

Federal Reserve Board's postmortem assessment

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Outcome of FRB self-assessment

As a result of the recent failure of Silicon Valley Bank (SVB), the Federal Reserve Board (FRB) completed a self-assessment to determine the key drivers of the SVB bank failure and weaknesses in the FRB's own supervision. The FRB highlighted its observations in the *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank*.^{*} As part of the review, the FRB summarizes its takeaways into four categories.

1

Inadequate management of basic interest rate/liquidity risk

2

Unrecognized vulnerabilities as SVB grew in complexity and size

3

Supervisors not ensuring that problems were resolved timely

4

Updated tailoring rule that impeded effective supervision

Outcome of FRB self-assessment (cont.)

Below highlights the outcomes of the FRB's self-assessment on its own and on SVB's shortfalls.

FRB self-assessment

- ▶ **Failed to effectively oversee the risks** inherent in the SVB's business model and balance sheet strategies
- ▶ Stronger focus on MRA/MRIA remediation progress (quantity) rather than on issues that remained open
- ▶ **Delay in providing downgrades** as it related to risk management due to pressure to reduce regulatory burdens and requirement to have significant evidence for conclusions
- ▶ Timely resolution of material issues not enforced by regulators
- ▶ **Lower supervisory and regulator requirements** for banks of SVB's size and nature
- ▶ **Too long transition period in rules** (e.g., SVB was not yet subject to capital, liquidity and risk management requirements even though it was a Category IV firm)
- ▶ Repeated observations of **weaknesses in risk management** not resulting in formal supervisory findings (e.g., MRA, MRAs)

SVB's shortfalls

- ▶ **Weaknesses** in internal liquidity stress test and contingency funding plans
- ▶ Utilization of less conservative stress test assumptions
- ▶ Vulnerabilities included:
 - ▶ **Foundational and widespread managerial weaknesses**
 - ▶ **Highly concentrated business model**
 - ▶ **Reliance on uninsured deposits**
- ▶ **Interest rate risk** not adequately assessed in growing securities business
- ▶ **Lack of effective transitional plan** from being a regional bank to a large foundational institution (e.g., lack of sufficient resources in place)
- ▶ Did not effectively **self-identify issues**
- ▶ Management "had a financial incentive to **focus on short-term profit over sound risk management**"*

Banks should prepare for potential upcoming changes from the FRB

The FRB has recognized the need to **strengthen its supervisory and regulatory frameworks** through its postmortem assessment. Although material changes would need to go through the FRB's standard notice and comment process, below highlights potential improvements to the frameworks that the FRB identified in its report.

Stronger supervisory framework

- ▶ Supervisory teams need to **improve their speed and agility** to ensure that the amount of supervision scales in line with firm growth.
- ▶ **The pace and timelines at which banks are remediating** their issues need to be monitored.
- ▶ As banks grow, they should **comply with heightened regulatory and supervisory standards more quickly.**
- ▶ Novel risks and the impacts of rapid growth, concentrated business models or other special factors need to be identified.
- ▶ Firms with capital planning, liquidity risk management, or governance and controls deficiencies **may be subject to additional capital or liquidity requirements.**
- ▶ Stronger supervisory guidance on **incentive compensation** for firms (i.e., longer-term financial performance vs. maximizing short-term financial metrics) should be provided.

Stronger regulatory framework

- Re-evaluate and enhance existing regulations** to define stronger requirements for a broader set of firms, including, but not limited to:
- ▶ Interest rate risk
 - ▶ Liquidity risk/models to capture uninsured deposits and apply requirements to a large population of banks
 - ▶ Capital requirements

What does this mean for you?

Changes to requirements mean that regulatory reporting teams will need to act

Given the anticipated regulatory regime changes over the short, medium and long terms, firms will need to consider the impact of these changes. Based on feedback from the FRB, a greater number of firms may be subject to increased capital and liquidity requirements and firms approaching \$100bn could face increased scrutiny. Below highlights key focus areas for regulatory reporting leads in light of anticipated regulatory changes.

Governance and processes: New requests and requirements may trigger changes to BAU.

- ▶ Assess **governance capabilities** including oversight of new reports subject to regulatory governance and policies
- ▶ Understand effectiveness of existing KPIs and escalation protocols (e.g., early warning indicators and associated rapid response/escalation)
- ▶ Focus on **long-standing issues** with the expectation of greater regulatory scrutiny
 - ▶ Confirm that **existing remediation plans evidence demonstrable progress with tangible reductions in risk** of reporting errors and improvements in controls
 - ▶ Confirm **remediation plans have the right balance between urgency** (fixes to correct errors) **and sustainability** (preventing ongoing errors / effectively addressing as they arise)
 - ▶ **Demonstrate and evidence control effectiveness, reliability and sustainability** as regulators will be more inclined to view exceptions as indicative of broader problems
 - ▶ Continue to invest in issues management processes with clear demonstration that **issues are remediated timely** with accountability for data owners
- ▶ Review **data governance model** to ensure its aligned with first line accountability for data quality
- ▶ Review **change management processes** to ensure monitoring of external changes to reporting requirements and internal changes driven by business changes or mergers / acquisitions
- ▶ Understand the **organization's risks** (e.g., concentrated business model, amount of uninsured deposits, etc.) and incorporate into models to escalate key issues to management
- ▶ Focus on **early adoption** of heightened regulatory standards as the organization grows in complexity and size

Operating model: Teams at capacity may be stretched thin as the regulatory burden increases.

- ▶ Evaluate **resourcing and talent needs to address increased regulatory scrutiny**, including location, skill set, roles and responsibilities:
- ▶ Determine how to scale model to meet more intense regulatory demands
- ▶ Ensure that **adequate training** is implemented and operational so that teams understand the importance of data quality, as well as regulatory findings

Technology and data: Regulators may expect acceleration of automation initiatives as data volumes increase.

- ▶ Review current state of reporting tools and determine whether **automated processes** are equipped to handle ad hoc requests from regulators
- ▶ Evaluate whether there is **sufficient funding** to address necessary technology enhancements
- ▶ Be able to accurately produce new regulatory reports/ad hoc requests through **data quality/strategic data sourcing**

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