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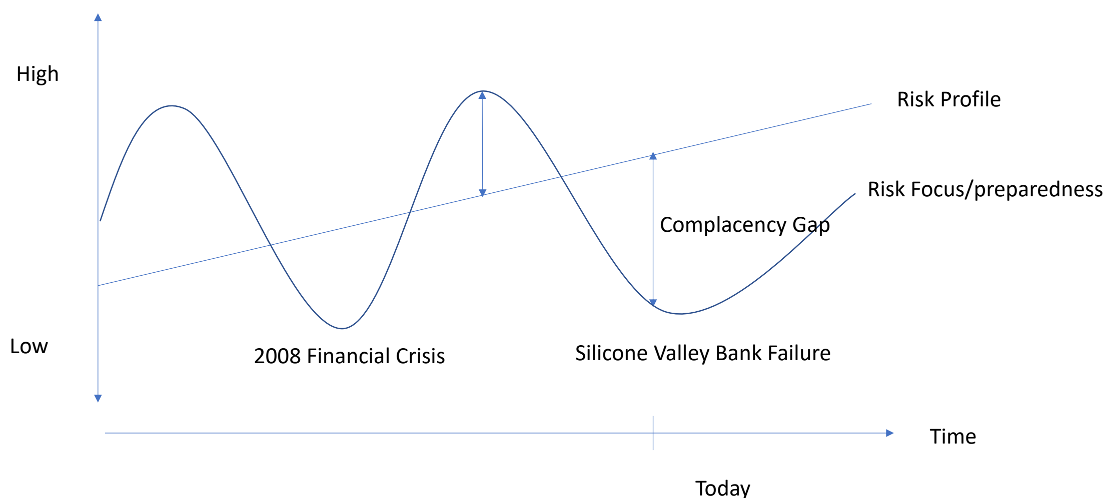
What went wrong at Silicon Valley Bank – Managing risk in a digital and agile world?

Anyone who has been around the risk management business long enough has learned that just when you think you have it all figured out, is when you probably are the most exposed to a new risk event. In many cases when you think you have eliminated risks you have created new ones. Risk has a way transforming itself into new exposures that can exceed your ability to manage.

What distinguishes a strong risk resilient organization is the ability to recognize when there is a gap in its risk profile, their ability to manage risk and figure out ways to mitigate. (See figure below)



However, the problem is that most organizations do not have the mechanism or willingness to close their "complacency" gap before it is too late. Take liquidity risk, by the time you have a liquidity problem, it's too late to do anything. The difference between winners and losers comes down to how you prepare for a potential liquidity event. But as many of you may know, this comes at a cost in terms financing readily available liquid assets to deploy. This impacts profitability and future growth.

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I recall prior to the financial crisis in 2008 I conducted a risk scenario workshop with the senior leaders of a large bank. The workshop was successful in terms of identifying the potential risk events. They succeeded in identifying all the risks that impacted them during the financial crisis, however, assigning a probability and more importantly the financial impact of the risks was a failure. They got it all wrong, mostly because assigning a real probability and dollar value would force them to reduce a "profitable" business and their bonuses. In the end the shareholders and customers ended up paying the price.

So why do we have this problem? Reasoning and facts help us arrive at judgments, but our own desires motivate us to act on or ignore those judgments. In recent bank failures management knew the risk they were taking but they decided to focus on maximizing their own utility and ignore the risk associated with profit and/or growth. This includes organizations we think are there to protect shareholders and customers. Many of them collect fees to review management reporting without really checking the source information. As an example, auditors do not create the financial and risk reporting, they review what management have created, the same is the case for lawyers and regulators. We now have a system where management are incentivized to maximize their own utility and we have the checkers relying on "alternative facts."

In my view until we address the gap between our judgement and our motivations to act, we will continue to have Silicon Valley Bank style bank failures, causing massive losses for customers and shareholders.

Questions for the reader to think about: Do we need new or updated regulations? Another independent line of defense? What about using AI technology to identify issues early? Do we need a different incentive structure for bank management?

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