SILICON VALLEY BANK COLLAPSE: FIVE LESSONS FOR BOARD DIRECTORS

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INTRODUCTION

As the collapse of the 16th largest bank in the US continues to play out on both Wall Street and main street, and the long-term ramifications of this bank failure are still very much uncertain, this document highlights some of the early takeaway lessons for board directors of financial institutions.

BRIEF SYNOPSIS

Silicon Valley Bank (SVB) is a Santa Clara, CA, based bank whose primary business was lending and taking deposits from Silicon Valley technology industry and their employees. They had a limited international footprint with a full subsidiary in the UK, a joint venture bank in China, branches for corporate lending in Canada and Germany, and representative offices across other parts of Europe. Following a run of their deposits, SVB was forced to sell a US$21b fixed-income securities portfolio to rebalance the balance sheet, resulting in a US $1.8b loss being disclosed to the market on March 8, 2023.

Following a failed capital raising to cover the losses, on March 8, 2023, the California Department of Financial Protection and Innovation (DFPI) publicly announced the voluntary liquidation of SVB. By March 10, 2023, the DFPI announced it had closed the bank due to cash flow and balance sheet insolvency. It appointed the Federal Deposit Insurance Corporation (FDIC) as the receiver.

Federal Regulators took the unprecedented step on Sunday, March 12, 2023 to announce it was backing all depositors. The US Treasury, Federal Reserve Bank and FDIC were determined to resolve the uncertainty on uninsured funds before the new week of trading. This included a statement that the taxpayer will not bear the resolution of SVB and that all senior management of SVB have been removed.

BOARD DIRECTORS LESSONS

The following are five lessons from observing this past week's events:

1. Never lose sight of financial risk management

In the past decade, non-financial risk themes have taken up a large proportion of the board's risk committee agenda. This included a focus on operational resilience, improving capabilities to handle the increasing frequency of cyber threats, actions on climate change, and, of course managing through the COVID-19 pandemic.

In the past 12 months, focus has understandably returned to credit risk due to rising interest rates, low unemployment and residual fiscal stimulus monies. Boards should ensure that these "basics" of banking are bring reported, managed and monitored.

It was unclear how much the board was made aware of the large unrealized losses within SVB's fixed-income securities portfolio, or the repricing mismatch of these long-term assets being supported by ever-increasing customer deposit rates. It highlights the importance of a comprehensive stress test framework to unearth insights likely to be buried in the data.

2. Keep on top of key person risk and succession planning

Despite the often quoted "the most important job of a board is hiring the CEO", board directors have to appreciate that this should extend to the CEO's direct reports. Critically it needs to include both the revenue-generating executive roles and leaders of the key control functions.

SVB did not have a permanently appointed CRO for most of 2022. This was when the asset-liability management risk exposure was compounding up to a size that threatened the bank's solvency. The new CRO was only formally appointed mere weeks before the bank's collapse.

Robust succession planning processes of senior leaders of control functions need to be in place. This ensures that expertise and persons of gravitas are there to provide continuous operational checks and balances, which may be difficult to achieve with executives in a temporary or acting capacity.

3. Social media has changed the nature of a bank run

Liquidity risk management has seen significant changes over the past several decades. After 2008, the Basel Committee on Banking Supervision (BCBS) introduced the new contingent liquidity risk metric: Liquidity Coverage Ratio (LCR). Even at that stage, the standardized stress run-off scenarios were thought of by some industry participants as severe. However, even these standard assumptions were dwarfed in some categories with the coordinated run of the depositors courtesy of social media and online communication channels.

Digital banking runs, with customers accessing their accounts online, have been seen in the past. What is new in 2023 is the speed at which customers were alerted to the weakness of SVB. In the same manner that a retail customer frenzy occurred with the meme stock crazes in 2022 (e.g., Gamestop), the mobilization of retail customers has been fundamentally changed.

It is not apparent SVB utilized these same social communication channels to help mitigate any of the panic. Crisis management best practices recommend addressing customer concerns on the same platforms. The broader issue of the psychology of a bank run magnified by social media needs much more attention from management, Boards and regulators.

4. Update perspectives on portfolio concentration

Concertation and correlation of your organization's portfolio has to be better understood. It needs to go beyond simple, broad industry segments. In SVB's case, what was underestimated was the concentration due to connectivity in communication.

The SVB depositor base was highly concentrated geographically, and via a close online community. Many in this customer base had deposits well in excess of the FDIC-insured amount of $250,000. What was witnessed were retail customers behaving with the speed and sophistication of a large corporate depositor. It is important to view concentration with a modern lens, given information is more widely available and digital funds transfers can be done with little friction.

5. Understand your capital management toolkit

Board directors must be familiar with processes and due diligence that will likely need their approval of business-as-usual and opportunistic capital transactions for their organizations. This includes being aware that sitting on undisclosed bad news while trying to raise capital will expose directors to legal liability and cause the institution serious reputational harm.

Desktop drills to improve processes and understanding are a key element of strong risk practices. Boards should understand how the market will respond to stable earnings and accretive shareholder value transactions should more capital be needed.

The reward for such strong risk practices is that your organization has the luxury of being able to take the opportunities that present themselves proactively. UK's government rapidly addressed the orphaned SVB subsidiary where HSBC stepped up to purchase the entity over the weekend before markets opened.

CONCLUSION

While the ramifications of the failure of SVB are still unfolding, it is clear that there are lessons to be learned for board directors. Directors should ensure comprehensive risk management frameworks, succession plans, an effective crisis response plan, and sufficient capital. By doing these things, boards will find themselves in a better position to protect their organizations from similar situations.

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