Federal Reserve Bank of San Francisco

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LFBO DEDICATED SUPERVISORY TEAM LEAD
LARGE INSTITUTIONS SUPERVISION GROUP
SUPERVISION + CREDIT

August 19, 2022

BY SECURE EMAIL

Mr. Dan Beck
Chief Financial Officer
C/O Ben Jones, Head of Regulatory Relations
Silicon Valley Bank
3003 Tasman Drive
Santa Clara, California 95054

Dear Mr. Beck:

This letter conveys a summary of the Federal Reserve's assessment of Silicon Valley Bank Financial Group's (SVBFG) practices and processes that were within the scope of the recently completed Horizontal Capital Review (HCR). The letter also includes an appendix summarizing the range of practice for projecting allowance for credit losses in stress across the participating firms.

Executive Summary

The Federal Reserve System recently completed the HCR, an assessment of certain aspects of capital planning practices at firms subject to the Federal Reserve's capital plan rule. The scope of the review was limited and does not represent a full evaluation of the firm's capital planning practices. Specifically, the review focused on assessing the effectiveness of internal audit programs over capital planning as well as the approaches used to project allowances that incorporate Current Expected Credit Losses (CECL) in capital projections under stress.[1]

[1] As part of the review, examiners assessed the firm's practices for compliance with the Federal Reserve Board's capital plan rule, 12 CFR 225.8, and consistency with the expectations outlined in SR Letter 12-17 / CA 12-14, *Consolidated Supervision Framework for Large Financial Institutions*, SR Letter 12-7, *Supervisory Guidance on Stress Testing for Banking Organizations with More Than $10 Billion in Total Consolidated Assets*, and SR Letter 11-7, *Guidance on Model Risk Management*.

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Examiners evaluated firm practices to assess compliance with applicable requirements. Additionally, the review included an evaluation of Risk Identification and Scenario Design as well as Mandatory Elements of the Capital Plan. The Federal Reserve took into account the firm's asset size, complexity, risk profile, business activities, and the materiality of identified issues in developing our assessment.

SVBFG's capital planning practices in the areas reviewed are partially consistent with supervisory expectations. Weaknesses were identified in both CECL in stress methodology and internal audit over capital planning. For CECL projections, the use of a constant add-on in both business as usual and stress projections lacks conceptual soundness as well as sensitivity to the macro-economic variables. Additionally, internal audit's risk assessment methodology lacks specificity to effectively identify risks within the capital planning framework. This issue is directly related to the existing Internal Audit Effectiveness MRIA cited in the Governance and Risk Management Exam Supervisory Letter dated May 31, 2022. As a result, no new finding is being cited for this issue.

Matters Requiring Attention (MRA)[2]

Matter Requiring Attention (MRA) - Allowance for Credit Loss (ACL) Stress Methodology

Issue: The firm's ACL methodology includes the application of a conceptually unsound material adjustment or "constant add-on" to its ACL projections across all projection quarters and scenarios. Although this issue was identified by the firm's Model Risk Management (MRM) function, management did not address the known weaknesses outright or through mitigating controls. The add-on is intended to address limitations in the firm's ACL methodology by capturing aspects of the ACL that are insufficiently addressed in the allowance projections.

[2] **Matters Requiring Immediate Attention** (MRIAs) arising from an examination, inspection, or any other supervisory activity are matters of significant importance and urgency that the Federal Reserve requires banking organizations to address immediately and include: (1) matters that have the potential to pose significant risk to the safety and soundness of the banking organization; (2) matters that represent significant noncompliance with applicable laws or regulations; (3) repeat criticisms that have escalated in importance due to insufficient attention or inaction by the banking organization; and (4) in the case of consumer compliance examinations, matters that have the potential to cause significant consumer harm. An MRIA will remain an open issue until resolution and examiners confirm the banking organization's corrective actions.
Matters Requiring Attention (MRAs) constitute matters that are important and that the Federal Reserve is expecting a banking organization to address over a reasonable period of time, but when the timing need not be "immediate." While issues giving rise to MRAs must be addressed to ensure the banking organization operates in a safe-and-sound and compliant manner, the threat to safety and soundness is less immediate than with issues giving rise to MRIAs. Likewise, consumer compliance concerns that require less immediate resolution should be communicated as an MRA. An MRA typically will remain an open issue until resolution and confirmation by examiners that the banking organization has taken corrective action. If a banking organization does not adequately address an MRA in a timely manner, examiners may elevate an MRA to an MRIA. Similarly, a change in circumstances, environment, or strategy can also lead to an MRA becoming an MRIA. The key distinction between MRIAs and MRAs is the nature and severity of matters requiring corrective action, as well as the immediacy with which the banking organization must begin and complete corrective actions.

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The add-on is material, and on average it accounts for 35 percent of quarterly stressed ACL. According to the firm's documented methodology, the add-on was not specific to the stress scenario. It was derived using the base scenario, raising concerns on its applicability and conservatism under stress.

Additionally, the firm's compensating controls framework for addressing weaknesses in the constant add-on is inappropriate given its materiality. MRM noted weaknesses in the conceptual soundness of the add-on in a February 2022 model validation, citing the lack of sensitivity to macroeconomic scenarios and portfolio scale, and recommended using a percentage-based add-on. Although MRM recommended a resolution date by the third quarter of 2022 for its cited issues, management did not put in place interim mitigating controls to address the known concerns with the constant add-on for its stress test evaluated under the Federal Reserve's 2022 HCR review.

Impact: The application of material qualitative adjustments with known conceptual soundness weaknesses and inadequate compensating controls may lead to inadequate ACL balances and inaccurate capital projections. Such inadequacies pose a safety and soundness concern by preventing firm management and the board of directors from making informed capital planning decisions.

Required Action(s): Management is required to strengthen the oversight of the process used to project ACL in capital planning. In considering how to address these concerns, management should review the relevant sections of SR 12-7, *Supervisory Guidance on Stress Testing for Banking Organizations with More Than $10 Billion in Total Consolidated Assets*. Prior to considering the issue for closure, examiners will expect to observe the following:

- The corrective actions required by MRM in the February 2022 model validation report have been remediated or otherwise mitigated through compensating controls.

- The processes used to oversee and address criticisms in capital planning methodologies (e.g., compensating controls) align with the principles of stress testing. When addressing these concerns, management should consider principle 3 on forward-looking and flexible stress testing, and principle 5 on strong governance and effective internal controls noted in SR 12-7.

Remediation Date: Remediation is expected to be completed by March 31, 2023.

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Closing

After reviewing this supervisory letter, and within 45 calendar days of its receipt, management is required to submit a written response to the MRA contained herein. We appreciate the assistance received from your management team and staff throughout the year. As a reminder, this letter is the property of the Board of Governors and is furnished to directors and management for their confidential use under applicable law.[3] We welcome the opportunity to further discuss any aspect of this letter or our supervisory process with members of the board or management.[4] Should you have any comments or questions regarding this letter, please directly contact **Redacted** @sf.frb.org.

Sincerely,

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Redacted LFBO Dedicated Supervisory Team Lead

Enclosure

cc: Ben Jones, Head of Regulatory Relations
Redacted , CDFPI
Redacted , Dedicated Examiner in Charge, CDFPI
Redacted , Section Chief, FDIC

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[4] Any institution about which the Federal Reserve makes a written material supervisory determination is eligible to utilize the appeals process as described in Internal Appeals Process for Material Supervisory Determinations and Policy Statement Regarding the Ombudsman for the Federal Reserve System, 85 Fed. Reg. 15175 (March 17, 2020). An appeal under this process may be made of any written material supervisory determination, as defined in the policy statement.

The Board's Ombudsman (Ombudsman) can provide assistance regarding questions related to the System']s material supervisory determination appeals process and claims of retaliation. The Ombudsman can also provide assistance to facilitate the informal resolution of concerns prior to the filing of a formal appeal. An institution may contact the Ombudsman at any time by calling 1-800-337-0429, by sending a facsimile to 202-530-6208, by writing to the Office of the Ombudsman, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, or by sending an e-mail to ombudsman@frb.gov.

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Appendix A – Range of Practice

HCR 2022 Allowance for Credit Loss (ACL) Projection in Stress

Overview

Many firms subject to the Capital Plan Rule [5] adopted the Current Expected Credit Loss (CECL) accounting standard in 2020 for business-as-usual (BAU) financial reporting and consequentially capital planning. The Capital Plan Rule requires firms to follow GAAP; therefore, if a firm has adopted CECL under GAAP, then that must be reflected in its capital planning projections. This would include estimating projected allowance for credit losses (ACL) for lifetime expected credit losses considering reasonable and supportable macroeconomic forecast expectations. The 2022 Horizontal Capital Review was the first time that the Federal Reserve has assessed Category IV [6] Firms' approaches for ACL under stress. This appendix outlines the range of practices observed during the review to assist firms in strengthening their ACL projection practices for future capital planning cycles.

Methodology

Most firms developed capital planning ACL projection methodologies that leveraged their BAU financial reporting approach for CECL. Methodologies were generally informed by credit loss projections and the economic scenarios. Varying degrees of complexity in firm approaches were observed, which often incorporated various judgmental elements to address how quickly ACL projections would reflect the full knowledge of the macroeconomic scenario and related losses. Most firms achieved a balance between using realistic reserving practices and making conservative assumptions to address uncertainty around ACL projection demonstrating a comprehensive view of the economic stress. Additional key themes and observations are outlined below:

Stronger practices included:

- Methods that reflected the impact of changing macroeconomic conditions in a timely manner and considered the expected life of loan losses for each quarter in the stress test window.
- Approaches that considered relevant past and current ACL experience as well as the use of conservative assumptions in areas of high uncertainty.
- Adjustments made to address methodology limitations, imprecision, and other qualitative adjustments that were evaluated for conceptual soundness and alignment with macroeconomic scenarios.

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[5] 12 CFR 225.8.

[6] Category IV standards apply to U.S. banking organizations and foreign banking organizations that have at least $100 billion in total assets and that do not meet the criteria for Category I, II, or III, as applicable. See 12 CFR 252.5(e).

- Support for capital planning ACL projection methods that demonstrated alignment to the firm's likely ACL outcomes should the modeled macroeconomic scenario occur.

Weaker practices included:
- Methods with minimal consideration of CECL's intent of building reserves ahead of loss realization or alignment to firms' actual reserve practices.
- Methodologies that lacked developmental evidence of key assumptions to allow for adequate support of material ACL components.
- Material elements or adjustments to the capital planning ACL methodology that were not dynamic to changing macroeconomic conditions or subject to periodic re-assessment for reasonableness.

Outcomes

A key assumption used when projecting ACLs for capital planning was when to build or release reserves, informed by both the lifetime loss forecasts and macroeconomic conditions. Most firms' ACLs peaked early in projection horizon, with consideration given to when full knowledge of the economic stress was reasonably known. In most circumstances, firms also were conservative in projecting reserve releases to replicate a probable management response to uncertainty coming out of a period of stress.

Stronger practices included:
- Aligning the timing and level of ACL builds relative to net charge-offs with the forward-looking principles of the CECL standard. Generally, this would include projecting a significant build in ACLs before net charge offs peak to align with expectations to build allowance ahead of expected losses under CECL.
- Clear demonstration of the sensitivity of provision expenses and capital deterioration to the changing macroeconomic conditions of the modeled scenario.
- Adequate life-of-loan loss coverage of the ACL relative to projected expected losses throughout the nine-quarter projection window.

Weaker practices included:
- Projected ACL builds that did not align with the forward-looking principles of the CECL Standard; often resulting in projected ACLs that peaked later than net charge-offs.
- Projections with limited to no sensitivity of quarterly provision expense and capital deterioration resulting from the macroeconomic conditions of the modeled scenario.

Reporting, Review, and Challenge

In the reporting, review, and challenge of ACL projections, senior management committees and independent review functions generally provided review and challenge of the end-to-end capital planning ACL projection process, including material assumptions, qualitative

adjustments, and projected outcomes. Firms typically established reporting lines and management information systems to ensure boards of directors received information surrounding stressed ACL projections to make informed capital planning decisions.

Stronger practices included:

- Reporting that demonstrated the effect of ACL builds and their key assumptions on firmwide capital trajectories, including sensitivity of ACL build to the pace of macroeconomic scenario and credit deterioration.
- Review of ACL methods, key assumptions, and material adjustments used to derive ACL projections that challenged the alignment to the firm's likely ACL outcomes should the modeled macroeconomic scenario occur.

Weaker practices included:

- Oversight of ACL projections that focused the on the review of credit loss estimates, without an evaluation of the timing of ACL build and reserve releases.
- Not considering material issues identified by independent review functions and their impact on ACL projections.

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