Proportionality in the European Banking Law.
Lessons from Silicon Valley Bank

by

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1. Banking regulation and proportionality after Silicon Valley Bank.

Banking law is usually characterized by a highly articulated prudential regulation, primarily aimed at containing the spread of negative externalities and limiting the systemic effects generally associated with bank failures.[1] Such rules, however, entail relevant compliance costs, penalizing smaller intermediaries (who often lack adequate economies of scale)[2] and incentivizing market concentration.[3]

For this reason, both banks and supervisors are required to adjust regulatory prescriptions proportionally,[4] according to the general principle outlined in Articles 5(4) and 96 TFUE.[5] Nonetheless, the European regulator has sought to better mitigate the incidence of the aforementioned regulatory costs by introducing a special discipline for "small and non-complex institutions" (Art. 4(1)(145) CRR). In particular, according to this new regulatory scheme, the latter can benefit from simplified transparency and reporting requirements (art. 433-*ter* and art. 415 and 430 CRR, respectively),[6] while art. 97(4) CRD IV provides for a lighter supervisory regime requiring supervisory authorities

[*] Although the essay is the outcome of a shared work, Sections 1, 2, and 3 can be attributed to Enrico Rino Restelli, while Sections 4, 5, and 6 are to Matteo Arrigoni.

[1] *Kern Alexander*, Principles of Banking Regulation, Cambridge, 2019, p. 37 et seqq.; with specific reference to rules on internal organisation, *Klaus J. Hopt*, "Corporate Governance of Banks and Financial Institutions: Economic Theory, Supervisory Practice, Evidence and Policy", European Business Organization Law Review, 2021, 16 et seq.

[2] *Bart Joosen/Matthias Lehmann*, Proportionality in: Mario P. Chiti/Vittorio Santoro (ed.), The Palgrave Handbook of European Banking Union Law, 2019, p. 68.

[3] *EBA Banking Stakeholder Group*, Proportionality in Bank Regulation, in: www.eba.europa.eu, 10 December 2015, p. 15.

[4] *Ana Paula Castro Carvalho/Stefan Hohl/Roland Raskopf/Sabrina Ruhnau*, Proportionality in banking regulation: a cross-country comparison, in: www.bis.org, 2017.

[5] *Joosen/Lehmann* (fn. 2), p. 70 et seq., highlighting that "primary law binds the legislative, the executive and the judiciary. As a consequence, not only the supervisory authorities … must comply with the principle, but the Commission, the European Parliament, the Council and the Court of Justice … as well".

[6] *European Commission*, CRR II Proposal, Impact Assessment, Brussels, 24 November 2016, SWD(2016) 377 final/2, p. 24 et seq.

to proportionate “the frequency and intensity” of SREPs with the size, nature, and risks concretely posed by each bank’s business.[7]
Indeed, the Single Supervisory Board itself recently made a case for a broader use of its discretionary powers “to enable supervisors to plan their activities in a more flexible way, in accordance with a multi-year SREP. This approach will allow supervisors to better calibrate the intensity and frequency of their analyses, in line with the individual bank’s vulnerability and broader supervisory priorities. This will also streamline the supervisory activities in a proportionate and risk-based manner, as [they] wouldn’t tick all the boxes every year. As a result, we expect a reduced burden for the banks too”.[8]
Against this background - in order to amend some loopholes related to the application of the principle of proportionality for banking groups[9] - the European Parliament has also recently proposed to amend Article 97(4) CRD IV to require supervisors to differentiate the exercise of ‘group SREPs’ according to (i) the possible mutualistic nature of member banks, as well as (ii) their qualification as small and non-complex institutions.[10]
In this context, the European approach to proportionality was recently challenged by the crisis of Silicon Valley Bank (SVB), a California-based institution specialised in financing technology start-ups and venture capital. As a matter of fact, the insolvency of SVB is generally attributed to some “regulatory failures” that led to a substantial loosening of prudential regulation and supervision.[11] Indeed, in 2018, U.S. banking law was extensively reformed precisely to mitigate the impact of the main regulatory costs on smaller banks.[12] However - it has been observed - “with the rollback of several key Dodd-Frank provisions, [and] the introduction of several easing requirements and lighter oversight for midsize banks ..., regulators

[7] *EBA*, Guidelines for common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing, EBA/GL/2022/03, para. 2.1.1 and 2.4.
[8] *Andrea Enria*, A new stage for European banking supervision, 28 March 2023, and *Id.*, Hearing of the Committee on Economic and Monetary Affairs of the European Parliament - Introductory statement, 21 March 2023, both in: www.bankingsupervision.europa.eu.
[9] *Federcasse*, Valutazione di Impatto della Regolamentazione (VIR) sugli effetti prodotti dalla riforma del 2016 sull’operatività delle banche di credito cooperativo, 22 February 2022, p. 14.
[10] *European Parliament*, Amendments 330 - 582, PE731.819v02-00, 22 August 2022.
[11] *Apostolos Thomadakis*, The collapse of SVB: A mix of poor risk management and regulatory failure, in: www.ecmi.eu, 27 March 2023; *Christos V. Gortsos*, Preventing a New Global Financial Crisis Amidst the Current ‘Inflation Crisis’ and the Spring 2023 Bank Failure Episodes, in: www.ssrn.com, 2023, 6 et seqq.; *Hinh T. Dinh*, Lessons from the Silicon Valley Bank Crisis, in: www.policycenter.ma, March 2023, p. 4; *Board of Governors of the Federal Reserve System*, Review of the Federal Reserve’s Supervision and Regulation of Silicon Valley Bank, in: *www.federalreserve.gov*, April 2023, 86 et seqq. and 91.
[12] *Dimitris K. Chronopoulos/John O.S. Wilson/Muhammed H. Yilmaz*, “Regulatory Oversight and Bank Risk”, Journal of Financial Stability, 2023, 1 et seq.

have not supervised these banks sufficiently".[13] Critics honed in on the loosening of liquidity requirements and capital discipline,[14] but also (and perhaps mostly) the introduction of 'lighter' supervisory practices.[15]

These drawbacks - along with the magnitude of the consequences the crisis of SVB generated - cast some doubt over the desirability of further strengthening the application of the proportionality principle in the European legal system, emphasising the dangers potentially associated with the weakening of supervision and prudential regulation.[16]

Against this backdrop, the present paper discusses potential lessons to be learned from the SVB failure from a policy perspective in European banking regulation. After briefly summarising the events that brought to the collapse of SVB, Section 2 and 3 will discuss the aforementioned regulatory failures to assess the actual fitness of EU prudential regulation. Section 4, then, will address the issues related to supervision to investigate the soundness of the reforms currently proposed by the European Parliament. Lastly, Section 5 will debate the problems arising from the increasing use of supervisory discretion to cope with the new risks highlighted by the failure of SVB with reference to the control over the business model of a bank. Section 6 concludes.

2. The loosening of the U.S. prudential regulation and the overall architecture of the European banking system.

During the pandemic, due to the favorable market conditions experienced by tech start-ups in that period, SVB tripled its deposits collection.[17] In the absence of alternative solutions, SVB invested the resulting liquidity in buying treasury bonds and other financial instruments with long maturities to profit on the associated interest margin.[18] However, the progressive

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[13] *Thomadakis* (fn. 11).

[14] For a summary of these changes, *Federal Reserve*, Requirements for Domestic and Foreign Banking Organizations, in: www.federalreserve.gov, 2019.

[15] *Board of Governors of the Federal Reserve System* (fn. 11).

[16] *Helen Thomas*, How 'competitive' would you like your bank regulation now?, 20 March 2023; *Lauren Fedor*, Top Democrat to accuse US regulators of allowing SVB to 'grow too big, too fast', 28 March 2023; and *Martin Arnold/Sam Fleming*, EU to speed up work on rules for failing banks in response to US crisis, 15 March 2023, all in: www.ft.com. With specific reference to the U.S. system, *Natalie Andrews/Eric Bazail-Eimil/Siobhan Hughes*, Lawmakers Split on Tighter Rules After Silicon Valley Bank Failure, in: www.wsj.com, 14 March 2023.

[17] Deposits collected by SVB as of December 31, 2019 were $61.757 billion; two years later, the overall value of deposits had increased to $189.203 billion (see the *Annual Reports - Form 10-K* published by SVB Financial Group for fiscal years 2020 and 2021, p. 85 and 81, respectively). For a summary of the events surrounding SVB's development and crisis, see *Board of Governors of the Federal Reserve System* (fn. 11), 17 et seqq.

[18] *Lai Van Vo/Huong T.T. Le*, From Hero to Zero - The Case of Silicon Valley Bank, in: www.ssrn.com, 2023, p. 8 et seqq.; *Dinh* (fn. 11), p. 3.

tightening of monetary policy caused a sudden devaluation of these investments,[19] just as the bank's customers had begun to withdraw their deposits to cope with the rising cost of money and changing market conditions.[20]

Facing a severe liquidity problem, SVB was then forced to sell these assets at a steep discount and suffered a $1.8 billion loss which prompted the bank to approve a substantial capital increase (amounting to $2.25 billion).[21] Such events, however, made investor fully aware of the difficulties that SVB was experiencing, triggering a large 'bank run'.[22] Indeed - according to SVB's own estimates[23] - the guarantee provided by the Federal Deposit Insurance Corporation (FDIC) did not cover as much as 96 percent of the , directly exposing these customers to the consequences of possible insolvency.

In order to curb the spreading of negative externalities throughout the entire financial system, on March 10, 2023, SVB was declared insolvent and the FDIC assumed control of the bank.[24] In this context, the FDIC recurred also to the "systemic risk exception" provided by 12 U.S.C. § 1823(c)(4)(G) in order to bail out all SVB depositors and prevent negative spillovers (as a general rule, in fact, in the U.S., such a guarantee is limited only to deposits up to $250,000).[25] On March 27, 2023, First Citizens Bank purchased SVB.[26]

2.1. The impact of liquidity and capital requirements in the SVB failure.

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[19] *Gortsos* (fn. 11), p. 3; *Dinh* (fn. 11), p. 3. Theoretically, changes in market prices should only affect those investments qualified by each institution as 'available for sale', whereas SVB was supposed to hold these assets up to their maturity. Nonetheless, due to a sudden liquidity crisis, SVB was forced to sell its investment prematurely and recognise the corresponding losses (see *infra*, par. 2.1.).

[20] *Gortsos* (fn 11), p. 3 and 10 et seqq. By 2022, indeed, deposits had decreased by $16.1 billion*: SVB Financial Group*, Annual Report for the fiscal year ended December 31, 2022 - Form 10-K, in: www.svb.com, p. 80.

[21] *Dinh* (fn. 11), p. 3 et seq.; see also the statement published by *SVB Financial Group*, Proposed Offerings of Common Stock and Mandatory Convertible Preferred Stock, in: www.svb.com, 8 March 2023.

[22] *Tabby Kinder/Antoine Gara/Joshua FranklinGeorge Hammond*, Silicon Valley Bank: the spectacular unravelling of the tech industry's banker, in: *www.ft.com*, 12 March 2023.

[23] *SVB Financial Group* (fn. 20), p. 80; but see also *Andrew Metrick/Paul Schmelzing*, The March 2023 bank interventions in long-run context - Silicon Valley Bank and beyond, National Bureau of Economic Research, 2023, p. 3.

[24] *FDIC*, Press Release - FDIC Creates a Deposit Insurance National Bank of Santa Clara to Protect Insured Depositors of Silicon Valley Bank, Santa Clara, California, in: www.fdic.gov, 12 March 2023.

[25] *FDIC*, Press Release - FDIC Acts to Protect All Depositors of the former Silicon Valley Bank, Santa Clara, California, in: www.fdic.gov, 13 March 2023; *Gortsos* (fn. 11), p. 7; *Metrick/Schmelzing* (fn. 23), p. 3.

[26] *FDIC*, Press Release - First Citizens Bank & Trust Company, Raleigh, NC, to Assume All Deposits and Loans of Silicon Valley Bridge Bank, N.A., From the FDIC, in: www.fdic.gov, 26 March 2023.

As already mentioned, one of the most controversial issues concerns the waivers to the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) requirements devised by the 2018 reform in favour of smaller U.S. banks, entirely exempting institutions with consolidated assets of less than $250 billion and wholesale weighted short-term funding of less than $50 billion from the application of these provisions.[27]
Such amendments were highly criticised, because "bank insolvency is … usually triggered by illiquidity" crisis, often generated by the difficulty of coping with sudden asset depreciation and subsequent deposit withdrawal.[28] This was true also for SVB failure. Indeed, according to the estimates of a recent study, such exemption would have allowed SVB to drastically reduce its short-term liquidity requirements (LCR) and set aside high-quality liquid assets (HQLS) of just 75 percent of the net cash flows needed to cope with adverse market conditions over a 30-day time horizon. In this regard, to align with the U.S. banking industry average (*i.e.*, 125%), SVB would have had to set aside HQLS for an additional $36 billion.[29]
Most strikingly, in this context, also market dynamics were unable to correct such failure, spontaneously directing banks towards socially virtuous behaviour even without clear-cut rules.[30] Indeed, the 2018 reform of LCR requirements has exempted banks from numerous disclosure obligations,[31] making it more complex for depositors and investors to obtain the information needed to police management decision.[32]
As to capital requirements, some authors have pointed out loopholes in the U.S. accounting and prudential regulations of non-trading book activities[33]: *i.e.*, those investments that a bank has decided, in the exercise of its

[27] 84 FR 59230 - Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements, para. IV and VI-B-2, which excludes banks with consolidated assets of less than $250 billion and wholesale weighted short-term funding of less than $50 billion from the above requirements: see *Board of Governors of the Federal Reserve System* (fn. 11), 87 et seq.
[28] *Charles A.E. Goodhart*, "The regulatory response to the financial crisis", 4(4) Journal of Financial Stability, 2008, 353.
[29] *Greg Feldberg*, Lessons from Applying the Liquidity Coverage Ratio to Silicon Valley Bank, in: www.yale.edu, 27 March 2023; for similar results, *Board of Governors of the Federal Reserve System* (fn. 11), 87 et seqq.
[30] Indeed, even supervisor had experienced significant difficulties in the task: *Board of Governors of the Federal Reserve System* (fn. 11), 60.
[31] *Feldberg* (fn. 29).
[32] *Michael S. Barr*, Why Bank Capital Matters, in: www.bis.org, 1 December 2022. In general, the high monitoring costs are likely to discourage investors from checking the actual management behavior. In addition, investors may also have to overcome the problems associated with the nature of information as "public good": *Ronald J. Gilson/Jeffrey N. Gordon*, "The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights", 113 Columbia Law Review, 2013, 863.
[33] *Board of Governors of the Federal Reserve System* (fn. 11), 21 et seq.

managerial discretion,[34] to keep in its portfolio until their natural maturity. Because of this peculiar feature, intermediaries can evaluate their 'held-to-maturity assets' without considering possible market price fluctuations and focusing only on credit risk and their amortised historical cost.[35] Nonetheless, such investments are still exposed to changes in interest rates, which should prompt banks to arrange appropriate hedging strategies when necessary - despite the original expectations - to sell a substantial portion of these assets.[36] However, in the absence of a specific regulation,[37] such risks may not be adequately reflected in the regulatory capital and corporate accounting.[38]
As of 31 December 2022, held-to-maturity assets represented 76% (*i.e.*, $91,32 billion) of the SVB investment securities and half of its total assets,[39] "nearly double" the average of the U.S. large bank institutions.[40] Still, in the absence of an appropriate regulation, SVB was able to conceal in its balance-sheet potential losses of approximately $15.1 billion,[41] finding itself unable to sell these assets to relieve the sudden liquidity shortfall safely. Indeed, had SVB sold part of its held-to-maturity investments, it would have been required to recognise the unrealised losses on a substantial portion of its portfolio.[42]
In conclusion, as the Federal Reserve expressly recognised, there is little doubt that the 2018 reform of the U.S. banking system created a "weaker regulatory framework". Indeed, "in the absence of these changes", SVB "would have been subject to enhanced liquidity risk management requirements, full standardised liquidity requirements," and "enhanced capital requirements", bolstering its resilience and possibly mitigating the systemic effects of its crisis.[43]

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[34] On the problems arising from the discretionary nature of this decision, squeezing the margin for a supervisory review, see *BCBS*, Interest rate risk in the banking book, in: www.bis.org, 2015, p. 3.
[35] *BCBS* (fn. 34); *Andrea Enria*, Exchange of views of the Committee on Economic and Monetary Affairs of the European Parliament, in: www.bankingsupervision.europa.eu, 21 March 2023.
[36] *Enria* (fn. 35); *BCBS* (fn. 34).
[37] *Greg Feldberg*, US Banks' Interest-Rate Risk Reporting and Regulation: A comparative Context, in: www.yale.edu, 26 March 2023; *Robin Wigglesworth*, How crazy was Silicon Valley Bank's zero-hedge strategy?, in: www.ft.com, 17 March 2023.
[38] *Erica X. Jiang/Gregor Matvos/Tomasz Piskorski/Amit Seru*, Monetary Tightening and U.S. Bank Fragility in 2023: Mark-to-Market Losses and Uninsured Depositor Runs?, in: www.ssrn.com, 2023.
[39] Respectively, *SVB Financial Group* (fn. 20), p. 64 et seqq.; and *Vo/Le* (fn. 18), p. 12.
[40] *Board of Governors of the Federal Reserve System* (fn. 11), 21 et seq.
[41] *Kinder/Gara et al.* (fn. 22); *Vo/Le* (fn. 18), p. 12;
[42] *Board of Governors of the Federal Reserve System* (fn. 11), 21 et seq., according to which "if a bank sells a portion of its HTM portfolio, the entire portfolio would be required to be reclassified as AFS and marked to market". For this reason, "in view of this accounting constraint and the large growth that had occurred in its HTM portfolio, SVBFG was limited in its ability to adjust its portfolio as the rate environment changed".
[43] *Board of Governors of the Federal Reserve System* (fn. 11), 91 et seq.

2.2. Liquidity and capital requirements and the scope of proportionality. The European framework.

Liquidity and capital requirements represent the backbone of prudential regulation. Not only do they provide additional funds and high-quality assets in times of market distress, but they also restrict banks (*ex-ante*) from taking up excessive risks by adding 'artificial' regulatory costs (that is, by making banks 'internalise' the social costs of their activity).[44] For this reason, as the crisis of SVB clearly shows, such requirements should not be incautiously relaxed, even for smaller banks.

In principle, the case for proportionality may appear weaker in relation to liquidity and capital requirements as such, while it may advocate for simpler regimes applicable to smaller institutions (for example, providing simplifed calculation criteria and formulae). In general terms, the rationale for proportionality is to mitigate the fixed costs of regulation for smaller intermediaries which do not possess adequate economies of scale. Capital requirements and liquidity provision, instead, represent variable costs (proportional 'in nature' and calibrated according to the actual risks taken by each institution): for this very reason, the level of coverage against such risks should be outside the scope of proportionality. Indeed, the choice to provide a milder regulatory capital regime for smaller institutions is likely a political one, aiming at promoting specific economic and industrial goals[45] rather than implementing proportionality and creating a level playing field.

Accordingly, acknowledging the importance of liquidity requirements, the European regulator has fully aligned its regulatory standards with the recommendations provided by the Basel Committee and refrained from introducing any waiver on the LCR, even for small and non-complex institutions.[46] Similar conclusions - with minimal exemptions - also hold for LCR reporting requirements.[47] As an only exception, subject to supervisory approval, the small and non-complex institution can benefit from a simplified

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[44] Capital requirements, in particular, compel banks to collect own funds in an amount proportional to the risk-weighted assets. By doing so, such requirements force banks to 'internalise' the risks posed by their activity: indeed, as risk-taking entails decreasing net marginal benefits, banks will have to set their risk appetite efficiently.

[45] And, in particular, the development of smaller banks, on the assumption that the negative externalities associated with their crisis are usually easier to manage and do not threat financial stability.

[46] *Enria* (fn. 35).

[47] *EBA*, Study of the cost of compliance with supervisory reporting requirementt, EBA/Rep/2021/15: minor changes in the reporting requirements concerning the "additional liquidity monitoring metrics" are now discussed by the European regulator.

methodology for calculating NSFR requirements (art. 428-*sextricies* CRR).[48] Overall, there is no doubt that this regulatory framework contributed to the development of a resilient banking system. Indeed - against a minimum LCR requirement of 100% of net cash flows (art. 412 CRR) - European banks have, on average, HQLS equal to 160% and "more than half of the existing buffers … are made up of cash and central bank reserves, which sensibly mitigates the risk of mark-to-market losses when liquidity needs arise".[49]
As to the interest rate risks (one of the major drivers of SVB's crisis),[50] the European regulatory capital regimes are also shaped according to these principles. Banks in particular must set aside adequate regulatory capital even for their *non-trading books* assets,[51] while supervisors retain a discretionary power to impose additional Pillar-2 capital requirements against this risk. In this context - specifically addressing one of the most dramatic issues that brought to the collapse of SVB - European intermediaries are also required to "take into account … the potential for actual losses to be incurred under stressed conditions, or as a result of secular changes in the market environment" (*e.g.* "where it might become necessary to liquidate positions that are intended as a long-term investment to stabilise earnings").[52]
At the same time, European institutions must implement appropriate governance arrangements to "identify, measure, monitor and control" all the risks arising from changes in interest rates (the so-called interest rate risk arising from the banking book, or IRRBB).[53] In particular, the management body is expected to implement a proper IRRBB strategy, identifying stringent limits to the bank's exposure to these risks.[54] This strategy must be fully aligned with the bank's overall risk appetite framework,[55] and it must consider "the extent to which the business model relies on generating earnings by 'riding the yield curve'" (*i.e.*, "funding assets with a comparatively long repricing period with liabilities with a comparatively short repricing period"). Notably, should the bank rely heavily on this source of earnings, (as SVB did)[56] the management body must specifically address how the institution "plans to survive periods of flat or inverse yield curves".[57] Against this

[48] Recital 53, Regulation (EU) 2019/876. A special regime is also provided for calculating liquidity requirements for those institutions participating in the same banking group: art. 8 CRR.
[49] *Enria* (fn. 35). As mentioned (*supra* Section 2.1.), on average, U.S. institutions possess HQLS amounting to 125% of the net cash flows needed to cope with adverse market conditions over a 30-day time horizon.
[50] See *supra* Section 2.
[51] *EBA*, Guidance on the management of interest rate risk arising from non-trading activities, ABE/GL/2018/02, July 19, 2018, para. 4.2; *Feldberg* (fn. 37).
[52] *EBA* (fn. 51), n. 30.
[53] *EBA* (fn. 51), para. 4.3, n. 41.
[54] *EBA* (fn. 51), n. 44.
[55] *EBA* (fn. 51), n. 32 et seq.
[56] *Gortsos* (fn. 11), p. 6.
[57] *EBA* (fn. 51), n. 34.

background, it is also expressly stated that accounting principles "should not drive" the bank's "risk management approach" (still, directors should always "be aware of the effects of accounting policies").[58]

Once again, small and non-complex institutions are subject to the same discipline, although they can apply these rules "in a proportionate manner, depending on the level, complexity and riskiness" of their overall portfolio.[59]

3. The role of corporate and risk governance.

Poor corporate governance and risk management policies certainly played a crucial role in the crisis of SVB.[60] Indeed - as noted by the Federal Reserve - the board of director and the chief risk officer "lacked large bank experience" and "had failed to establish appropriate risk management". In addition, "internal governance structures were inadequate given [the bank's rapid] growth", and "internal audit coverage" was insufficient, too.[61]

Notably, internal rules on directors' and managers' compensation were largely ineffective.[62] Most strikingly, the variable part of the remuneration accounted for as much as 90% of the total amount paid to the CEO (81% for the other board members) and was calculated exclusively according to the company's profitability, without any reference to the bank's risk profile. In such a context, the power of the nomination and compensation committee to "adjust payouts for negative risk outcomes" was the only (clearly insufficient) counterbalance to excessive risk-taking.[63] The SVB compensation policies also defined claw-back policies in rather general terms by leaving too much discretion over the conditions under which the bank could have recouped the incentive paid to the management.

3.1. The European framework on corporate governance and the quest for proportionality after SVB.

It is broadly acknowledged that the establishment of organisational, administrative, and accounting arrangements is essential to ensure a credit

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[58] *EBA* (fn. 51), n. 38.
[59] *EBA* (fn. 51), n. 19.
[60] *Thomadakis* (fn. 11); *Board of Governors of the Federal Reserve System* (fn. 11), 45 et seqq.
[61] *Board of Governors of the Federal Reserve System* (fn. 11), 48.
[62] *Board of Governors of the Federal Reserve System* (fn. 11), 72 et seqq.; *Antoine Gara/Patrick Temple-West/Tabby Kinder*, Executive pay at Silicon Valley Bank soared after big bet on riskier assets, in: *www.ft.com*, 24 March 2023.
[63] *SVB Financial Group*, 2023 Proxy Statement - Schedule 14A, in www.svb.com, 39 et seqq.

institution's sound and prudent management.[64] For this reason - with few exceptions (*e.g.*, the appointment of a risk committee inside the board;[65] the possibility to combine risk management and compliance functions;[66] or the assignment of the outsourcing function to a board's member[67]) - all European banks are required to comply with the same set of rules, especially with reference to risk management and internal controls. In this framework, proportionality is very limited in scope and only represents a simple criterion to 'shape' the general application of uniform rules according to "the nature, scale, and complexity of the risks inherent in the business model and the institution's activities" (art. 74(2) CRD IV).[68]
More so, similar conclusions hold for the regulatory provisions on management remuneration, the variable part of which should always "reflect a sustainable and risk-adjusted performance" (art. 92(2)(g)(ii) CRD IV). According to this, the "variable remuneration components" - which should not exceed the amount of the total compensation fixed part (art. 94(1)(g)(i) CRD IV) - must be adjusted "for all types of current and future risks" and must take also "into account the cost of the capital and the liquidity required" (art. 94(1)(j) CRD IV). Although smaller banks may benefit from some minor exemptions (art. 94(3)(a) CRD IV),[69] these latter do not undermine the effectiveness of the overall regulatory framework.
Once again, the European framework already provides a detailed regulatory solution to all the major concerns raised by the failure of SVB, although - it has been argued - "rule on corporate governance could be further enhanced at least in relation to remuneration and risk management".[70]
Still, perhaps surprisingly, the analysis of the SVB crisis may suggest a partially different approach. Despite the startling deficiencies in SVB risk management and internal controls functions, the bank's crisis had partly been caused by the materialisation of risks overlooked or underestimated even by the supervisor.[71] To be sure, correctly identifying and evaluating *all* the risks to which a bank is currently exposed may be very challenging: new unaccounted risks can suddenly materialise, while supposed negligible risks

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[64] *Ex multis*, *Hopt* (fn. 1); *Peter O. Mülbert/Alexander Wilhelm*, CRD IV Framework for Banks' Corporate Governance, in: Danny Busch/Guido Ferrarini (ed.), European Banking Union, 2020, p. 223.
[65] Art. 76(3) CRD IV.
[66] *EBA*, Guidelines on internal governance, EBA/GL/2017/11, 21 March 2018, para. 19.3.
[67] *EBA*, Guidelines on outsourcing arrangements, EBA/GL/2019/02, 25 February 2019.
[68] *EBA* (fn. 66), Title I; *Castro Carvalho/Hohl et al.* (fn. 4).
[69] *EBA*, Guidelines on sound remuneration policies under Directive 2013/36/EU, EBA/GL/2021/04, 2 July 2021, para 4.
[70] *Gortsos* (fn. 11), p. 12 et seq.
[71] *Amplius*, see Section 4.2.

may easily turn into a significant problem for a bank's sound and prudent management.[72]
At the same time, predicting how a future banking crisis might unfold may be difficult, too,[73] and cognitive biases can undermine managers' ability to make informed decisions. As it often happens, people tend to "assess the likelihood of risks by asking how readily examples come to mind" (availability heuristic),[74] and even managers - although professionals - are prone to such biases. Banks' directors "spent the past decade worrying about credit and liquidity risks", while interest rates grabbed far less attention.[75] According to behavioural economics, this cognitive background could easily drive managers toward incorrect assumptions, "influencing" how they "prepare for and respond to crisis" and "business choices".[76] Such considerations may explain - at least in part - why SVB managers (and supervisors) were so blind to the risks arising from changes in interest rates.
In conclusion, it is undisputed that effective management of risks and conflicts of interest should be a primary goal of corporate governance arrangements, clearly advising against an incautious loosening of these regulatory standards. At the same time, a generalised tightening of corporate governance rules may also be counterproductive. Indeed, the need to provide more robust risk management does not necessarily require stricter limits in the banking activity and more burdensome and meticulous procedures: the European regulatory framework already addresses all the major issues the SVB crisis brought to light, and more stringent rules will only further limit the scope of proportionality affecting mostly the smallest banks. Instead, it may be helpful to rethink the global architecture of governance structures in order to provide innovative solutions to better cope with cognitive limitations of individuals in the banking sector (*e.g.* group thinking, heard effect, or - as shown by SVB - availability heuristic).
At the same time, it should be noted that even introducing a more detailed, punctual and overarching set of rules on risk management and internal

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[72] *Jon Danielsson/Charles Goodhart*, What Silicon Valley Bank and Credit Suisse tell us about financial regulations, in: www.cepr.org, 25 March 2023.
[73] *Michael S. Barr*, Statement before the Committee on Banking, Housing, and Urban Affairs U.S. Senate, in: www.federalreserve.gov, 28 March 2023.
[74] *Richard H. Thaler/Cass S. Sustein*, Nudge. Improving decisions about health, wealth and happiness, 2008, p. 27 et seqq., according to which "the availability heuristic helps to explain much risk-related behavior, including both public and private decisions to take precautions".
[75] *Gillian Tett*, Silicon Valley Bank shows the perils of regulators fighting the last war, in: www.ft.com, 13 March 2023, highlighting that "the last time [interest rates] caused big losses (in derivatives markets) was in 1994".
[76] *Thaler/Sustein* (fn. 74), 28. As to the use of past data, *Enria*, A new stage (fn. 8) noted that "by taking the data from the financial crisis and plugging them into the pandemic, we came out with the wrong answer. So, that for me was a lesson. We need to continue using models, of course - we use them in regulation. But we also need to have expert judgement and some way of adjusting from the outcomes of the model and the way in which we look at risks".

controls does not necessarily result in a more efficient and reliable outcome[77] (whereas it certainly increases compliance costs, especially for smaller institutions). Indeed, the current corporate governance regime relies upon pervasive networks of internal procedures and arrangements intermediaries must adopt according to the supervisory guidelines. However, "to operate successfully", every bureaucracy "must attain a high degree of reliability of behavior" and "an unusual degree of conformity with prescribed patterns of action", often perceived by the bank staff as an authentic 'liturgy'. Such "ritualism ensues with an unchallenged insistence upon punctilious adherence to formalized procedure", and it "may be exaggerated to the point where primary concern with conformity to the rules interferes with the achievement of the purposes" of the procedure itself. [78] This structure, though, "interferes with ready adaptation under special conditions not clearly envisaged" by the management.[79] On the other hand, highly detailed procedures and behavioral patterns also tend to 'encapsulate' people thinking in predefined clusters and prevent banking personnel from adapting their activity to the ever-changing economic contest, spotting the appearance of new risks, and exacerbating the problems posed by path dependencies and cognitive biases.

4. The intensity and frequency of supervisory activity may be graduated according to the characteristics of the supervised entity.

There are many opinions on which the weakening of the supervisory activity has contributed to the SVB crisis. In addition to external observers,[80] the Federal Reserve itself[81] has also underlined this aspect. The consequence of such an analysis is thus to emphasise the importance of high-level

[77] *Amedeo Valzer*, "La disciplina del credito ai consumatori per l'acquisto di immobili residenziali", LXXIV Banca borsa titoli di credito, 2021, I, 913 ff.
[78] *Robert K. Merton*, Social Theory and Social Structure, 1957, 197 ff.
[79] *Merton* (fn. 78), 200 ff.
[80] For example, Karen Petrou, managing partner of Federal Financial Analytics, argued that the outcome of the cases of SVB and Silvergate Capital Corp. "is evidence of a significant supervisory problem" (*Ben Eisen*, Where Were the Regulators as SVB Crashed?, in: www.wsj.com, 11 March 2023); more sharply, *Aaron Klein*, SVB's collapse exposes the Fed's massive failure to see the bank's warning signs, in: www.brookings.edu, 16 March 2023, stated that "the failure of Silicon Valley Bank (SVB) is a failure of supervision as well as regulation" and that "the Federal Reserve failed as a bank supervisor".
[81] As anticipated by *Board of Governors of the Federal Reserve System*, Press Release, 13 March 2023, in: www.federalreserve.gov, an analysis was carried out whose outcome is the *Board of Governors of the Federal Reserve System* (fn. 11).

supervision[82] and, consequently, the need to strengthen that power.[83] In even more explicit terms, to avoid other cases like the SVB case, the intensity and frequency of bank stress tests conducted by the supervisory authority should then be increased,[84] abandoning the current approach of graduating both the frequency and the supervisory effort according to the banks' characteristics instead.

In support of this approach, it has been pointed out that SVB would not be subjected to stress tests until 2024, three years after crossing the $100 billion asset threshold, which is suitable for increasing such tests in the United States.[85] In the U.S. system, the frequency of the checks then increases for banks in the categories which followed – indeed, starting with banks with consolidated assets over USD 250 billion (Category III banks), the stress tests become annual. The conclusion of the reasoning is straightforward: such critical elements "raise questions over how closely the Fed was following developments at SVB".[86]

However, as will be shown below, the supervisory malfunctioning was not due to a lack of frequent supervision or thorough testing. Given the reduced benefits that an increase in the intensity or depth of analysis of the supervisory activity entails and, simultaneously, because of the increased costs for the supervised entities, it seems reasonable to envisage a proportionate approach to supervisory activity.

4.1. The Federal Reserve's supervisory activity in the SVB case.

At a closer look, the SVB crisis cannot be attributed to a limited frequency of checks or a reduced intensity of investigation by the supervisory authority due

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[82] *Karel Lannoo/Rosa M. Lastra/Rym Ayadi*, Another unexpected banking crisis, yet another opportunity to fix a still-broken banking system, CEPS, March 29, 2023.

[83] *Jerome Powell*, Transcript of Chair Powell's Press Conference, in: www.federalreserve.gov, March 22, 2023, p. 11, stated that "it is clearly we do need to strengthen supervision"; in the same sense, *M. S. Barr* in *Board of Governors of the Federal Reserve System* (fn. 11), p. 2, according to which "our first area of focus will be to improve the speed, force, and agility of supervision".

[84] Within a more general discourse, *Raghuram G. Rajan/Viral V. Acharya*, The Fed's Role in the Bank Failures, in: www.project-syndicate.org, March 28, 2023, argue that "another problem, however, is that supervisors did not subject all banks to the same level of scrutiny that they applied to the largest institutions (which were subject to stress tests, among other things)".

[85] *Board of Governors of the Federal Reserve System* (fn. 11), 12 et seq. and 86. Indeed, to be subject to enhanced prudential standards, a bank's assets must exceed $100 billion over an average of four quarters; however, the move to a biennial stress test for Category IV banks - as SVB used to be - may lead to an additional year of delay if the phasing-in period ends in an odd-numbered year: *Barr* (fn. 73), p. 8 and fn. 11.

[86] This is the opinion of Kathryn Judge, a professor at Columbia University, in *Colby Smith/Stefania Palma*, Regulators face questions over missed warning signs at Silicon Valley Bank, in: www.ft.com, 13 March 2023.

to the little power conferred on it. On the contrary, supervisory interventions relating to SVB have not been lacking in recent years,[87] even if a simplified regime has been introduced with reference to banks considered to be small.
Specifically, the Federal Reserve made some significant interventions. For example, in January 2019, the authority underlined the concern about risk management by the SVB through the Matter Requiring Attention. Towards the end of 2021, deficiencies in the bank's liquidity risk management were found. Further findings were highlighted in May 2022. In summer 2022, the bank's management rating was downgraded, thus activating the bank's growth restrictions envisaged by law (Sec. 4(m) Bank Holding Company Act). In October 2022, there was the meeting with the bank's senior management to express new concerns regarding the risk profile relating to the intermediary's interest rate. The Federal Reserve transmitted a supervisory finding on the management of this risk in November 2022. Finally, in February 2023, there was an analysis of a report on the impact that rising interest rates could have on the financial condition of some banks in general, and with specific reference to SVB.[88]
In the light of this evidence, the words of the Federal Reserve chairman were not implausible when he claimed that, in relation to SVB, "supervisors did get in there and they were, as you know obviously, they were on this issue, but nonetheless, this still happened".[89] Even more clearly, it was recognised that "SVB's foundational problems were widespread and well-known, yet core issues were not resolved, and stronger oversight was not put in place".[90]

4.2. The main explanations for the supervisory failure in the SVB case

[87] For a summary, *Board of Governors of the Federal Reserve System* (fn. 11), 16, 27 et seq., where also the evidence that "from 2019, the Federal Reserve issued 54 supervisory findings to" SVB.
[88] For further information, see *Andrew Ackerman/Dave Michaels*, Fed Raised Concerns About SVB's Risk Management in 2019, in: www.wsj.com, 19 March 2023; *Board of Governors of the Federal Reserve System* (fn. 11), Key Takeaway, ii; *Barr* (fn. 73), p. 5 et seq. Further confirmations emerge from the intervention of the Governor of the Bank of England: *Andrew Bailey*, Letter to the Cahir of the Treasury Committee, in: committees.parliament.uk, 22 March 2023, p. 11.
[89] *Powell* (fn. 83), p. 12, who then added that "I will tell you though that we have, there have been presentations about interest rate risk. I mean it's been in all the newspapers, it's not a surprise that there are institutions that have had un-hedged long positions in long duration securities that have lost value as longer-term rates have gone up due to our rate increases. So that's not a surprise. I think, as you know, as is now in the public record, the supervisory team was apparently engaged, very much engaged with the bank repeatedly, and was escalating but nonetheless, what happened, and so that's really the purpose of, one way to think about the review that Vice Chair Barr is conducting is to try to understand how that happened and try to understand how we can do better and what policies we need to change" (*ivi*, p. 18).
[90] *Board of Governors of the Federal Reserve System* (fn. 11), 5; it was further found that "the issues most relevant to the failure of SVBFG - rising interest rates, impact on securities valuation, and liquidity pressure - were identified, analysed, and escalated" (*ivi*, 72).

Given the activities undertaken by the Federal Reserve just mentioned in the previous subparagraph, the authority could not avert the SVB crisis. Therefore, as the same authority has asked,[91] one is expected to wonder what went wrong: in other words, why the supervisory authority was unable to prevent the SVB crisis. On this point, it should be noted that the Federal Reserve has identified the main risks; instead, the problem must be underestimating these risks' impact. In this regard, the primary explanations for this result are the following.[92]

First, the business of correctly identifying and estimating the extent of risks present in the financial system is very complex: "even if the authorities successfully identify a lot of risk and areas where it is taken, there is an infinite scope for risk to emerge elsewhere"[93] or that the relevance attributed to the risks identified is different from what occurs. Therefore, Barr's point on this matter makes sense: "we must be humble about our ability—and that of bank managers—to predict how a future financial crisis might unfold, how losses might be incurred, and what the effect of a financial crisis might be on the financial system and our broader economy".[94]

Furthermore, as was mentioned earlier, an evaluation error may be influenced by cognitive biases. As graphically described, supervision is 'trained to fight the last war': in the past decade, the main risks have been credit and liquidity; interest rate risk, on the other hand, was not a significant threat before the SVB case. The influence of this cognitive bias may therefore have been an outcome-determinative factor.[95]

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[91] The review provided answers to the following questions: "How effective is the supervisory approach in identifying these risks? Once risks are identified, can supervisors distinguish risks that pose a material threat to a bank's safety and soundness? Do supervisors have the tools to mitigate threats to safety and soundness? Do the culture, policies, and practices of the Board and Reserve Banks support supervisors in effectively using these tools?": *Barr* (fn. 73), p. 7 et seq.

[92] Further explanations are, in the opinion of the writer, less relevant because they are confined within the U.S. system, and, therefore, not useful as a 'lesson' for European Union law. For example, it has been highlighted how the 'double' supervisory system in the United States - with federal and state supervision - could have contributed negatively (in more detail, *Smith/Palma* (fn. 86); in the same sense, it was underlined that the transition of SVB from the 'Other banks' category to 'Category IV', with consequences in terms of stress tests and prudential requirements, led to delays in the supervisory activity, which represented an obstacle (*Board of Governors of the Federal Reserve System* (fn. 11), 43 et seq.).

[93] *Jon Danielsson/Charles Goodhart* (fn. 56).

[94] *Barr* (fn. 73), p. 9.

[95] *Gillian Tett* (fn. 75); in the introductory letter to the *Board of Governors of the Federal Reserve System* (fn. 11), *Michael S. Barr* wrote that "we need to guard against complacency. More than a decade of banking system stability and strong performance by banks of all sizes may have led bankers to be overconfident and supervisors to be too accepting". Albeit less explicitly, also *Enria*, A new stage (fn. 8), argued that "in those cases, it is supervision that needs to look at the business model" and that, for the future, "we need to be strong in understanding whether a business model is viable".

In the light of these arguments, it is possible to draw an initial conclusion: an increase in supervisory activity does not solve the problems described above. Other dynamics may have influenced a light supervisory approach. First, it was argued that the Federal Reserve had no incentive to raise the alarm about potential interest rate risk after it was the unintended but accepted consequence of its monetary policy decisions. Second, the fact that the Basel regulatory framework assigns a zero-risk weight to sovereign bonds could explain why the risk of assets invested in sovereign bonds has been underestimated[96]. Overall, there may have been a temptation to reduce rules and controls to encourage investments of a technological nature[97] or, more generally, due to the 'culture' of decreasing administrative costs for banks and, conversely, increasing the burden of proof for vigilance.[98] To this, it was pointed out that the CEO of SVB (the most important bank supervised by the San Francisco Federal Reserve) served on the board of directors of the San Francisco Federal Reserve itself until the day the bank went bankrupt,[99] even if the supervisory authority itself maintained that "the report found no evidence of unethical behaviour on the part of supervisors".[100]

In conclusion, the risks borne by SVB appear to have been rather simple, and indeed have been identified by the supervisor. The critical issue was instead that of having *underestimated* the identified risks. Consequently, it is not correct to attribute a reduced frequency of checks and a superficial analysis to supervision. These explanations could help understand why, with specific

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[96] *Gillian Tett* (fn. 75); with specific reference to the monetary policy of the Federal Reserve, see also *Raghuram G. Rajan/Viral V. Acharya* (fn. 84).

[97] In general, *Enria* (fn. 35), points out that "I need to be careful here because I don't want to say that this happened in the case of the specific banks we are talking about, but there could sometimes be the temptation to look favourably on banks and financial institutions which are investing, particularly in new technologies, in new instruments and experimenting with these sort of new, innovative instruments. And there could be the temptation to say 'okay, to let these models flourish, let's maybe make the regulatory or supervisory requirements for these banks a little bit less demanding'. I think I'm very supportive. I think that we need to let our banks also invest in new technologies. They need to do so. I want to have new fintech companies becoming banks and maybe challenging the incumbents. But if you're a bank, you need to be regulated and supervised as a bank and you need to be strict in the application of the requirements. And I think this is an important principle that we need to keep in our attitude towards supervision going forward".

[98] Specifically, "staff repeatedly mentioned changes in expectations and practices, including pressure to reduce burden on firms, meet a higher burden of proof for a supervisory conclusion, and demonstrate due process when considering supervisory actions. There was no formal or specific policy that required this, but staff felt a shift in culture and expectations from internal discussions and observed behaviour that changed how supervision was executed": *Board of Governors of the Federal Reserve System* (fn. 11), 36.

[99] *Klein* (fn. 77); Becker, CEO of SVB, would have a mandate until 2024: *Federal Reserve Bank of San Francisco*, Result of Director Election, September 10, 2021, in: www.frbsf.org. On the Federal Reserve Bank of San Francisco's website, Becker's previous 'Group 1' seat is now listed as 'Vacant Seat'.

[100] *Board of Governors of the Federal Reserve System* (fn. 11), 14.

reference to SVB, it was stated that "staff relayed that they were actively engaged with SVB but, as it turned out, the full extent of the bank's vulnerability was not apparent until the unexpected bank run on March 9"[101]. Therefore, more than the number of controls, their quality is relevant and, above all, the way the supervised entity respects the indications of the regulatory authority is relevant.

4.3. The European Regime.

In any case, the European rules have more significant safeguards than the U.S. ones.
First, due to its size, SVB would have been qualified as a category 1 or 2 bank (large institution), with the consequence that the evaluation of all the elements of the SREP would have had a frequency, respectively, of at least one year or two years.
From a different point of view, the three-year assessments are contemplated for category 3 and 4 banks, which, however, include intermediaries with significantly different characteristics from SVB: category 3 includes small-medium institutions which, among other things, are "operating domestically or with non-significant cross-border operations, and operating in a limited number of business lines"; category 4, on the other hand, includes small and non-complex entities. In the case of banks included in category 3 or 4, however, the addition of other defence mechanisms is envisaged, among which, for example, the duty of the supervisory authorities to monitor key indicators on a quarterly basis, to produce a documented summary of the overall SREP assessment at least annually, and, finally, to update the assessments of all individual SREP elements at least every 3 years, or sooner in light of material new information emerging on the risk posed.[102]
Suppose we draw some lessons from the SVB case. In that case, we must therefore consider that the principle of proportionality is applied differently by the U.S. and the E.U. and that the regulatory system in which it operates has peculiar characteristics. Therefore, it is incorrect to deduce from the SVB incident a need to increase supervision in the European Union. Not only was the problem mainly qualitative, and not quantitative; but also, the rules on the supervision of banks already allow for more in-depth control in Europe, compared to the U.S. regime.

5. The importance of the business model and the powers and limits of the supervisor.

[101] *Barr* (fn. 73), p. 6.
[102] EBA (fn. 7), paras. 2.1.1 e 2.4.

Among the problematic aspects of SVB, the one that most contributed to the crisis was undoubtedly the peculiar business model adopted by the bank. Particular attention must therefore be paid to the supervision of this characteristic.

5.1. The SVB's business model and its criticalities.

More specifically, SVB's business model featured several critical elements.
As regards balance sheet liabilities, for example, the dizzying growth of bank deposits (about 212 billion dollars at the end of 2022, compared to only 115 billion dollars in 2020) could lead to problems for a bank because "risk controls and buffers against potential losses often don't grow in line with new risks being taken by fast-growing banks".[103] Similarly, the fact that a high percentage of deposits were not protected by the FDIC (about 96%) increases the risk of a bank run.[104] The concentration of deposits and the consequent reduction in coordination costs between depositors (who communicate with each other easily) also explain the possible herd effect which facilitates the bank run.[105] Finally, the fact that most depositors were tech start-ups entails a high concentration risk in a specific sector. This ultimately exposes a bank to a deposit outflow if these companies need to raise liquidity, not having access to further funding rounds.
On the other hand, concerning the balance sheet assets, the purchase - during the period of explosive growth 2019-2021 - of more than 100 billion dollars of mortgage-backed securities issued at low-interest rates, without having adequate hedges to protect their value in the event of an increase in interest rates, exposed SVB to high risk.[106]
An inadequate business model adopted by a bank can compromise its solvency and, in the event of bank failure, the stability of the entire financial system. Therefore, to avoid this undesirable outcome, the supervisory authorities need the power to intervene to correct a bank's business model.

5.2. The powers and limits of intervention of the supervisory authority on the business model of a bank in the European Union.

Within the European legal system, the above considerations justify the power conferred on the supervisory authority to "require the reinforcement of the arrangements, processes, mechanisms, and strategies implemented", as well as to "restrict or limit the business, operations or network of institutions or to request the divestment of activities that pose excessive risks to the soundness

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[103] *Eisen* (fn. 80), quoting D. Tarullo, former governor of the Federal Reserve, according to whom the rapid growth of the bank has also been defined as a "yellow flag for supervisors".
[104] *Raghuram G. Rajan/Viral V. Acharya* (fn. 84).
[105] *Powell* (fn. 83), p. 11.
[106] *Klein* (fn. 80).

of an institution" (Art. 104(1)(b) and (e) CRD IV; see also Art. 16(2)(b) and (e) SSMR).

At the same time, the intervention of the supervisory authority with regard the business model of banks involves a constriction of the freedom to conduct a business (protected by Art. 16 of the Charter of Fundamental Rights of the European Union and by the European Convention for the Protection of Human Rights and Fundamental Freedoms). Therefore, although the SREP assessment contemplates it, is a delicate aspect.

Still, the freedom to conduct business is not absolute. Protecting a specific constitutional freedom could prejudice another freedom or general interest. Therefore, it is possible to restrict the freedom to conduct a business to pursue another interest (such as stability), provided that an adequate balance between potentially conflicting interests is guaranteed. From this perspective, "it likewise seems legitimate that these rights should, if necessary, be subject to certain limits justified by the overall objectives pursued by the Community, on condition that the substance of these rights is left untouched".[107]

Regarding the matter under analysis, therefore, it is necessary to limit any excessive discretion of the supervisory authority in reviewing the business model of a bank. As has been pointed out recently, supervisors can identify what is not working to banks, but they cannot tell them which business areas to focus on.[108]

Specifically, the problem also emerges from reading the EBA Guidelines on the SREP: if, on the one hand, "competent authorities may require the institution to make adjustments to risk management and control arrangements, or to governance arrangements, to match the desired business model or strategy" and, at the same time, "may require the institution to make changes to the business model or strategy";[109] on the other hand, "competent authorities should conduct regular business model analysis (BMA) to assess business and strategic risks", but "without undermining the responsibility of the institution's management body for running and organising the business, or indicating preferences for specific business models".[110]

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[107] Quote from ECJ, 14 May 1974, *J. Nold, Kohlen- und Baustoffgroßhandlung v Commission of the European Communities*, C-4/73, ECLI:EU:C:1974:51, according to which "if rights of ownership are protected by the constitutional laws of all the Member States and if similar guarantees are given in respect of their right freely to choose and practice their trade or profession, the rights thereby guaranteed, far from constituting unfettered prerogatives, must be viewed in the light of the social function of the property and activities protected thereunder. For this reason, rights of this nature are protected by law subject always to limitations laid down in accordance with the public interest". See also ECJ, 13 July 1989, *Hubert Wachauf v Bundesamt für Ernährung und Forstwirtschaft*, C-5/88, ECLI:EU:C:1989:321; ECJ, 30 July 1996, *Bosphorus Hava Yollari Turizm ve Ticaret AS v Minister for Transport, Energy and Communications and others*, C-84/95, ECLI:EU:C:1996:312.

[108] *Enria*, A new stage (fn. 8).

[109] EBA (fn. 7), para. 10.5., points 551 and 552.

[110] EBA (fn. 7), para. 4.1., point 71.

What are the limits to the discretion of the supervisory authority? In addition to a constraint about the content of its intervention, the supervisory authority must verify the existence of the conditions for its intervention. It can intervene in the business model or strategy of a bank if: "a. they are not supported by appropriate organisational, governance or risk control and management arrangements; b. they are not supported by capital and operational plans, including allocation of appropriate financial, human and technological (IT) resources; and/or c. there are significant concerns about the sustainability of the business model".[111]
To be compliant with the indications of the Court of Justice mentioned above, of the three conditions, the third deserves further study. When exactly do "significant concerns about the sustainability of the business model" arise? This sentence is vague and lends itself to multiple interpretations. To avoid possible abusive use of this condition, it seems correct to consider this condition satisfied only when it emerges, from a stress test, that a bank cannot contain the risks assumed within its risk appetite. Indeed, internally, "the outputs of stress tests (quantitative and qualitative) should be used as inputs to the process of establishing an institution's risk appetite and limits".[112] In establishing its risk appetite, a bank has then to identify a risk threshold within the risk capacity, taking into account a "forward-looking and, where applicable, subject to scenario and stress testing to ensure that the financial institution understands what events might push the financial institution outside its … risk capacity".[113]
In conclusion, if a bank, even under conditions of stress, satisfies its risk appetite, the supervisory authority cannot intervene on the bank's business model. Conversely, the supervisory authority would violate the criteria identified by the Court of Justice. Rather, the supervisory authority can

[111] EBA (fn. 7), para. 10.5., point 552.
[112] EBA (fn. 7), para. 4.2., point 31.
[113] FSB, Principles for An Effective Risk Appetite Framework, November 18, 2013, para. 2.1., let. h, 6. This indication is well outlined, for example, in the Italian legal system, which defines "risk tolerance" (Trad. it.: *soglia di tolleranza*) as the maximum permitted deviation from risk appetite; the tolerance threshold is set to ensure in any case the bank sufficient margins to operate, even under conditions of stress, within the maximum risk that can be assumed. Suppose the assumption of risk beyond the established risk objective is permitted. In that case, the management actions necessary to bring the assumed risk back within the pre-established objective are identified without prejudice to compliance with the tolerance threshold (Trad. it.: "*la devianza massima dal risk appetite consentita; la soglia di tolleranza è fissata in modo da assicurare in ogni caso alla banca margini sufficienti per operare, anche in condizioni di stress, entro il massimo rischio assumibile. Nel caso in cui sia consentita l'assunzione di rischio oltre l'obiettivo di rischio fissato, fermo restando il rispetto della soglia di tolleranza, sono individuate le azioni gestionali necessarie per ricondurre il rischio assunto entro l'obiettivo prestabilito*"): see *Banca d'Italia*, Disposizioni di vigilanza per le banche, Circolare n. 285 del 17 dicembre 2013, Parte I, Tit. IV, Cap. 3, Sez. 1, para. 3.

intervene 'indirectly' by identifying the stress scenarios that limit the choices of banks in setting the risk appetite.[114]

6. Conclusion.

As part of the process of revising the rules on European banks, the case of SVB has led to a slowdown in the choice of introducing more significant elements of proportionality about the supervision - and, in particular, to the SREP - on small and non-complex banks. Even the crisis of a bank, such as SVB, considered 'small', in fact, involves systemic risks.
As we have demonstrated, the reforms proposed in the European Union are nonetheless heading in the right direction, also in consideration of the marked difference that the notion of proportionality assumes in the United States. Indeed, in the European Union, the principle of proportionality rests on the notions of "small and non-complex institution" and "large institution" (respectively, art. 4(1)(145) and (146), CRR).[115] The first qualification, in particular, encompasses banks with consolidated assets of no more than €5 billion *and* whose activities - due to their nature, features, riskiness, interconnections, and cross-border operations - are not reasonably capable of threatening the stability of the system, according to a discretionary judgment referred to the supervisory authority.[116] Instead, it is sufficient for a bank to have consolidated assets worth more than €30 billion for it to necessarily be considered a "large institution". In the U.S. legal system, by contrast, all credit institutions with consolidated assets of less than $250 billion (Category IV banks) enjoy the lighter regulatory framework introduced by the 2018 banking reform.[117] All the more so, despite the power to impose specific additional obligations on individual banks with assets over $100 billion, the supervisory authority never resorted to it for SVB, although the latter was the 16th largest commercial bank in the U.S.,[118] with consolidated assets of $211.8 billion.[119] In other words, SVB in the EU it would have qualified as a large institution.
The reforms proposed in the European Union are heading in the right direction for many reasons.
First, the case of SVB shows that there are no reasons for derogating from the rules on capital and liquidity: the risks associated with the bank's business -

[114] Moreover, the concretely identified scenarios are particularly relevant: cf. ESRB, Macro-financial scenario for the 2023 EU-wide banking sector stress test, January 23, 2023.
[115] *Joosen/Lehmann* (fn. 2).
[116] Similar conclusions also hold in the Single Supervisory Mechanism for the notion of "significant institution": Article 40(1), Regulation (EU) No. 468/2014.
[117] *Board of Governors of the Federal Reserve System* (fn. 11), 10 et seq. and 81 et seq.; *Thomadakis* (fn. 11); *Chronopoulos/Wilson/Yilmaz* (fn. 12).
[118] *Federal Reserve Statistical Release*, Large Commercial Banks, 21 December 2022.
[119] *SVB Financial Group* (fn. 20), p. 29.

such as credit, liquidity, and interest rate risks - do not depend on the entity who bears them, so that it would be unreasonable to grade the application of a rule according to the characteristics of the addressee. In this sense, the European legislator appropriately provides for a uniform application of these rules for all banks. Indeed, prudential capital can be a 'buffer' against unexpected risks and losses, which not even complex risk weighting models or supervisory inspections can identify and manage.[120]

A somewhat different argument can be made regarding corporate governance. Since it is difficult to correctly identify and estimate the risks that a bank assumes, also due to cognitive biases, the 'quality' of the verification is more important than the 'quantity'. Therefore, proportionality can also be applied to corporate governance rules while safeguarding some key elements that can represent distorting incentives (for example, the regulation of remuneration). In any case, the reforms proposed in the EU intend to reduce banks' compliance costs, at least the ones that are linked to the activities that a bank performs to respond to the indications of the supervisory authority. As emerges from the analysis, the intensity of controls is not one of the major causes of the crisis suffered by SVB, and, in any case, the European legal system has more excellent controls for banks similar in size to that of the Californian bank. Instead, the main problem arose from the difficulty in identifying or correctly assessing the risks identified, which derived above all from the business model, which is very different from that of European banks.[121] Moreover, reducing compliance costs for smaller banks also has a further positive effect: it does not incentivise concentration operations that can lead to the creation of larger banks, whose crisis is then challenging to manage without public interventions.

Finally, the SVB case and the other recent banking crises bring to light a fundamental problem: the trust of depositors plays a fundamental role in the banking system and must therefore be adequately preserved. Indeed, even if a bank is essentially sound, it can suddenly risk failure if its customers lose confidence and withdraw their deposits.[122] From this point of view, if we want to contribute to strengthening the banking system, instead of disregarding proportionality to increase rules and controls, the most effective solution is to complete the Banking Union and, therefore, to set up the European deposit insurance scheme. In the case of SVB, the withdrawal of money by depositors has taken chiefly place from 'unsecured' deposits, which would also be excluded from the public guarantee from a European perspective. Moreover, it is true that even depositors within the 'insured range' can choose to devolve their savings elsewhere, for example, in search of more profitable

[120] *Barr* (fn. 32), p. 8.
[121] *Enria*, A new stage (fn. 8).
[122] *Barr* (fn. 32), p. 2; in more broad terms, *Gortsos* (fn. 11), p. 5.

prospects.[123] Nonetheless, it is equally sure that such a scheme would help create a more robust environment,[124] because the risk of depositors in one Member State's banks moving their savings outward would be reduced.[125] Therefore, it is correct to follow the further and recent institutional indication on the completion of the Banking Union.[126]

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[123] This explains the dynamics involving Charles Schwab Bank and the fact that this bank is assimilated to SVB due to the choices on the asset side: *Alessandro Graziani*, Depositi in fuga: nel mirino c'è Charles Schwab Bank, in: Il Sole 24 Ore, 2 April 2023.

[124] See also *Thomadakis* (fn. 11), p. 4.

[125] Indeed, national deposit guarantee schemes «continue to provide sufficient but still limited coverage in terms of counterparties covered and amount of compensation»: see *Gortsos* (fn. 11), p. 6.

[126] *Eurosummit*, Statement, Brussels, EURO 502/23 EUROSUMMIT 1 TSGC 3, 24 March 2023, 1; see also *Silvia Merler*, Fast and furious: how digital bank runs challenge the baking-crisis rulebook, in: www.bruegel.com, 27 March 2023.