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Before the U.S. House Oversight & Accountability Committee's Subcommittee on Health Care and Financial Services

At the Hearing *A Failure of Supervision: Bank Failures and The San Francisco Federal Reserve*

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Chairwoman McClain, Ranking Member Porter and members of the Subcommittee, my name is Jeremy Newell. I am a senior fellow at the Bank Policy Institute and founder and owner of Newell Law Office PLLC, but I am here today in my individual capacity.[1] The views I share today are informed by a career spent as a bank regulatory attorney, which has included a first-hand view of bank supervision through roles at banks, in private practice and at the Federal Reserve.

1. Introduction

I am very pleased to testify today, as this hearing presents an opportunity to examine an activity that is incredibly important and consequential, but almost always occurs in secret: bank supervision. Because banks play such a crucial role in supporting businesses and consumers and enjoy the privilege of federal deposit insurance, they are subject to an arrangement unique within our federal administrative state – not only to statutes, rules and law enforcement, but also to a standing workforce of federal employees whose principal job is to proactively examine whether they operate in a manner that is safe, sound and compliant with the law.

Bank examiners' jobs are important ones. While ultimately it is up to bankers alone to properly manage their own banks, and it is not the job of supervisors to prevent every bank from failing, good supervision enables the federal banking agencies to identify and seek correction of unsafe and unsound practices before they lead to a bank's failure, thereby limiting the number of such failures and their consequences.

Reflecting those goals, the best bank supervision is supervision that is grounded in clear rules, disciplined in its focus on material risks that might lead to a bank's failure and informed by subject matter expertise and an independent view of those risks amongst examiners. To be clear, it is not an easy job. Individual examiners must contend with dynamic markets and evolving practices, thousands of pages of examination procedures to follow and a range of competing internal priorities and objectives. When supervision is effective, it generally succeeds quietly. When it is not, its failures are public – often spectacularly so.

Today we examine such a case. While responsibility for Silicon Valley Bank's failure rests first and foremost with its management, understanding where the Federal Reserve's supervision of SVB may have gone wrong is a rare and important chance to examine its supervisory practices in full public view and to identify potential future improvements. We are aided in this regard by the rapid, preliminary reports issued by both the Government Accountability Office and the Federal Reserve concerning how SVB was supervised, and by the Federal Reserve's release of some – though certainly not all – of the relevant supervisory materials. These are helpful first steps. But much more is needed if one wishes to get to the bottom of whether SVB was supervised appropriately and to understand all that might be done to make future supervision more effective. Simply put, we don't have a full picture; what the Federal Reserve has provided to date is both selective and incomplete, omitting many relevant

[1] Thus, the views I express are my own, and not necessarily those of the Bank Policy Institute, any client or any other organization with which I have been affiliated.

details and materials and glossing over key information about how, why and by whom various supervisory decisions were made.

Further analysis is especially important because what facts and information the Federal Reserve *has* made public to date suggest several serious problems in supervision that the Federal Reserve's report does not meaningfully acknowledge. The Federal Reserve's own review concludes that its examiners did not fully appreciate SVB's weaknesses and did not take sufficient steps to demand that those weaknesses be fixed, but casts blame on decisions made by former Federal Reserve leaders that it alleges "reduc[ed] standards, increas[ed] complexity, and promot[ed] a less assertive supervisory approach."[2] As I'll discuss today, the underlying facts and evidence strongly suggest that is the wrong diagnosis. Rather, the details and information that the Federal Reserve has provided so far paint a rather different picture – one in which supervisors were principally focused on the wrong issues, occupied with processes rather than material risks and were plenty assertive – just not about the risks that were SVB's undoing. In this regard, four key takeaways stand out.

First, supervision of SVB was heavily focused on compliance processes, governance and immaterial risks. and not material risks to the financial integrity of the bank – that is, core safety and soundness.

Second, examiners largely relied on a system of issuing examiner directives – so-called "matters requiring attention" or "MRAs" – that was neither prioritized nor appropriately directed at the financial risks that ultimately led to SVB's failure.

Third, supervisors failed to enforce important enhanced prudential standards in the areas of liquidity and risk management that were applicable, even though they were well aware that SVB was not in compliance with them.

And *fourth*, supervisors oriented much of their activity around supervisory rating frameworks that were by design highly subjective and grounded in examiner judgment, with the result that SVB's exam ratings over time often bore no relationship to its actual risk profile.

Taken together, the picture that we do have today strongly suggests that the Federal Reserve's supervision of SVB may have been emblematic of a larger culture of bank supervision that has increasingly lost its way, becoming distracted from its core mission of scrutinizing bank safety and soundness and resembling something more akin to examination-as-management consulting. It also suggests that the reforms that are needed don't simply involve "tougher" supervision or more rules, but instead a broader structural reform of supervisors' approach that is aimed at ensuring that examiners are better directing their attention and already-considerable supervisory tools to the kinds of core risks to bank financial integrity that led to SVB's failure.

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[2] *See* Board of Governors of the Federal Reserve System, *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank* (April 2023) [hereinafter the "Report"] at iii; Vice Chair for Supervision Michael Barr's Cover Letter to the Report at 1.

2. The Purpose and Mechanics of Bank Supervision

Before turning to any assessment of how the Federal Reserve Board and Federal Reserve Bank of San Francisco supervised SVB, it is useful to first (i) reflect on the underlying purpose of the prudential supervision of banks, (ii) briefly review the key mechanisms by which supervision is conducted and (iii) identify several key factors that may inform how we approach judging the effectiveness of Federal Reserve supervision more generally.[3]

A. The Underlying Aims of Bank Supervision

Importantly, bank supervision is unique among our federal government's various approaches to regulating the private conduct of businesses and individuals. Whereas most industries are subject to U.S. laws and regulations that govern their conduct and are enforced by designated government agencies, banks are also subject to a third pillar of government control in the form of periodic or continuous examination by dedicated personnel of the federal banking agencies. While there is a robust scholarly debate as to the precise origins and theoretical functions of bank supervision in the United States,[4] in practical terms the general purpose of our system of bank supervision as it actually operates is intuitive and clear: to permit the federal banking agencies to identify and demand correction of cases in which a bank has failed to comply with applicable laws and regulations or engaged in an unsafe or unsound practice on a *contemporaneous* rather than *post hoc* basis.

Particularly important here is the supervisors' obligation to identify and demand correction of any unsound or unsafe practices – which means, according to the leading judicial precedent, "practices that threaten the financial integrity" of a bank.[5] This overarching focus on the financial integrity of banks reflects, among other things, the interest of the FDIC as insurer of U.S. bank deposits and the resulting potential for moral hazard. The Federal Reserve's own articulation of the goals of its supervisory framework for large financial institutions is consistent with this focus on the underlying safety and soundness of supervisory institutions. Specifically, it identifies two primary objectives of its supervisory framework: (i) "[e]nhancing resiliency of a firm to lower the probability of its failure or inability to serve as a financial intermediary; and (ii) [r]educing the impact on the financial system and the broader economy in the event of a firm's failure or material weakness."[6]

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[3] As an important point of clarity, I emphasize that I am speaking here about the *prudential* supervision of banks performed by the federal banking agencies, and not supervision of federal consumer financial protection matters, which serves distinct and separate purposes and, in the case of banks with more than $10 billion in assets, is vested by law exclusively with the Consumer Financial Protection Bureau, not the federal banking agencies.

[4] See, e.g., Peter Conti-Brown & Sean Vanatta, *Risk, Discretion, and Bank Supervision* (March 30, 2023), *available at* https://ssrn.com/abstract=4405074 or http://dx.doi.org/10.2139/ssrn.4405074.

[5] 651 F.2d 259 at 267 (5th Cir. 1981). The prohibition on unsafe and unsound practices, which was added to our bank regulatory framework in 1966, is arguably the single most important provision in U.S. banking law.

[6] Federal Reserve Supervision & Regulation Letter 12-17 / CA 12-14, *Consolidated Supervision Framework for Large Financial Institutions* (2012).

B. The Supervisory Toolkit

Keeping that underlying purpose in mind, the mechanisms by which bank supervision is actually conducted are wide-ranging, and the banking agencies' existing supervisory tools vary substantially in terms of level of formality, level of intrusiveness and level of coercion. The federal banking agencies' toolkit for supervision includes four basic categories of supervisory activity.

i. *Examination of banks*

Examination of banks may occur through periodic formal exercises that assess a firm holistically (e.g., routine bank exams conducted once every twelve or eighteen months), through bank-specific "targeted" exams that assess specific subjects (e.g., a targeted liquidity exam), "horizontal" exams that assess the same area across a number of banks in a uniform manner and/or "continuous monitoring" involving ordinary course engagement with bank management on supervisory topics. As a matter of policy, bank supervisors conduct more (and more frequent) of these various examination activities at larger and more complex banks. The results of these examination activities may be communicated to firms in the form of a formal report of examination, a "supervisory letter" communicating specific issues or concerns on an ad hoc basis, or informal communications (e.g., emails or conversations with bank management about specific issues or concerns).

ii. *Issuance of supervisory criticism*

Where examiners identify an issue or concern that they believe should be corrected, there is again a spectrum of ways they might choose to communicate that concern to a bank. At the least formal end of the spectrum, this might include simply flagging the issue for consideration in conversation or other communications with bank management or noting the issue in the discussion portion of an exam report or supervisory letter. A more formal step would be the issuance of a "matter requiring attention", "matter requiring immediate attention", or similar directive that briefly describes the issue or concern and requires that management remediate the issue by a certain date, with the understanding that failure to do so could result in more serious repercussions.[7] And a more formal step still would be to issue a violation of law finding,

[7] There is no uniform MRA/MRIA framework used by all three federal banking agencies; rather, each employs different standards, nomenclatures, and practices. For example, the Federal Reserve defines MRAs as "matters that are important and that the Federal Reserve is expecting a banking organization to address over a reasonable period of time, but when the timing need not be 'immediate.' While issues giving rise to MRAs must be addressed to ensure the banking organization operates in a safe-and-sound and compliant manner, the threat to safety and soundness is less immediate than with issues giving rise to MRIAs." Federal Reserve Supervision & Regulation Letter 13-13, *Supervisory Considerations for the Communication of Supervisory Findings* (2013). In contrast, the OCC's Supervision Process provides that "[t]he OCC uses MRAs to communicate concerns about a bank's deficient practices" and "expects the bank's board to oversee timely and effective correction of the practices described in an MRA." Comptroller's Handbook Examination Process Bank Supervision Process Version 1.0, June 2018 Version 1.1, September 2019, at 46. The absence of a uniform standard across the banking agencies may reflect that the fact that, in contrast to examination, enforcement activity and supervisory ratings, the MRA/MRIA framework has no explicit basis in statute, but instead has been constructed by the agencies as a matter of internal procedure.

typically coupled with MRAs or MRIAs, that might also serve as a predicate to future enforcement activity.

iii. *Supervisory ratings*

Informed by their other supervisory activities, each of the banking agencies also issue periodic supervisory ratings for the banking organizations they supervise. At the insured bank level, these ratings are issued under the "CAMELS" framework that was first devised in 1979 at the direction of Congress[8] and, other than the addition of the "sensitivity to market risk" component in 1996, has not been revisited or revised since.[9] This framework involves the assignment of individual "component" ratings for each of capital, asset quality, management, earnings, liquidity and sensitivity to market risk, as well as a composite rating. At the holding company level, these ratings are issued by the Federal Reserve under several different frameworks that assess certain risk management and financial condition factors that are common to holding companies, including a large financial institution rating system that generally applies to bank holding companies with more than $100 billion in consolidated assets and was established in late 2018.[10] These ratings generally reflect the results of examination activities, and are one of the most consequential products of bank supervision, as the failure to maintain certain ratings at either the insured bank or bank holding company level can trigger very serious consequences for banks, including limits on their ability to engage in new or additional activities, open new branches, or expand through mergers and acquisitions.

iv. *Initiation of enforcement or similar action*

Where examiners have identified a significant issue or concern that rises to the level of a violation of law or constitutes an unsafe or unsound practice, they may choose to initiate an enforcement or similar action. These may take a variety of forms, including:

- A *memorandum of understanding*, which is a non-public enforcement action under which the bank agrees in writing to take certain required steps;
- A *cease-and-desist order*, a public form of enforcement action under which the bank is required to take certain steps;[11]
- A *civil money penalty* order, which orders the bank to pay a fine;[12]

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[8] *See* Public Law 95-630 (1978) (codified at 12 U.S.C. §§ 3301, 3305(a)).

[9] See 61 Fed. Reg. 67021 (Dec. 19, 1996) (hereinafter the "1996 Statement").

[10] *See* 83 Fed. Reg. 58724 (final rule) (Nov. 21, 2018). The other framework is the RFI/C(D) rating system (commonly referred to as the RFI rating system), which generally applies to bank holding companies that don't meet the LFI threshold. *See* Federal Reserve Supervision & Regulation Letter 19-4 / CA 19-3, *Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than $100 Billion* (Feb. 26, 2019).

[11] C&Ds are final orders issued pursuant to 12 U.S.C. § 1818(b) that may, among other things, require a bank or institution-affiliated party ("IAP") to cease and desist from an unsafe or unsound practice or violation of law and to take affirmative action to correct or remedy any conditions resulting from any violation or practice, including a requirement to make restitution (or provide reimbursement, indemnification, or guarantee against loss).

[12] CMP orders are typically issued under 12 U.S.C. § 1818(i) and require a bank or IAP to pay a monetary penalty.

- A *capital directive*, which requires the bank to take certain specific steps to improve its capital position;[13]
- A *prompt corrective action directive*, which imposes restrictions and actions on a bank that has breached certain mandatory capital levels required under the FDI Act;[14] and
- A *safety and soundness order*, which requires the bank to correct specific deficiencies and imposes restrictions until the deficiency has been corrected.[15]

Although the decision to pursue an enforcement or similar action to address a supervisory issue or concern is typically considered part of the supervisory process, that decision also generally marks the point at which the banking agency's activity shifts from a supervisory activity to an enforcement activity.

v. *Key facets of the supervisory toolkit*

For today's purposes, I would offer three relevant observations from the brief survey of the bank supervisory toolkit I have just outlined. First, I would note that none of this toolkit is particularly new or recent. Its current form dates to 1991, when substantial changes were made as part of the Federal Deposit Insurance Corporation Improvement Act,[16] and has generally been left untouched by banking legislation enacted since, including the 2010 Dodd-Frank Act and subsequent amendments thereto. Second, I would emphasize the fact that this toolkit is incredibly robust, extensive and dynamic. Regulators certainly do not lack a wide range of options, of varying degrees of formality and rigor, when it comes to how they supervise individual banks. This is particularly true where said bank is operating in an unsafe or unsound manner; here, the agencies' array of powers is more akin to an armory than a toolkit. And third, as a consequence of the wide-ranging nature of the tools available to the banking agencies, examiners must exercise a substantial amount of judgment and discretion in determining which tool to reach for under any given set of circumstances, and when to "escalate" their efforts to a more powerful tool when problems linger. When it works best, this examiner judgment and discretion permits supervisors and banks to engage in constructive, back-and-forth discussions to properly assess risk and identify opportunities for improvement and remediation, which is a more effective overall approach than an overly prescriptive or rigid set of examiner mandates.

C. Trends in Supervisory Focus – Processes v. Risks

As I've outlined above, the banking agencies possess extensive supervisory powers, with a clear mission to focus those powers on identifying and demanding correction of unsafe or

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[13] Capital directives are generally issued under 12 U.S.C. § 3907 and require a bank to achieve a minimum capital requirement by a specified date, submit and adhere to an acceptable capital plan, and/or take other actions to achieve the required capital ratios

[14] PCADs are issued under Section 38 of the Federal Deposit Insurance Act, 12 U.S.C. 1831*o*, which establishes a framework of supervisory actions for insured banks that are not adequately capitalized, including restrictions and prohibitions that become more severe as an institution's capital declines.

[15] Safety and soundness orders are generally issued pursuant to 12 U.S.C. § 1831p-1 in cases where a bank has failed to submit or implement an acceptable safety and soundness plan required by the relevant banking agency.

[16] Public Law 102-402 (1991).

unsound banking practices that threaten the financial integrity of supervised firms. Considering that background, it is somewhat surprising that modern bank supervision has forcefully embraced an approach that is overwhelmingly focused on examining *processes* – that is, risk management processes, governance structures, compliance programs and policies and procedures – and not the *actual underlying financial condition and risks* those processes ostensibly support. A brief review of any of the banking agencies' examination and supervision manuals make clear that this is by design; while it is difficult to document these trends across manuals that run in the thousands of pages, it suffices for present purposes to note that these manuals articulate examination objectives and procedures that are almost wholly focused on process and not actual risks.[17] An illustrative example of this intentional elevation of process over actual risk is provided by one of the banking agencies' recent updates to its examination manual, performed earlier this month and presumably in response to recent events, which added the following language:

> "[Targeted reviews] of first-line Risk Areas are essential for assessing risk exposures; however, an equal, if not more important goal is to assess risk management functions (i.e., second-line of defense) and internal audit (i.e., third-line of defense). The effectiveness of an institution's control structure through its second- and third-lines of defense is fundamental to its risk management and a priority for FDIC to monitor and assess; therefore, when developing the Supervisory Plan (Plan), examiners should consider how to design the strategy to assess the risk management practices, products, lines of business (LOBs), and systems as well as the effectiveness of the entirety of the risk management program."[18]

For the Federal Reserve in particular, this reflects a problem in supervision that has been acknowledged for at least a decade. For example, when the Federal Reserve Bank of New York prepared a report in 2009 seeking to draw on bank supervisory lessons learned from the Global Financial Crisis, they concluded that that the Federal Reserve should refocus bank supervision "away from studying banks' systems and toward developing standardized approaches to assessing risk itself" and "[r]e-think risk-focused supervision to increase the emphasis on independent identification and examination of actual risks at banks compared to risk-control reviews."[19] As I discuss below, understanding this historical concern about the procedural focus of bank supervision helps to clarify what may have gone wrong in supervision of SVB.

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[17] Recognizing that blunt metrics have their limits, it does seem notable that the Federal Reserve's own supervision manual for bank holding companies uses each of the terms "process(es)," "policy(ies)," and "procedure(s)" roughly 1,600 times.

[18] FDIC Risk Management Manual of Examination Policies, Supervisory Planning – Continuous Examinations, Section 21.2 at 21.2-2 (updated May 2023).

[19] *See* David Beim and Christopher McCurdy, *Report on Systemic Risk and Bank Supervision* at 3 (August 2009), *available at* https://elischolar.library.yale.edu/cgi/viewcontent.cgi?article=5893&context=ypfs-documents.

D. The Challenges of Supervisory Secrecy

One of the great challenges posed to anyone attempting to gauge the effectiveness of bank supervision is that it is, largely speaking, entirely secret. This secrecy is principally a function of the legal prohibition that the banking agencies have imposed on public disclosure – by anyone other than the agency itself – of "confidential supervisory information", a term that the agencies have broadly construed to include almost all aspects of the supervisory process, including not only exam reports and supervisory letters but also any communications to or from agency staff. The stakes of this CSI regime are high, as the agencies have repeatedly made clear that they treat violations of their own CSI regulations as criminal conduct under 18 USC §641, which prohibits theft of government property. As I routinely tell junior lawyers who are new to banking, the first rule of bank supervision is that you can't talk about bank supervision.

To be clear, there are strong public policy reasons for our regime that protects confidential supervisory information, the most important of which is the need to safeguard the extraordinarily sensitive and confidential information that banks are routinely compelled to hand over to their examiners. But supervisory secrecy also has costs; in particular, it substantially frustrates the kinds of agency transparency and accountability that we otherwise take for granted almost everywhere else in federal government. Unlike agency rulemaking, enforcement and adjudication activities, which generally take place fully in public view, supervision occurs behind closed doors, such that outsiders cannot assess whether supervisors are acting appropriately, and banks cannot complain when supervisors are acting inappropriately. The result is an asymmetry unlike other fields of federal regulation, where we generally only hear one side of the story – the banking agencies'– and must take their word for it.

That external oversight of bank supervision is typically so difficult is what makes the Federal Reserve's release of certain supervisory information about SVB a rare opportunity for oversight. The fact that SVB has already failed makes many of the typical policy problems associated with disclosing CSI inapplicable, and thus presents a rare chance for us all to take a comprehensive and unflinching look at how bank supervision actually happens in practice, and to have a public debate about how bank supervision might be made more effective and better focused on its core purposes. And, as I discuss further below, it also helps to highlight ways in which the challenges of supervisory secrecy call for compensating controls in the form of better oversight and accountability mechanisms, both inside the agencies and outside them, that facilitate the identification and remediation of problems when bank supervision loses its way. In the absence of traditional sunshine, other disinfectants seem badly needed.

E. The Federal Reserve System's Unique Organization of Supervisory Activities

Any assessment of the federal supervision of SVB must also take into account the unique and rather idiosyncratic organization of bank supervision that prevails within the Federal Reserve System. Unlike its sister bank regulatory agencies, which conduct their supervisory activities directly, the Federal Reserve Board of Governors has delegated day-to-day supervision of state member banks and bank holding companies to the individual Federal Reserve Banks, subject to various types of continued Federal Reserve Board involvement, which includes (i) Board

oversight of the Federal Reserve Bank's supervisory activities, (ii) an informal advisory role for Board staff in material supervisory determinations (particularly with respect to larger banks), (iii) a formal, programmatic role for Board staff in defining and implementing supervisory priorities and exercises through Board-controlled supervisory groups (e.g., the Large Institution Supervision Coordinating Committee, more commonly known as the "LISCC") and (iv) a formal Board role in certain key decisions (e.g., whether to approve certain applications and/or initiate enforcement action).

This unusual division of supervisory labor within the Federal Reserve System has long and complex historical roots, and I take no position on the wisdom of this or any other division of labor. But whatever its potential benefits, this arrangement also poses special challenges, particularly when it comes to ensuring that there is clear ownership, accountability and independent oversight of supervisory decisions. Thus, in the context of assessing supervisory effectiveness at the Federal Reserve in particular, investigating whether and to what extent these challenges may have undermined the effectiveness of supervision at SVB should be an important part of the exercise.

F. Towards a Simple Heuristic for Judging Bank Supervision

Drawing on the brief summary of bank supervision I have attempted to provide here, I would suggest several keys questions that should serve as a useful "rule of thumb" for assessing whether supervision – at SVB or elsewhere – was effective in retrospect.

First, were the supervisors *examining the right things*? That is, were their examination activities principally focused on the material risks that could threaten the financial integrity of the bank, consistent with the core legal prohibition on unsafe or unsound banking practices and the federal government's financial interest as deposit insurer?

Second, were the supervisors *identifying and demanding correction of the right problems*? Here again, were examiners focused on identifying and requiring remediation of material risks and unsafe and unsound practices, or was their attention – and thus management's attention – instead diverted to processes, policies and procedures and immaterial risks?

Third, in cases where they did examine the right thing and did identify the right problems, did they *choose the right supervisory tool*? In other words, were supervisors resorting to more forceful supervisory tools for those issues that were most critical to the financial integrity of the bank, or was there instead a basic incongruence between the severity of supervisory intervention used and the underlying threat to the bank's financial integrity posed?

As I discuss further below, the Federal Reserve's supervision of SVB does not fare well under each of these three questions.

G. Recognizing the Difficulty of Being an Examiner

Before moving on describe my own assessment of the Federal Reserve's supervision of SVB, one important word of caution is in order: we should always be both cautious and humble when judging the work of supervisors, particularly after something has gone wrong. Bank

examination is a hard task, requiring substantial expertise and the exercise of significant judgment in a complex, dynamic landscape. Those who perform it are almost universally smart, hard-working and well-meaning public servants. Their failures are highly public, while their successes are not. And the benefits of hindsight can often obscure the very real constraints that come with making difficult decisions in an uncertain environment and subject to competing internal priorities and incentives. While this recognition should not stop us from the kind of searching and unflinching scrutiny that is needed to ensure that bank supervision is as effective as it ought to be, it also helps us to remember that any criticism of bank "supervisors" is in reality a criticism of the system of supervision being used and how examiners have been directed, managed and resourced, and generally not a criticism of the underlying individuals involved.

3. Assessing the Federal Reserve System's Supervision of Silicon Valley Bank

With the above general background on prudential bank supervision in mind, I will now properly turn to the topic of today's hearing, which is to begin to assess the effectiveness of the Federal Reserve's supervision of SVB in light of the bank's recent failure. Unfortunately, as an outside observer, I can offer only tentative conclusions, as the internal report issued by the Federal Reserve on this topic and supervisory materials released in conjunction with that report provide only a selective and incomplete picture of what occurred, and omit a range of important materials, details and issues. However, on the basis of those facts and supervisory materials the Federal Reserve *has* provided, it seems clear that SVB's supervisors were often not examining the right things, not identifying and demanding correction of the right issues and not choosing the right supervisory tools for the right things. In particular, four clear problems emerge from the Federal Reserve report and accompanying supervisory materials:

- A misguided supervisory culture heavily focused on compliance processes, governance and immaterial risks, and not on the material risks to the financial integrity of SVB that were its undoing;
- Reliance on a system of issuing MRAs and other examiner directives that was neither prioritized nor appropriately directed at the financial risks that led to SVB's failure;
- A failure to enforce important enhanced prudential standards in the area of liquidity risk and risk management that were applicable, even though supervisors were aware of SVB's noncompliance with them; and
- Use of supervisory rating frameworks that were by design highly subjective and grounded in examiner judgment, with the result that SVB's exam ratings over time often bore no relationship to its actual risk profile.

This picture, suggested by the facts as we know them now, stands in rather stark contrast with the conclusions drawn in the Federal Reserve's April 2023 report, which asserts that to the extent that supervisory mistakes were made, these were primarily a function of insufficiently stringent supervision and regulation under prior leadership.

A. First Things First: SVB's Failure was Principally a Failure of Management

Although my focus here will be assessing how Federal Reserve supervision performed in the context of SVB's failure, consistent with the topic of this hearing, I wish to make explicit what might otherwise might only be implicit – however well supervisors did or did not perform, SVB's failure was first and foremost a function of the decisions and actions of SVB's management, which ultimately served SVB poorly over the course of the dynamic events of 2022 and early 2023. Thus, no amount of criticism one might make of supervisors' performance in this context should be misconstrued as suggesting otherwise.

B. The Incompleteness of the Public Record Makes Definitive Assessment Difficult

Offering any definitive assessment of how the Federal Reserve supervised SVB is difficult at this stage due to the substantial incompleteness of the public record. Certainly, the report issued by the Federal Reserve in April of this year provides a significant amount of detail, and the Federal Reserve should be applauded for publicly releasing at least some of the relevant supervisory materials in connection with that report. Together, those materials provide a useful starting point, and allow one to form a tentative view of what may have gone wrong, as I do here. There are, however, serious limitations to these materials as a comprehensive public record of the Federal Reserve's supervisory conduct.

First, although a large number of supervisory documents were made public, much important material has not been. For example, the Federal Reserve has only released those supervisory reports and letters that are germane to the causes of SVB's failure, withholding a large body of additional reports and letters on other topics. This makes it hard to evaluate whether, taken on the whole, supervisory attention was appropriately focused on the right things. That's especially concerning because, as I describe below, a key problem in SVB's supervision appears to have been one of signal-to-noise ratio; in examining SVB, supervisors appear to have focused on the noise and missed the signal. Yet, in releasing its report, the Federal Reserve has made public all the examinations materials related to the signal, and none of the examination materials reflecting the noise. Put another way, an important question is what the ratio was of examiner time spent on material risks to SVB's financial integrity relative to less important matters. The Federal Reserve's report makes that impossible because it provides only the numerator and not the denominator.

Second, much of the information provided in the Federal Reserve's report – often bearing on important questions and facts – is entirely based on internal interviews with relevant Federal Reserve staff or conclusory statements for which no evidence is offered. This makes several important aspects of the report impossible to verify or independently assess. Presumably, access to contemporaneous records of these events (emails, interview notes, etc.) would allow one to draw one's own conclusions, rather than merely accept the report's interpretation of events.

Third, the report and released supervisory materials generally provide very little information about the respective roles played by the Reserve Bank and the Board in various events and decisions. The absence of those details makes it very difficult to ascertain which decisions were made by whom, an information gap that both frustrates any real accountability for

those decisions and makes it difficult to evaluate to what extent the unique division of supervisory labor within the Federal Reserve System may have delayed or altered decisions about what to examine, what issues to raise and which supervisory tools to use.

Fourth, there are inherent limits to the Federal Reserve's report as a methodological matter. Although Federal Reserve staff should be credited for producing such a detailed and lengthy self-analysis in such a short time, the report's limitations are self-evident – it was not prepared by an independent third-party, it does not document its methodology or its authorship, it does not document many of its factual assertions and statements and it apparently does not reflect the consensus of the Federal Reserve Board.

C. The Current Public Record Suggests Serious Failures of Supervision[20]

While the current public record has its limits, what we do have at this stage is enough, I believe, to identify several core problems that appear to have limited the effectiveness of the Federal Reserve's supervision of SVB. If one carefully reviews of the facts provided in the Federal Reserve's report and the accompany exam materials that were released, a relatively clear picture emerges – one of supervisors deeply focused on SVB's processes and policies but without an independent view of the serious risks to SVB's financial integrity that were building, a willingness to demand corrective action and escalate issues where the stakes were low while failing to do so when critical prudential rules were violated, and oriented around a ratings process that itself was vague and unfocused.

i. *The Federal Reserve's supervisory approach to SVB was principally focused on nonfinancial risks and regulatory compliance matters, and not the fundamental weaknesses in SVB's risk profile that led to its failure.*

As the facts and timeline set forth in the Federal Reserve's report make clear, the weaknesses that caused SVB's demise were neither obscure nor complicated – SVB accumulated significant interest rate risk in its government securities portfolio that called into question its solvency, was reliant on large uninsured deposits collected from a single business sector for funding and lacked an adequate liquidity strategy to survive a run on those deposits once questions about its solvency concerns became pronounced. These weaknesses were not merely SVB's poor risk management practices, but rather were *outcomes* of those poor practices – namely, fundamental risks to SVB's financial condition posed by the composition of its assets and liabilities.

In light of those risks, one would have expected that, particularly as SVB's balance sheet rapidly expanded in ways that amplified them, Federal Reserve examiners would have both identified those risks and demanded management take expeditious steps to reduce interest rate risk, buttress liquidity and diversify funding sources. The examination materials and facts

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[20] I note that this portion of my testimony borrows heavily from recent analysis of the subject co-authored with my BPI colleague Pat Parkinson. *See* Jeremy Newell & Pat Parkinson, *A Failure of (Self-) Examination: A Thorough Review of SVB's Exam Reports Yields Conclusions Very Different from Those in the Federal Reserve's Self-Assessment* (May 8, 2023), available at https://bpi.com/a-failure-of-self-examination-a-thorough-review-of-svbs-exam-reports-yields-conclusions-very-different-from-those-in-the-feds-self-assessment/.

provided in the Federal Reserve's report make clear that this did not occur. Rather, Federal Reserve examiners appear to have been largely focused on nonfinancial risks, governance structures and compliance processes and procedures that were only weakly and indirectly related to its actual financial condition and safety and soundness.

This misguided focus is quite evident in the composition of the 31 MRAs and MRIAs that remained open at the end of 2022, as detailed in Table 2 of the Federal Reserve's report. Of these 31, only six directly concern management of liquidity risk, and only one concerns management of interest rate risk; the remainder concern informational technology and security (13), lending and credit risk management (3), broad programmatic concerns about governance, audit, and risk management (3), vendor management (2), BSA/AML (2) and trust and fiduciary risk management (1).[21] Looking only at the 12 MRIAs open at that time, the story is similar – only two dealt with liquidity risk, and none addressed interest rate risk.[22]

It is difficult to assess the precise scope and scale of supervisory and management attention that these other MRAs and MRIAs may have demanded, as the Federal Reserve has only made public those supervisory materials that purportedly are germane to the causes of SVB's failure; thus, supervisory materials related to informational technology, vendor management, BSA/AML and other topics were not made available. That selective disclosure, whether deliberate or not, obscures any reader's view of the overall supervisory picture and implies that examiners were wholly focused on the relevant issues; in fact, Table 2's list of MRAs and MRIAs suggests that they largely were not.

Nonetheless, the overall picture can be discerned from Table 2 alone: at the end of 2022, SVB management had a long list of supervisory criticisms they were expected to address, only a small portion of which were directly related to the significant financial risks that SVB had accumulated at that time and would lead to its failure a little over two months later. Put more simply, with the benefit of hindsight, the Federal Reserve's supervisory scrutiny appears to have been mostly focused on the wrong things.

The lack of appropriate supervisory focus also appears to have been exacerbated by an apparent lack of *prioritization* among SVB's many open MRAs/MRIAs. Other than the differentiation between matters requiring immediate attention (and those not), the examination materials do not provide any indication that supervisors placed priority on remediation of any of these matters over any of the others. While there are different "due dates" assigned for remediation for some of these MRAs/MRIAs, these generally seem to have reflected the amount

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[21] *See* Report at 28. As a footnote in a report notes, this excludes four consumer compliance issues that were open at the time. It is not clear whether those open consumer compliance issues were a function of *Federal Reserve* supervision. They certainly should not have been, as the Dodd-Frank Wall Street Reform and Consumer Protection Act vests the CFPB with *exclusive* supervisory authority over banks with more than $10 billion in assets as concerns compliance with federal consumer financial laws and associated compliance systems and policies. *See* 12 U.S.C. § 5515.

[22] *See id.*

of remedial work likely to be involved, and not the importance of that remediation.[23] It may be the case that prioritization was implicit in the age of each MRA; but in that case, SVB might have reasonably assumed that its very oldest MRAs – calling for improvements in information technology/security and vendor risk management – were most important at that time, when that certainly was not the case.[24] That assumption is fully consistent with the common view – well-known to any bank manager or board member – that "aged" MRAs can be viewed as a serious management failure and lead to ratings downgrades or other serious repercussions.[25]

This large, undifferentiated mass of supervisory criticisms may have also undermined the ability of examiners to quickly and credibly escalate specific, more serious issues and concerns for rapid supervisory action. Similarly, the sheer scope and scale of supervisory directives, unprioritized and largely relevant to compliance processes and nonfinancial risks, also seems likely to have distracted management and focused too much of its attention on matters of lesser importance at the very time that existential risks to SVB's safety and soundness continued to accumulate.

ii. *To the extent that examiners did identify and convey concerns in the areas that directly contributed to SVB's failure, examiners were far too focused on risk management processes and procedures, and not on actual risk.*

As noted, there *were* several instances in which Federal Reserve examiners identified problems in SVB's management of liquidity and interest rate risk. Specifically, the Federal Reserve issued a set of MRAs and MRIAs to SVB on Nov. 2, 2021 that called for a range of enhancements to its liquidity risk management processes, which followed a targeted liquidity planning exam conducted earlier that fall.[26] A year later, the Federal Reserve also issued a single MRA calling for changes to SVB's interest rate risk simulations and modeling, which appears to have been a product of its continuous monitoring work.[27] While these supervisory actions focused on the most important issues – namely, SVB's interest rate and liquidity risk profiles – their effectiveness likely suffered because they largely addressed the internal processes that SVB used to measure and manage these risks rather than *the actual resulting risks themselves*.

For example, in the context of the Federal Reserve's 2021 targeted liquidity planning exam, the Federal Reserve identified "foundational shortcomings in … internal liquidity stress

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[23] For example, and as further discussed below, the sole MRA that was issued on the critically important topic of interest rate risk management in November 2022 provided SVB with 45 calendar days to provide a written response to the MRA, and nearly eight months to address the MRA. *See* SVB 2022 CAMELS Examination Supervisory Letter (Nov. 15, 2022) at 2-3.

[24] Indeed, more than half of the MRAs and MRIAs open at year-end 2022 had been outstanding longer than those pertaining to liquidity risk, and all were older than SVB's lone MRA on interest rate risk. *Id.*

[25] See, e.g., Acting Comptroller of the Currency Michael J. Hsu, Detecting, Preventing, and Addressing Too Big To Manage (Jan. 17, 2023) at 6 ("[t]he accumulation and aging of MRAs is a signal that something is amiss.")

[26] *See* SVBFG Liquidity Planning Target Supervisory Letter (Nov. 2, 2021).

[27] *See* SVB 2022 CAMELS Examination Supervisory Letter (Nov. 15, 2022).

testing (ILST), … the liquidity limits framework, and … the contingency funding plan (CFP),” on the basis of which it issued six interrelated supervisory findings:

- A MRIA requiring SVB to “enhance their project plan for liquidity risk management” by year-end;
- A MRIA requiring SVB to “establish an effective process for reviewing and challenging liquidity risk management practices” by the end of Q1:2022;
- A MRA requiring SVB to “enhance its ILST scenario design” by the end of Q2:2022;
- A MRA requiring SVB to “to develop a comprehensive liquidity limit and monitoring framework commensurate with the liquidity risk profile of the institution” by the end of Q2:2022;
- A MRA requiring SVB to “enhance deposit segmentation [in its ILST] to reflect the risks associated with their deposits” by the end of Q2:2022; and
- A MRA requiring SVB to make targeted improvements to its contingency funding plan by the end of Q2:2022.[28]

Again, while these supervisory directives are certainly relevant to the issues that led to SVB’s failure, the process-based focus on these MRAs and MRIAs is plainly evident on their face, as they largely address project plans, internal review processes and scenario design and limit frameworks; only the last two of these MRAs (and none of the MRIAs) are directed at substantive shortcomings that played a role in its failure (i.e., a misunderstanding of its likely deposit outflows under stress because of limited deposit segmentation and a reliance on untested sources of contingent funding).[29] As the report describes in detail, these supervisory criticisms appear to have largely motivated SVB to take a wide range of actions to revise its liquidity risk management processes, and not to actually reduce its liquidity risk,[30] and one could reasonably wonder whether the process-oriented criticisms actually distracted rather than incentivized SVB from improving its actual liquidity risk profile. The Federal Reserve report appears to acknowledge this in a limited way, noting that “at times assessments relied on supervisory judgment that did not show elevated concerns for the actual liquidity position, only risk-management practices.”[31]

The process-over-substance focus of supervision that is evident from this list of supervisory directives is underscored by the events that followed, which plainly revealed that SVB had an actual liquidity risk problem, and not merely poor processes and controls. SVB responded by implementing an updated ILST, which promptly revealed SVB to be out of compliance with Regulation YY's requirement that it hold a sufficient liquidity buffer based on

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[28] *See* SVBFG Liquidity Planning Target Supervisory Letter (Nov. 2, 2021).

[29] It is somewhat ironic that although the MRA calling from greater depositor segmentation in SVB’s assessment of funding stability hit the right issue, its motivation appears to have been misguided. It criticized SVB for assuming that all or most depositors would behave similarly – which is precisely what happened when customers began withdrawing deposits in March 2023.

[30] The Federal Reserve report concedes that management’s responses in this area were focused on “changing model assumptions, rather than improving the actual liquidity position.” Report at 58.

[31] Report at 55.

ILST results over a 30-day horizon. Yet, for reasons the Federal Reserve report does not explain, no supervisory action was ever taken on this regulatory violation. Instead, and even as late as August 2022, examiners continued to express a favorable view of SVB's actual liquidity risk profile, stating that "actual and post-stress liquidity positions reflect a sufficient buffer."[32] SVB's supervisory ratings reflect a similarly positive view; notwithstanding the six MRAs and MRIAs issued on the basis of the 2021 targeted liquidity exam, SVBFG's was assigned an LFI rating for liquidity planning and positions of "Conditionally Meets Expectations," and the CAMELS liquidity rating of SVB remained a "1" (Strong) until November 2022 – when it was downgraded only to a "2" (Satisfactory).[33]

When it came to supervising another crucial cause of SVB's failure, interest rate risk, the story is similar. The lone MRA issued to SVB on interest rate risk in November 2022 was not focused on SVB's actual level of interest rate risk, but rather on the simulations and models it used to measure and manage that risk, which supervisors found "unreliable" because they "gave a false sense of safety in a rising rate environment and masked the need to take actions earlier in the rate cycle."[34] This process-rather-than substance focus is evident in the language of the MRA, which required SVB to:

> Backtest IRR simulations against actual results and compare against latest forecasts to determine driver(s) of inconsistency and reasonableness of assumptions;
>
> Correct deficiencies identified through the backtest;
>
> Perform an analysis of deposit mix shifts and run-offs across different rate and VC funding scenarios; [and]
>
> Incorporate deposit mix shifts and run-offs into IRR simulations, either directly or as part of sensitivity analysis.[35]

It is not clear from the public materials whether and when this MRA was remediated, but it's worth noting that even had it been instantly addressed, improved interest rate risk modeling by SVB would have simply shown what SVB's own securities filings had highlighted for some time[36] — that SVB was significantly and dangerously exposed to rising interest rates.

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[32] SVBFG and SVB 2021 Supervisory Ratings Letter (Aug. 17, 2022) at 5.

[33] I note that, while the examination materials indicate that SVB's CAMELS liquidity rating was downgraded in August 2022, the relevant document omits any discussion of that particular rating. This is especially curious given that the document contains a well-organized discussion of each SVB rating component, from which liquidity is glaringly absent. I am unable to ascertain whether this is simply an omission due to examiner error or otherwise explained by materials not made public.

[34] SVB 2022 CAMELS Examination Supervisory Letter (Nov. 15, 2022) at 4.

[35] *Id.*

[36] *See, e.g.,* Form 10-Q filed by SVB Financial Group for the Quarterly Period Ended March 31, 2022 at 88 (discussion of economic value of equity metrics).

Moreover, the stated basis of this MRA – the fact that prior interest rate risk models had proved to be unreliable – also strongly suggests that SVB's examiners did not have any independent view of SVB's interest rate risk, but instead were wholly reliant on the accuracy (or not) of SVB's own estimates. Again, as late as August 2022, Federal Reserve examiners were expressing a favorable view of SVB's interest rate risk position, issuing a CAMELS component rating for sensitivity to market risk of "2" (Satisfactory) and observing that "[s]ensitivity to [m]arket [r]isk is adequately controlled with moderate potential that earnings performance or capital positions will be adversely affected."[37]

The Federal Reserve report states that, on Nov. 1, 2022 (just three months later), Federal Reserve supervisors had "planned" to downgrade this rating to a "3" (Less-than-Satisfactory), but this downgrade was not finalized because "SVB failed before the letter was sent to the firm."[38] (The report does not nor substantiate the purported "plan" to lower this rating, nor does it explain why a period of four months was insufficient to vet and communicate this new rating to the bank.)

Finally, another key way that one might assess whether supervisors were appropriately focused on actual risk (and not just risk processes) is to evaluate what views the Federal Reserve expressed to SVB about its effort to remediate the Federal Reserve's supervisory findings – that is, SVB's responses to the Federal Reserve's MRAs and MRIAs. This material would illuminate whether supervisors were focused on ensuring that SVB was actually mitigating underlying risks as it improved its processes, as opposed to simply ensuring that SVB was checking the relevant compliance boxes that examiners had established. Unfortunately, as I've described above, the Federal Reserve has made none of that material publicly available, nor does the report describe it in even general terms. Fortunately, these materials were made available to the GAO, and the GAO's own report suggests that examiners were focused on the latter, not the former. Specifically, the GAO notes that "[w]hile SVB management failed to take adequate and timely steps to mitigate risks, FRBSF staff generally accepted SVB's planned actions to correct deficiencies. Our review of examination staff's acknowledgment of SVB management responses found the staff generally agreed that SVB's planned actions were reasonably designed to remediate" the MRAs and MRIAs that had been issued."[39] This strongly suggests that, again, supervisors were focused on supervisory and regulatory compliance (in this case, with the procedural actions required under the MRAs and MRIAs), and not on reduction of the underlying risks.

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[37] SVBFG and SVB 2021 Supervisory Ratings Letter (Aug. 17, 2022) at 8.

[38] Report at 64-65.

[39] Government Accountability Office, *Bank Regulation: Preliminary Review of Agency Actions Related to March 2023 Bank Failures* (GAO-23-106736) (April 28, 2023) [hereinafter "GAO Report"] at 22.

iii. *While supervisors issued numerous MRAs and MRIAs based on general supervisory expectations, regulators failed to enforce several key requirements of Regulation YY, including those requiring SVB to have a CRO and to hold a sufficient liquidity buffer as per its ILST results.*

The supervisory materials and Federal Reserve report indicate that, while examiners were focused on compelling SVB to modify its governance and risk management processes to bring them into compliance with examiners' expectations, it took no action whatsoever on two clear violations of Regulation YY (the Federal Reserve's enhanced prudential standards rules) pertaining to liquidity risk and risk management.

First, as noted above, the report indicates that SVB's internal liquidity stress tests routinely showed that, beginning in 2022, SVB was in violation of Regulation YY's requirement that it hold a sufficient buffer of liquid assets to survive a 30-day period of liquidity stress.[40] The report offers no explanation for why this aspect of Regulation YY was not enforced, and indeed, the supervisory materials released provided by the Federal Reserve make *no reference at all* to the fact that SVB as in violation of Regulation YY's liquidity rules. This absence is particularly difficult to understand given that, as the report observes, "the ILST has become the industry and supervisory standard for measuring an individual firm's liquidity risk profile and determining required levels of liquidity.[41] Yet as the report notes, and notwithstanding what SVB's ILST revealed, the supervisors' "concerns were focused on the 2021 Liquidity examination issues," and "the 2022 LFI and CAMELS ratings letter assessed the liquidity position as adequate."[42]

Second, and equally problematic, the report notes that SVB failed to have a chief risk officer for much of 2022; this represented a violation of a separate Regulation YY requirement that it maintain one at all times.[43] Again, no action was taken. As a result, for a period of seven months in 2022, risk management at SVB was run by a committee of senior risk officers, many of whom were new and still completing "baseline assessments."[44] In SVB's case, it seems safe to presume that the absence of a CRO during that critical time period had precisely the type of negative impact to safety and soundness that motivated the Federal Reserve to enact that aspect of Regulation YY in the first place. By way of explanation, the report notes that "[i]n consultation with Board staff, supervisors decided not to issue the violation since the firm was actively searching for a CRO with appropriate skills and experience."[45] An alternative explanation of supervisors' forbearance on this matter – perhaps more plausible – is the fact that,

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40 See Report at 56.

41 Report at 55.

42 Report at 56.

43 *See* Report at 49.

44 *Id.*

45 Report at 49.

as the GAO report (but not the Federal Reserve report) notes, it was the Federal Reserve's supervisory actions that "compelled" SVB to terminate its CRO in the spring of 2022.[46]

Taken together, supervisors' failure to enforce these two clear violations of Regulation YY reinforces the core conclusions above – namely, that supervisors were overwhelmingly focused on processes and procedures, many of them only weakly related (if at all) to SVB's safety and soundness, while failing to act on critical safety and soundness problems that should have been readily apparent. This failure would also appear to undermine one of the core "takeaways" of the Federal Reserve's report, which is that had SVB been subject to the enhanced prudential standards that predated the Board's 2019 tailoring rules, it may have better managed its liquidity and capital position and maintained a different balance sheet.[47] Any suggestion that the application of additional Regulation YY standards would have been beneficial is difficult to understand, given supervisors' decision not to enforce those aspects of Regulation YY that not only *did* apply, but directly addressed the risks that ultimately contributed to SVB's failure. Put simply, since examiners failed to enforce those enhanced prudential standards that were applicable, having even more of them apply to SVB would have only served to multiply examiners' errors, not correct them.

iv. *The rapid shift in SVB's supervisory ratings and the Federal Reserve's acknowledgment that other ratings may have been warranted suggest that those ratings frameworks are highly subjective, lack clear standards and are not focused on actual risks and financial condition.*

As described in the report and supervisory materials, SVB was frequently assigned supervisory ratings that appear difficult to reconcile with the risks inherent in SVB's assets and liabilities. For example:

- SVB's liquidity rating under CAMELS remained a "1" (Strong) for the period 2017-2022, and was a "2" (Satisfactory) from late 2022 through failure;
- SVB's sensitivity to market risk rating under CAMELS remained a "2" (Satisfactory) from 2017 through failure; and
- SVBFG's liquidity rating under the RFI framework was "Strong-1" during the relevant period (2017 to 2022), and its liquidity planning and positions rating under the LFI framework was "Conditionally Meets Expectations" during the relevant period (2022 to failure).[48]

Similarly, the Federal Reserve report highlights numerous cases where the relevant ratings systems' inherent subjectivity and reliance on examiner judgment appear to have frustrated or complicated supervisory efforts. For example, in assigning SVBFG's 2021 LFI ratings, the supervisory team "considered rating Governance and Controls "Deficient-1" but decided, in consultation with Board staff, that they "had not yet established the necessary support

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46 GAO Report at 23.

47 Report at 13.

48 See Report at iii.

for such a downgrade given that only a few months had passed since the previous supervisory team had rated SVBFG as 'Satisfactory-2' on a composite basis."[49] As a result, supervisors chose to conduct a targeted exam of risk management and governance – begun over four months later – before issuing a Governance and Controls rating of "Deficient-1" nearly a year later. While the report concludes that this sequence of events was the result of recent changes in Federal Reserve supervisory policy and "due process considerations that had been articulated by policymakers for several years," it seems much more likely to reflect that (i) both the earlier and later ratings were highly subjective exercises and (ii) relied on examiner judgments that varied substantially as between the earlier and later examination teams.

Yet another example is the Federal Reserve's rating of SVB's interest rate risk. As noted above, as late as August 2022, Federal Reserve examiners issued a CAMELS component rating for sensitivity to market risk of "2" (Satisfactory), observing that "Sensitivity to Market Risk is adequately controlled with moderate potential that earnings performance or capital positions will be adversely affected."[50] Yet a mere three months later, the report notes that Federal Reserve supervisors planned to downgrade this rating to a "3" (Less-than-Satisfactory) after SVB's models and actual financial performance began showing declining net income due to interest rate effects.[51] This sudden shift in supervisory ratings assessments again suggests that the relevant ratings framework was unduly subjective and overly reliant on examiner (mis)judgment.

Finally, in a similar vein, the report highlights numerous instances where ratings different than those actually assigned "could" have been warranted. For example, the report notes that:

- "By early 2023, when SVBFG's liquidity and interest rate risk profile had deteriorated, and risk management was not making sufficient impact, a Governance and Control rating of 'Deficient-2' should have been considered."
- "Under the applicable ratings definition, the ratings for Risk Management and Management could have been downgraded to a 'Less-than-Satisfactory-3' (in 2021). Instead, supervisors maintained the 'Satisfactory-2.'"[52]
- "Based on the severity of the six findings from the 2021 liquidity examination, however, a more negative assessment (e.g., 'Deficient-1' for Liquidity) would have been supportable."[53]
- "[L]iquidity ratings for SVB and SVBFG were not appropriately updated in 2022 and 2023 to reflect the multiple data points that displayed fundamental weaknesses in the liquidity position and risk-management practices."[54]

49 Report at 42.

50 SVBFG and SVB 2021 Supervisory Ratings Letter (Aug. 17, 2022) at 8.

51 *See* Report at 64.

52 Report at 47.

53 Report at 55.

54 Report at 60.

While the report frequently explains these discrepancies by reference to the benefit of hindsight and/or a supervisory approach overly focused on "due process," it fails to consider an alternative, more plausible explanation: the relevant ratings systems were too subjective and lacked clear standards. And to compound matters, as I describe in detail above, examiners appear to have lacked an informed, independent view of the risks that they were purportedly rating under this framework.

4. <u>Potential Areas for Future Consideration</u>

As I have described above, the current public record concerning how Federal Reserve supervised SVB has important gaps that must be filled before a truly definitive and unflinching assessment of bank supervision in this case may be rendered. Concrete examples of how such gaps might be addressed include public release and/or independent review of the following:

- All the additional supervisory materials withheld by the Federal Reserve from release to date (e.g., exam reports related to topics the Federal Reserve appears to have deemed irrelevant or unimportant to SVB's failure);
- Internal Federal Reserve correspondence, interview transcripts or notes and/or other internal materials on which the assertions or conclusions in the Federal Reserve report are based (in each case subject to appropriate redaction of individual names);
- Analysis of contemporaneous records and documents to assess the Federal Reserve report's assertion that changes in supervisory policy in recent years led to slower action by supervisory staff and a reluctance to escalate issues, with particular focus on understanding whether this (as opposed to some other factor) was the specific driver of several long supervisory delays described in the report (e.g., negotiation of an MOU and/or various changes in SVB's ratings);
- Analysis of which supervisory decisions were made by Reserve Bank v. Board staff and at what levels, with a view to assessing to what extent the unique division of supervisory labor within the Federal Reserve System may have delayed or altered decisions about what to examine, what issues to raise and which supervisory tools to use;
- Analysis of whether supervisors' approach to SVB, particularly as concerns interest rate and liquidity risks contributing to it failure, was consistent (or not) with the approach taken in other Federal Reserve Bank districts;
- Analysis of the internal supervisory policy priorities and objectives of both the Board and FRBSF relative to the fundamental interest rate and liquidity risks that contributed to SVB's failure; and
- Analysis of the experience and level of training of examiners assigned to SVB relative to the key interest rate and liquidity risks that contributed to SVB's failure.

In addition, given that the public record to date nonetheless suggests several significant problems in Federal Reserve supervision, several reforms to the Federal Reserve's overall approach to supervision would appear to warrant careful consideration. Those include the following:

- Holistic and programmatic changes to appropriately focus supervisory activities, resources, and priorities on risks that are material to the financial integrity of the

supervised institution, including greater emphasis on the development of independent examiner views on such risks.[55]

- Review and reform of how the agency uses MRAs, MRIAs and other forms of supervisory criticism, including (i) clear standards that focus those tools on risks that are material to the financial integrity of the supervised institution and (ii) better prioritization by supervisors of required remediation that is consistent with those risks.[56]
- Review and reform of all supervisory ratings systems, including the woefully outdated CAMELS framework, with a view towards making those systems more objective and better focused on risks that are material to the financial integrity of the supervised institution.[57] Such reform should include, most importantly, elimination or overhaul of the CAMELS "Management" component, which has been the locus of current supervision's process-over-substance tendencies, as it is the only of the six CAMELS components that does not directly assess actual risks to bank safety and soundness, yet has been treated as the most important component, not the least.
- Greater clarity and transparency as to how various authorities for supervisory activities and decisions are allocated to Federal Reserve Bank and Federal Reserve Board staff, respectively, both to the public with respect to general policies and to individual supervised institutions with respect to specific activities and decisions.
- Review of potential enhancements to internal review and oversight of supervisory activities and decisions within the Federal Reserve System, including consideration of the addition of new second and third "lines of defense" within the Federal Reserve to ensure independent review and testing of its supervision function, similar to the risk control model imposed by the Federal Reserve on larger institutions it supervises.

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[55] For an example of concrete and detailed suggestions in this regard, see Greg Baer & Jeremy Newell, *How Bank Supervision Lost Its Way* (May 25, 2017), *available at* https://bpi.com/how-bank-supervision-lost-its-way/.

[56] For an example of concrete and detailed suggestions in this regard, see Greg Baer & Jeremy Newell, *The MRA is the Core of Supervision, but Common Standards and Practices are MIA* (Feb. 18, 2018), *available at* https://bpi.com/the-mra-is-the-core-of-supervision-but-common-standards-and-practices-are-mia/.

[57] For an example of concrete and detailed suggestions in this regard, see Bank Policy Institute Letter to Jerome Powell and Jelena McWilliams, *Substantive Review & Revision of the Uniform Financial Institution Rating System* (Jan. 10, 2020), *available at* https://bpi.com/wp-content/uploads/2020/01/BPI-Comment-Letter-re-CAMELS-Docket-No-OP-1681-RIN-3064-ZA08-002.pdf