Silicon Valley Bank Crisis: Identifying Key Lessons That Can Be Drawn From It

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Abstract

The SVB Bank Crisis was a significant event that unfolded in the financial sector on 10 March 2023, causing widespread repercussions and raising questions about risk management practices within the banking industry. This research paper aims to provide a comprehensive analysis of the SVB Bank Crisis, examining its causes, consequences, and lessons that every nation can learn from the incident. The paper begins by exploring the factors that contributed to the crisis, including the bank's decisions to convert short-term deposits into long-term investments and the lack of transparency and accountability within the organization. It highlights the departure of the Chief Risk Officer(CRO) and the absence of risk analysis for an extended period as significant indicators of potential vulnerabilities. Furthermore, the research paper delves into the regulatory framework surrounding the banking sector, discussing how certain actions, such as exemptions from stress tests and the rolling back of post-financial crisis banking rules, could have impacted the risk landscape and contributed to the crisis. Drawing from the SVB Bank Crisis, the paper identifies several key lessons that all the stakeholders like banks, central banks, central governments, depositors and investors can learn to. These lessons encompass areas such as robust risk assessment, effective governance, and risk culture, strengthened regulatory compliance, comprehensive risk management policies and procedures, robust internal controls, ongoing monitoring and reporting, talent management and training, scenario analysis and stress testing, effective risk communication, and the importance of continuous improvement. Through a thorough analysis of the SVB Bank Crisis and the subsequent discussion of preventive measures, this research paper aims to contribute to the understanding of risk management practices in the banking industry and provide insights for policymakers, regulators, and banking professionals to prevent similar crises in the future.

Introduction

Bank failures are not unfamiliar occurrences, and each time people hear news of a bank experiencing losses or collapsing, They become concerned about the potential impact. The collapse of Silicon Valley Bank marked the second-largest bank failure in American history, following the

2008 collapse of Washington Mutual Bank, which had significant repercussions on the global economy. On March 10 2023, Silicon Valley Bank of California collapsed after a series of events, and shortly after, another bank, Signature Bank, faced a similar fate, sending shockwaves across the world. While many bank failures are often associated with fraudulent activities, SVB's crisis did not involve any scams or misappropriation of funds. Instead, the crisis stemmed from incorrect decision-making by the bank and a failure to grasp market dynamics, which would have been evident to anyone with basic knowledge of the economy. Notably, there were lapses in responsibility, not only from the bank itself but also from regulatory bodies such as The Federal Reserve System, FDIC (Federal Deposit Insurance Corporation), and OCC (Office of the Comptroller of the Currency).

Background

SVB, also known as Silicon Valley Bank, was established in 1983 by Bill Biggerstaff and Robert Medearis. Bill Biggerstaff, a former executive at Wells Fargo, and Robert Medearis, a professor at Stanford University, founded the bank in Santa Clara, California. SVB quickly rose to become the 16th largest bank in the United States, specializing in serving the unique needs of startups, technology-based companies, and venture capitalists. During its early years, SVB placed significant emphasis on investing in real estate ventures. In the early 1990s, SVB's investment portfolio heavily relied on real estate, accounting for approximately 50% of its holdings. However, the bank faced a significant setback in 1992 when the California real estate market experienced a burst, resulting in substantial losses for SVB. This downturn led to an annual loss of $2.2 million for the bank, highlighting the vulnerability of its assets to market fluctuations and the risks associated with concentrating investments in a single sector. In response to the real estate crisis, SVB implemented strategic measures to diversify its investment portfolio. By 1995, real estate investments comprised only around 10% of the bank's overall holdings. This shift in strategy allowed SVB to reduce its exposure to the volatile real estate market and redirect its focus toward other sectors, fostering a more diversified and resilient investment approach. The challenges faced by SVB in the early 1990s provided valuable lessons in risk management, emphasizing the importance of diversification and adaptability. However, despite the lessons learned, the crisis that unfolded in 2023 presented a similar situation, albeit on a much larger scale. Unfortunately, the challenges proved insurmountable for the bank, leading to its eventual collapse.

What happened with SVB

SVB has a large number of deposits from its clients, most of which are startups. During COVID-19the flow of deposits towards the bank multiplied because software tech-based companies were in profit at that time.In March 2021 SVB witnessed a 100% increase in deposits in 12 months from $62 billion to $124 billion.[1]Bank invested in bonds at a time when bond prices were high due to lower fed rates. In 2022 the federal reserve started increasing fed rates so much that fed rates went from 0.05 % in 2020 to 4.57% in January 2023. This situation led to less supply of money in the market and startups started withdrawing their deposited money, which the bank did not have. So the SVB sold its bonds at a loss of $1.8 billion and also announced to raise the capital of $2.8 billion. As soon as this news got out, the general public got a sense that the bank doesn't have money so Bank Run[2] started. No bank can survive a complete bank run. Customers withdrew $42 billion, nearly a quarter of the bank's total deposits within a single day. After this California Department of Financial Protection and Innovation announced that it has taken possession of Silicon Valley Bank. The receivership of the bank gets transferred to the Federal Deposit Insurance Corporation. FDIC created a new bank called Deposit Insurance National Bank of Santa Clara. All the assets of SVB were taken over worth $209 billion to continue the usual business activities. and then the search for the merger began. Later it was acquired by First Citizen Bank.

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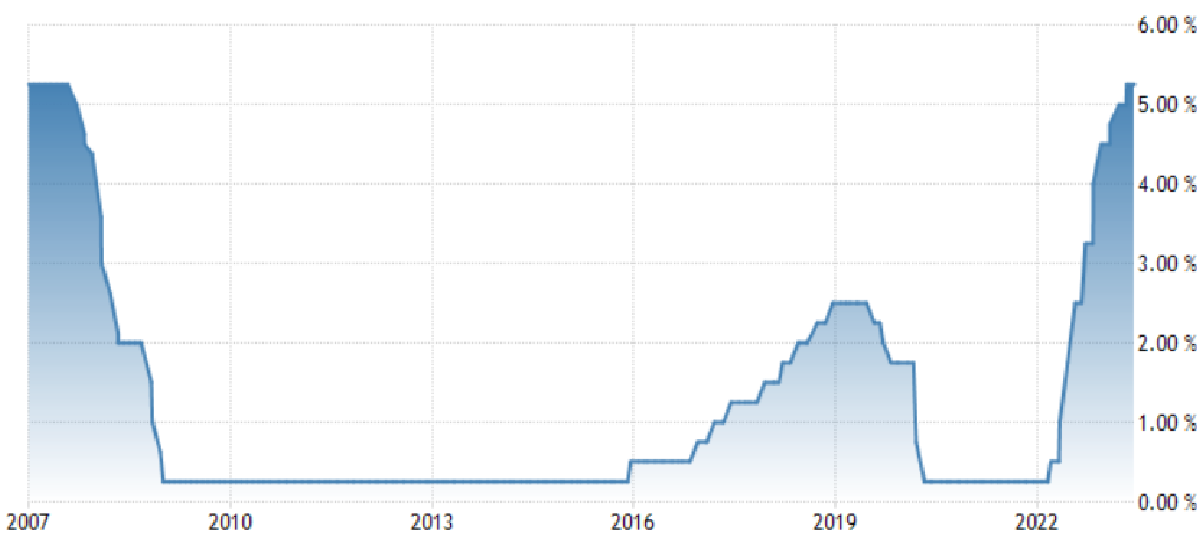
[1] Economic Times 11 March 2023

[2] When a large no. of customers of a bank hurry to withdraw their deposits simultaneously because they believe the bank may fail.

The role of the Federal Reserve

Federal Reserve decreased the fed rates drastically after the 2008 financial crisis in 2008 from 5.26% to 0.16 % in 2009. For so many years from then fed rates were constantly rising but slowly. When the pandemic came in 2020 due to an economic slowdown the US government infused $4 trillion into the economy along with fed rates went record low. This was the time when SVB had an immense amount of deposits that they invested in bonds. During 2022 due to several reasons, inflation was on the rise. One of the reasons for inflation was the revival of the economy after covid and Russia Ukraine war. To curb the inflation and limit the supply of money in the market, the federal reserve started increasing the fed rates and the interest rate shot up 88% in just one year. (Refer to the graph)



The role of bank

SVB made a series of poor decisions that contributed to the crisis. The bank converted short-term deposits into long-term investments, which proved to be detrimental. In 2023, SVB disclosed in a proxy statement that their chief risk officer, Laura Lzurieta, left the company in October 2022 but had stopped working in April 2022. It was also revealed that Kim Olson took over the position of Chief Risk Analyzing Officer in December 2022, meaning there was no chief risk analyzing officer for an eight-month period. This lack of risk oversight raised concerns. Transparency and accountability were also lacking within the bank. Notably, the bank's top management was aware of the impending collapse. CEO Gregory Becker sold over 12,000 shares for a substantial amount on February 26, while the CFO sold shares worth a significant sum on the same day. These actions indicated a lack of responsibility and raised questions about their awareness of the crisis. Following the 2008 financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted, which imposed rules and regulations on banks regarding investment decisions and stress testing. However, SVB's CEO hired lobbyists to exempt the bank from these guidelines, arguing that SVB was a smaller bank focused on funding startups and should be exempted from such restrictions. In 2018, President Donald Trump signed a law that rolled back banking rules implemented after the financial crisis. This law exempted banks with total assets less than $250 billion from certain stress tests, which were designed to ensure sound decision-making within banks. In summary, SVB's crisis resulted from poor decision-making, lack of risk oversight, transparency, and accountability. The actions of the bank's management, including selling shares prior to the collapse, raised further concerns. Additionally, attempts to bypass regulatory guidelines and exemptions from stress tests undermined the safeguards put in place after the 2008 financial crisis.

Role of Market

During the COVID-19 pandemic, when most businesses were forced to shut down, software-based tech firms emerged as the backbone of the economy. With the implementation of the work-from-home concept, these firms attracted substantial investments, with venture capitalists pouring a significant amount of money into them. SVB, as a beneficiary, experienced a significant increase in its deposit base, which more than tripled over a three-year period from 2019 to 2022.

SVB then converted these deposits into long-term bonds. However, as inflation started to rise in 2022, the Federal Reserve raised interest rates. This, coupled with the onset of a startup winter characterized by a decrease in available funding for startups, resulted in a reduced inflow of money into these ventures. Since startups often have limited capital reserves, they look to use the deposited funds for their operational needs. Consequently, when numerous customers simultaneously began withdrawing their deposits, which the bank did not have readily available, SVB had to sell its bonds at a loss. The market reacted swiftly to this situation, instilling panic among depositors when news spread that the bank was facing a shortage of funds. As a result, depositors rushed to withdraw their money, causing the share prices of SVB to plummet by 60% in a single day and 80% overall. Such a situation is incredibly challenging for any bank to survive.

Impacts of SVB collapse

Once news regarding Silicon Valley Bank became public, United States banks had lost over $100 billion in stock market value, and European banks also lost around $ 50 billion in value according to Reuters calculation.[3] Companies who revealed that they were customers of SVB also lost share value, for example, Roku, Inc. and Y combinator. Although the government has promised the customers that all of their money is safe even the amount which was uninsured, the situation for startups is critical as they don't have assets in multiple bank accounts and they don't have many sources to fund their activities. Still, this will not lead to economic shivers around the world like in 2008 because it was operating in a particular sector and the government's efforts are working as shock absorbers. There were some Indian startups also who were customers of SVB here impacts can be positive or negative.

A. International Investors will now be more cautious of investing in startups because of the direct impact of the SVB crisis which can result in reduced funding which can result in scale

[3] Reuters 11 March 2023

down of operations and shutdowns. Especially later-stage startups who need big capital to scale up their business.

B. Investors will now give more priority to the financial stability and risk profile of startups and will put forth their profit and revenue first.

C. This situation can shift the focus of investors from early stage startups to later stage startups whose business model and stronger revenue generating skills are tested through time and market.

D. SVB financial group through Silicon Valley bank, SVB capital, SVB Private and SVB securities is one of the largest service providers for the technology and life sciences/healthcare companies. SVB's startup banking practice, early stage practice and sponsor finance services have been truly innovative. These practices have contributed significantly to the growth of the bank which had earned trust and credibility from the market. The collapse of SVB is an opportunity for other banks and non-banks service providers. There are many financial service companies in India who offer the same services as SVB, albeit on a smaller scale and collapse presents a chance for new businesses to offer new products to offer new products and services .

Indian Context and Yes Bank

Yes bank in India failed in March 2020 just 3 years before the failure of SVB . It was the first time in India when a large private sector bank was rescued. Moratorium , liquidity support and market based restructuring of the bank were the three methods used by RBI to rescue YES bank. While the causes of failure of two banks were different, Yes bank failed because of non serious investors, outflow of liquidity, no market led revival in sight and most importantly deteriorating lending book whereas SVB failed because of higher investment losses and market volatility. During the period when Yes Bank was under a moratorium, the Reserve Bank of India (RBI) swiftly implemented a special liquidity window of approximately Rs 60,000 crore for the private sector. This measure aimed to facilitate the repayment of depositors who were withdrawing their funds from the bank. Additionally, an emergency credit line of Rs 50,000 crore was promptly introduced.

Likewise, the Federal Reserve has also devised a plan to offer liquidity support to vulnerable banks, including SVB depositors. SVB's depositors, primarily start-ups, have gained access to all their deposited funds. Regulation and supervision were weak in case of SVB but RBI worked swiftly and quickly in case of Yes bank . There were several challenges at the time of Yes bank's collapse First, COVID-19 triggered economic slowdown and investors were not willing to inject capital into Yes bank. Second, the government-imposed lockdowns and travel restrictions, which were inevitable due to the pandemic, presented considerable difficulties in coordinating the rescue exercise. Moreover, the banking sector faced disruption as they had to implement loan moratoriums and restructuring plans for their customers, adding strain to their financial position. Additionally, the safety risks posed by the pandemic to both bank employees and customers made it challenging to conduct physical inspections of bank branches or on-site audits. After 3 years the RBI and government successfully rescued Yes bank, restoring depositors confidence in the bank and investors in the market. Hopefully SVB will meet the same fate.

Recommendations

Solving three key issues:-

1. Irresponsible behavior of central banks
2. Wrong decision-making of the company
3. Stopping unethical practices like lobbying

1. **What can be done on the central level** - Central banks like the Federal Reserve in case USA and RBI in case of India have to play their regulatory roles more responsibly.
    a. Increasing or decreasing fed rates (repo rates Indian equivalent) should be well studied and well thought out by economists. Drastically changing interest rates which the federal bank did can send economic shocks in the market, which exactly happened in the case of the silicon valley bank crisis.

b. Central banks can raise the deposit insurance limit to strengthen financial security.
c. Setting up a risk analyzing department at every bank should be compulsory. Active communication between the risk analyzing department and bank authorities. Routine reports of risk analysis should be submitted to central banks as well along with the company.
d. Adequate capital buffer and liquid reserves (Statutory liquid ratio and cash reserve ratio in the case of India) should be maintained compulsorily and nobody should be exempted from it.
e. Banks can be regularized in terms of lending. Restrictions can be put for certain sectors which are in risk or guidelines can be issued for investing and lending money in several sectors instead of putting too much money in one sector.

2. **What can be done on bank level**- Silicon Valley bank has taken several wrong decisions which involve not making their investment portfolio robust and diverse, not keeping adequate capital buffers and liquidity reserves and not actively involved in risk analysis.

a. Transparency between the management and higher authorities. It will lead to every working individual in the bank knowing the situation and not letting a person with higher authority take advantage in a crisis as the SVB CEO Gregory Becker did.
b. A robust investment profile should be maintained which means banks should not invest their full money in any one asset. Investments should be diversified in different places like government bonds, corporate bonds, real estate, stock market, mutual funds, gold etc.
c. Improving the inner working environment of the banks are needed, which means promoting ethical conduct and responsible risk taking, encouraging open communication and whistle blowing mechanism.

3. What can be done on depositors level- Concentration of money has always been bad at one place . If you have deposited more amount with any bank than what is insured by the central bank or government and if this is all the money you had this is where the risk of concentration comes in. So not just investment should be diversified but also savings and deposits should also be diversified.

4.Lobbying- Practices like lobbying are corrupt practices which are not fruitful in any environment. And in situations like this where impacts can be so widespread that it can affect the world population, legislators need to be extra careful.

a. Every bill and law passed by the parliament should be scrutinized by committees specially established for the purpose.
b. Committee members should be experts who have knowledge in the related field.

5. Some risk management and regulatory measures.

Enhance Risk Assessment:

a. Conduct thorough evaluations of risks across all areas of the organization, covering diverse risk categories including credit risk, market risk, liquidity risk, operational risk, and compliance risk.
b. Utilize both quantitative and qualitative approaches to assess risks and their potential implications for the financial stability of the bank.
c. Consistently review and revise risk assessments to ensure alignment with evolving business dynamics and regulatory standards.

Effective Governance and Risk Culture:

a. Establish robust governance structures that define clear roles, responsibilities, and reporting lines to foster accountability and oversight.
b. Cultivate a risk-aware culture throughout the organization, emphasizing ethical conduct, integrity, and responsible behavior.

c. Encourage open communication channels to facilitate the reporting of potential risks or breaches.

Strengthened Regulatory Compliance:

a. Ensure adherence to regulatory requirements and industry best practices, ensuring compliance with applicable laws, regulations, and guidelines.
b. Establish a robust compliance function to monitor and enforce compliance with regulatory obligations.
c. Stay informed about regulatory changes and proactively adapt policies and procedures to align with new requirements.

Comprehensive Risk Management Policies and Procedures:

a. Develop and implement comprehensive risk management policies and procedures tailored to the specific risk profile of the bank.
b. Clearly document risk appetite, risk tolerance, and risk limits to guide decision-making processes.
c. Regularly review and update risk management policies and procedures to account for evolving market conditions and emerging risks.

Robust Internal Controls:

a. Establish strong internal control mechanisms to enable effective risk management and mitigation.
b. Implement segregation of duties, perform regular reconciliation processes, and conduct independent internal audits to identify control weaknesses.
c. Foster a control environment that emphasizes adherence to policies, procedures, and regulatory requirements.

Ongoing Monitoring and Reporting:

a. Deploy a robust risk monitoring system that enables timely identification of emerging risks and deviations from risk appetite.

b. Establish key risk indicators (KRIs) and develop risk dashboards or reports to facilitate continuous monitoring and reporting.
c. Regularly communicate risk information to senior management, the board of directors, and relevant stakeholders.

Talent Management and Training:

a. Attract and retain skilled professionals with expertise in risk management.
b. Provide comprehensive training programs to enhance employees' understanding of risk management principles, policies, and procedures.
c. Cultivate a culture of continuous learning and professional development to stay abreast of evolving risks and best practices.

Lessons for RBI

Mere 49 days after the collapse on April 28 2023 United States Federal Reserve released its report on the review of the bank's supervision and regulation. This report highlighted the failure of FED in not taking action sooner. KPMG issued a clean audit report on 31 December 2022 accounts of Silicon Valley Bank on 24 February 2023. It is surprising that bank regulators , market , credit rating agencies and SVB board nobody was able to visualize what was coming. The point is that in the report FED has done a brilliant job in self assessment and critical analysis of oneself. Report showcases how supervisors even after identifying vulnerabilities did not take steps quickly enough to get those problems fixed by SVB. It is alien to hear such self critical remarks from regulatory authorities in India like RBI. In the recent past there were few disasters like demonetisation , IL & FS and Yes bank but in none of the cases RBI highlighted its own problems and where it lacked to prevent these disasters from even happening. Should RBI be complimented for rescuing Yes bank or should it be reviewing its own competence in the field as a highest regulatory body ? As the old saying goes by" prevention is better than cure". It's high time RBI should learn from FED as how to look upon yourself and prevent such economical disasters from even happening in these tough times because there is no guarantee you will solve the problem every time it occurs.

Conclusion

SVB Bank Crisis serves as a poignant reminder of the significance of robust risk management, effective governance, and regulatory oversight within the banking industry. The collapse of Silicon Valley Bank, which stands as the second-largest bank failure in American history, shed light on the potential ramifications of poor decision-making and a lack of understanding regarding market dynamics. Throughout the course of this research paper, an exploration of the causes, consequences, and key takeaways from the SVB Bank Crisis has been conducted. It became apparent that the bank's actions, such as the conversion of short-term deposits into long-term investments, a deficiency in transparency, and a failure to address emerging risks, played a significant role in the crisis. Moreover, the regulatory environment, including exemptions from stress tests and the rollback of post-financial crisis regulations, exposed vulnerabilities within the banking system. The crucial lessons derived from this crisis revolve around the imperative need for robust risk assessment, effective governance, a risk-conscious culture, enhanced regulatory compliance, comprehensive risk management policies and procedures, strengthened internal controls, continuous monitoring and reporting, talent management and training, scenario analysis and stress testing, effective risk communication, and an unwavering commitment to continuous improvement.Looking ahead, it is of utmost importance for banks and regulatory authorities to prioritize these lessons and implement measures to avert similar crises. Bolstering risk management practices, cultivating a culture that embraces risk awareness, and fortifying regulatory frameworks are all pivotal in safeguarding the stability and integrity of the financial system.

By assimilating the lessons learned from the SVB Bank Crisis and adopting preventive measures, the banking industry can mitigate risks, augment transparency, and safeguard the interests of depositors, shareholders, and the broader economy. A continuous collaboration between banks, regulators, and policymakers is indispensable in maintaining financial stability and instilling public confidence in the banking sector. Ultimately, the SVB Bank Crisis stands as an invaluable case study for both academia and industry professionals, underscoring the significance of prudent risk management, responsible decision-making, and a robust regulatory framework in preserving the stability of the banking sector and averting future crises.

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