making unsecured loans. It also gave them a competitive advantage because "unwinding that is difficult."

Even if it wasn’t a requirement, most startups keep all of their cash at a single bank because it’s convenient. “SVB had been at it for 40 years and had built up trust with the venture capital community to work with companies if the loans were not performing or the company was having challenges,” Horowitz said.

Who regulated SVB?

It’s complicated. Banks can choose to be chartered by the state or federal government. The Office of the Comptroller of the Currency regulates nationally chartered banks. State-chartered banks “have both federal and state oversight,” the DFPI said via email.

In California, state-chartered banks that are members of the Federal Reserve System have the Fed as their primary federal regulator. SVB was in this category.

The FDIC is the primary federal regulator for California-chartered banks that are not Fed members. San Francisco’s First Republic Bank, which is also under pressure, is in this camp.

California requires almost all banks to be examined at least once a year. “We fulfill this obligation with the help of our federal regulatory partners through joint examinations,” the DFPI wrote.

Neither the DFPI nor the Fed would say who did what at SVB, but “it is my understanding” that for the largest Fed-member banks, such as SVB, the Fed was required to do an on-site exam every 12 months, although “it may be joint” with the state agency, said Keith Bishop, a partner with law firm Allen Matkins and a former California Commissioner of Corporations.

In addition, all banks in California have FDIC insurance and therefore must comply with certain FDIC rules. SVB’s consumer activities were regulated by the Consumer Financial Protection Bureau. And its publicly traded parent company was regulated by the Securities and Exchange Commission and the Fed.

Which regulator was responsible for preventing the bank’s failure?
“Given the divided authority, everybody could point their finger at everybody else,” Bishop said. “I guess you could say the Federal Reserve was the big dog, the primary federal regulator, but the DFPI as the chartering agency has responsibility too for safety and soundness.”

Did the Fed take any steps to prevent a failure?
Yes, according to news reports citing unnamed sources, but not enough.

As early as 2019, the Fed alerted management to problems with the bank’s risk controls, the Wall Street Journal reported..

In early 2022, the San Francisco Fed appointed a more senior team of examiners to SVB, Bloomberg said.

Last year, examiners issued about six citations known as “matters requiring attention” and “matters requiring immediate attention.” These are “supervisory memos urging but not compelling action,” the Journal reported.

Powell seemed to confirm the six citations.

According to the New York Times, by July 2022, the bank “was in a full supervisory review,” and was “ultimately rated deficient for governance and controls. It was placed under restrictions that prevented it from growing through acquisitions.” By early this year it was in a horizontal review that identified additional weaknesses. But “at that point, the bank’s days were numbered.”

Why didn’t the Fed pay more attention to how its interest-rate increases would affect bank solvency?

“Their mindset was inflation, inflation, inflation,” Seru said. Bad loans caused the 2008 financial crisis, and SVB hadn’t made many loans in recent years.

Bishop agreed. “They say you’re always fighting the last war. The last war was risky loans. This war is about interest-rate risk. I think the lesson here is: Address that risk, but don’t be just locked into fighting this one risk.”

Was SVB an isolated case?
The bank is often called unique, because of its concentrated client base, large unrealized bond losses and enormous level of uninsured deposits. But while it was extreme, it is hardly the only bank at risk of a run. Other banks took in large deposits in 2020-21 and invested them in long-term bonds that seemed safe, at least from default.

An academic study published shortly after the bank failed looked at more than 4,800 U.S. banks to gauge their exposure to interest-rate and deposit-flight risk, the factors that led to SVB’s collapse.

They found that the average bank’s bonds and other long-term assets have lost around 10% percent of their value over the past year and are worth about 9% less than the value shown on their books. (Banks are not required to update the market value of their bonds if they plan to hold them to maturity.)

About 10% of banks had worse levels of unrealized losses than SVB. But in terms of uninsured deposits as a percent of assets, SVB was in the top 1%.

The researchers estimated banks’ ability to withstand a run under various withdrawal scenarios. In one, it assumed that half of all uninsured deposits flee. “The bank under this case is considered insolvent if the (market) value of assets – after paying all uninsured depositors – is insufficient to repay all insured deposits,” the authors wrote. In this case, 186 banks holding about $300 billion in insured deposits would be considered insolvent. Most are small and mid-size banks but several are large, with more than $250 billion in assets.

“There is no doubt a ton of stress in the banking system,” said Stanford’s Seru, one of the co-authors. “But because of what the Fed has done, we are not going to see failures, at least that come out, in the immediate future. The Fed has to figure out how to take many weak banks in the system and either shut them down or have them consolidate into something that is viable.”

On Thursday, Treasury Secretary Janet Yellen said in prepared remarks for a House subcommittee that "we have used important tools to act quickly to prevent contagion. And they are tools we could use again."

Before SVB failed, its deposed chief executive Gary Becker was on the San Francisco Fed’s board of directors. Did he have any role in the bank’s supervision?
No. San Francisco is one of 12 Federal Reserve Banks. Each bank has an independent nine-member board of directors from the private sector. Three directors come from member banks, the others represent other industries, labor and community groups.

They “help shed light on economic and credit conditions in their districts,” review the regional bank’s goals and top executives and “maintain an effective system of internal auditing procedures and controls,” according to the St. Louis Fed. But they “have no involvement in matters related to banking supervision, including specific supervisory decisions."

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