Office of Inspector General
Board of Governors of the Federal Reserve System
Consumer Financial Protection Bureau

Executive Summary, 2023-SR-B-014R, September 27, 2023

# Review of the Supervision of Silvergate Bank

## Background

We conducted this evaluation to assess the Board of Governors of the Federal Reserve System's and the Federal Reserve Bank of San Francisco's (FRB San Francisco) supervision of Silvergate Bank.

Under delegated authority from the Board, FRB San Francisco supervises the banking organizations in the 12th Federal Reserve District, including Silvergate. The Board's Division of Supervision and Regulation oversees the Federal Reserve Banks in executing their supervisory responsibilities and issues supervisory policy and guidance to help the Reserve Banks operate in a manner consistent with the Board's expectations.

Silvergate was established as an industrial loan company in August 1988, and in December 2012, it became a state member bank supervised by FRB San Francisco and the California Department of Financial Protection and Innovation. Beginning in 2013, Silvergate senior management changed the bank's strategy to focus on cryptocurrency customers. In March 2023, the bank's holding company announced its intent to voluntarily liquidate Silvergate.

We initiated this evaluation in March 2023 on a discretionary basis following the voluntary liquidation announcement to assess, with the benefit of hindsight, the potential lessons to be learned for bank supervisors. The scope of our evaluation included supervisory activities conducted from 2013 to 2023 related to Silvergate's change in business strategy, deposit growth, concentrated business activities, and governance and risk management practices.

We cannot publicly release our full report given Silvergate's status as an open institution and the confidential supervisory and trade secret information described in our report. The public disclosure requirements outlined in section 38(k)(4) of the Federal Deposit Insurance Act do not apply to Silvergate because it has not failed or caused a loss to the Deposit Insurance Fund.

## Factors That Led to Silvergate's Voluntary Liquidation

Silvergate's concentration in crypto industry deposit customers, rapid growth, and multilayered funding risks led to the bank's voluntary liquidation. Beginning in 2013, Silvergate senior management changed the bank's strategy to focus on customers engaged in crypto activities. Silvergate grew exponentially in a 5-year period, with total assets increasing from less than $1 billion in 2017 to more than $16 billion at the end of 2021. Significant weaknesses in Silvergate's corporate governance and risk management capabilities also contributed to its voluntary liquidation. Silvergate's board of directors and senior management were ineffective, and the bank's corporate governance and risk management capabilities did not keep pace with the bank's rapid growth, increasing complexity, and evolving risk profile. Silvergate had significant, multilayered concentration risk: The bank's deposit accounts were largely funded from companies in one industry, and nearly all deposits were uninsured and noninterest bearing. Further, nepotism, evidenced in the several familial relationships among members of the bank's senior leadership team, undermined the effectiveness of the bank's risk management function.

These multilayered concentrations made the bank highly susceptible to deposit flight. In 2022, the crypto sector encountered significant stress as crypto prices plummeted and a large crypto exchange company filed for bankruptcy. In November 2022, Silvergate experienced significant deposit outflows that led to a liquidity crisis. In March 2023, Silvergate's holding company, Silvergate Capital Corporation (SCC), did not file its annual U.S. Securities and Exchange Commission 10-K report by the expected filing date. In a regulatory filing, SCC explained that its independent public auditor was unable to complete its audit procedures because SCC was unable to provide the auditors with the required information to complete those procedures given the "continuous developments" at the holding company and the bank, including regulatory inquiries, investigations, and potential liabilities resulting from litigation. That same month, Silvergate experienced another significant deposit outflow and the bank's holding company announced its intent to voluntarily liquidate Silvergate. As of the date of this report, the bank had not failed and therefore did not result in a loss to the Deposit Insurance Fund; the bank was winding down its operations.

## Findings

First, we found that the Board and FRB San Francisco considered requiring Silvergate to file an application under Regulation H as it evolved to a novel business model focused on the crypto industry, but did not. The Board and FRB San Francisco viewed the bank's activities as traditional banking activities because the bank received cash deposits from and made loans to its crypto industry deposit customers. Regulation H requires state member banks to obtain approval from the Board before changing the general character of their business. We believe the Board's and FRB San Francisco's narrow interpretation of whether Silvergate's activities constituted a change in general character or traditional banking activities appears to directly contradict the expectation of the Board's guidance on Regulation H contained in Supervision and Regulation Letter 02-9, which is to assess the risk implications of a bank's strategy shift. The Board's and FRB San Francisco's narrow interpretation allowed Silvergate to enter a new business activity and gradually shift from commercial and mortgage banking activities to operating as a monoline entity serving the crypto industry without obtaining approval or implementing any conditions to address that transition.

Second, we found that examiners should have escalated concerns through stronger, earlier, and more decisive supervisory action. While interviewees mentioned that resource constraints hindered their supervisory efforts, we believe that examiners should have taken more aggressive and decisive supervisory action to escalate several issues in light of the bank's unchecked growth; its volatile funding and deposit concentrations; and its significant, pervasive, and persistent weaknesses in key control functions.

Third, we identified ways in which FRB San Francisco could have strengthened the process to transition Silvergate from the Community Banking Organization (CBO) portfolio to the Regional Banking Organization (RBO) portfolio. In 2021, Silvergate's total assets exceeded $10 billion; as a result, the bank transitioned from the CBO portfolio to the RBO portfolio in January 2022. We found that FRB San Francisco could have assigned an RBO team to Silvergate earlier to facilitate the transition.

Fourth, we found that the Board's examiner guidance does not include information that could have helped examiners address the risks associated with Silvergate's business model and deposit composition. Although the guidance addresses liquidity risk management and rate-sensitive deposits, it does not address deposits that are highly susceptible to flight risk, such as uninsured and noninterest-bearing deposits and deposits that are highly concentrated in one industry.

Lastly, we found that the Board does not have guidance for examiners supervising banks projecting or experiencing significant, rapid growth and does not have guidance on how examiners should assess whether a bank's risk management capabilities and key control functions have evolved with that growth. Examiners did not take sufficient measures to pressure Silvergate to improve its risk management capabilities and key control functions so that it could effectively manage the bank's escalating risk profile.

## Recommendations

Our report contains recommendations designed to enhance supervisory processes based on lessons learned from Silvergate's voluntary liquidation. In its response to our draft report, the Board concurs with our recommendations and outlines actions to address each recommendation. We will follow up to ensure that the recommendations are fully addressed.

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Recommendations, 2023-SR-B-014R, September 27, 2023

# Review of the Supervision of Silvergate Bank

## Finding 1: The Board Should Clarify Its Approach to Supervising Banking Organizations That Change Their Strategy

| Number | Recommendation | Responsible office |
|---|---|---|
| 1 | Update SR Letter 02-9 to provide additional details on what may constitute a change in the general character of a state member bank's business, including providing examiners with a variety of examples or scenarios that could help them to determine when a bank needs to file an application and receive approval from the Board under Regulation H. | Division of Supervision and Regulation |
| 2 | Discuss and reinforce the updates made to SR Letter 02-9 in response to recommendation 1 with Reserve Banks through training. | Division of Supervision and Regulation |
| 3 | Develop guidance to ensure that banking organizations engaged in new and novel business activities have a custom-tailored supervisory plan and approach appropriate for their uniqueness and associated risks. | Division of Supervision and Regulation |
| 4 | Develop a plan to ensure that S&R's oversight activities assess compliance with the guidance developed in response to recommendation 3. | Division of Supervision and Regulation |

## Finding 2: Examiners Should Have Taken More Aggressive Supervisory Action Sooner

| Number | Recommendation | Responsible office |
|---|---|---|
| 5 | Develop and implement a plan for instructing CBO and RBO examiners to take a forward-looking view of a bank's risk profile and the possible and plausible outcomes of that risk profile when assigning CAMELS composite and component ratings, including<br>a. guidance for examiners on effectively balancing a bank's financial results and condition with its risk profile when assigning CAMELS composite and component ratings, particularly for banks with concentrated business models susceptible to boom and bust cycles.<br>b. guidance for examiners on circumstances that warrant a heightened sense of urgency to initiate CAMELS composite or component ratings downgrades, identify when a bank is exhibiting unsafe or unsound banking practices, or designate a bank as being in "troubled condition."<br>c. required training for examiners that reinforces the guidance developed as part of this recommendation, including scenarios that exemplify the challenges of assigning CAMELS composite and component ratings and the implications of potentially deferring composite or component ratings downgrades when a disconnect has developed between a bank's financial condition and results and its escalating risk profile. | Division of Supervision and Regulation |

## Finding 3: The Board Should Better Prepare Institutions and Examiners for Transitions from the CBO Portfolio to the RBO Portfolio

| Number | Recommendation | Responsible office |
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| 6 | Develop guidance for examiners on preparing firms to transition from the CBO portfolio to the RBO portfolio that includes references to updated and relevant guidance applicable to firms that cross the $10 billion asset size threshold. | Division of Supervision and Regulation |
| 7 | Develop a plan to minimize the time necessary to establish a new RBO CPC and supervisory team for CBOs approaching the $10 billion asset size threshold. | Division of Supervision and Regulation |
| 8 | Develop guidance for examiners on supervising firms approaching the $10 billion total assets threshold that describes<br>a. how to prepare for the transition, including the roles and responsibilities of the Board, the CBO team, and the RBO team, and the expectations for sharing relevant information between the portfolio teams.<br>b. procedures for developing and updating the supervisory plan before, during, and after the transition. | Division of Supervision and Regulation |

## Finding 4: The Board Should Expand Examiner Guidance Related to Volatile Funding Sources

| Number | Recommendation | Responsible office |
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| 9 | Expand the scope of examiner guidance related to volatile funding sources and liquidity risks to highlight the risks associated with concentrations in uninsured deposits and noninterest-bearing deposits. | Division of Supervision and Regulation |
| 10 | Expand examiner guidance to address supervising firms with concentrated deposits, large customer relationships, and concentrated business models susceptible to boom and bust cycles based on the lessons learned from Silvergate's voluntary liquidation. | Division of Supervision and Regulation |

## Finding 5: The Board Should Develop Guidance to Address Rapidly Growing Banks

| Number | Recommendation | Responsible office |
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| 11 | Develop guidance for examiners on supervising banks projecting or experiencing rapid growth. The guidance should include<br>a. parameters for identifying significant, rapid growth that may hinder a bank's ability to operate in a safe and sound manner and parameters for identifying when a bank is growing in an unchecked manner based on conditions in the market that have surpassed management's capability to effectively manage it.<br>b. actions examiners should take as a bank projects or experiences such growth or in response to sustained, unchecked growth, including any expected escalations.<br>c. actions examiners should take when supervising banks susceptible to volatile market conditions. | Division of Supervision and Regulation |
| 12 | Develop guidance for banks projecting or experiencing significant, rapid growth that includes expectations for ensuring that they have requisite staff and risk management capabilities and effective key control functions. | Division of Supervision and Regulation |