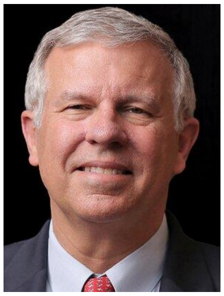
A Tale Of 2 SVB Reports: Where The Fed's Barr And OIG Differ

By **Randall Guynn, Margaret Tahyar and Kirill Lebedev** (November 13, 2023)



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Diagnosing the true reasons for the failure of Silicon Valley Bank earlier this year and the contagion it fostered is critical to prescribing the right medicine to reduce the risk of similar contagion in the future.

That is why recognizing the key differences between the report[1] recently prepared by the Office of Inspector General of the Board of Governors of the Federal Reserve System and the report[2] prepared by Federal Reserve Vice Chair for Supervision Michael Barr is so important.

The Barr report was a self-assessment by the supervisory staff of the source of SVB's failure. The report, released just over a month after the bank's failure on March 10, was prepared under extreme time pressure with little time to weigh the evidence or reflect on the root causes. There is an open question whether the staff may have been less than candid about their own mistakes or those of their colleagues.

Federal Reserve Gov. Michelle Bowman has repeatedly called for a truly independent investigation of the deficiencies in supervision that contributed to SVB's failure. Though not the truly independent investigation that Bowman has called for, the OIG report, released on Sept. 25, was a more independent review with more time to weigh the evidence and reflect on the root causes.

Media reports have described the OIG report as nearly identical to the Barr report. In fact, the report is far more critical and less forgiving of the supervisory staff than the Barr report.

For example, it does not blame regulatory tailoring for the staff's deficiencies, except for when SVB had assets between $50 billion and $100 billion. Nor does it blame the staff's deficiencies on a less assertive supervisory culture instituted by former Vice Chair for Supervision Randal Quarles.

The Barr report alleges that the Federal Reserve's implementation of the tailoring requirement in the Economic Growth, Regulatory Relief, and Consumer Protection Act was a major factor in the staff's failure to detect or take prompt action to remediate SVB's deficiencies in managing its liquidity and interest rate risks.

If that is the case, it would be appropriate to question whether that regulatory tailoring should be modified or eliminated consistent with the congressional mandate.

The OIG report alleges that only the supervisory staff's understanding of how EGRRCPA was supposed to affect the supervision of firms between $50 billion and $100 billion was responsible for any deficiencies in supervising SVB and only during the period when SVB's assets fell within that range.

If that is the case, then regulatory tailoring cannot be blamed for any of the staff's mistakes that occurred after SVB passed the $100 billion mark, which occurred nearly three years before SVB failed.

Similarly, the Barr report alleges that the former vice chair for supervision's excessive focus on due process, transparency and public accountability led to a less assertive supervisory culture that prevented the supervisory staff from detecting or taking forceful action against SVB's failure to manage its risk of runs by uninsured depositors or the interest-rate risk of its long-dated securities portfolio.

If that is true then it might be appropriate to question whether the supervisory obligations to comply with traditional due process, transparency or public accountability obligations standards should be modified or eliminated.

The OIG report, however, alleges the root causes of the supervisory deficiencies did not include an excessive focus on due process, transparency or public accountability or a less assertive supervisory culture instituted by the former vice chair for supervision, but rather a number of other factors including the staff's failure to tailor supervision to SVB's salient, i.e., most important, risks. If that is the case, then it would be a mistake to weaken such protections based on the Barr report.

These differences between the two reports may be explained by the greater independence of the OIG report from the supervisory staff and the additional time the OIG had to gather and weigh evidence and reflect on the root causes of the deficiencies in the supervision of SVB and the related contagion it fostered.

Bank supervision is critically important for the stability of the banking sector. Much of it happens behind a veil of secrecy because of the doctrine of confidential supervisory information.

As a result, in those few instances where the crucial work of the supervisory staff becomes public, it behooves us to ask whether the supervisory staff has the right kind of tools, resources, training and management and is subject to effective oversight by the full Board of Governors, in addition to the vice chair for supervision.

A separate report[3] on SVB's failure by a team at the Center for Financial Stability led by former Federal Deposit Insurance Corp. Chair Sheila Bair made a recommendation based on this concept of oversight — namely, that the Federal Reserve should create a new supervisory committee to supplement the vice chair for supervision in overseeing the supervisory staff and encourage the board to more carefully consider the financial stability implications of its monetary policy.

One of the recommendations in the OIG report is that bank examiners be more "empowered" and that they have the ability to act in a more agile way. Questions about tools, resources, training, transparency and public accountability are also key to these recommendations.

We think that a deep dive into the differences, missed by most commentators, between the OIG report and the Barr report on the SVB failure is warranted. There are both common elements and very different perspectives that we believe are worth considering.

Barr Report

The Barr report concluded that the primary cause of SVB's failure was rooted in failures by SVB's "senior management ... to manage basic interest rate and liquidity risk" and the lack of effective oversight by SVB's board of directors.

While acknowledging that supervisors did not take sufficient steps to ensure that SVB fixed those problems quickly enough, the Barr report blamed the staff's failure to do so on two exonerating factors:

- The regulatory tailoring mandated by EGRRCPA; and

- A shift in supervisory practices under the direction of the previous vice chair for supervision, including pressure to reduce the burden on firms, meet a higher burden of proof for supervisory conclusions, and demonstrate due process when considering supervisory actions, that resulted in a less assertive supervisory culture.

Different Perspective on Supervisory Deficiencies That Contributed to SVB Failure

While the OIG report agreed with the Barr report that the primary cause of SVB's failure was rooted in basic risk management mistakes by its senior leadership and deficient oversight by its board of directors, the OIG report is more pointed in its criticism and less forgiving of the Federal Reserve's supervisory staff than the Barr report.

The OIG report also described the impact of EGRRCPA as being significantly more limited — to reducing the intensity of supervision of SVB during the short period when SVB had assets between $50 billion and $100 billion.

In sharp contrast to the Barr report, the OIG did not attribute any of the staff's supervisory deficiencies to a less assertive supervisory culture promoted by Quarles as a result of his excessive focus on due process, transparency and public accountability. The OIG report identified the following supervisory deficiencies as contributory causes of SVB's failure.

- The failure of the Federal Reserve's supervisory unit for regional banking organizations, or RBOs, to keep pace with SVB's growth and complexity, because of the following factors:

    - The supervisory staff's belief that they were supposed to supervise banks with assets between $50 billion and $100 billion in the same way they would supervise smaller banks;

    - Insufficient RBO examiner resources and hours devoted to supervising SVB;

    - Insufficient RBO expertise with large, complex institutions based on their experience supervising smaller firms, making certain weaknesses not as apparent; and

    - A decision to pause onsite examinations at the start of the COVID-19 pandemic in 2020.

- Failure to transition SVB from the RBO portfolio to the large and foreign banking organizations, or LFBOs, portfolio in a timely and effective manner after SVB crossed the $100 billion threshold during the second quarter of 2020.

- Failure to downgrade SVB's supervisory ratings to unsatisfactory until August 2022, nearly 2 ½ years after SVB crossed the $100 billion mark.

- Ineffective coordination between RBO supervision and LFBO supervision in the supervision of SVB as it transitioned to the LFBO portfolio.

- Failure of LFBO examiners to focus on SVB's risks from rising interest rates on SVB's held-to-maturity investment securities portfolio.

- Too much focus on SVB's processes instead of prioritizing imminent potential financial threats to the institution's viability.

Neither the OIG report nor the Barr report mention that there were many months without a vice chair for supervision in place, which may have contributed to supervisory deficiencies with respect to SVB.

OIG Recommendations

The OIG made several recommendations for the director of the Division of Supervision and Regulation to remediate the supervisory deficiencies identified above, including to assess the current RBO and LFBO supervisory planning processes and implement measures to tailor supervisory plans to better promote a timely focus on salient risks.

In other words, the supervisory staff's failure to tailor its supervision of SVB to focus on SVB's salient, i.e., most important, risks was one of the contributory causes of SVB's failure.

In the case of SVB, the most important risks would presumably have included the risk of a sudden and significant outflow of deposits because of SVB's high concentration of uninsured deposits from a concentrated pool of depositors — i.e., private equity funds and venture capital funds and their high-tech and life sciences portfolio companies — and its high-interest-rate risk arising from its concentration of investments in long-dated, fixed-rate debt securities.

According to public statements by Quarles immediately after publication of the Barr report, that is precisely what he claims he urged in a series of town hall meetings with supervisory staffs of the board and Reserve Banks, including the FRB San Francisco.[4]

He claims he told the supervisory staff in those town hall meetings to "stop distracting both the institutions and ourselves with excessive attention to routine administrative matters and focus on what's really important — like interest rate and liquidity risk."[5]

He reportedly claimed, "I would often use the phrase, 'And if they won't do what's really important, smite them hip and thigh.'"[6] He said the Barr report on "Silicon Valley Bank — which notes that 31 supervisory findings were issued to the bank [in August 2022] — is evidence that his advice was not heeded."[7]

Without public access to a transcript of those town hall meetings or the talking points used in them, the public cannot assess whether his directions to the supervisory staff anticipated the recommendations in the OIG report about tailoring supervision to a firm's salient risks or whether they promoted a less assertive supervisory culture as the Barr report alleged.

Assuming such a transcript or talking points exist, they could only be obtained if the board voluntarily chose to disclose them or Congress compelled disclosure.

Correction: A previous version of this article incorrectly stated Bowman's reason for calling for an independent investigation. The error has been corrected.

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[1] https://oig.federalreserve.gov/reports/board-material-loss-review-silicon-valley-bank-sep2023.pdf.

[2] https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf.

[3] https://centerforfinancialstability.org/research/CFSMonPaper101623.pdf.

[4] Victoria Guida, Quarles hits back at Barr's SVB report, PoliticoPro (April 28, 2023).

[5] See Kyle Campbell, For Fed supervision, cultural shortcomings are nothing new, American Banker (May 8, 2023).

[6] Id.

[7] Id.