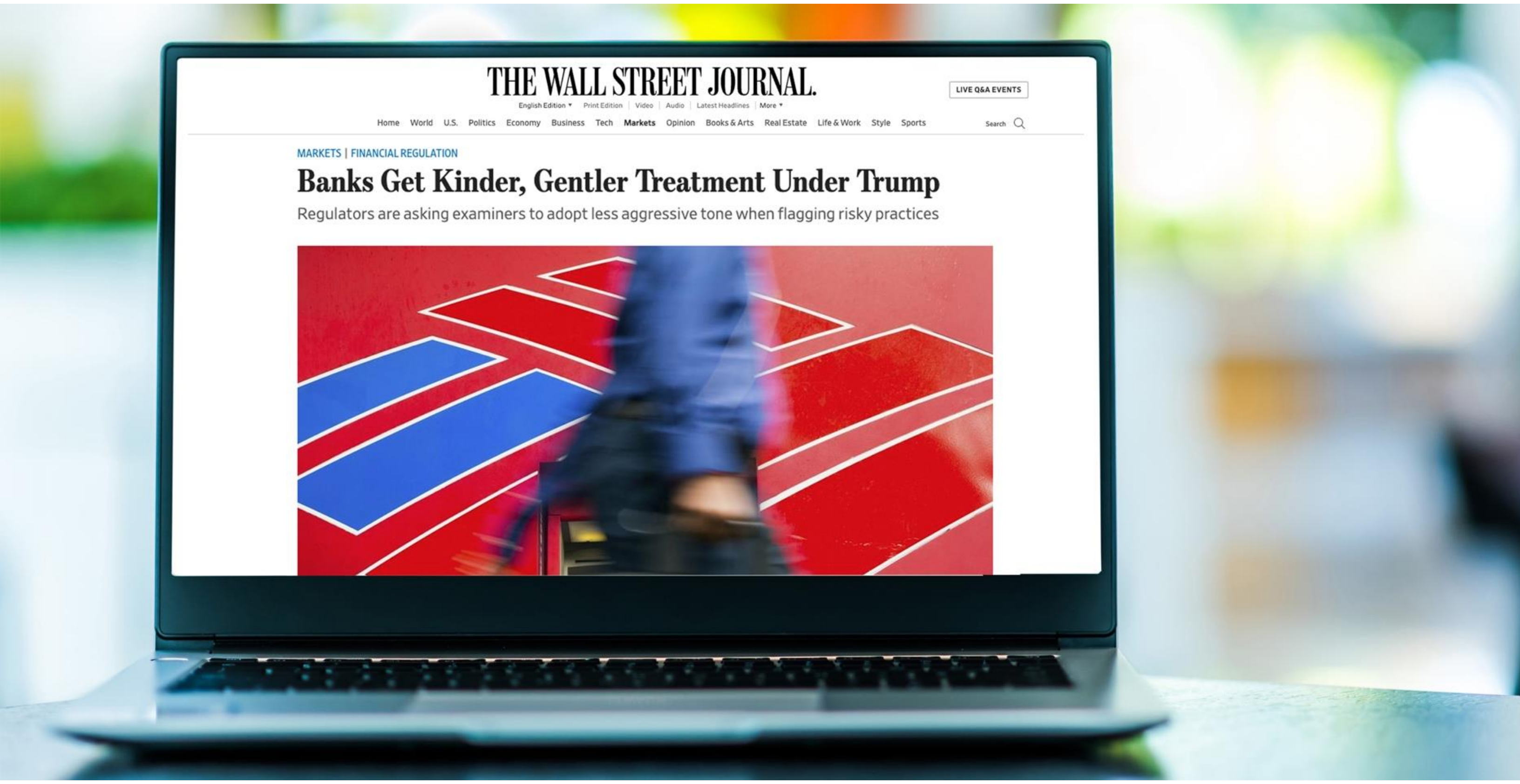
BANKING FACT SHEET

Federal Reserve Deregulation Caused the Failure of Silicon Valley Bank and the 2023 Banking Crisis



Dennis M. Kelleher | *Cofounder, President, and CEO*

March 27, 2023

TABLE OF CONTENTS

INTRODUCTION

The facts make clear that the failure of Silicon Valley Bank (SVB), Signature Bank, and the ongoing banking crisis was avoidable, and the causes are not a mystery: once Trump took office in 2017, the ***financial industry was significantly unleashed, unsupervised, and unpoliced***. When that happens, the industry is incentivized to take excessive risks and engage in reckless if not illegal behavior because they get to enrich themselves by gambling with other people's money. The result is that bankers and financers have unimaginable upside and little if any downside, which taxpayers and Main Street families end up paying for. ***The evidence for this is objective, overwhelming, indisputable, and publicly available***, including as specifically applied to SVB and others impacted by the current banking crisis.

This should surprise no one. Eliminating financial protection rules and weakening supervision are like getting rid of the security guards, taking the locks off the doors, and removing the alarm systems at banks in a high crime area while simultaneously reducing the cops patrolling the streets and taking away the ammo of the few cops who are left. There is only going to be one result: high risk, reckless, and illegal behavior. That is what happened in banking and finance during the Trump administration.

While the results of this irresponsible deregulation are only becoming visible now, they were ***inevitable, predictable and, indeed, predicted in detail in real time*** starting early in the Trump administration. As described below, the very risks now materializing were identified in the dissents of then-Federal Reserve Governor Lael Brainard, then-FDIC Director Marty Gruenberg, as well as by Better Markets in more than 50 deregulatory rulemakings across the financial regulatory agencies and in many reports, fact sheets, and articles throughout the Trump administration (as detailed in Appendixes 1 and 2 attached below).

Yet in the face of this public, high-profile, substantive, and repeated opposition that detailed the very risks that have now materialized, Federal Reserve (Fed) Chair Jay Powell, former Vice Chair for Supervision (VCS) Randy Quarles, and others nonetheless massively deregulated and delivered the very banking crisis now happening in the country. That's why if local Fed supervisors failed at SVB or elsewhere, it's because they were set up to fail by Powell and Quarles who undermined them and tied their hands, as detailed below. Blaming others would be nothing more than scapegoating much less culpable people for the knowing failures of the Fed's leadership.[1]

Given the Fed's lead role in deregulating the banks and causing the current crisis, the focus of this Fact Sheet is on banking deregulation at the Fed. It comprehensively reviews the Fed's deregulation that was enacted during the Trump Administration, including the significant and direct role of Chair Powell as aided and abetted by Quarles once he got to the Fed. Tellingly, Powell began deregulating even before Quarles arrived at the Fed when, in August of 2017, he pushed a proposal that weakened the use of Matters Requiring Attention ("MRA"s) and even Matters Requiring Immediate Attention ("MRIA"s), now at the center of the SVB collapse. Then, in September 2018, they undermined supervision at SVB and elsewhere by de facto eliminating the use of guidance, tying the hands of supervisors. Deregulating and undermining supervision from Washington DC, however, was not enough for the Fed. Quarles (along with FDIC Chair McWilliams) traveled the country determined to ensure that the Fed's on-the-ground line-supervisors got the message to go easy on the banks and bankers, ushering in "kinder, gentler treatment" that empowered bankers at the expense of supervisors, safety and soundness, and even financial

[1] Of course, none of the actions or conduct of the Fed, Powell, Quarles or other personnel from the Fed or any other regulatory agency in any way absolves the members of the Board of Directors or the executives and officers of SVB for their deficient conduct, gross mismanagement, irresponsible if not reckless or illegal conduct in connection with the collapse of the bank. They, first and foremost, are responsible for what happened, and they should be held fully accountable by the Department of Justice, the SEC, shareholders, and regulators as warranted by the facts and circumstances.

stability. Regulators, with the Fed in the lead, also gutted the Volcker Rule which enabled SVB to, among other things, increase investments in venture capital firms and sell its hedges in 2022 on $15.26 billion of its available for sale (AFS) securities for short term gains. That opened the gaping hole of unrealized and unhedged losses at SVB in March 2023, causing the collapsed and contagion that has required bailouts and inflicted widespread pain across the US (as detailed below and in Appendix 3 attached below).

Unfortunately, those deregulation facts are getting lost in a tidal wave of misinformation. With so many involved in causing or contributing to the failure of SVB, Signature Bank, and the ongoing banking crisis, many are now engaged in coordinated disinformation campaigns to distract from their roles or looking for scapegoats to avoid responsibility and accountability. Unsurprisingly, the banking industry and their allies are foremost among them, seeking to blame anyone but themselves, releasing incomplete and misleading information masquerading as "analysis," and doing whatever it takes to prevent additional financial safety rules, no matter how necessary. Sadly, the Fed isn't far behind, apparently selectively disclosing highly confidential supervisory information to the media in an attempt to distract from involvement and the failures of Chair Powell, shape a more friendly narrative, and preempt VCS Michael Barr's investigation.

In focusing on the actual facts, it is important to remember that while the Trump administration was in the lead and deserves the largest share of blame, it did not do this alone. It was aided and enabled by bank directors and executives supported by their trade groups, lobbyists, lawyers and their many political, academic, media and other allies, as well as by financial regulators, elected officials, prosecutors, and the broader financial industry, including the titans of Wall Street, who all irresponsibly pushed a deregulation agenda when most knew better. After all, the catastrophic crash in 2008 was caused by many if not most of the same drivers of this banking crisis, including in particular widespread deregulation in the years preceding that crash and regulators catering to the industry rather than protecting the public.

As important, the debate over the significance of the law passed on a bipartisan basis in 2018 (with the Orwellian title of "Economic Growth, Regulatory Relief, and Consumer Protection Act," EGRRCPA) is a misleading distraction. Yes, it deregulated large banks like SVB and Signature, and, yes, it sent a loud and clear message that deregulation was coming, that systemic risk concerns were limited mostly to the largest Wall Street megabanks, and greenlighted the Fed to deregulate further than the letter and spirit of the law. However, that law was just one piece of a much larger, broad-based, sweeping deregulation juggernaut during the Trump administration. That included more than 50 deregulation rules and actions across all the financial regulatory agencies (see Better Markets' Road to Recovery Report), as directed and supported by the Trump White House. While the media and others focus on the easy-to-cover, easy-to-understand Congressional actions like EGRRCPA, the real action deregulating finance happens in the dark and almost entirely uncovered corners of multiple regulatory agencies – where Better Markets has participated in more than 400 rulemakings since being founded in 2010. Focusing on EGRRCPA is literally missing the forest of deregulation for a tree, albeit a sizeable one.[2]

[2] EGRRCPA deregulation predictably contributed to the current crisis because large U.S. banks were known to be domestic systemically important banks – DSIBs – even if not GSIBs. Nevertheless, EGRRCPA eliminated the legislative requirement that enhanced standards be applied to bank holding companies with between $50 billion and $100 billion in assets and raised the asset size-based threshold for the required application of those stronger rules and standards for bank holding companies from $50 billion to $250 billion. It also gave the Fed broad discretion to determine whether it should continue to apply the stronger, enhanced prudential standards to bank holding companies like SVB with assets of between $100 billion and $250 billion. The Fed, under the leadership of Chair Powell and VCS Quarles, exercised that discretion to significantly deregulate banks like SVB far beyond what the law required. Like the rest of the deregulation during the Trump administration, facts didn't matter much when EGRRCPA was passed. For example, supporters of EGRRCPA claimed it was necessary because the Fed was mindlessly imposing a one-size-fits-all regulatory regime on all banks, but that was inaccurate. The Fed actually had a range of prudential standards that it applied depending on a bank's risk profile and tailored to the risks of its activities, as detailed here. This Fact

None of this is to suggest that the Dodd-Frank Financial Reform and Consumer Protection Act (Dodd-Frank) was eviscerated. Thankfully, that didn't happen. While the pillars of financial reform were significantly weakened during the Trump administration, there is no question that the banks and the financial system are much stronger now than they were in 2008, with more capital, liquidity, and resilience. However, that is the wrong benchmark. After all, in 2008 the financial system was in the worst shape since the Great Crash of 1929, so it had better be in better shape now than then. The key question is whether the financial system in 2023 is as strong as it needs to be to protect the economy and the American people. The answer to that question is clearly no and it was made much weaker, fragile, and vulnerable by the deregulation during the Trump administration, led by Chair Powell at the Fed.

Trump's Massive, Widespread Deregulation

From the start of the Trump administration, deregulating finance was on the top of the agenda, and he appointed deregulators at the White House, the Fed, the FDIC, the OCC, the SEC, the CFTC, and the CFPB. Tellingly, this deregulation agenda was not enacted based on evidence or data (as made clear by the absence of such in the rulemakings), but on vacuous words and phrases, like "tailoring," "efficiency," "right-sizing," "streamlining," "fairness," and "fine-tuning." This was fueled by a mindless ideology and zeal that found every self-interested industry argument for deregulation compelling and persuasive, no matter how unsupported.

But the rhetoric used to disguise their deregulation cannot hide the reality of their primary objectives: (1) to dramatically reduce the rules that protect Main Street families from the high risk, dangerous activities of finance, and (2) to interfere with supervisors' ability to ensure that banks operated in a safe and sound manner and were not a threat to financial stability. The Trump administration and its many enablers accomplished their objectives and the failures of SVB, Signature and the ongoing financial crisis are a direct result.

At the Fed, the deregulation work was led by Chair Powell and Vice Chair for Supervision Quarles; at the FDIC, by Chair McWilliams; at the OCC, by Acting Comptroller Noreika followed by Comptroller Otting; at the CFPB, by Directors Mulvaney and Kraninger; at the CFTC, by Chairs Giancarlo and Tarbert; and, at the SEC, by Chair Clayton. These deregulators were abetted by others in the Trump administration, including at the Treasury Department by Sect. Mnuchin, who was also Chair of the Financial Stability Oversight Council (FSOC), which he neutered; at the White House by the Chair of the National Economic Council (NEC) Gary Cohn, the former Goldman Sachs' President, and his deputy Andrew Olmem; at the Office of Financial Research (OFR) by Dino Falaschetti; and at the PCAOB by Bill Duhnke. These deregulators were supported by Republicans in the House, especially those on the House Financial Services Committee (HFSC), and in the Senate, especially the members of the Senate Banking Committee (SBC).

Reviewing all their deregulatory actions would probably take a book or two and the Fed's actions were most consequential for banks, SVB, and the ongoing banking crisis. That is the focus of this Fact Sheet.

Fed Deregulation of SVB Was Led by Chair Powell

Sheet is not going to further discuss the law and the role it played in the collapse of SVB because it has already been widely reviewed elsewhere, whereas the Fed's dramatic deregulation and Powell's role have not been. *See*, *e.g.*, Caitlin Reilly, *Post-mortems begin on Silicon Valley Bank failure*, ROLL CALL (March 13, 2023), *available at* https://rollcall.com/2023/03/13/biden-raps-2018-bank-law-as-post-mortems-begin-on-svb-failure/.

While the deregulation was widespread, there is no question that Chair Powell and VCS Quarles at the Fed were in the lead pushing further and faster than others, including the legislators who passed EGRRCPA. In enacting the rules required by EGRRCPA, the Fed deregulated the large banks like SVB, Signature and others far beyond what the law required and beyond even what some supporters of the law believed appropriate. But that was just the tip of the deregulation iceberg.

Powell Leads the Charge on Deregulation and Weakening Supervision

Some want to pin all the blame for the Fed's deregulation on former VCS Quarles, who does in fact deserve a great deal of blame. However, that would overlook and understate the critical role of Chair Powell, who favored deregulation long before he got to the Fed. At the Fed, Chair Powell not only voted for every single deregulation rule Quarles proposed, but he also enthusiastically supported that deregulation in speeches, Q&As, and in Congressional testimony (including in decidedly misleading testimony when he misrepresented the Fed's deregulation and tried to minimize his role). Tellingly, Chair Powell also lead the deregulatory charge **before** VCS Quarles was even sworn in on November 6, 2017.

It's important to understand that this was a strategic, targeted two-prong attack on the Fed's regulation **and** supervision of banks. While regulation gets most of the attention, supervision is as important, which is why the industry attacked both and why Powell and Quarles materially weakened both.

There are a couple of hundred people working on regulation at the banking regulators, but there are more than 5,000 working in supervision. Many of those working in supervision do not go to work at the offices of the banking regulators; they work on-site at the banks, especially at the biggest banks, working full time examining all the operations and activities of the bank. Regulations are detailed rules that result from a time-consuming, lengthy process (often taking years) governed by the Administrative Procedure Act, which includes significant if not overwhelmingly industry input and influence. However, those rules do not and cannot capture all the many aspects of banking and bankers' conduct. If they did, the rules would be forever long, detailed and, nevertheless, quickly outdated as the world of banking and finance rapidly changes. That's why guidance is so critically important to the proper regulation and supervision of banks: it flexibly fills in the many interstices of the rules in a dynamic and flexible way as the world and banking evolves, enabling supervisors to require bankers to prioritize safety, soundness, and financial stability at all times even as conditions change.

Powell, Quarles, and others weakened regulation **and** supervision, enabling excessive risk taking that resulted in banks being fragile and prone to failure like SVB, Signature and others. Much of that is captured and detailed in the documents in Appendix 1 (including as summarized in a Sept. 15, 2020 Special Report by Better Markets: "The Road to Recovery: Protecting Main Street from President Trump's Dangerous Deregulation of Wall Street") and in the rule proposals in Appendix 2 (including Better Markets comments letters addressing those rules), so only a few key actions will be highlighted here.

For example, Chair Powell was the driving force behind two proposals the Fed made on August 3, 2017. One proposed changes to the rating systems for large financial institutions and was finalized on Nov. 11, 2018 and impacted the entire range of supervision at banks, including SVB and Signature. The other was innocuously and misleadingly entitled "supervisory expectations for Boards of Directors," which seriously changed how supervisors reviewed the conduct of banks and, importantly, how they communicated deficiencies with management and the Board – key issues at SVB.

Better Markets strenuously objected to this proposal in a detailed comment letter. It pointed out that the proposal failed to disclose material information about or the basis for these significant changes, set supervisory expectations too low, and enabled management to keep boards in the dark about key supervisory issues which would prevent boards from discharging their management oversight duties. Weak boards and dominating management restricting information to boards were key problems in the 2008 crash and often enabled a culture and practice of excessive risk taking if not illegal conduct. Yet Powell's proposed rule did not consider any of that but would significantly limit supervisors' ability to hold management to account for such actions and limited their ability to ensure that the Board was informed and could exercise their oversight of management.

For example, Powell's proposal would fundamentally change the Fed's then existing practice regarding the communication of critical supervisory findings to boards. It provided that most informal enforcement actions, known as Matters Requiring Attention ("MRA"s) and even more urgent Matters Requiring Immediate Attention ("MRIA"s), would only be directed to senior management for corrective action, not to boards, who would be left in the dark. Removing supervisory direct access to boards would dramatically reduce the authority of supervisors and the power MRAs and even MIRAs. It would also deprive boards of information they needed to discharge their oversight duties and would make boards even more dependence on senior management for the availability and quality of key information.

This was a radical proposal given that the information contained in MRIAs and MRAs is on its face highly material to a board's oversight function. The proposal described MRIAs as "matters of significant importance and urgency that the Federal Reserve requires a supervised institution to address immediately." It explained that such matters include those—

> (1) that "have the potential to pose significant risk to the safety and soundness of the institution;"
>
> (2) that "represent significant noncompliance with applicable laws or regulations;"
>
> (3) that constitute "repeat criticisms that have escalated in importance due to insufficient attention or inaction by the institution;" and
>
> (4) that "have the potential to cause significant consumer harm."

MRAs rise to nearly the same level of importance. They are matters concerning the same basic array of threats to an institution as MRIAs, including dangerous, destabilizing and even lawless conduct, but that pose less urgency because the harm is less imminent. The proposal explained that issues giving rise to MRAs are "important" and "must be addressed to ensure the institution operates in a safe-and-sound and compliant manner," although the threats to safety and soundness and to consumer protection are considered "less immediate."

The proposal was dangerous in other ways also pointed out in the comment letter. While this wasn't finalized as a rule until February 26, 2021, it nonetheless immediately sent an unmistakable message to supervisors to back off both management and board members, including related to the identification of some of the most important matters like MIRAs and MRA.

This proposal is directly related to seriously weakening and undermining the supervision of banks like SVB and undoubtedly enabled the mismanagement and risk taking at SVB and elsewhere, as increasingly specific leaks to the media of highly confidential supervisory information have revealed.[3]

First, *Bloomberg News* reported on March 17, 2023, that starting in 2022 Fed

[3] Confidential supervisory information (CSI) cannot be publicly disclosed even by the bank that the CSI relates to. Indeed, it is a violation for the bank or anyone to even publicly acknowledge the **existence** of MRAs, MIRAs, or a 4(m) restriction. Because there are civil and criminal penalties if CSI is improperly disclosed, such information is often a closely held secret even within the bank itself. It cannot be overstated what a serious and very rare breach it is for anyone to be disclosing or discussing such CSI publicly as has recently frequently been the case regarding SVB.

> "examiners began sending [SVB] two types of warnings: [MRAs and MIRAs]. [They] are supposed to seize executives' attention, requiring they fix problems to avoid more severe sanctions, known as consent orders."

Second, *The New York Times* reported on March 19, 2023 even more detailed highly confidential supervisory information about SVB, including that

> "In 2021, a Fed review of the growing bank found serious weaknesses in how it was handling key risks. Supervisors … issued six … warnings known as [MRAs and MIRAs], flagged that [SVB] was doing a bad job of ensuring that it would have enough easy-to-tap cash on hand in the event of trouble. But the bank did not fix its vulnerabilities. By July 2022…[it was] rated deficient for governance and controls…."

Also on March 19th, the *Wall Street Journal* reported on an apparently internal SVB presentation that disclosed that the Fed

> "raised concerns about risk management at SVB ***starting at least four years before***…. In January 2019, the Fed issued a [MRA] to SVB over its risk management systems…. Regulators are supposed to make sure the problem is addressed, but it couldn't be learned if the Fed held SVB to that standard in 2019. Over time, the [Fed] issued numerous warnings to SVB."

Third, the *Wall Street Journal* reported on March 24, 2023 that "SVB was placed in a '4M' restriction" after getting the MRAs and MIRAs, and that

> "Last fall, the San Francisco Fed met with senior management of the bank and highlighted problems with the bank's handle on interest-rate risk in a rising rate environment…."

It also reported that Powell said at a press conference on Wednesday, March 22, 2023, that "The supervisory team was apparently very much engaged with the bank [and] repeatedly was escalating." But he failed to mention that these supervisory actions did not include the transmission of the MRAs or MIRAs being sent by supervisors to SVB's board because of the deregulatory actions he had previously pushed.

Apparently, this "volley of warnings about the company's poor risk management" and the "stack of MRAs and MRIAs" at SVB had little if any impact. Or, as *The American Prospect* noted, "[i]n reality, [the matters requiring attention/MRAs and matters requiring immediate attention/MIRAs] obviously *didn't* require any attention" and "the only takeaway from the SVB situation is that this troubled bank with poor risk management did not fear its regulator." That would seem to be the foreseeable result of Powell's push to downgrade MRAs and MIRAs and supervision generally.[4]

As *The American Prospect* also noted, the entire SVB debacle is "an effective admission that banks don't really listen to them [the Fed's supervisors], confident in the knowledge they won't suffer any penalties for such imprudence and will in fact be rescued if anything goes really wrong."

As starkly illustrated in the attached Appendix 2, these rule proposals, however dangerous, were just the beginning of the Fed's deregulatory juggernaut, which increased in frequency and impact once Quarles arrived in November 2017.

---

[4] Of course, SVB's CEO being on the board of the Federal Reserve Bank of San Francisco, SVB's regional regulator and supervisor, undoubtedly played a role as well. *See* Gretchen Morgenson, *The Federal Reserve is supposed to monitor the nation's banks for risk. Is it up to the job?*, NBC News (March 22, 2023), available at https://www.nbcnews.com/business/business-news/federal-reserve-san-francisco-silvergate-silicon-valley-bank-failure-rcna75908.

Fed Undermines Supervision Further by Tying Supervisors' Hands

Another example of the Fed making supervision even more difficult – and, again, directly related to the collapse of SVB, Signature and the problems at other banks – was when the Fed, the FDIC, the OCC, the CFPB and the National Credit Union Administration issued a joint statement on September 11, 2018, that greatly limited the power and authority of supervisors. Again, it was innocuously if not misleadingly entitled "Agencies Issue Statement Reaffirming the Role of Supervisory Guidance."

Rather than "reaffirming the role of supervisory guidance," they were in fact announcing its demise. The regulators stated, in substance, that supervisors could not use guidance to rein in a bank's risky conduct even if it threatened safety and soundness or financial stability unless it also broke a specific law or rule. For many years, banking regulators and supervisors had issued guidance covering a wide range of issues and conduct, often at the request of the industry for clarity and, well, guidance. Supervisors used that guidance to force banks to focus on safety, soundness, and financial stability by limiting banks' riskiest conduct. That, however, limited the banks' highest risk activities which were also the most profitable activities. Restricting and defanging the use of guidance by supervisors was at the top of the industry's wish list. This reportedly included lobbying of the Fed and OCC by the CEOs of the Bank of America and JPMorgan Chase, among others. As they did for more than four years (because Quarles did not resign as VCS until the end of December 2021, almost a full year into President Biden's first term), Trump's deregulators delivered, meaningfully limiting one of the supervisors' most important tools in reining in risk at the banks like SVB, Signature and others.

As former Fed Governor Dan Tarullo said,

> "I believe that part of it [the problems at SVB] is just the 'Don't be too tight on your supervision, you need to find legal problems before you tell the banks to change what they were doing."

That shifts the balance of power from the supervisors to the bankers who can press them to identify specific rules or laws that relate to supervisors' identification of threats to safety and soundness. Moreover, the supervisors know that the most senior leadership of the Fed will not back them up. Indeed, they are the ones insisting that supervisors go easy on the banks. To do otherwise would not just be unwise or unfruitful, but a career limiting decision for supervisors.

As a banking expert recently put it in a *New York Times* article,

> "[W]hen it came to 'bringing in the big guns' – backing up the stern warnings with legal enforcement – supervisors must, in many ways, rely on the Fed Board in Washington. If bank leadership thought the Board was unlikely to react to their deficiencies, it might have made them less keen to fix the problems."

As one FDIC official recently said to the *Wall Street Journal*,

> "Absent some emergency…it can be challenging for supervision to push back against management if the bank is in compliance with all of its capital and liquidity requirements, as SVB was."

Moreover, as reported by the *Wall Street Journal*, once the Fed issued its "guidance on guidance" expressly stating it didn't have the force of law,

> "After that, it became more of a battle to get a bank to agree to changes, according to a former big-bank examiner for the San Francisco Fed, who said the move 'created 10,000 more steps.'"

The article detailed the problems supervisors faced once the Fed Board deprived them of the ability to rely on guidance and forced them to focus narrowly on specific rules and laws to get banks to comply:

“Ideally, when bank examiners pointed out problems, the bank’s management would agree and voluntarily comply. But former examiners for the San Francisco Fed said that a bank might involve its lawyers if it didn’t agree with the examiners’ findings, treating the process as a court case rather than a routine oversight matter.

“If examiners thought the bank should prepare for a scenario such as rapid growth, soaring interest rates and abrupt loss of deposits, as later happened to SVB, examiners would be hobbled by the absence of explicit regulatory guidance calling for such preparations, another examiner said. The bank could point out such a combination of events had never happened before and preparing for it would hurt shareholder returns, this former examiner said.”

Of course, equipping the banks with arguments to fight supervisors seeking safety and soundness changes was what the industry wanted and that’s what the Fed’s actions were inevitably going to deliver. **If the supervisors could not point to a specific rule or law relating to the conduct, bankers and their lawyers fought them every step of the way. And the supervisors, bankers and lawyers knew that Chair Powell, VCS Quarles, and the leadership in Washington would not support them in disagreements with the bankers.**

Remarkably, even the Fed issuing such guidance expressly stating that the banks didn’t have to pay attention to guidance wasn’t enough for the financial industry. It wanted even greater leverage to fight supervisors fulfilling their duty to ensure banks were operating in a safe and sound manner. They lobbied the five agencies that issued the joint statement in 2018 to codify it as a rule and, on October 29, 2020, just days before the Presidential election in 2020, they proposed just that and the Fed and the other agencies adopted the final rule on March 31, 2021.

Fed Directly Beats on the Bank Supervisors to Go Easy on the Banks

While those proposals indirectly undermined the proper supervision of banks, Quarles wasn’t about to do indirectly what he had the power to do directly: use his full weight and authority as the Fed’s Vice Chair for Supervision to personally and directly beat up on the supervisors to go easy on the banks, albeit using euphemisms to try to hide his intent and objective. Coming on top of the actions reviewed above, this *Wall Street Journal* headline on December 12, 2018 says it all:

MARKETS | FINANCIAL REGULATION

Banks Get Kinder, Gentler Treatment Under Trump

Regulators are asking examiners to adopt less aggressive tone when flagging risky practices

Trump administration officials hope to reshape relationship with banks.
PHOTO: CHRIS KEANE/BLOOMBERG NEWS

By Lalita Clozel Follow
Dec. 12, 2018 1:11 pm ET

The story reported that,

> "[t]wo Trump-appointed officials [Fed VCS Quarles and FDIC Chair McWilliams] have spent several months touring the country, visiting bank examiners in regional offices and asking them to adopt a less-aggressive tone when flagging risky practices and pressing firms to change their behavior."

The article noted that "[t]he internal effort to change the culture among examiners has included specific directives from Trump-appointed officials. Mr. Quarles told Fed examiners to include positive feedback in their reports instead of focusing only on deficiencies."

Quarles was quoted basically bragging about how extensive he intended to gut the supervision of banks:

> "Changing the supervision culture 'will be the least visible thing I do and it will be the most consequential thing that I do."

As if foreseeing the collapse of SVB, Signature and problems at other banks, the story then reports that "[c]ritics say friendlier examiners could blunt the effect of postcrisis rules, giving banks more freedom to engage in riskier practices." The prescient article explicitly detailed the risks of Quarles' actions as well as their similarities to what regulators had done wrong in the years before the 2008 crash. History was repeating itself, although it didn't materialize until 2023.

The Fed-Led Gutting of the Volcker Rule Enabled SVB to Increase Risk-Taking and Sell Its AFS Hedges for Short Term Gains, Directly Resulting in Its Collapse

A key driver of the 2008 crash was banks engaging in very high risk and dangerous proprietary trading, which used and endangered depositors' money to subsidize banks' socially useless but incredibly lucrative gambling. This was little more than reckless, leveraged, swing-for-the-fences, risk-taking to maximize short term returns and bankers' annual bonuses, routinely reaching $10 million and some reaching as much as $100 million – for one year.

These activities were dramatically curtailed in the Dodd-Frank Act in provisions referred to as the "Volcker Rule," which had two parts: one limited banks' direct prop trading and one limited banks' indirect prop trading by investments in outside funds like venture capital (called "covered funds"). Both parts of the rule were gutted by Fed-led changes under the leadership of Powell and Quarles. SVB used this deregulation to take excessive risks and amplify (short term) returns, contributing to its failure. These Fed-driven changes were accurately reported as a "victory for the financial services industry."

The first weakening of the rule was proposed on July 17, 2018 (finalized on July 22, 2019). As pointed out in our 57-page comment letter, the new rule very broadly gutted the Volcker Rule in many material ways and, again, lacked a valid basis, mostly just repeating conclusory industry claims without any data or supporting information that Powell, Quarles and others nonetheless found persuasive. Among other things, this rule eliminated a presumption that was a bright line and replace it with a complicated if not impossible series of tests to determine compliance with what was left of the rule. The new rule eliminated the original presumption that positions held for less than 60 days were prohibited short term prop trading. Because the rule also expanded information asymmetries between supervisors and banks, the result of eliminating the presumption was to put supervisors in the impossible position of policing the rule in the dark, which de facto meant that positions held for less than 60 days were excluded from the enforcement of the rule.

Another key change was to the applicability of the Volcker Rule to banks' trading books and liquidity management like the US Treasury and agency securities SVB had in its available for sale (AFS) portfolio. The original rule would have prohibited SVB from realizing short term profits from sales in its AFS portfolio. Once the Volcker Rule was no longer applicable due to this change, SVB could realize those short-term profits from such sales, and it did in very significant amounts with consequences that directly relate to its failure.

Specifically, at the end of 2021, SVB had more than $15 billion of its AFS portfolio hedged as it prepared for the Fed to raise rates. However, as its short-term profitability dropped in 2022, SVB unwound $11 billion of those hedges to book short term gains of $517 million in the first six months of 2022. As reported by the *Financial Times* in "How crazy was Silicon Valley Bank's zero-hedge strategy?,"

> "And at the end of 2021, SVB's financial accounts indicate that on the AfS side it held $15.26bn of interest rate swaps to hedge against the impact of rising rates on its big bond portfolio. So, what happened? Well, it looks that weakening profitability in 2022 as the tech world made SVB do something really dumb. In the first quarter, it unwound $5bn of AFS hedges to book a $204mn gain, and in the second quarter it dumped another $6bn of hedges to lock in a $313mn gain."

By the end of 2022, SVB "only had $563 million worth of hedges left on its books."

SVB clearly sold the swaps hedging its AFS position to realize short-term gains. This would have been prohibited by Volcker Rule before it was weakened. The original Volcker Rule required that the

> "sale of securities contemplated and authorized by the plan must be principally for the purpose of managing the liquidity of the banking entity, and **not** for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position taken for such short-term purposes."

Thus, the Fed-led changes to the Volcker Rule allowed SVB to reduce $15.26 billion in hedges on its AFS portfolio to almost nothing. (This is spelled out in more detail in Appendix 3 attached below.) Put differently, **imagine what would have happened if the Fed didn't weaken the Volcker Rule and, in March of 2023, SVB had $15.26 billion less in unrealized losses.**

The second very significant weakening of the Volcker Rule was proposed on Feb. 28, 2020 and finalized on July 31, 2020. As pointed out in our comment letter, the new rule targeted a key part of the Dodd-Frank Volcker Rule restrictions that limited banks' investments in hedge funds, private equity, and, notably, venture capital funds, which would expose the banks to the high-risk investments and volatility of those funds. These so-called "covered funds" were largely off limits to banks like SVB, until the Fed and others weakened and removed several key limitations.

These changes were consequential for SVB, which took full advantage of them to dramatically increase its risk in a way that was directly tied to its fragility and failure. While five regulators had to agree to change the rule, the Fed was in the lead and they changed the definition of "Covered Funds" to exclude credit funds, certain venture capital funds, customer accommodation funds, and family wealth management vehicles. The exclusion of venture capital funds was due to the direct lobbying of Silicon Valley Bank, so much so that regulatory agency staff often referred to it as the "Silicon Valley Exemption."

In addition to increasing SVB's geographic and industry concentration in venture capital, these changes to the Volcker Rule contributed in the year following to SVB nearly doubling in size, driven in part from returns from investments:

> "SVB also has an incredibly powerful stream of fee income that has generated more revenue than the bank's lending business in the last four quarters. The bank has solid core fee income that encompasses most typical banking fees and then other fee income lines such as foreign exchange and credit card fees. Silicon Valley Bank also has developed a strong investment bank that specializes in the healthcare and life sciences sector

> and continues to perform well. The bank also makes a ton of money from warrants and equity investments it earns when it banks early-stage companies that most banks will not service. When some of these start-ups go public or get acquired later on, the bank cashes in on those warrants and investments. For instance, the bank sold shares that it obtained from a warrant in the crypto exchange Coinbase Global for $166 million."

There's no denying that the weakening of the Volcker Rule by the regulators—with the Fed in the lead—enabled SVB and other banks to increase their risk-taking, undermining their resilience, creating fragility, and contributing to collapse.

Fed's Deregulatory Agenda Included Many Other Rules

The Fed's deregulation rulemakings included more than a dozen rules in addition to those discussed above. They included rules weaking and lower capital for many banks, weakening stress tests, decreasing liquidity requirements, exempting large banks from crucial supervisory requirements, and weakening the substance and reducing the frequency of stress tests. The rules the Fed proposed and finalized during the Trump administration are listed in Appendix 2 with links to Better Markets' comment letters, which identify the risks and dangers of the many deregulations and weakening of supervision.

In addition to comment letters and participating in the rulemaking process, Better Markets also repeatedly detailed the risks and dangers of the deregulation being implemented at the Fed and at the other agencies. For example, these risks were spelled out as early April 10, 2018, in a law review article entitled "Financial Reform Is Working, But Deregulation That Incentivizes One-Way Bets Is Sowing the Seeds of Another Catastrophic Crash," in a presentation on "Stress Testing as a Policy Tool" at a Federal Reserve Conference in Boston, Massachusetts on July 9, 2019, in a Fact Sheet on Aug. 28, 2019 that highlighted "The Key Changes That Seriously Weaken The Volcker Rule," in a presentation on Sept. 16, 2019 to the Financial Stability Board at the Federal Reserve Bank of New York entitled "The Too Big To Fail Problem Is Alive, Well and Getting Worse," and in a White Paper issued in December of 2020, entitled "Federal Reserve Actions Under the Trump Administration Have Significantly Weakened Post-Crisis Banking Protection Rules." A selected list of these materials and more produced by Better Markets related to Powell and the Fed's deregulation actions are in Appendix 1 attached below.

Another way to understand the extent and gravity of the Powell's and Quarles' deregulation is to read the dissents of then-Fed Governor Lael Brainard. Her votes and dissents, along with her speeches and other public statements, were only the visible part of her fight against the Fed's deregulation juggernaut, as detailed in this June 2019 article: "How an Obama Fed appointee is scuttling Wall Street's bid to ease rules." Notably, because of the Fed's culture of unanimous decision making and collegiality, votes against rules—much less actual dissents—have been rare. In fact, Brainard's vote against a deregulatory rule in April 2018 was the first time a Fed governor voted against a rule in more than seven years at the time. (To a lesser extent, a similar deregulation dynamic was playing out at the FDIC where then-FDIC Director Marty Gruenberg repeatedly dissented from Chair McWilliams deregulation agenda.)

Additional Fed Supervision Failures

Having dangerously weakened the stress tests and reduced their frequency, it is still inexplicable that the Fed didn't at least include material interest rate risk in what was left of the stress tests, given it is such a longstanding, well-known and obvious risks for banks. Those failures were compounded by the Fed when it radically and rapidly changed interest rates from zero to 5% (compounding years of policies that decoupled asset pricing from underlying risks, giving rise to widespread systemic instability as detailed here and discussed here and here).

The Fed should have required supervision to send swat teams into almost every bank as soon as it was determined to implement such a major if not historic policy pivot. Remember, Powell in a very short period of time went from "we're not even thinking about thinking about raising rates" and stridently and unequivocally insisting that inflation was "transitory" to "we're going to raise rates a lot and really fast to stop skyrocketing inflation." The risks embedded in banks' balance sheets were clear and those swat teams should have been sent in the early fall of 2021 as it became clear inflation was not transitory and been completed by the end of 2021 in preparation for the move to QT and rate increases in early 2022. This isn't unfair hindsight. It should have been a no brainer at the time. Every bank has an abundance and variety of interest rate sensitive assets, and it was clear that the Fed's interest rate policy changes were going to drive the value of those assets down. Interest rate risk is ***the*** known, obvious risk.

Yes, the Fed warned the banks like they warned everyone else with their public statements, moving in effect from "transitory" to "not transitory" to "inflation is such a serious problem that the Fed is going to change policy 180 degrees." But banks have portfolios of various sizes and compositions that cannot be repositioned as quickly as the Fed can change interest rate policy. The Fed knows that which is why it's inexcusable for the Fed not to have required supervisors to review and size the scope of the ticking time bombs embedded in banks' balance sheets that they were creating before they exploded. Of course, that would not excuse the inexplicable failure to include material interest rate increases in stress tests scenarios over the years. Regrettably, this is all too consistent with the overall thrust of deregulation generally and weakening stress tests and making them less reliable in particular.

CONCLUSION

While the blame game and search for scapegoats have begun, the facts make clear that the Fed, with Chair Powell in the lead, are responsible in large part for the failure of SVB and the ongoing banking crisis. Both were avoidable, and the causes are not a mystery: once Trump took office in 2017, the financial industry was significantly unleashed, unsupervised, and unpoliced. When that happens, the industry is incentivized to take excessive risks and engage in reckless if not illegal behavior because they get to enrich themselves by gambling with other people's money. The evidence for this is objective, overwhelming, indisputable, and publicly available, including as specifically applied to SVB and the current banking crisis.

While the results of this irresponsible deregulation are only becoming visible now, they were inevitable, predictable and, indeed, predicted in detail in real time starting early in the Trump administration. Nevertheless, Powell, Quarles, and others massively deregulated the banks and gutted supervision, delivering the very banking crisis now happening in the country. Powell began this in August of 2017 even before Quarles arrived at the Fed when he pushed a proposal that weakened the use of Matters Requiring Attention ("MRA"s) and even Matters Requiring Immediate Attention ("MRIA"s), now at the center of the SVB collapse. In September 2018, they also undermined supervision at SVB and elsewhere by de facto eliminating the use of guidance, tying the hands of supervisors. Deregulating and undermining supervision from Washington DC, however, was not enough for Quarles. He traveled the country determined to ensure that the Fed's on-the-ground line-supervisors got the message to go easy on the banks and bankers, ushering in "kinder, gentler treatment" that empowered bankers at the expense of supervisors, safety and soundness, and even financial stability. Powell, Quarles, and others also gutted the Volcker Rule which enabled SVB to, among other things, increase investments in venture capital firms and sell its hedges in 2022 on $15.26 billion of its available for sale (AFS) securities for short term gains. That opened the gaping hole of unrealized and unhedged losses at SVB in March 2023, causing the collapsed and contagion that has required bailouts and inflicted widespread pain across the US.

Those are just the tip of the Powell-led Fed's deregulation juggernaut that caused this crisis. That's why if on-the-ground Fed supervisors failed at SVB or elsewhere, it's because they were set up to fail by Powell, Quarles and others who undermined them and tied their hands. Blaming others for the intended and foreseeable results of their actions would be nothing more than scapegoating much less culpable junior people for the knowing failures of the Fed's leadership. These facts also make clear why the Fed cannot investigate itself: no one working at the Fed, no matter how diligent and credible, is going to identify the current Chair as a leading cause of the collapse of SVB and the ongoing crisis no matter how overwhelming the evidence.

Of course, none of the actions or conduct of the Fed, Powell, Quarles or other personnel from the Fed or any other regulatory agency in any way absolves the members of the Board of Directors or the executives and officers of SVB for their deficient conduct, gross mismanagement, irresponsible if not reckless or illegal conduct in connection with the collapse of the bank. They, first and foremost, are responsible for what happened, and they should be held fully accountable by the Department of Justice, the SEC, shareholders, and regulators as warranted by the facts and circumstances.

APPENDIX 1

Selected Reports, Fact Sheets, and Articles Detailing the Dangers of Deregulation Throughout the Trump Administration

April 10, 2018 Law Review: "Financial Reform Is Working, But Deregulation That Incentivizes One-Way Bets Is Sowing the Seeds of Another Catastrophic Crash."

July 9, 2019 Federal Reserve Conference Presentation: "Stress Testing as a Policy Tool."

Aug. 28, 2019 Fact Sheet: "The Key Changes That Seriously Weaken The Volcker Rule."

Sept. 16, 2019 Presentation to the Financial Stability Board: "The Too Big To Fail Problem Is Alive, Well and Getting Worse."

June 24, 2020 White Paper: "No Financial Crash Yet Thanks to Dodd-Frank and Banking Reforms."

July 21, 2020 Special Report: "Then Years of Dodd-Frank and Financial Reform: Obama's Successes, Trump's Rollbacks and Future Challenges."

Sept. 15, 2020 Special Report: "The Road to Recovery: Protecting Main Street from President Trump's Dangerous Deregulation of Wall Street."

Dec. 3, 2020 White Paper: "Federal Reserve Actions Under the Trump Administration Have Significantly Weakened Post-Crisis Banking Protection Rules."

June 28, 2021 Fact Sheet: The Fed's "2021 Stress Test Results: All Bank and No Bite."

Aug. 23, 2021 Special Report: "Should Federal Reserve Chairman Jay Powell Be Reappointed?"

Oct. 26, 2021 Op Ed: "Why Jay Powell has been a 'dangerous man' at the Fed."

March 24, 2022 Report: "The Increasing Dangers of the Unregulated 'Shadow Banking' Financial Sector."

July 13, 2022: An Agenda for the Incoming Federal Reserve Vice Chair for Supervision Michael S. Barr.

Aug. 11, 2022: "The Increasing Dangers of the Unregulated 'Shadow Banking' Financial Sector: Money Market Funds."

Dec. 22, 2022 Report: "Protecting our Economy by Strengthening the US Banking System Through Higher Capital Requirements."

January 17, 2023 Report: "Federal Reserve Policies and Systemic Instability: Decoupling Asset Pricing from Underlying Risks."

March 23, 2023 Report: "The Ongoing Use and Abuse of Cost-Benefit Analysis in Financial Regulation."

APPENDIX 2

The Federal Reserve Board Rulemaking During the Trump Administration

August 9, 2017: Proposed to amend the supervisory expectations for boards of directors at financial institutions. Better Markets' comment letter. Finalized on February 26, 2021.

December 7, 2017: Proposed a trio of changes to stress testing model disclosures. Better Markets' comment letter. Finalized separately on February 28, 2019 (here and here).

April 19, 2018: Proposed rule weakening capital requirements for large banks. Better Markets' comment letter.

April 25, 2018: Proposed rule undermining stress testing requirements. Better Markets' comment letter. Finalized on March 13, 2019.

July 17, 2018: Proposed rule weakening the "Volcker Rule" ban on proprietary trading. Better Markets' comment letter. Finalized on July 22, 2019.

November 21, 2018: Proposed rule exempting many large banks from crucial supervision requirements. Better Markets' comment letter. Finalized on November 1, 2019.

December 21, 2018: Proposed rule lowering capital requirements for many banks. Better Markets comment letter. Finalized on November 1, 2019.

January 8, 2019: Proposed rule unnecessarily reducing the frequency of stress tests. Better Markets' comment letter. Finalized here and here.

April 4, 2019: Proposed rule relating to total loss absorbing capacity of large banks. Better Markets' comment letter. Finalized on January 6, 2021.

March 15, 2019: Proposed rule lowering supervision requirements for foreign banks. Better Markets' comment letter. Finalized on November 1, 2019.

March 24, 2019: Proposed rule weakening capital requirements for large banks. Better Markets' comment letter. Finalized on November 1, 2019.

November 7, 2019: Proposed rule eliminating important margin requirements on inter-affiliate swaps. Better Markets comment letter. Finalized on July 1, 2020.

February 28, 2020: Proposed rule further weakening the "Volcker rule" ban on proprietary trading. Better Markets' comment letter. Finalized on July 31, 2020.

March 20, 2020: Interim final rule making it easier for banks to continue to pay dividends during the height of the Covid-19 pandemic. Better Markets' comment letter. Finalized on October 8, 2020.

March 23, 2020: Interim final rule once again bailing out money market funds. Better Markets' comment letter. Finalized on October 28, 2020.

May 11, 2020: Rule finalizing the decision to enable bank dividends during the Covid-19 pandemic. Better Markets' comment letter. Finalized on October 8, 2020.

July 16, 2020: Rule on "Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks." Interim final rule.

October 7, 2020: Proposed rule on "Amendments to Capital Planning and Stress Testing Requirements for Large Bank Holding Companies, Intermediate Holding Companies and Savings and Loan Holding Companies." Better Markets' comment letter. Finalized on February 3, 2021.

October 15, 2020: Proposed rule on "Rules Regarding Availability of Information." Better Markets' comment letter. Finalized on April 9, 2021.

November 5, 2020: Proposed rule on "Role of Supervisory Guidance." Better Markets' comment letter. Finalized on April 8, 2021.

January 12, 2021: Proposed rule on "Computer-Security Incident Notification Requirements for Banking Organizations and Their Bank Service Providers." Finalized on November 23, 2021.

APPENDIX 3

Silicon Valley Bank's Use of the Fed-Weakened Volcker Rule to Eliminate AFS Hedges for Short Term Gains

The activities engaged in by Silicon Valley Bank (SVB) with respect to their management of US Treasury and agency securities would need to comply with liquidity management requirements of the Volcker Rule. As originally written in 2013, the Volcker Rule had specific requirements that must be followed for liquidity management activities to be excluded from the prohibition on proprietary trading. The following is an excerpt from the preamble of the original Volcker Rule that explains these requirements (italics and bold highlights are added for emphasis and were not in the original text):

> After carefully reviewing the comments received, the Agencies have adopted the proposed exclusion for liquidity management with several important modifications. As limited below, liquidity management activity serves the important prudential purpose, recognized in other provisions of the Dodd-Frank Act and in rules and guidance of the Agencies, of *ensuring banking entities have sufficient liquidity to manage their short-term liquidity needs*.
>
> To ensure that this exclusion is not misused for the purpose of proprietary trading, the final rule imposes a number of requirements. First, the liquidity management plan of the banking entity must be limited to securities (in keeping with the liquidity management requirements proposed by the Federal banking agencies) and specifically contemplate and authorize the particular securities to be used for liquidity management purposes; describe the amount, types, and risks of securities that are consistent with the entity's liquidity management; and the liquidity circumstances in which the particular securities may or must be used. **Second, any purchase or sale of securities contemplated and authorized by the plan must be principally for the purpose of managing the liquidity of the banking entity, and not for the purpose of short-term resale, *benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits*, or hedging a position taken for such short-term purposes**. Third, the plan must require that any securities purchased or sold for liquidity management purposes be highly liquid and limited to instruments the market, credit and other risks of which the banking entity **does not reasonably expect to give rise to appreciable profits or losses as a result of short-term price movements**. **Fourth, the plan must limit any securities purchased or sold for liquidity management purposes to an amount that is *consistent with the banking entity's near-term funding needs***, including deviations from normal operations of the banking entity or any affiliate thereof, as estimated and documented pursuant to methods specified in the plan. Fifth, the banking entity must incorporate into its compliance program internal controls, analysis and independent testing designed to ensure that activities undertaken for liquidity management purposes are conducted in accordance with the requirements of the final rule and the entity's liquidity management plan. Finally, the plan must be consistent with the supervisory requirements, guidance and expectations regarding liquidity management of the Agency responsible for regulating the banking entity.
>
> The final rule retains the provision that the financial instruments purchased and sold as part of a liquidity management plan be highly liquid and ***not reasonably expected to give rise to***

> ***appreciable profits or losses as a result of short-term price movements***. This requirement is consistent with the Agencies' expectation for liquidity management plans in the supervisory context. It is not intended to prevent firms from recognizing profits (or losses) on instruments purchased and sold for liquidity management purposes. Instead, ***this requirement is intended to underscore that the purpose of these transactions must be liquidity management.*** Thus, the timing of purchases and sales, the types and duration of positions taken and the incentives provided to managers of these ***purchases and sales must all indicate that managing liquidity, and not taking short-term profits (or limiting short-term losses)***, is the purpose of these activities.
>
> The exclusion as adopted does not apply to activities undertaken with the stated purpose or effect of hedging aggregate risks incurred by the banking entity or its affiliates related to asset liability mismatches or other general market risks to which the entity or affiliates may be exposed**. Further, the exclusion does not apply to any trading activities that expose banking entities to substantial risk from fluctuations in market values, unrelated to the management of near-term funding needs, regardless of the stated purpose of the activities**.

Robin Wigglesworth in a Financial Times's FT Alphaville article titled "How crazy was Silicon Valley Bank's zero-hedge strategy?" outlined the activities that SVB undertook with respect to the assets it held for liquidity management purposes:

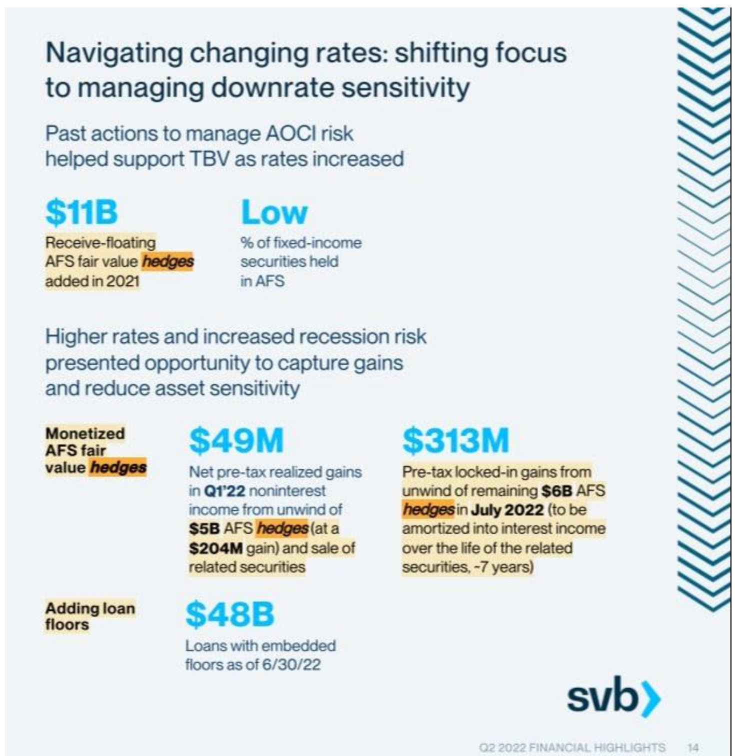
> The first thing to remember is that SVB's bond portfolio was basically in two different accounting buckets. At the end of 2022 it held $91.3bn in a "held-to-maturity" portfolio — bonds you plan to hold on to until they are repaid — and $26.1bn in an "available-for-sale" portfolio, which is marked to market.
>
> ***
>
> Because of rising rates the *actual* market value of the HTM portfolio was about $76bn at the end of 2022, according to someone who has seen the details of the portfolio and shared them with FTAV — an unrealised loss of $15.1bn.
>
> Yes, SVB didn't have any hedges on this bit. But doing so would arguably be nonsensical. Remember, the entire HTM portfolio is held at par, but the value of the hedge would obviously fluctuate with the market.
>
> So if rates rise then a bank makes money on the hedge, but the bonds stay at par. If rates fall then they lose money on the hedge, but they can shift bonds from HTM to AfS and sell them at the higher price. That means it basically becomes a directional bet on interest rates that flows straight into the income statement, something that most banks abhor.
>
> ***
>
> The AfS bucket is definitely where most self-respecting banks lugging around a big portfolio of bonds will hedge their interest rate risk. Otherwise, the income statement would bounce around according to whatever the market does from one quarter to the next. SVB seems to have been aware of danger. Here's what CFO Daniel Beck told analysts in early 2021:

"We're certainly positioning at this point for the potential for higher rates. So in the quarter, we put on close to $10 billion worth of swaps on that available-for-sale portfolio. And we're going to continue to do more to protect against that, to mitigate the impact of potential further rate movement."

And at the end of 2021, SVB's financial accounts indicate that on the AfS side it held $15.26bn of interest rate swaps to hedge against the impact of rising rates on its big bond portfolio. So, what happened?

Well, it looks that weakening profitability in 2022 as the tech world made SVB do something really dumb. **In the first quarter, it unwound $5bn of AFS hedges to book a $204mn gain, and in the second quarter it dumped another $6bn of hedges to lock in a $313mn gain.**

Or as the bank put it in a July 2022 presentation to investors, it was "shifting focus to managing downrate sensitivity". (H/T the FT's Antoine Gara for the below slide):



You can see the shift here in SVB's 2022 annual report. **By the end of last year it only had $563mn worth of hedges left on its books**….

As the FT Alphaville article shows, SVB clearly sold the swaps hedging its AFS position to lock in short-term gains that arose from the Fed's increase in interest rates. ***<u>This action appears contrary to the original Volcker Rule</u>*** which required (as quoted at length above) that the

"**sale of securities contemplated and authorized by the plan must be principally for the purpose of managing the liquidity of the banking entity, and not for the purpose of short-term resale, *benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits*, or hedging a position taken for such short-term purposes**."

Importantly, the original Volcker Rule would not likely have precluded SVB from selling its swap positions held for hedging their AFS portfolio. However, SVB would have had significant hurdles to show that selling only the hedge was necessary for prudent liquidity management. In most likelihood, SVB would have had to have taken one of these possible actions:

(a) Sell the AFS portfolio along with the AFS hedge positions, or
(b) Sell a portion of both the AFS portfolio along with a portion of the AFS hedge positions in a proportionate manner that kept the remaining AFS portfolio hedged while generating necessary *liquidity for SVB*.

But, neither of these actions would likely have generated significant net gains to increase SVB's earnings, which appears to have been the motive for selling the hedges.

That was only allowed because of the 2020 weakening of the Volcker Rule, which significantly modified the definition of the trading account. That radically narrowed the scope of the Volcker Rule. Under the Dodd-Frank law, *proprietary trading* is defined as engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments.

In the original Volcker Rule, the "trading account" was defined broadly to cover as much of a bank's securities activities as possible. For example, when a bank may have an account defined as "trading" under GAAP, GAAP does not preclude a bank from buying and selling securities through other accounts. Indeed, banks often buy and sell securities through their AFS account or the account for equity securities with readily determinable fair value.

However, in 2020, the scope of the Volcker Rule proprietary trading ban was effectively narrowed to just a portion of the trading book to which the market risk capital rule applies. Section 351.3 (when read its entirety) allows a bank to limit application of the proprietary trading ban to the operative portion of Section 351.3(b)(ii):

> "Any account that is used by a banking entity to purchase or sell one or more financial instruments that are **both** market risk capital rule covered positions **and** trading positions (or hedges of other market risk capital rule covered positions)…."

As such, SVB's AFS positions, including the swaps hedging the AFS position, were excluded from the definition of proprietary trading once the Fed-led regulators weakened the Volcker Rule in 2020.

Better Banks | Better Businesses

Better Jobs | Better Economic Growth

Better Lives | Better Communities

Better Markets is a public interest 501(c)(3) non-profit based in Washington, DC that advocates for greater transparency, accountability, and oversight in the domestic and global capital and commodity markets, to protect the American Dream of homes, jobs, savings, education, a secure retirement, and a rising standard of living.

Better Markets fights for the economic security, opportunity, and prosperity of the American people by working to enact financial reform, to prevent another financial crash and the diversion of trillions of taxpayer dollars to bailing out the financial system.

By being a counterweight to Wall Street's biggest financial firms through the policymaking and rulemaking process, Better Markets is supporting pragmatic rules and a strong banking and financial system that enables stability, growth, and broad-based prosperity. Better Markets also fights to refocus finance on the real economy, empower the buyside and protect investors and consumers.

For press inquiries, please contact us at press@bettermarkets.com or (202) 618-6430.

1825 K Street, NW | Suite 1080 | Washington, DC 20006 | 202-618-6464 | www.bettermarkets.org