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Financial Statements

BY BRENDAN PORTER

Did Accounting Classifications Play a Role in SVB's Collapse?



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Silicon Valley Bank (SVB) disclosed on March 8, 2023, that it completed the sale of \$21 billion in assets, incurring a loss of \$1.8 billion on the transaction. In an attempt to raise additional equity capital, SVB also announced that it was conducting a secondary offering of common stock. Within 48 hours, SVB's clients struggled to withdraw more than \$140 billion (or 80 percent) of deposits, and the bank collapsed under the pressure. Two days later, SVB was closed by its regulators and placed under the administration of the Federal Deposit Insurance Corp. In the process, more than \$15 billion of shareholder value was wiped out.¹

SVB's sudden and dramatic demise has sparked intense scrutiny and questions about what went wrong and whether relevant risks had been adequately disclosed to investors. With the subsequent failure of First Republic Bank and the turmoil in regional bank stocks, further questions have been raised about the adequacy of existing accounting practices and the extent to which this contributed, if at all, to current market unrest. Although the topic of how a bank's debt securities should be recorded on financial statements was the subject of reforms in the years following the Great Financial Crisis, some now argue that it should be revisited in light of recent bank failures.

This article sheds light on the mixed-measurement model used in the U.S., which refers to the fact that some debt securities are measured at "fair value" (an estimate of their market value), while others are measured at their historical cost. Each classification has specific ramifications for the presentation of financial results. By examining SVB's disclosure practices and associated

financial statements, this article reviews the information made publicly available to market participants. In addition, the article explores arguments in favor of and against the mixed-measurement model, and concludes with a review of the Federal Reserve's findings regarding the root causes of SVB's failure.

The Accounting Classification of Debt Securities

There are various accounting classifications for the financial reporting of debt securities. Each one has its own distinct accounting treatment, and these treatments can have a direct impact on how financial results are presented. The classification chosen depends on such factors as the transaction's purpose, management's intended use of the securities and the reporting entity's ability to meet specific criteria. There are three primary classifications:²

- *Trading Securities*: These securities are acquired with the intent of selling the security in the near term to capitalize on short-term price movements. On the balance sheet, these securities are recorded at fair value. Any changes in fair value are recorded as unrealized gains or losses on the income statement.
- *Available for Sale (AFS)*: If a debt security is not intended to be held until maturity or used for short-term trading, it can be classified as AFS. These securities, similar to trading securities, are also recorded at fair value on the balance sheet. However, unlike trading securities, changes in the fair value of AFS securities will not affect the income statement. Rather, these changes will be recorded in accumulated other comprehen-

¹ SVB Financial Group, Press Release (Form 8-K) (March 8, 2023); S&P Capital IQ (2023), SVB Financial Information; Gregory W. Becker, Written Testimony Before the U.S. Senate Committee on Banking, Housing and Urban Affairs (May 16, 2023).

² Financial reporting can be complex. The descriptions herein represent a simplified discussion of the relevant accounting standards (ASC 320).

sive income (AOCI), a component of equity on the company's balance sheet.

- **Held to Maturity (HTM):** If management intends and has the ability to hold a security until its maturity, it can be classified as HTM. This means that regardless of, for example, short-term changes in value, interest rates or funding markets, management does not plan to sell the security. HTM securities are recorded on the balance sheet at their amortized cost, reflecting the initial value of the security (*i.e.*, its historical cost). Changes in the fair value of HTM securities generally do not directly affect financial statements.

The fact that certain securities are measured at fair value while others are measured at their historical cost, depending on their accounting classification, is referred to as the “mixed-measurement model.” It is important to understand these classifications for a robust assessment of risk, given that each classification will have a different impact on how financial results are presented. Using a simple illustrative example, Exhibit 1 shows how the classification of a debt security could affect the income statement and balance sheet of a reporting entity. It assumes that the fair value of a debt security decreased by \$1,000 during the measurement period.³

As the simplified Exhibit 1 demonstrates, if the debt security in question had been classified as HTM, the impact of a \$1,000 loss in value would have no direct impact on the financial statements. Under the other two classifications, the loss would affect the company's equity balance, either through the income statement or AOCI. While some have concluded that the HTM designation allows reporting entities to “hide” losses on HTM securities, in SVB's case, as set forth herein, these unrealized losses were hiding in plain sight.

SVB's Recent Performance and Disclosures

From 2019-22, the commercial banking industry experienced a substantial increase in deposits, totaling more than \$5 trillion. This increase can be partly attributed to the monetary and fiscal accommodation implemented in response to the COVID-19 pandemic. Across the industry, banks elected to invest a large portion of the deposit inflow into liquid assets, such as cash and securities, rather than using the deposits to fund new loans. A review of SVB's financial statements confirms this trend.

During this period, SVB's deposit base grew by more than \$110 billion, a nearly 300 percent increase. While a portion of these deposits were invested in new loans, SVB's management chose to invest a large portion of these funds in debt securities, including Treasury bonds and mortgage-backed securities. These securities were predominantly highly rated and backed by the U.S. government, and the potential for credit losses was low. However, similar to any debt security exposed to interest-rate risk, changes in interest rates could lead to changes in the fair value of SVB's securities portfolio. Exhibit 2 provides an overview of SVB's investments in debt securities from 2019-22.⁴

³ Actual financial reporting would involve additional considerations and complexity beyond the scope of this article.

⁴ SVB Financial Group, Annual Reports (Form 10-K) (2020-2022); S&P Capital IQ (2023), SVB Financial Information.

As shown in Exhibit 2, the majority of SVB's investments were classified as HTM, and the bulk of this investment occurred in 2021, prior to recent increases in interest rates. In 2022, the Federal Reserve began to raise interest rates, and in just 14 months, the federal funds rate increased from near 0 percent in February 2022 to almost 5 percent currently. As interest rates increase, the market value of debt securities with fixed interest rates decreases rapidly. Therefore, SVB's HTM portfolio experienced significant losses. However, these losses would not (and did not) directly affect the presentation of financial results because of how they were classified on SVB's balance sheet.

Yet the information to assess this potential risk existed in SVB's financial disclosures. Its balance sheet noted that while the carrying amount of HTM securities was \$91.3 billion, their fair value was \$76.2 billion. In addition, in the accompanying notes to the financial statements, SVB provided even more detail regarding the composition of its HTM securities portfolio and the components of the \$15 billion unrealized loss, as shown in Exhibit 3.

With this information, a financial analyst could restate SVB's balance sheet on a fair-value basis and, despite the limitations of accounting classifications, incorporate the HTM losses directly into a set of non-GAAP,⁵ amended financial statements. In light of this, one might question opponents of the mixed-measurement model. If the relevant losses are disclosed anyway, then what is the issue? In the subsequent section, there will be a review of the arguments for and against this model, highlighting the reasons why some market participants feel that it should change.

Argument for and Against the Mixed-Measurement Model

The use of fair value measurements in financial statements became a subject of debate in the aftermath of the 2008 financial crisis. While the Financial Accounting Standards Board appeared to initially lean toward universally employing a fair-value measurement, the mixed-measurement model was ultimately retained. Proponents of the mixed-measurement model have two arguments:⁶

- **Management Intent Is Relevant:** The current classifications allow management the flexibility to accurately reflect the business reason and intent behind owning spe-

⁵ GAAP stands for “Generally Accepted Accounting Principles.”

⁶ CFA Institute, Letter to the Financial Accounting Standards Board Regarding Proposed Accounting Standards Update (Sept. 30, 2010).

Exhibit 1

	Classification:		
	Trading	AFS	HTM
Income Statement:			
Revenue	\$ 100,000	\$ 100,000	\$ 100,000
Less: Costs	(80,000)	(80,000)	(80,000)
Add: Unrealized Gain/(Loss)	(1,000)	-	-
Net Income	\$ 19,000	\$ 20,000	\$ 20,000
Balance Sheet			
Beginning Equity Balance	\$ 10,000	\$ 10,000	\$ 10,000
Add: Net Income	19,000	20,000	20,000
Add: AOCI	-	(1,000)	-
Ending Equity Balance	\$ 29,000	\$ 29,000	\$ 30,000

cific securities. When a security is classified as HTM, this communicates that it was purchased for the contractual cashflow stream provided by the debt instrument, and that subsequent changes in the economic environment are not expected to alter management's intent to receive that stream of cashflows. Therefore, short-term fluctuations in fair value are not relevant when the stated business purpose of holding the security is considered.

- *Fair Value Introduces Unnecessary Volatility:* If all assets were recorded at fair value, the resulting short-term changes in the interest-rate environment or other factors affecting the value of debt securities would introduce volatility in financial results. For example, the average quarterly change in the fair value of HTM securities in SVB's case exceeded \$3 billion in 2022. In contrast, the company's net income averaged less than \$400 million per quarter.⁷ Thus, interim changes in the

fair value of these securities could overshadow other financial metrics.

Critics of the mixed-measurement model highlight that existing standards result in the exact same debt security having materially different values on different bank balance sheets. If one bank classified the security as HTM, it would be recorded at cost, reflecting the security's value in a historical transaction that may have occurred years prior. On a second bank balance sheet, if the same security was classified as AFS, it would be recorded at current market prices, which could be materially higher or lower. Those who were against the mixed-measurement model have made three arguments:

- *Transactions Occur at Fair Value:* If SVB changed its intent and sold the HTM securities, it would receive fair value in the transaction. Furthermore, if SVB sought to use the HTM securities as collateral for a loan, lenders would likely not provide financing based on historical costs; they would lend against fair value. Investors

7 SVB Financial Group, Annual Report (Form 10-K) (2022); S&P Capital IQ (2023), SVB Financial Information.

Exhibit 2

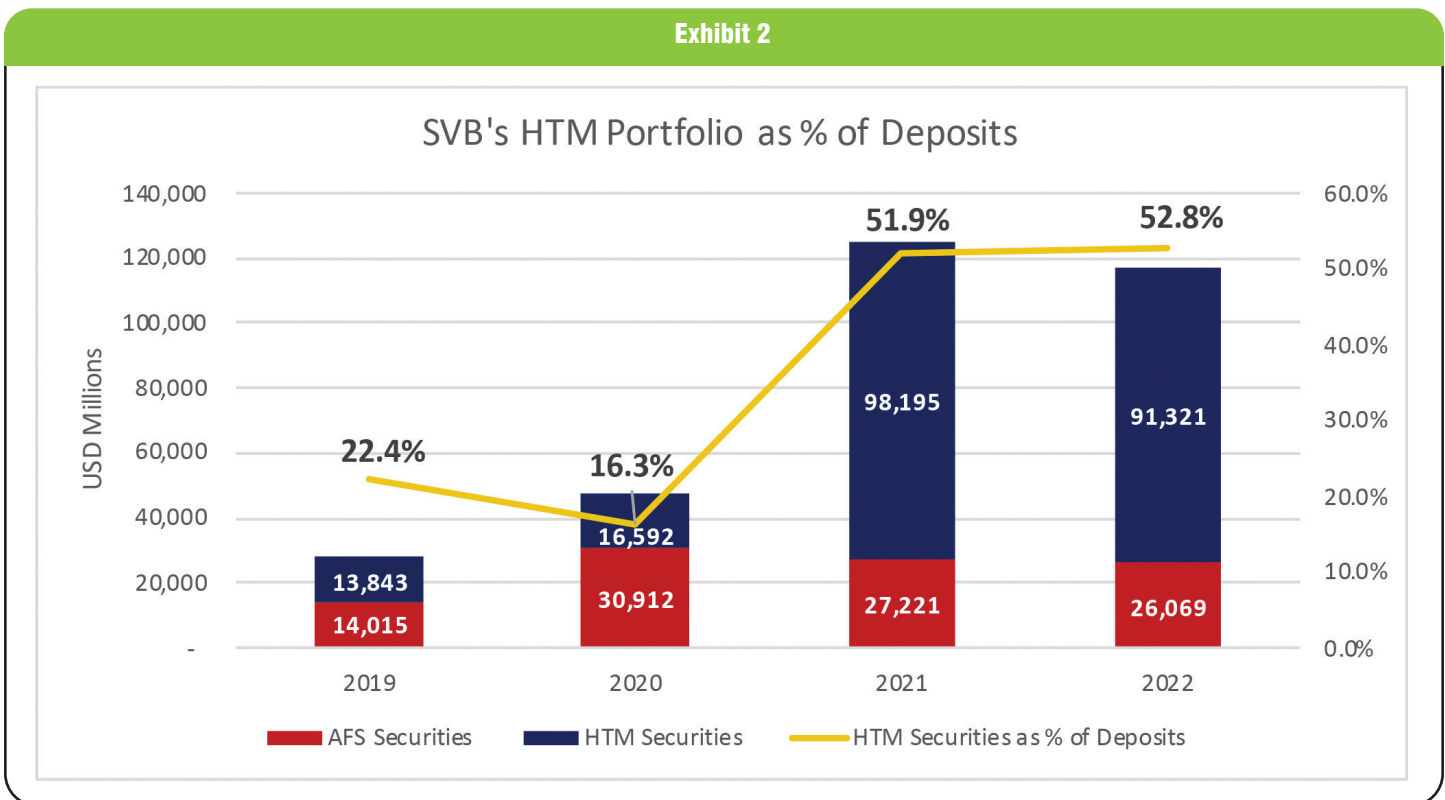


Exhibit 3

SVB's HTM Securities (\$ Millions)	As of December 31, 2022		
	Amortized Cost	Unrealized Gains / (Losses)	Fair Value
U.S. Agency Debentures	486	(52)	434
Agency-issued MBS	57,705	(9,349)	48,356
Agency-issued CMO - Fixed Rate	10,461	(1,885)	8,576
Agency-issued CMO - Variable Rate	79	(2)	77
Agency-issued CMBS	14,471	(2,494)	11,977
Municipal bonds and notes	7,417	(1,267)	6,150
Corporate Bonds	708	(109)	599
Total HTM Securities	91,327	(15,158)	76,169

or clients of SVB would find fair value information equally relevant when deciding to invest or keep deposits with the bank.

- *Historical Cost Is Not Relevant:* While a balance sheet reflects the actual cost and value of HTM securities at a point in time, this does not adequately reflect the current value. As SVB’s case demonstrates, the economic environment can change rapidly, significantly affecting the value of bank assets. The historical cost of HTM securities purchased in a low interest-rate environment is no longer relevant when rates rise 5 percent.

- *Investors Adjust Book Values:* Throughout 2008, many bank stocks traded below their stated book values. Market prices indicated that investors were potentially discounting reported asset values to reflect current market conditions. If market participants base investment decisions and price stocks based on an estimate of fair value, then financial statements should be presented on this basis to reflect the information that investors want to see. Rather than being buried in a footnote to the financial statements, this information should be more visible. In SVB’s case, analysts were discussing the company’s HTM losses as early as November 2022, and reports published in early 2023 noted that if the HTM losses were recognized in financial statements (*i.e.*, adjusted to fair value), the bank’s equity balance would be eliminated.

It remains to be seen whether recent events will prompt any significant change in the way debt securities are recorded in financial statements. While there are arguments both for and against the mixed-measurement model, further discussion and evaluation may be needed to determine the most appropriate course of action should any potential changes be pursued.

The Federal Reserve’s Assessment of SVB’s Failure

If the losses on SVB’s securities portfolio were disclosed, and if analysts had been discussing the fair value of these securities as early as November 2022, some might also question how the HTM classification could have contributed to SVB’s failure at all. In the wake of SVB’s collapse, the Federal Reserve prepared a report to examine whether its supervisory and regulatory action (or inaction) contributed to the bank’s demise. The report ultimately admitted that the Federal Reserve “failed to take forceful enough action” but highlighted numerous relevant factors, including:⁸

- *Mismanagement:* The Federal Reserve concluded that SVB’s board failed to properly manage risks, including interest-rate risk. For example, although SVB had hedges in place to protect against rising interest rates, these hedges were removed relatively early in the rate cycle.

- *Uninsured Deposits:* SVB had a large concentration of uninsured deposits, which accounted for 94 percent of SVB’s total deposits (more than twice as high as industry peers). The Federal Reserve concluded that SVB’s

announcement of asset sales on March 8, 2023, led uninsured depositors to perceive financial distress, and move quickly to withdraw deposits.

- *Customer Concentration:* SVB primarily catered to the technology and venture-capital industries, which are highly cyclical. While SVB benefited from record growth in deposits from these customers in 2020 and 2021, when the sector slowed and clients began burning cash, SVB’s deposit base eroded.

The report also commented on SVB’s HTM securities and acknowledged that accounting classifications may have constrained management’s ability to react as the economic environment changed. The Federal Reserve stated that the HTM classification “limited” SVB’s ability to adjust its securities portfolio as interest rates increased. If any portion of an HTM portfolio was sold, the entire portfolio would have become tainted, and all unrealized gains/losses would have to have been recognized immediately. This constraint, introduced by the accounting classifications SVB’s management selected, may also have contributed to SVB’s failure.

Conclusion

In light of the recent series of bank failures, some investors and other market participants are calling for a revisit of the financial-reporting standards and the accounting classification of debt securities. SVB’s losses on HTM securities had been disclosed to investors, yet the Federal Reserve concluded that this classification may have limited management’s ability to act. Whether the mixed-measurement model is the most suitable approach to present financial results and effectively communicate relevant risks to market participants remains the subject of ongoing debate. Determining the optimal framework for financial reporting and accounting is a complex task, but any lessons learned from recent events can hopefully contribute to an even more effective and robust framework for financial reporting. **abi**

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⁸ Board of Governors of the Federal Reserve System, Review of the Federal Reserve’s Supervision and Regulation of Silicon Valley Bank (April 28, 2023).