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By Risk Intelligence Solutions & Consultancy



SVB Failure Analysis

The last few days, many clients have asked our opinion regarding the Silicon Valley Bank (SVB) collapse. With the path for Basel III Banking Regulatory changes set for implementation for our region (Caribbean, Central- and South America), this event is a wake-up call to the Financial Sector. It emphasizes the importance of Stress Testing, Interest Rate Risk, Liquidity and Regulatory Capital reforms.

What follows, are in our opinion the most important issues that led the SVB downfall. They are ordered from worst to bad.

Issue #1 - Deregulation

In 2018 we see a rollback, reform of the Dodd-Frank Act of 2010, which set stricter regulations for banks, to counteract the 2008 financial crisis. The 2018 reform got rid of the \$50 billion threshold, which many banks had argued was needlessly encumbering them. Instead, among many other changes, the rollback law made the enhanced regulations standard only for banks with at least \$250 billion in assets. That resulted in only about a dozen banks at the time.

SVB which at the time had assets approaching \$40 billion, was one of the banks that embraced the reform. That was reflected in the following statement: “The \$50 billion level would “unnecessarily” burden SVB and require the company to spend time and money complying with rules instead of providing loans to job-creators”.

Issue #2 - Excessive Interest Rate Risk

SVB have seen their client deposits tripled from 2019 to 2021. The bank chose to invest more than half its assets, \$108 billion in Treasury and Agency bonds. From that investment, over \$80 billion was locked in for a 10+ year duration bonds, against a weighted average yield of 1.56%.

Peculiar enough, the investment was not hedged, exposing the bank to excessive interest rate risk. Compliance with the Basel III Stress Testing and Interest Rate Risk standards, would have raised flags for a potential disaster by the summer of 2021 when we saw the first Fed rate hikes to counteract inflation.

Issue #3 - Liquidity Risk

With the FED interest rate increases to combat inflation, we also saw the value of the bonds in SVB’s portfolio, start to lose their value. That is the case due to an usual inverse correlation between interest rates and bonds. As a result of that, the unrealized losses of SVB piled up, while we also saw venture capitalists start to withdraw their money from the bank.

In order to increase liquidity and meet the demand of deposit outflows, the bank decided to sell a portion of its bonds. Because of the increased interest rates, the bank made a \$21 billion loss.

Compliance with the Basel III Liquidity standards would have required the bank to have enough High-Quality Liquid Assets (HQLA) and maintain a stable funding profile to cover short- and long-term liquidity needs. Eventual issues would have been identified way before a failure if these figures were part of a monthly supervision.

Issue #4 – Internal Risk Assessment and Controls

Although we are yet to get more information regarding SVB’s Internal Risk Assessment and Controls, initial signs indicate serious deficiencies. We know for a fact that the bank was without a Chief Risk Officer between April 2022 and January 2023. Next to that, interviews with ex-employees and clients both mention stagnant technology and “clunky” client experience. Considering these conditions, it must be hard to properly run a slowly failing \$200 billion bank.

Issue #5 - Audit

KPMG has provided SVB with a clean bill of health just 14 days before its collapse. That certainly raises questions about the quality of the audit. As a follow-up to that, KPMG has stated that: “the audit work considered all facts available at the time the reports were issued, and that market-driven events in the following days led to the banks’ crises”.

If we were looking at a sudden, overnight, severe interest rate hike, I could agree with the auditors' statement. That is unfortunately not the case. Its inconceivable that the auditor didn't find any issues whatsoever and didn't see any potential risk during their last audit.

Conclusion

The collapse of the 16th largest bank in the USA, a bank that has been in the Forbes best US banks top 20 for the last 5 years, should not be taken lightly. It's collapse which is the second largest bank failure in US history, is now showing its ripple effect on the worldwide financial markets, while the effect on the large (uninsured) depositors and fintechs is yet to unravel.

We believe that stimulating growth may require us to challenge existing standards, set new boundaries or even sacrifice our sacred cows. We don't believe there is nothing wrong with that. We should however carefully assess whether our approach doesn't cannibalize everything we have built so painstakingly. We should embrace a tech-driven, sustainable, risk conscious growth approach.