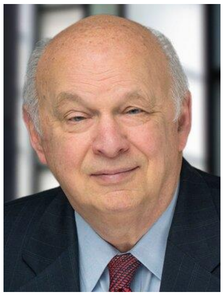
A Comparison Of 2 Bank Failures, With Regulatory Lessons

By **Thomas Brooks, Alexis Crump and Jane Luxton** (May 30, 2023)



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A little more than a month after the high-profile closures of Silicon Valley Bank and Signature Bank, California bank regulators closed First Republic Bank, marking the second-largest bank failure in U.S. history and launching a hurried bidding process from several banks.

In the early morning hours of May 1, the Federal Deposit Insurance Corp. was appointed receiver, and it then transferred all of First Republic's deposits and most of its assets to JPMorgan Chase & Co.

A Tale of Two Bank Failures

While both First Republic and SVB had similar factors that contributed to their downfall, the processes by which they were sold differed from each other. Both banks rapidly increased growth during the last three years. Each grew exponentially, as SVB tripled in size from $71 billion to over $211 billion in assets from 2019 to 2021, and First Republic more than doubled in asset size from $99 billion in 2018 to $212 billion in 2022.

Typically, this is a red flag for bank regulators. Even if there is sufficient capital to support such growth, regulators should be wary that bank management is able to timely hire and train personnel to ensure compliance with laws and regulations as well as the policies and procedures of the bank itself.

The Federal Reserve's report reviewing its supervision and regulation of Silicon Valley Bank found that SVB's board of directors and management failed to manage their risks. However, that review also found that "supervisors did not fully appreciate the extent of the vulnerabilities as Silicon Valley Bank grew in size and complexity."

Both banks had uninsured deposits that far exceeded the amount of their insured deposits — more than 67% of First Republic's deposits were uninsured and SVB had over 93% of uninsured deposits, the most in the U.S. These levels are extraordinarily high.

But virtually all banks have some level of uninsured deposits. The fact that uninsured deposits exist in a bank does not make that bank unsafe. Failure to adhere to supervisory imposed safety and soundness standards makes a bank unsafe.

Banking is a business of trust. When that trust is lost, depositors will turn elsewhere to safekeep their funds. That is why the FDIC was created in 1933, to give depositors comfort that their money was safe in U.S. banks.

SVB and First Republic both experienced quick, unexpected historical outflows of deposits. On March 9, SVB lost $40 billion and informed the Federal Reserve that it expected to lose $100 billion the next day. According to the congressional testimony of Michael J. Roffler, former chief executive officer and president of First Republic Bank, some of SVB's deposit outflows actually found its way into First Republic's deposit base.

But that trust in First Republic by SVB depositors did not last for long. As a result of the panic that ensued after the demise of SVB, in the first week thereafter, First Republic lost about $100 billion in deposits. It was saved from immediate failure by a quick deposit infusion of $30 billion from a Chase-led consortium of 11 banks, but that just prolonged First Republic's demise.

Timing of the SVB and First Republic Resolution Processes

SVB was closed on March 10 and the FDIC was appointed receiver. Typically, when a bank fails, over the ensuing weekend the FDIC is able to find another bank to purchase all of its assets and assume all of its deposits, both insured and uninsured.

However, instead of resolving the SVB situation over the two-day weekend, it took the FDIC more than two weeks to find a buyer, and a purchase and assumption transaction was finalized with First-Citizens Bank and Trust Co. on March 27. During this period, First Republic lost over $100 billion in deposits as a result of the financial panic that followed the failures of SVB and Signature Bank.

Had the FDIC been able to sell SVB during that first weekend, would the level of financial panic have been diminished and could First Republic's failure have been avoided, saving the FDIC $13 billion in estimated losses? Why did the resolution of SVB take 17 days when First Republic was resolved in one day?

As the Federal Reserve was the primary federal regulator of SVB, the FDIC had less knowledge of the financial status of SVB. Usually, bank regulators communicate with each other if there are problems with one of the banks that they regulate.

The review found "31 open supervisory findings when it failed in March 2023, about triple the number observed at peer firms." All of these findings related to safety and soundness issues that SVB failed to correct, and the Federal Reserve did not use its enforcement tools to ensure appropriate compliance.

It appears that the FDIC was not aware of these issues and that could have led to its delay in preparing a bid package to send to other potential bank acquirers.

The FDIC has not provided a report regarding the failure of First Republic, but Roffler stated in his congressional testimony:

> Neither regulator expressed concern regarding First Republic's strategy, liquidity, or management performance — just the opposite. The success of these efforts is demonstrated by the historical lack of regulatory issues or litigation against First Republic.

With First Republic, the FDIC was its primary federal regulator and its examiners had intimate knowledge of the bank's condition. Since there were no significant supervisory issues with First Republic, the FDIC was able to timely develop a bid package that produced competitive bids, which resulted in the least cost to the FDIC — hence the one-day closing and immediate sale of First Republic.

What Comes Next

We now have experienced two of the three largest bank failures in history. Might one have been avoided if there had been timely communication among the federal bank regulators?

The ease of moving deposits has increased markedly, and even faster methods are coming soon. As almost half of all deposits are uninsured, federal and state bank regulators face a challenge as to how to control or diminish rapid deposit outflows when even a hint of financial panic exists.

Quicker use of enforcement tools and better communication among them would be a useful start.

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