White Paper

Post-SVB - Call To Action For The Banking Industry

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The Silicon Valley Bank (SVB) crisis is a wake-up call for banks to improve balance sheet modeling, to pressure test their contingency playbooks and communication plans, and to better understand risk silos and asset monetization capabilities.

Much has been written in the past 48 hours about the events at SVB: rapid deposit outflows led to a fire sale of securities at a significant loss, which further led to a depletion of the capital base and a solvency crisis. A mature risk management program should prevent exactly this event.

The SVB event has highlighted four flaws in the typical bank risk management approach that other institutions should mobilize to address. While none of these recommendations are a panacea, together they can help other banks ensure resiliency and preparedness for similar challenges.

1. **Stress testing should be conducted across all risk siloes**

   Like most banks, SVB probably conducted interest rate, credit, market, and liquidity risk stress testing. What it might have failed to do is understand the spill-over implications across different risk types. Specifically, there were challenges in addressing:

   - <u>Interest rate risk</u> via unrealized losses in the value of long duration assets due to rising rates
   - <u>Liquidity risk</u> via rapid deposit outflows. This hit SVB harder than other banks because its deposits were concentrated in the most impacted sectors. For SVB, limited asset monetization channels resulted in a fire sale of assets.

   Banks' call to action:

   Banks need to urgently build balance sheet modeling, stress testing, and scenario analysis capabilities that transcend organizational risk and balance sheet silos and link to their strategic planning process. Additionally, reverse stress testing (i.e., considering what it will take to "break the bank") will force banks to have a more complete understanding of the interconnectedness and correlation of various risk types.

2. **Liquidity should not be mistaken for cash**

   By all definitions, SVB had plenty of liquidity (high-quality liquid assets, as defined by prudential standards). What SVB lacked was the ability to convert the liquidity to cash to meet payment obligations in a period of market stress without resorting to a fire sale of assets and a subsequent immediate recognition of large losses. One cause was that SVB lacked scalable securities financing capabilities (i.e., repo) or other means to generate liquidity.

   Banks' call to action:

   This event should encourage banks to pressure test their asset monetization assumptions in their liquidity stress testing framework (i.e., ability to convert HQLA buffer into cash and broader impacts of doing so) and their contingency liquidity plans. Treasurers and CFOs should a) review their liquidity options and b) seek to further develop securities financing capacity to help raise liquidity during periods of stress without resorting to a fire sale of securities. If they can be issued quickly, granular disclosures on liquidity can reassure investors (while general statements should be avoided.)

3. **Concentration risk in the deposit book should be better understood**

An underestimation of the deposit decline velocity was a major contributor to the under preparedness of SVB. SVB's deposit base was concentrated in a specific sector where account balances were declining rapidly. A 'run on the bank' turned into a 'sprint on the bank' due to the interconnectedness of the client base, actions of key influencers, and the pace of action in a digital ecosystem (digital banking and communication channels). A lack of understanding of the concentration risk within their deposit base led to surprise at the scale and pace of the liquidity need.

Banks' call to action:

Bank's must assess the concentration risk (industries, geographies, and archetypes) in their deposit portfolios and, as a result, more aggressively challenge net liquidity outflow assumptions in times of market stress. Beyond immediate depositors, banks also need to have an understanding of, and associated approach to, the influence of key stakeholders (often outside the direct depositor base) especially when the business is concentrated in a relatively small set of specific industries or geographies.

4. There should be a crisis playbook fit for the social media age

SVB represents the first major bank failure in the social media age. The fact that the FDIC took over SVB in the middle of the day on Friday rather than waiting for COB shows how quickly the situation changed. The pace and collective response of depositors was enabled by social media, digital communication, and digital banking. This made the speed of the crisis more resemble a massive cyber breach than a bank run from decades past.

SVB seemed unprepared to respond to such events in a coordinated fashion—both internally and in communication with their investors and depositors. Customer comments indicate that client-facing and investor-facing staff were unprepared to deal with the resulting inquiries or manage the volumes of withdrawals. A failure to reassure key investors and depositors as to what was happening and why was a fundamental contributor to the pace of the demise.

Banks' call to action:

Banks must establish, review and, regularly exercise playbooks for a liquidity crisis. These playbooks should enable banks to better communicate and position their approach to: (1) liquidity raising (2) internal organization (3) operational resilience and, (4) investor, regulatory and customer communications. Just like a cyber event or operational incident response, banks should regularly conduct 'war gaming' exercises to ensure a coordinated response across siloed, and currently unprepared, areas of the bank in the event of a similar crisis.

Importantly, the plan should have a single executive on point and clear roles each individual team must play to ensure coordination across all of the relevant areas of the bank.

Even for banks who have different profiles from SVB, the crisis is a wake-up call to further strengthen the approach to risk management and better prepare to respond to crisis in a well-coordinate and tested fashion.

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