FedFin Client Report

Wednesday, January 11, 2023

Financial-Policy Consequences of Silvergate's Travails

Client Report: CRYPTO38

Executive Summary

Karen Petrou's memo earlier this week and her comments to the *American Banker* about Silvergate have sparked many client questions. In this report, we provide additional context for aspects of this bank's condition with policy consequences. High-profile cases such as this have a long history of suddenly shifting long-pending policies; depending on outcomes, this bank's challenges and those of any other crypto-heavy banks will almost surely do so. In general, the case already confirms U.S. regulators of the wisdom of additional capital for crypto-exposed banks along the lines recently finalized by global regulators (see FSM Report **CRYPTO37**). However, it also raises significant questions about the role of the Federal Home Loan Banks, brokered deposits, resolution policy, and AOCI recognition – and these are just for starters as the bank struggles to stay afloat.

Analysis

As before, our analysis of Silvergate's risk is based on its January 5 preliminary fourth-quarter results; the extent to which risks these illuminate materialize will have significant impact on the degree to which regulators and/or the Congress takes action to redress the issues including:

- **Federal Home Loan Banks:** The *Banker* article cited above notes that Silvergate received a $4.3 billion advance from the Federal Home Loan Bank of San Francisco secured by government and agency obligations now encumbered for sale in the event of continuing depositor runs. The bank has few if any mortgage obligations – the ostensible mission of FHLB advances – with the advance thus positioning the System as a new lender of last resort apparently willing to step in when the Federal Reserve might deem a discount-window loan ill-advised in light of a bank's solvency vulnerability. Mission considerations are already a top priority for the pending FHFA review of the Home Loan Bank System, but the nature of this advance may also force renewed focus on the System's lien ahead of even the FDIC. After Indy Mac failed in 2009 at great cost to the FDIC and no risk to the same San Francisco Bank now backing Silvergate, there was much talk of rewriting the law to end this prior lien. Talk will turn to demands if the FDIC

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is forced to resolve Silvergate at heightened cost due to this prior lien as was the case in 2009, but the odds of a statutory change given current Congressional conditions seems unlikely.

- **Least-Cost Test:** In its statement on merger policy (see FSM Report **MERGER9**), the FDIC challenged the statutory least-cost test that often forces the agency to agree to advantageous purchase-and-assumption transactions of troubled banks rather than market-disciplining receiverships or conservatorships. Should the FHLB advance or other circumstances force a similar course for Silvergate in the event of failure, the agency is likely to request a change in law. Given that Congress is as unlikely to make it as to address broader FHLB System reform, the FDIC may push to the boundaries of the least-cost test to avoid the purchase that Silvergate's management seems to believe ensures stakeholder protection even if the Fed and/or California decides to close the bank.

- **AOCI Recognition:** The bank's 4Q statement acknowledges that at least some held-to-maturity (HTM) securities were sold to handle its $8.1 billion run. The wording seeks to minimize how many HTM securities were sold, but agency standards do not judge portfolio status based on percentages. If some HTM securities are sold, then the bank's portfolio as a whole is tainted and all unrealized losses must be recognized in recalculated capital ratios. Current standards do, however, permit regulators to circumvent AOCI recognition under circumstances such as sudden financial-condition deterioration. To the extent this is done for Silvergate, banks allowed to avoid AOCI recognition (i.e., all but the GSIBs and slightly smaller regionals) may feel more assured that HTM holdings protect capital ratios at little risk in the event of unanticipated stress. This in turn could make reported capital ratios more vulnerable to sudden, downward adjustments unless mandatory stress testing addresses this for banks subject to the stress capital buffer.

- **Brokered Deposits:** The bank also held $2.4 billion in brokered CDs as of the end of the fourth quarter. No information is given on CD maturities, making it unclear how many may roll off during the first quarter and how Silvergate plans to replace them. As clients know, brokered deposits are a longstanding problem, with the FDIC in 2020 finalizing controversial rules (see FSM Report **DEPOSITINSURANCE111**) liberalizing the extent to which troubled banks can continue to gather brokered deposits. Now-Chair Gruenberg opposed key aspects of these rules and may undertake revisions if Silvergate's brokered funds exacerbate resolution challenges and/or costs.

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