SVB: COULD THE CONDUCT OF ONE, DICTATE THE FATE OF ALL?

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The past few weeks have been marred by a flurry of panics in the banking sector, first in the US and then spreading to Europe. Initially, it was Silvergate, which announced its voluntarily liquidation on 8 March. That boiled over into a "bank run" on SVB, prompting the Federal Deposit Insurance Corporation (FDIC) to take over all its deposits on 10 March. Then, the banking panic spilled over to Signature which was shut down by regulators on 12 March. Last weekend (March 18/19), more fallout surfaced as we saw the fire sale of Credit Suisse to UBS in a government-brokered deal and shares of First Republic Bank suffer heavy losses due to its similarities with SVB.

As SVB collapsed and contemplations began as to the why and how, a lot of ESG (Environmental, Social and Governance) critics took the opportunity to blame the bank's collapse on its ESG focus and '**wokenomics**'. SVB's Board was blamed **for focusing on its Diversity and Inclusions (DEIs) policies rather than risk management.**

WAS SVB PUTTING TOO MUCH EFFORT AND FOCUS ON ESG AND DEI?

The original thesis of ESG is to combine profit and purpose. In terms of purpose, SVB held a critical role in supporting the start-up ecosystem globally and served predominantly start-ups and pre-IPO companies as clients. The bank enabled young companies, most of which were working on providing solutions to much needed social and environmental issues, to operate without hindrance.

In terms of ESG strategy, SVB did have a focus on DEI, but it extended beyond gender or race and was implemented among employees and clients. According to its Corporate Responsibility Report, the Board of SVB took a multidimensional approach to diversity and considered a variety of skills and attributes:

- Industry experience, particularly in banking and client industries
- Functional, technical or other professional expertise
- Gender, age or racial/ethnic diversity
- Other important attributes, such as veteran status and geographical diversity

It should be stated that banks, tech companies and especially the start-up community, which SVB served, are notorious for being non-diverse, and, in fact, have a long history of red-lining and systemic discrimination. According to the 2022 proxy filing, senior leadership of SVB was 38% female (globally) and 38% non-white (US). On its Board, 5 out of 11 Directors were women (45%). However, 10 out of these 11 Board Members were white and 7 were aged 60 and higher. Additionally, 11 out of 12 Executive Board members including the CEO, CFO and COO were male and all 12 were White. **The bank has good targets to improve diversity but at the time, it was certainly not as diverse.**

WOULD TIGHTER REGULATIONS HAVE HELPED?

While the story of SVB is more complicated, one of the important factors appears to have been the rollback of various regulations put in place after the Global Financial Crisis (GFC) to prevent banks from imploding. Regulations since the GFC have forced banks to **hold more capital than before and to deleverage to a large extent**, while forcing them to hold large amounts of "High Quality Liquid Assets" to satisfy the stringent liquidity requirements.

However, these regulatory requirements are mainly targeted to global and systemic banks, rather than regional players. In 2018, the US Congress loosened the post-GFC Dodd-Frank regulations that would have required a bank such as SVB to undergo more frequent stress tests. One direct implication of this fallout could be the necessity to tighten bank regulations. Some senators in the US are already demanding legislation to repeal Trump-era financial deregulation. Similar calls are being made in the UK, as the City of London looks to review its banking regulations. **Legislators could also extend minimum capital requirements to smaller, regional banks and those in shadow banking, and disincentivize risky behaviour by reforming bankers' pay schemes.**

However, even if they had been carried out, these stress tests would have only detected exotic or extreme risks. What could have helped in this case was improved systematic supervision.

The bank had clear risk-control flaws and disclosed losses, although unrealized, in its SEC filings. The San Francisco Fed, which regulated the parent company, and California regulators, who oversaw the bank itself, could have required SVB to raise capital last year, when it was less vulnerable. They could have also required the bank to increase rates on its savings accounts. That would have eroded earnings, but it could have preserved liquidity and maintained confidence.

COULD PM AND ESG ANALYSTS HAVE FORESEEN THIS?

SVB was championed for its sustainable credentials as a business, winning accolades and recognition for workplace gender equality, philanthropy and responsible investment. According to Morningstar data, out of c.900 funds, **3.3% of Article 9-SFDR funds and 2.6% of Article 8-SFDR funds were exposed to SVB.**

As sustainable investors, our first and foremost expectation from our investee companies is that they prioritise their most material **ESG risks**. In the case of banks, this refers to managing the G in their organization through effective risk management and good governance practices, which would enable them to fulfil their core function of providing finance to the ecosystem they operate in. For example, when the crisis broke out, **La Française AM was not invested in Crédit Suisse due to its poor governance and risk management practices which were highlighted in our ESG assessments**. The bank showed limited and selective reporting on climate, strategy, and wider governance issues. The repeated involvement in controversies – both big and small - pointed to poor risk management and questionable business conduct (money laundering, tax fraud and bribery scandals). Frequent leadership turnover meant governance changes were difficult to stick, which in turn led to widespread reputational damage.

If we look closely, there were a few red flags regarding the governance of SVB which should have alerted investors and regulators alike. SVB had the same auditors for more than 30 years, and evidently, they failed to have a fresh perspective on issues during the shift. **The number of Board Members with experience in Risk Management decreased from 11 to 8 in 2022 and management took no action after a commissioned report by Blackrock's consultancy arm in early 2022 rated its risk management practices as sub-par.**

SVB did not have a Chief Risk Officer for most of 2022. However, it did have a risk management team, an Enterprise Risk Management Framework, a Risk Committee which was chaired by the Board Chair, a Credit Committee, and a Finance Committee. According to Bloomberg, the seven-member Risk Committee met 18 times in 2022, more than double the 7 meetings in 2021. Why the risk management team and the Board Committees of the bank failed to foresee and hedge for the growing liquidity risk, one cannot say.

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