Hancock Askew & Co LLP
Accountants & Advisors

REGULATING THE UNPREDICTABLE: A LOOK-BACK ON THE BANK FAILURES IN THE DIGITAL ERA

NOVEMBER 2023

INTRODUCTION

In the dynamic world of finance, banks play a pivotal role as pillars of stability, overseeing transactions that fuel our daily lives. Yet, beneath this strength lies a delicate vulnerability. When exposed, it sends ripples through economies.

In an era defined by the rapid dissemination of information and the viral spread of trends through social media, recent events have underscored the powerful influence of technology. Bank failures, triggered by a mere tweet, emphasize the transformative power of digital platforms. This intricate interplay shapes a landscape where innovation harmonizes with vulnerability.

This article delves into the aftermath of bank failures, unearthing impacts on what lies ahead for individuals, businesses, and the crucial element of trust.

We navigate disruptions caused by collapses, outlining strategies for resilience. As we uncover the intricate mechanisms at play, we fortify the foundation of financial structures. This journey is not just about comprehending the past; it's about forging a more resilient and stable future.

In the spring of 2023, a remarkable and concerning pattern emerged as three out of the four largest bank failures in history unfolded. The demise of Silicon Valley Bank (SVB) serves as a poignant example of mismanagement, leading to a cascading series of failures across its leadership, oversight, and regulatory frameworks. SVB's situation is remarkable due to its unique and highly concentrated business model, which revolves around servicing tech startup companies in Silicon Valley. Some of these companies are tech giants such as Roku, Circle, Pinterest, Shopify, etc. An important aspect of SVB’s failure is that they relied heavily on tech investors; ones that would be most active on social media platforms such as X (formerly known as Twitter) and Instagram.

During the month of April 2023, the Federal Reserve (Fed) released their review of what went wrong at SVB. Among the findings reported, the Fed highlighted four causes of the bank's failure:

1. The bank's top leadership failed to effectively handle their risks related to interest rates and liquidity. However, the bank also faced notable vulnerabilities such as exposure to interest rate risks and a heavy reliance on uninsured deposits. Nonetheless, SVB's collapse also highlights existing shortcomings in regulatory measures and oversight that required attention.

2. The Fed supervisors did not fully appreciate the extent of the vulnerabilities as SVB grew in size and complexity. The regulatory requirements set for SVB were insufficient, and the supervision of the bank lacked the necessary urgency which is further explored in this paper. Furthermore, the consequences of SVB's failure spread more widely than expected, causing systemic risks beyond what the Fed's risk management framework had anticipated.

3. When supervisors did identify vulnerabilities, they did not take sufficient steps to ensure that SVB fixed those problems quickly enough.

4. The Fed's lightening of the oversight of mid-sized banks impeded effective supervision by reducing standards, increasing complexity, and promoting a less assertive supervisory approach. This just worsened as the bank rapidly grew in asset size and consistently shifted its regulatory requirements from portfolio to portfolio, taking longer transition periods for new standards to be applied in a timely fashion.

The unprecedented event that unfolded at SVB exemplifies the profound impact of technology and the role of social media in shaping the financial industry. The convergence of technology, finance, and social media led to a tech-fueled panic that reverberated throughout SVB. Social media platforms served as a catalyst, amplifying concerns, and spreading panic among depositors and investors. As news and discussions about SVB's stability or lack thereof circulated on X and other social media channels, a wave of anxiety swept over the bank's stakeholders.

This bank run, triggered and perpetuated by the influence of social media, had a profound impact not only on SVB but also on the broader financial landscape. The repercussions extended beyond SVB's own fate, rippling through the industry, and affecting other financial institutions.

[1]

[1] 'The first Twitter-fueled bank run': how social media compounded SVB's collapse | Silicon Valley Bank | The Guardian

One such institution that felt the consequences of SVB's collapse was First Republic Bank. Experiencing parallel challenges to SVB, First Republic Bank also succumbed to failure due to comparable factors. These factors encompassed the presence of substantial uninsured deposits and liquidity challenges. First Republic Bank concentrated on catering to high-net-worth individuals with balances exceeding $250,000. As SVB faced a massive decline in deposits and its shares plummeted, First Republic Bank also experienced a significant decline in deposits and substantial withdrawal requests driven in part by the high volume of uninsured deposits that they carried, along with financial struggles caused by the broader interest rate environment. First Republic Bank’s assets were then acquired by JPMorgan Chase. This event marked the largest financial institution collapse since the 2008 financial crisis, underscoring the magnitude of the situation and the systemic risks it posed.

Furthermore, SVB's failure had a domino effect, with Signature Bank also facing the threat of closure due to widespread deposit withdrawals. This chain reaction highlighted concerns in these banks about poor management practices and inadequate responsiveness to regulatory recommendations. The effects of these failures reached far beyond their immediate impact, raising concerns of a looming economic crisis. Recognizing the critical importance of maintaining confidence in the economy, the Fed swiftly acted by stepping in to bail out SVB. The Fed demonstrated its commitment to uphold financial stability and safeguard the interests of depositors. In a remarkable move, the Fed not only ensured the return of depositors' funds but also exceeded the $250,000 threshold, reaffirming its dedication to maintaining public trust. This decisive action not only averted a potential downward spiral in public sentiment but also highlighted the essential role of regulatory institutions in stabilizing the economy during times of uncertainty.

The SVB bank failure stands as a stark reminder of the transformative power of technology and the profound influence of social media on the financial industry. It serves as a wake-up call for institutions to embrace technological advancements while also recognizing and addressing the risks they bring. By harnessing technology responsibly and adapting to the changing landscape, financial institutions can mitigate potential vulnerabilities and build a more resilient and secure future.

The SVB case serves as a cautionary tale for financial institutions, emphasizing the need for robust risk management strategies and an acute awareness of the impact of technology and social media in the digital age. The incident also underscores the importance of proactive regulatory oversight to ensure the stability and resilience of the financial sector in the face of rapidly evolving technological advancements.

REGULATORY RESPONSE

The regulators' assessment of SVB failure points to mismanagement, board oversight lapses, and inadequate supervision by the Fed. Regulators emphasized poor management and excessive risk-taking as key factors behind SVB's and Signature Bank's collapse. Despite the banking system's overall resilience, SVB's case exposes regulatory weaknesses needing attention.

BANKS' RESPONSIBILITIES

In the wake of lessons learned from SVB's failure, banks must proactively adapt. They should establish clear authority lines, engaged board oversight, independent risk functions and cultivate a risk-aware culture. Strategic alignment of risk management practices is crucial, including evaluating regulatory impact, diversifying clientele and integrating risk considerations into decision-making. By embracing these measures, banks fortify resilience and readiness to navigate evolving regulatory terrain.

On this matter the term risk culture becomes the center of attention. It is because the failing banks did not have a strong risk culture in place that they mismanaged their interest rate risk, liquidity risks and capital requirements. The Fed is focusing on how to regulate the way banks manage their risks. In doing so, banks will need to improve the way they incorporate a proper risk culture into their business strategies in order to form awareness on how to mitigate the likelihood of adverse results occurring from a sudden shift in interest rate changes, liquidity issues or capital shortages.

The Office of the Comptroller of the Currency (OCC) anticipates that banks will "be on the balls of their feet" in terms of risk management in the future, much like our inspectors are. As a result, banks should:

- Avoid getting complacent about recent relative stability in bank markets and favorable credit performance data over the course of the pandemic.
- Reevaluate exposures, particularly asset and liability concentrations, across a variety of scenarios.
- Take precautions against a false sense of security.
- Take precautions in accordance with each bank's risk profile to protect capital and maintain high liquidity.
- Continue to exercise restraint and effective risk management in all risk areas, rather than merely in response to headlines.
- Get ready to respond quickly, convincingly, and explicitly to inquiries from clients, investors, depositors, and other stakeholders regarding their condition and risk profile.[2]

REGULATORS' RESPONSIBILITIES

To address the lessons learned from SVB's failure, regulators are taking measures to reinforce and enhance the financial system's regulatory framework. They are focused on bolstering the supervision process, aiming to increase its speed, efficacy and adaptability. Simultaneously, regulators are reassessing existing regulations, tailoring them to banks of different sizes. The emphasis lies in strengthening risk management practices, particularly in overseeing interest rate and liquidity risks, refining capital requirements and enhancing incentive compensation programs.

[2] Acting Comptroller Issues Statement on Key Risks Facing Federal Banking System | OCC

HA &C

REGULATORY IMPLICATIONS TO BANKS

As banks prepare for heightened scrutiny, regulators are expected to intensify onsite examinations, potentially involving more extensive and extended visits. Regulatory examinations will delve into accuracy of assumptions in liquidity stress tests, alignment with rating systems, and risk management procedures.[3] Regulators will explore banks' strategies, client mixes and business model concentrations beyond thresholds, aiming for a comprehensive grasp of associated risks. Regulatory compliance will demand effective systems for risk identification, measurement, monitoring and mitigation. Boards' oversight alignment with strategy and risk management will be scrutinized, emphasizing an understanding of risk profiles and proper resource allocation for risk mitigation.

The Fed has completed its review of the underlying factors that led to SVB's failure and stated that more attention should be paid to the transition risk of adoption to heightened standards by rapidly growing firms. The Fed is planning to revisit the framework and reevaluate the range of rules affecting banks with over $100 billion in assets. The below short, mid and long term impacts can be expected by smaller regional banks:

SHORT TERM (IMMEDIATE IMPACT):

In the short term, banks with $50 billion in assets may not experience immediate changes, as the regulators seem primarily focused on banks with $100 billion or more in assets. However, there could be some spillover effects as regulatory standards are revised. The regulators' emphasis on stronger risk management, oversight of incentive compensation and capital requirements could lead to a heightened awareness of these areas among smaller banks as well. These banks may also benefit from the lessons learned from SVB's failure in terms of improving their risk assessment and management practices.

MID TERM (1-3 YEARS):

In the midterm, banks with $50 billion in assets may start to feel the impact of the regulators' efforts to enhance the resilience of the financial system. As the regulators revisit the tailoring framework and consider re-evaluating rules for banks with larger assets, there might be some trickle-down effects. The focus on interest rate risk management, liquidity risk, and capital requirements could lead to adjustments in supervisory practices and expectations for smaller banks. These banks might need to refine their risk management strategies and practices to align with potential changes in regulatory standards.

LONG TERM (BEYOND 3 YEARS):

In the long term, the changes in the regulatory framework and supervision could become more comprehensive and affect banks with $50 billion in assets more directly. If the regulators continue to progress in their efforts to raise the baseline for resilience and strengthen standards for a broader set of firms, including those with lower asset levels, banks with $50 billion in assets may experience increased scrutiny. They might need to adapt to evolving regulatory expectations, particularly regarding risk management, liquidity management and capital adequacy. The potential changes to stress testing and incentive compensation oversight could also become more relevant for these banks in the long term.

[3] US bank regulators vow tougher rules, oversight after bank failures | Reuters

HA&C

If the SVB failure could be summarized into a single word, the best depiction for it would be concentrated in “overconfidence.” Several factors pointed out the fact that the combination of a lack supervision and an overconfidence from a decade plus of financial stability in the banking system, supervisors delayed taking action even when SVB was showing signs of weakness. A bank’s top leadership should have a contingency plan in the face of uncertainty; and they should be prepared to evaluate risks with rigor ahead of potential vulnerabilities that could result in potentially hazardous impact to the organization.

Banks should establish clear lines of authority, responsibilities and decision-making processes, require active engagement by the board of directors in risk oversight, independence of risk management functions and promote a risk-aware culture. Financial institutions must strategically adapt their risk management practices, aligning with the changing expectations of regulators. In doing so, the following key aspects are important for institutions of all sizes to have in place if they want to reflect an effective risk profile while staying compliant with new regulatory requirements and avoiding a similar failure scenario within their organization. These aspects are:

INTERNAL CONTROLS

A good, effective system of internal controls aim to meet company objectives and protect their interests. Internal controls not only address the risks to the company but also reduce incurrences of unnecessary costs or effort. It also allows management to stay ahead of flaws in the ordinary course of business, identify risks, mitigate such risks, control the sharing of information, monitor and evaluate the company’s performance in alignment with management’s risk appetite.

FINANCIAL RISK MITIGATION

Recognizing the significance of financial risk in recent bank failures, institutions need to enhance their capabilities in managing interest rate, liquidity, and capital requirements. This involves developing sophisticated models that accurately gauge the impact of interest rate fluctuations, liquidity shocks, capital funding and market volatility on the institution's financial health. Through continuous stress testing and scenario analysis, banks can identify potential vulnerabilities stemming from these multidimensional risks and proactively adjust their strategies to minimize adverse effects. By aligning their risk appetite with regulatory expectations, banks can establish a resilient financial foundation capable of withstanding both expected and unexpected market movements, ensuring their preparedness to navigate the intricate interplay of interest rates, liquidity conditions and market dynamics.

CORPORATE GOVERNANCE

In order for a firm to be resilient under a broad range of economic, operational and other stresses, top leadership, along with support of senior management, should provide for a system of rules, practices and processes that drive the direction and control of a firm. In instances which management failed to establish a risk-management and control infrastructure suitable for its current size and complexity, it certainly would not succeed with anticipated or unanticipated growth. This principle highlights the importance of having a sound corporate governance and risk culture in place.

ERM FRAMEWORK

In response to evolving regulatory requirements, a pivotal step for banks is implementing a robust Enterprise Risk Management (ERM) framework. This approach not only identifies, assesses and mitigates risks across dimensions, but also aligns with business strategies. By evaluating potential impacts on operations, risk profiles and client relationships, banks can adjust their strategies to ensure resilience. This includes diversifying client bases and revenue streams and adopting a client-centric approach that harmonizes business strategies with risk management practices, fostering stability and customer trust amidst regulatory and market shifts.

STRATEGIC BUSINESS ADAPTATION

As regulatory requirements evolve, banks must align their business strategies with heightened risk management expectations. This entails assessing the potential impact of changing regulations on the institution's operations, risk profile should evaluate their client mix, concentrations, and business models to identify areas of potential vulnerability. By diversifying their client base and revenue streams, banks can mitigate the risks associated with heavy reliance on specific sectors or industries. Furthermore, adopting a client-centric approach that aligns business strategies with risk management practices can foster greater stability and customer trust, ensuring the institution remains resilient in the face of regulatory and market shifts.

KEY ELEMENTS IN AN EFFECTIVE ENTERPRISE RISK MANAGEMENT FRAMEWORK

In the ever-changing world of finance, effective risk management is essential for banks' stability and success. This guide delves into key aspects of robust enterprise risk management, from crafting risk appetite statements to uniform risk assessment methodologies, mitigation strategies, monitoring and contingency planning. By embracing these practices, banks can navigate uncertainties, align with regulations and ensure a secure and resilient future.

RISK APPETITE STATEMENTS: Banks should craft a comprehensive risk appetite statement that defines the acceptable level of risk exposure in line with their strategic goals. This statement serves as a guiding framework for shaping risk mitigation strategies and ensuring alignment between risk-taking activities.

RISK ASSESSMENT: The identification of various risks, including technological advancements & changing market conditions, is essential. By conducting comprehensive risk assessments, banks can stay ahead of potential failures and take preemptive measures to mitigate risks. Moreover, ensuring a uniform risk assessment methodology across the organization becomes crucial for aggregating risks at an enterprise level, facilitating a holistic understanding of interconnected vulnerabilities and enabling effective risk management strategies.

RISK MITIGATION STRATEGIES: Banks must develop and implement risk mitigation strategies that align with their risk appetite. This involves employing risk controls, diversifying portfolios and establishing risk limits to manage risks effectively. The integration of qualitative and quantitative analysis enhances risk identification and resource allocation for effective risk management.

RISK MONITORING & REPORTING: Continuous risk monitoring and comprehensive risk reporting are essential for effective risk management in financial institutions. These practices maintain an up-to-date risk profile and ensure transparency and accountability. Regular reporting allows key stakeholders, including the board of directors and management, to make informed decisions. This integration of monitoring and reporting strengthens risk management, especially in response to evolving regulatory expectations stemming from recent bank failures.

DEDICATED RISK PERSONNEL: Establishing dedicated risk committees within the bank's governance structure is vital for robust risk management. These committees, comprising of experienced individuals from diverse backgrounds, provide specialized oversight and guidance on risk-related matters. Their collective expertise ensures a comprehensive approach to risk assessment, mitigation and strategy alignment.

POLICIES & PROCEDURES: Clearly defined risk management policies and procedures serve as the foundation for effective risk governance. Banks should develop and regularly review these documents to ensure alignment with changing risk landscapes and regulatory requirements. Robust policies and procedures outline risk ownership, escalation processes and the integration of risk management into decision-making frameworks.

TRAINING: Training programs are instrumental in cultivating a risk-aware culture within the bank. Employees at all levels should receive ongoing training to understand the intricacies of risk management, including risk identification, assessment and reporting. By enhancing the risk literacy of its workforce, a bank can establish a proactive approach to risk management.

CONTINUOUS IMPROVEMENT: Risk management is an evolving process that requires constant adaptation. Banks should regularly assess their risk management practices, incorporating lessons learned from internal and external events. Continuous improvement efforts enable banks to remain agile in the face of changing risk landscapes and emerging threats. By consistently refining risk management strategies, banks can enhance their resilience and readiness to navigate potential challenges.

CONTINGENCY PLANNING: Banks need to develop robust contingency plans to handle unforeseen events or crises. Stress scenarios, crisis communication protocols and predefined actions during distress ensure preparedness and responsiveness to evolving risks.

HOW CAN HANCOCK ASKEW OFFER SUPPORT?

To effectively navigate these challenges, the value of risk advisory services becomes evident. At Hancock Askew, we specialize in providing comprehensive risk advisory services designed to support organizations in both dynamic and complex situations. Our tailored services cater to the unique needs of financial institutions, assisting them in achieving strategic objectives while mitigating potential risks.

Financial institutions collaborating with Hancock Askew gain access to a team of dedicated experts who possess a deep understanding of the challenges and opportunities within the sector.

We are committed to crafting solutions that align with each client's distinct needs, enabling them to thrive in a constantly evolving landscape while maintaining a strong focus on risk management and compliance.

Our range of offerings includes:

- Enterprise Risk Management
- Internal Audit Outsource / Co-source
- FDICIA / Sarbanes-Oxley Compliance
- Business Process Consulting
- Governance Risk & Compliance
- Cybersecurity & Data Privacy
- IPO Readiness
- SOC Readiness

Considering the SVB case and its repercussions, the importance of robust risk management in the financial industry is underscored. Hancock Askew stands ready to provide informed guidance and support as institutions navigate technological disruptions and evolving regulatory frameworks.

We invite you to reach out to us today to explore how our services can empower your institution to excel in this dynamic environment.

Prepared & Written by:

John Lowell, PMP, Noureddine Naamani, Jose Roman, CPA, CFE | Hancock Askew & Co.

John Lowell, PMP

Director of Risk Advisory

jlowell@hancockaskew.com

786.598.8569

HANCOCK ASKEW & CO LLP
ACCOUNTANTS & ADVISORS

Risk Advisory at Hancock Askew

www.hancockaskew.com