



The Fall of Silicon Valley Bank: A Warning for Emerging Markets

 Liliana Rojas-Suarez

Following a couple of days of bad news about the faltering Silicon Valley Bank (SVB), the Federal Deposit Insurance Corporation (FDIC) announced on March 10 that the bank was put into receivership for restructuring. Just a few days before, SBV was reportedly the [16th largest bank](#) in the United States and was granted an *investment grade* category by the rating agencies (AA3 rating by Moody's and BBB by Standard & Poor's). On March 12, the US Treasury, Federal Reserve, and FDIC [announced actions](#) on SVB and one more bank, Signature Bank, based on systemic risk concerns.

Although the actions by the US authorities have so far calmed local markets, fears of contagion around the globe continue (witness [Credit Suisse's current troubles](#)), and many observers are asking the obvious questions: Where were the regulators in the lead up to the crisis? What happened to the strict regulations imposed on banks after the Global Financial Crisis, including Basel III, the international standards for capital adequacy, stress testing, and liquidity requirements? Why did these regulations fail to prevent SVB's collapse? Or should the blame fall on the Fed for raising interest rates too high, too quickly, destabilizing the financial system?

These questions are extremely relevant for emerging markets. As in the US and other advanced economies, most emerging markets have implemented Basel III regulations and are fighting inflation through increases in interest rates. My view is that the Fed and the central banks of most emerging markets are doing their job, using the tools at their disposal for controlling inflation and protecting financial stability, but there are faults in existent regulatory and supervisory frameworks that weaken supervisors' ability to detect the build-up of problems in the banking systems.

First, on monetary policy. Unquestionably, a precondition for effective monetary policy is a sound banking system. There are multiple examples in [advanced](#) and emerging markets where, in the

context of weak financial systems, sharp and sustained increases in interest rates ended in severe banking crises. The only way for a central bank to minimize the potential trade-off between price stability and financial stability resulting from interest rate hikes is to ensure that banking systems are sound in the first place. Where financial systems are strong, tighter monetary policy to control inflation does not need to end in deep financial problems, as central bankers around the world have acknowledged.

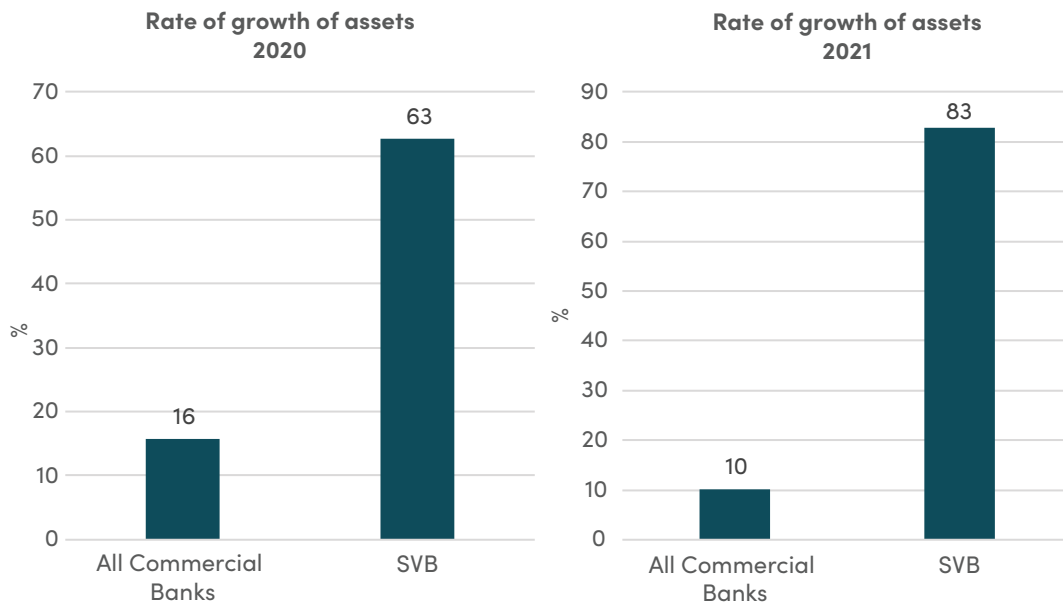
So, what is behind a sound banking system? Largely, a combination of good financial regulation and good risk management at the bank level. By now, evidence [abounds](#) on the poor managerial quality of SVB to the extent that its top executives are being [sued for fraud](#). But there certainly were failures in supervision and regulation. Bank regulators and supervisors in emerging markets should be looking closely at their own banking systems now with the lessons of SVB's collapse in mind.

Underwhelming supervisory oversight

A well-known early warning sign of bank problems is a rapid expansion in bank assets, which signals an increase in risk-taking. Normally, asset expansion takes the form of fast growth in credit (I say “normally” because the main role of banks is to take deposits to extend loans). In the case of SVB, more than 50 percent of its assets were bonds, mostly Treasury bonds. That in itself was a red flag: a commercial bank that focuses on buying bonds rather than on lending is weakening the value of its franchise, which lies on its capacity to undertake maturity transformation from short-term deposits to long-term loans. In doing so, sound banks focus on monitoring the quality of debtors to ensure that they make good on their payments, rather than betting on the performance of securities.

During the peak of the COVID period, overall bank deposits grew significantly, partly reflecting the increase in precautionary savings. But SVB assets ballooned well-above the overall system. As shown in Figure 1, SVB assets increased by over 60 percent in 2020 and by over 80 percent in 2021. By comparison, the rates of growth for the entire US banking system increased by 16 percent and 10 percent respectively. As startups in the tech sector were booming during the pandemic, deposits into SVB—known as a bank for tech companies—also skyrocketed. Since most of these deposits came from small firms, they surpassed the maximum amount that the FDIC insures, namely, \$250,000. In other words, most of the deposits—a shocking 90 percent—were uninsured. Rather than channelizing funds into loans, SVB sharply increased its holding of long-term Treasury bonds.

Figure 1. Growth in SVB assets, 2020 and 2021



Sources: Fed St. Louis Fed and YCharts

Were supervisors and rating agencies lulled into a false sense of security by the fact that US Treasury bond are considered the world's *safest asset*, certainly much safer than loans, and that they are defined as *high-quality liquid* assets in Basel III? It's hard to know, but the fact is that they tolerated the large accumulation of these assets. And yes, they are highly liquid in the sense that there is a huge active global market for them, *but as with any other fixed-income security, their price declines when interest rates rise*. That is, they are subject to market risks. And when there is a run of deposits (as was the case for SVB's uninsured depositors), the value of those bonds may not be sufficient to meet depositors' demands for their money.

How can banks protect against market risks arising from increasing interest rates? Through hedging, usually done through interest rate swaps. *Allegedly*, those hedges were nowhere to be found in the case of SVB—a tremendous failure of risk management by SVB's managers that supervisors did not catch.

In sum, the list of bad bank practices that supervisors failed to either detect or promptly correct is impressively long. On the liability side: concentration of deposits in the volatile tech industry and an overwhelming majority of uninsured depositors. This combination left the depositors base prone to a run at the first sign of problems. On the asset side: high concentration in securities subject to market risk and lack of hedges for these risks. How did supervisors miss the writings on the wall?

What about cracks in the regulatory framework?

Were supervisors and rating agencies misled by SVB's compliance with key regulations? In short, yes.

A bit of recent history may help here: most countries around the world have committed to implement [Basel III](#), the global regulatory set of standards guiding banks' activities, especially capital and liquidity requirements, put forward after the Global Financial Crisis. Basel III recommendations, however, apply only to internationally active banks. It is up to the discretion of countries' authorities to apply the regulations to all banks. Complementing the [Dodd-Frank regulations](#) of 2010, in 2013 the US chose to adopt Basel III, applying liquidity requirements [only to large and internationally active banks](#), which are considered to be a potential risk to the financial sector. However, for the majority of banks not classified as large enough, the 2013 regulation applies a modified version of Basel III, with less strict, but still stringent liquidity requirements.¹ **In both Dodd-Frank and Basel III, stress testing requirements were a central part of the regulation.**

But in 2018, the Economic [Growth, Regulatory Relief, and Consumer Protection Act](#) relaxed some of these regulatory standards, including two in particular. First, under the original Dodd-Frank legislation, banks with consolidated assets of \$10 billion had to comply with strict regulatory and stress testing standards. The 2018 modification drastically raised the threshold to \$250 billion. With consolidated assets fluctuating around \$230 billion, SVB no longer had to comply with the original Dodd-Frank regulation. Second, after 2018, only banks with assets above \$250 billion were required to conduct stress testing.² **Now, when banks' need stress testing to gauge their resilience to increases in interest rates the most, the regulation is lacking.**

In addition, some regulation was temporary relaxed in 2020 to support bank lending during the COVID-19 period. Specifically, the 2020 "[Current Losses Transition Rule](#)" provided banks with the *option* to delay for two years the increase in bank capital requirements resulting from the adoption of a new—and better—accounting standard (the [CECL](#)—Current Expected Credit Losses). This option also granted banks three additional transition years to smooth the adjustment of capital. While relaxation of certain regulatory standards was common practice around the world during the pandemic, it was quite unusual to find such long period of postponement.

Did all US banks elected to use this five-year transition option that, effectively, reduced incentives to raise additional capital? Most likely not. [Reports](#) suggest that large banks had already started to

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- 1 [Basel III Liquidity Coverage ratio](#) requires banks to hold sufficient amount of high-quality liquidity to meet net cash outflows during a 30-day period under an acute stress scenario. In the US, for banks that were not classified as large enough, the [regulations complementing Dodd-Frank](#) required banks to hold sufficient high-quality liquidity to meet 70 percent of withdrawals under an acute stress scenario. To estimate liquidity requirements, banks were expected to conduct stress tests. One obvious stress scenario, of course, is significant and sustained increases in interest rates.
 - 2 In implementing the Economic Growth, Regulatory Relief, and Consumer Protection Act, the Office of the Comptroller of the Currency [stated in 2019](#): "Specifically, the final rule revises the minimum threshold for national banks and Federal savings associations to conduct stress tests from \$10 billion to \$250 billion, revises the frequency by which certain national banks and Federal savings associations will be required to conduct stress tests, and reduces the number of required stress testing scenarios from three to two."

implement the new regulation before the transition option was issued and considered it more costly to go backwards and then forward again. Not surprisingly, SVB elected to use the five-year option.

Thus, the mix of poor risk management in some banking institutions, weakened regulation, and faulty supervision created a perfect storm for the eruption of severe banking problems. SVB was the natural disaster to emerge.

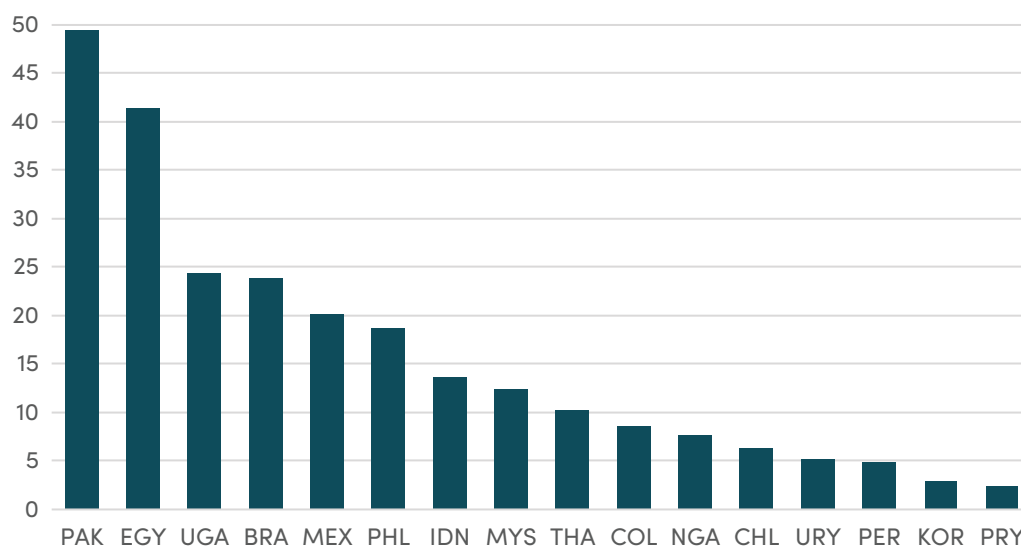
Where do emerging markets stand?

The good news first: in contrast to the US, most emerging markets have chosen to apply Basel III regulatory standards to all banks, not just the largest banks, although the state of implementation of these rules varies significantly between countries. Importantly, while authorities in most countries relaxed some banking regulations during the COVID-19 period to support the provision of loans to the real economy (including the rules on loan classification and provisioning for non-performing loans), these relaxations have expired by now in most countries.

However, learning from the SVB experience, there are some red flags that should alert supervisors in emerging markets. Two deserve particular attention.

First, large holdings of government bonds in banks' balance sheets are not a rare occurrence in many emerging markets. As shown in Figure 2, in countries such as Pakistan and Egypt the share of public sector securities in total bank assets surpasses 40 percent and ratios above 20 percent are not uncommon.

Figure 2. Share of Public Sector Securities in Total Bank Assets, 2022, in percent



Source: IMF-IFS

Just as in the US, central banks in these countries—and in most emerging markets—are raising interest rates to fight inflation. Are banks in countries with large holding of government paper hedging for market risk? Are they and their supervisors conducting the necessary stress tests to identify whether banks are really liquid and can stand an unanticipated withdrawal of funds? Answer to these questions may identify where the next banking crisis would occur.

Second, although regulation is improving, serious deficiencies remain in accounting, transparency, and the quality of supervision in many countries. Figure 3 shows two indices based on data from Angiles et al. (2019) ranging from 0 to 1 where larger values represent higher quality of the indicator. The variable *Powers of Supervisory Authority* measures the independence and capacity of the supervisory authority to look after financial stability and intervene and restructure banks when necessary. *Quality of Accounting and Transparency* measures the extent to which banks disclose information in a transparent way using international accounting standards.

Figure 3. Quality of supervision and accounting and transparency in emerging markets



Source: Update of Montoro and Rojas-Suarez (2011), based on Anginer et al (2019)

Clearly, there are some countries in the sample where serious improvements are needed.³ Even if regulation is strong, weaknesses in supervision could lead to failures in identifying the accumulation of excessive risk in the financial system and result in banking crises.

There's a common saying that every cloud has a silver lining. If there's a silver lining to the SVB collapse, it may be that, hopefully, bank regulators and supervisors around the world will learn from it. For the majority of emerging markets, where previous episodes of banking crises were devastating and turned back the clock on development progress, it is crucial to promptly correct deficiencies. It is essential that emerging markets allow their central banks to use the interest rate tool to fight inflation without fearing major disruptions in their financial systems.

3 Since this is 2019 data—the most recent I was able to find with comprehensive information for a large number of countries—it is possible that important improvements have been implemented in some countries in the most recent years.

LILIANA ROJAS-SUAREZ is a senior fellow and the director of the Latin America Initiative at the Center for Global Development.



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