

Is the “Lehman Crisis” Reappearing

-- Analysis of the Reasons for the Bankruptcy of SVB and Its Enlightenment

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Abstract: On March 7, 2023, Silicon Valley Bank (SVB) announced that it is honored to have been named the best bank in the United States by Forbes magazine for five consecutive years. Dramatically, three days later, it collapsed within 48 hours due to insolvency, causing a huge uproar and becoming the largest bank failure in the United States since the 2008 financial crisis. This case firstly introduces SVB and its unique business model, outlines its process of suffering from severe runs and ultimately leading to bankruptcy after monetary policy changes, and states its series of subsequent impacts on the global economy after bankruptcy. Next, analyze the reasons for the bankruptcy of SVB from two aspects: the deficiencies in its own risk control and the lack of supervision from internal and external regulatory departments. Finally, by reviewing the entire process of the bankruptcy of SVB, we can obtain the enlightenment for China's banking industry and financial regulatory agencies from this incident.

Keywords: Silicon Valley Bank; liquidity risk; Interest rate risk.

1. Introduction

Recently, the news of Silicon Valley Bank (SVB) bankruptcy within 48 hours undoubtedly caused a wave of turbulence in the international financial market. On March 9th, SVB suddenly announced that it had decided to raise \$2.25 billion by selling its common and preferred shares, as the sale of some securities in its investment portfolio would result in a loss of \$1.8 billion. This decision became the trigger for its bankruptcy, on the same day, its stock price plummeted by more than 60%, and its market value evaporated by \$9.4 billion during the same day. On March 11th, even more shocking news came out: SVB was shut down by California regulators, and the Federal Deposit Insurance Corporation (FDIC) was appointed as bankruptcy administrator to take over SVB.

SVB only took 48 hours from announcing liquidity risk to bankruptcy. Although it raised over \$2 billion in funds to self-rescue by selling shares, it still couldn't escape the fate of being entrusted. SVB became the largest bankrupt bank in US since the 2008 financial crisis, How did it collapse step by step, and what are the reasons behind it?

2. The Introduction of SVB

SVB was founded in 1983 and is the 16th largest bank in the United States. It is a regional bank headquartered in California, primarily serving innovative companies and businesses. It provides traditional commercial banking services such as credit, fund management, and trade deficit to customers. Its uniqueness reflects in its customer base, which focus on technology innovation companies and their investors in the fields of software, hardware, life sciences, new energy, and new materials.

In the early 1990s, the high-tech industry in Silicon Valley began to rise, and a large number of science and technology innovation enterprises emerged with urgent need of funding. In such an environment, SVB has combined high-yield equity investment with low-risk debt investment, exploring a

business model, then its business has been greatly expanded, covering various regions including North America, Asia, and Europe. Its popularity increased a lot, many well-known IT companies such as Facebook and Twitter being its financing clients. As of the end of 2022, SVB had total assets of approximately \$211.8 billion and total deposits of approximately \$175.4 billion, both of which were among the top 20 banks in the United States.

The main business model of SVB is investment-loan linkage, its credit for start-up enterprises generally adopts a follow-up investment model, when the enterprise obtains venture capital equity investment, SVB approved the credit limit in a certain proportion. The approved credit generally requires third-party guarantees such as venture capital or intellectual property collateral. Usually, SVB charge interest rates higher than regular corporate loans to science and technology innovation companies, and may also acquire a certain proportion of corporate stock warrants to increase future earnings. In addition, SVB also provides credit support to venture capital companies, providing certain loan support when the latter's projects require capital investment but liquidity is scarce. The business model of SVB is shown in the Figure 1.

SVB's profit model relies on a "high interest margin" strategy. From the debt side, SVB is different from ordinary commercial banks. Commercial banks rely on a large number of household savings accounts for deposits, but SVB's deposits mainly absorb funds from venture capital and technology enterprises. This can achieve the maximum retention of funds within the bank, even if they are transferred between investors and invested enterprises. And risk investors are usually not sensitive to interest rates, so the cost on the debt side is not high. From the asset side, due to the high profitability of science and technology enterprises entering the market expansion stage, SVB generally offers higher interest rates for loans to small and medium-sized technology enterprises. Therefore, SVB achieved "high interest margin" successfully, and its net interest margin remained at a high

level among peers from 2015 to 2022.

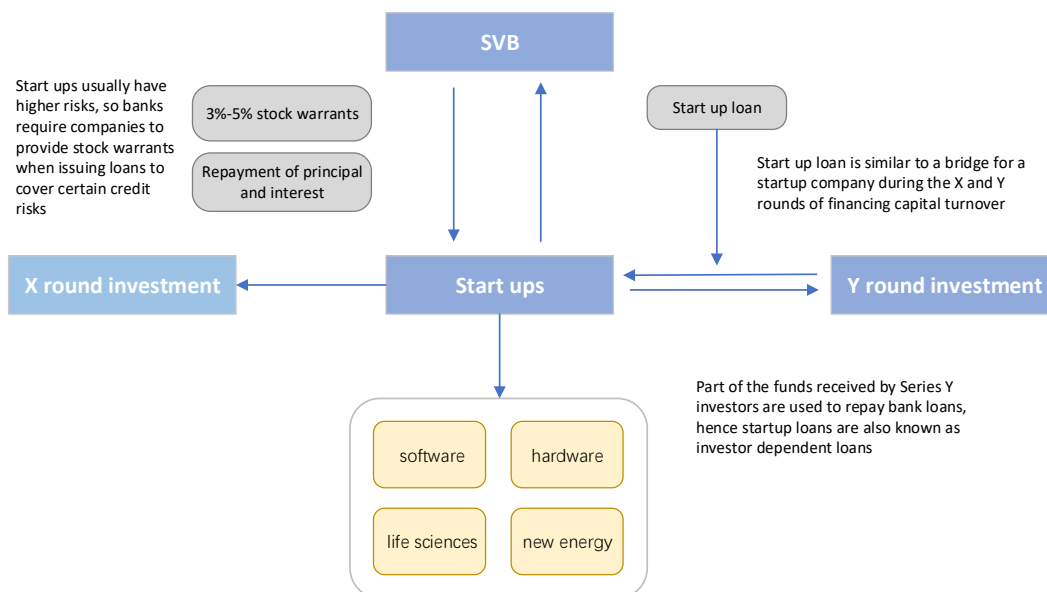


Figure 1. The business model of SVB

3. Risk Emerge: Mismatched Terms Bring Liquidity Risks

3.1. SVB absorb a large amount of deposits

The business of SVB has its particularity since its business scale is closely related to venture capital in the Silicon Valley region. During the entrepreneurial boom and loose liquidity period, the scale of SVB's business increased rapidly. In 2020, the United States mainly adopted a loose monetary policy to cope with the economic recession caused by the pandemic, resulting in a surge in market liquidity. The low interest rate loan combined with the booming venture capital activities

targeting start-ups in technology companies has made it easy for these companies to obtain a large amount of funds. So, a large amount of money entered SVB's customer base through various financing channels such as the stock market. Due to the fact that the financing of these technology enterprises far exceeds their actual development needs, they deposited a large part of the funds they had obtained into SVB, resulting in a significant increase in SVB's deposit size. As of June 2020, the deposit size of SVB was 74.5 billion US dollars. As of the end of 2021, the deposit size of SVB reached 189.2 billion US dollars, an increase of more than twice. Figure 2 shows the total amount of bank deposits in Silicon Valley from 2016 to 2022.

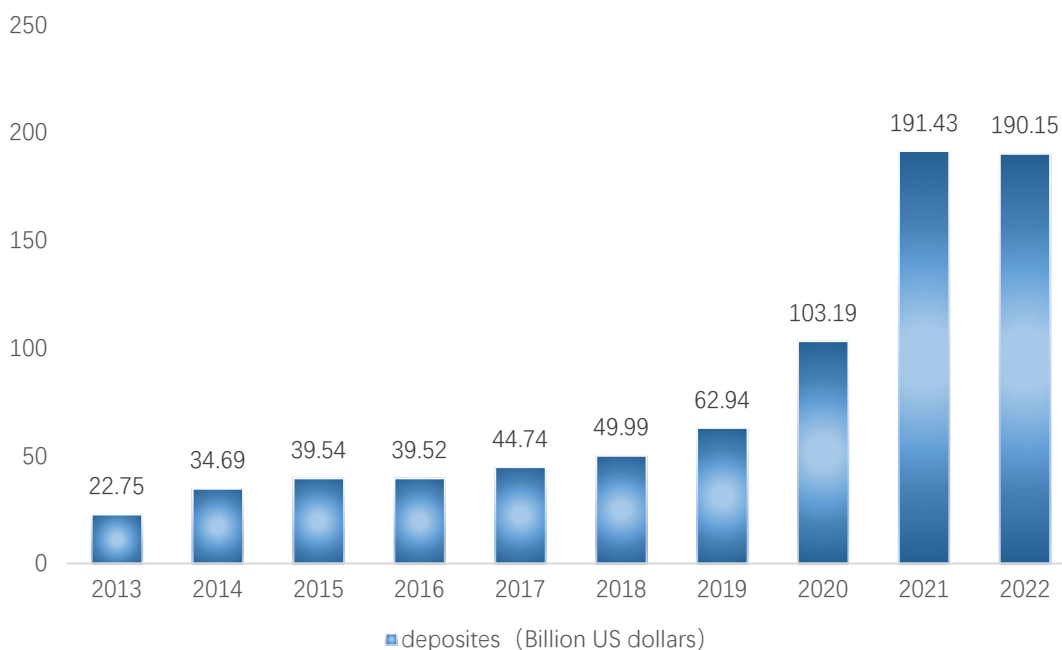


Figure 2. Total deposits of SVB in 2016-2022

3.2. Accumulating high value securities positions

Since SVB's client, the technology companies, obtaining sufficient financing from capital market, their loan needs have been greatly reduced. Therefore, SVB needs to seek other ways using the large amount of funds in hand to create more profits from these large deposits. It chose to allocate more than half of its assets to US treasury bond bonds and MBS. Although the yield of treasury bond is stable and has a lower risk coefficient than other investment products, it can only be redeemed when it is due. If it is sold in the market before the time comes, it may face the risk that the principal cannot be recovered. At the same time, once encountering an increase in interest rates, the returns from early selling will be much lower than the cost of funds, resulting in losses. MBS, which is called Mortgage-Backed Security, is a new type of securitized financial product that packages mortgage loans that take decades to recover funds and turns them into

collateral. The returns of investment products like MBS are also closely linked to monetary policy. It can be seen that those two maturity mismatched methods would bring some difficulty when liquidity risks arises.

Public information shows that from the middle of 2020 to the end of 2021, SVB's holdings of US treasury bond bonds, local bonds and government agency bonds will increase significantly from US \$8.5 billion at the end of 2020 to US \$23.6 billion at the end of 2021, and the MBS held to maturity will increase from US \$16.2 billion to US \$96.9 billion. However, the amount of cash and cash equivalents, which are the most important for banks to ensure their liquidity, has decreased, accounting for only 7% of total assets as of the end of 2021. This asset allocation structure means that SVB has not set aside an equal proportion of sufficient cash to cope with short-term withdrawals from depositors. In the Figure 3 and Figure 4, they shows that most of the assets exist in a long-term form, resulting in mismatched maturities and potential liquidity risks.

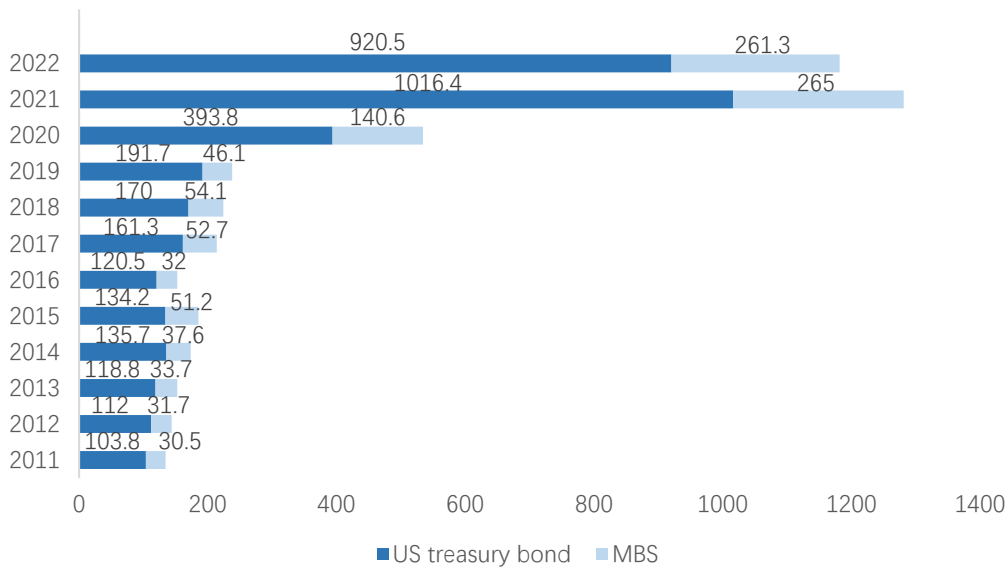


Figure 3. SVB U.S. Treasury and MBS Holdings

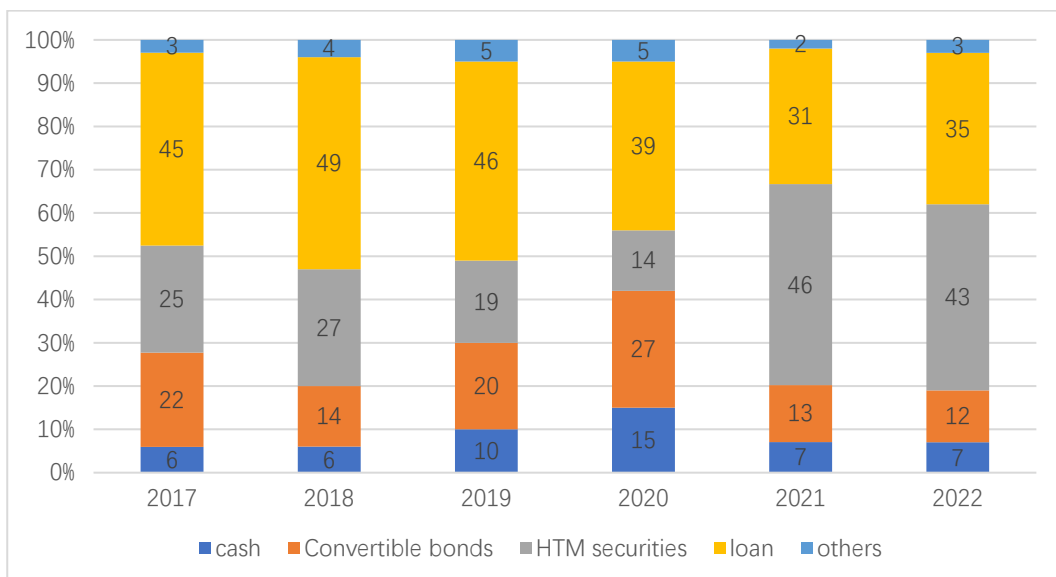


Figure 4. SVB asset allocation

3.3. Asset prices plummet sharply

Starting from 2022, the Federal Reserve has initiated its most aggressive interest rate hike in 40 years to combat inflation, with seven major rate hikes within a year, raising the benchmark interest rate from 0 to 4.5%. This has brought a fatal blow to the deposit and two investment products of SVB.

Firstly, after a significant interest rate hike, the financing costs of enterprises increased, so the scale of IPO financing in the information technology industry has plummeted. The problem of financing difficulties for startups has become increasingly prominent. Many high-tech startups withdrew deposits from SVB to support their business operations, so a large amount of deposits are gradually flowing out of SVB's debt side. As of the end of 2022, SVB's deposit balance was \$173.1 billion, a decrease of 8.5% from the end of 2021. Therefore, SVB was forced to sell its assets to meet depositors' withdrawals. But at this time, it faced the dilemma of decline in bond prices after interest rates rise. Previously, the average yield of treasury bond purchased by SVB was 1.79%, but after the drastic interest rate increase in 2022, the yield of treasury bond has reached 4.7%, resulting in a loss of nearly 1.8 billion dollars from this sale of SVB. In addition, after the increase in interest rates, residents burdened with mortgage loans are unwilling to repay in advance, and the speed of MBS's fund recovery is also significantly decreasing. If SVB sell its holding MBS at this time, it need subsidize the buyer's interest difference for nearly two years.

Overall, interest rate hikes led to increased customer demand for deposits, forcing SVB to sell off its assets, and both of its main assets are facing huge losses due to interest rate hikes, creating a vicious cycle that continues to exacerbate its liquidity risk.

4. Crisis Outbreak: SVB Deeply Embroiled in A Liquidity Crisis

4.1. Rush of runs occur

Actually, at that time, if the assets held by SVB were not in a trading state, there would be no actual loss, and the change in value would not be reflected on the books. However, when the first batch of depositors started to withdraw deposits, the bank was forced to change the bonds originally marked as held to maturity to tradable, therefore reflected huge losses on the books. At the same time, in early March, Moody's notified SVB that it was preparing to downgrade its credit rating. SVB's parent company, SVB Financial, was concerned that rating downgrade could weaken investors and customers' confidence in SVB's financial health. So it suddenly announced to sale \$21 billion of convertible assets at a loss of \$1.8 billion, issued convertible bonds to raise \$15 billion in funds, and raised \$2.25 billion through the sale of common and preferred shares on March 8th. It believed that doing so could improve financial stability and avoid a credit rating downgrade.

However, these self-rescue measures by SVB made the market more aware of its liquidity risk, and the three announced measures pointed to the same signal: SVB have experienced a serious cash crisis. Depositors were worry that SVB's capital would suffer losses and affect the safety of their deposits, so they have joined the ranks of withdrawals, leading to the bank's most terrifying nightmare - a run. within

a single day, the wave of runs completely crushed SVB: customer withdrawal requirements reached as high as \$42 billion, almost a quarter of the bank's total deposits.

In addition, the capital market is also in a state of anxiety. Such a large-scale stock issuance means that the existing shareholder equity was severely diluted, so many of the SVB investors started to sell their stocks. On March 7th, the stock price fell by 15%. As the event escalated, the stock price plummeted by 60% on March 9th, and in the evening, the cash balance of SVB had turned into negative \$1 billion. In order to cope with the run, SVB were forced to sell more bonds, resulting in greater losses and creating a vicious cycle.

4.2. Bankruptcy become foregone outcome

On March 10th, market panic continued to spread, and the stock price of SVB plummeted by 68%, the stocks were Previously worth \$267 fell to less than \$35. SVB had to declare bankruptcy 48 hours after announcing the sale of bonds. The Federal Deposit Insurance Corporation (FDIC) has issued a statement stating that the California Department of Financial Protection and Innovation (DFPI) has announced the closure of SVB and appointed FDIC as bankruptcy administrator on the grounds of "insufficient liquidity and insolvency".

According to a statement released by the FDIC, in order to protect insured depositors, the FDIC has created the Deposit Insurance National Bank (DINB). When SVB closed, the FDIC, as the receiver, must immediately transfer all insured deposits from SVB to the DINB. The FDIC stated that the headquarters and all branches of SVB will reopen on the 13th, and all insured depositors can retrieve their insured deposits no later than the morning of the same day. According to the standard, the maximum insured amount per insured depositor is \$250000. However, the regulatory reports shown that many depositors of SVB have deposits higher than this number, as of the end of 2022, 89% of SVB's deposits were not insured.

4.3. Butterfly effect manifest

The SVB incident triggered panic in the market over the entire US banking industry, and some European banks and emerging markets had also been affected. Although the US Treasury, Federal Reserve, and FDIC reaffirm that the bankruptcy would not cause systemic risk, US banking stocks still suffered severe selling. The stock of First Republic Bank plummeted 75% during the trading session, Western Alliance Bank closed down 47%, PacWest and Zion both fell more than 20%. According to the industry index of 156 US listed banks tracked by UK financial information professional services firm Refinitiv, 149 banks experienced varying degrees of decline in closing prices during that period.

In addition, the butterfly effect of SVB's bankruptcy has emerged. Some small and medium-sized banks in the United States followed the footsteps of SVB. On March 12th, SBNY, the 29th largest bank in the United States with assets exceeding \$100 billion went bankrupt. Besides, there was also a voluntary liquidation of Silver Gate Bank. Together, there were three bank failures in the United States within a week.

What's even more terrifying is that, the crisis of SVB bankruptcy was gradually spreading to Europe. On March 15th, the stock price of Credit Suisse, Switzerland's second largest bank with a century of history, plummeted sharply. On March 19th, UBS Group announced a acquisition of Credit Suisse for a total consideration of 3 billion Swiss francs

(approximately 3.25 billion US dollars). Subsequently, Deutsche Bank, Germany's largest bank by asset size, saw its stock price plummet by 15% due to market concerns about its exposure to commercial real estate in the US, creating the largest decline in three years.

5. Trace the Reasons: Why Did SVB Go Bankrupt?

5.1. Insufficient risk control of SVB

By analyzing the SVB event, it can be concluded that the bank ran due to the excessive allocation of short-term deposits on assets with longer term structures, and fail to adjust asset allocation strategies in time. In fact, the deeper reason is the insufficient risk management ability of SVB itself, which can be listed in the following aspects.

Firstly, the risk management is inadequate. As early as the end of 2021, regulatory authorities had discovered deficiencies in liquidity management at SVB, involving six indicators including liquidity stress testing, emergency funds, and liquidity risk control. Besides, in May 2022, regulatory authorities downgraded the management rating of SVB to "average" due to its weak board supervision, weak risk management, and insufficient internal audit functions. This fully demonstrates the inadequate risk control performance of SVB. The Risk Management Department and Risk Strategy Committee of SVB actually had a clear understanding of the structure, maturity, and potential risks of its assets and liabilities, but in reality, but they put risk warnings on the shelf and didn't conduct corresponding measures to deal with those risks. According to public information disclosed in the 2023 shareholder power of attorney of SVB, Laura Izurieta, the Chief Risk Officer, has actually ceased her duties since April 2022 and officially resigned in October 2022, the new Chief Risk Officer was appointed until January 2023, which coincided with a period of significant changes in the financial

market. The long-term vacancy of Chief Risk Officer to some extent led to the failure of making risk strategies adjustments in time, and also reflects that SVB did not attach enough importance to risk governance.

Secondly, the risk appetite is unreasonable. Banks are highly leveraged enterprises with operational risks and natural fragility, and their risk preferences determine the effectiveness of their risk strategies. In reality, the risk appetite of banks should be set in conjunction with macroeconomic conditions and their risk bearing capacity, the continuous monitoring should be also carried out to timely adjust risk preferences. The period from 2020 to 2021 met a downward trend in US interest rates, SVB allocated over 70% of its newly added deposits to long-term mortgage-backed securities (increasing its holdings by \$80 billion in MBS) to obtain higher returns. This action resulted in a serious imbalance in its asset liability structure, which brought out greater liquidity risk.

Thirdly, the risk strategy is incorrect. Under its aggressive risk appetite, the bank's business strategy directly led to a higher concentration of risk. This high concentration is reflected in two aspects. On the one hand, there is a high concentration of customers, with a high degree of overlap between asset and liability customers. SVB focused on serving PE/VC institutions and startups, so its performance was closely related to the development of those customers. As shown in Figure 5 and Figure 6, as of the end of 2022, PE/VC institutions and startups accounted for approximately 43% of SVB's deposit customers and 73% of its loan customers. When the macro economy became weak and the performance of start-ups showed a downward trend, SVB's customers withdrew a large amount of deposits to maintain their livelihoods; At the same time, the decline in valuation of these enterprises has also had a negative impact on their loan repayment ability, which directly weakening the operational stability of SVB.

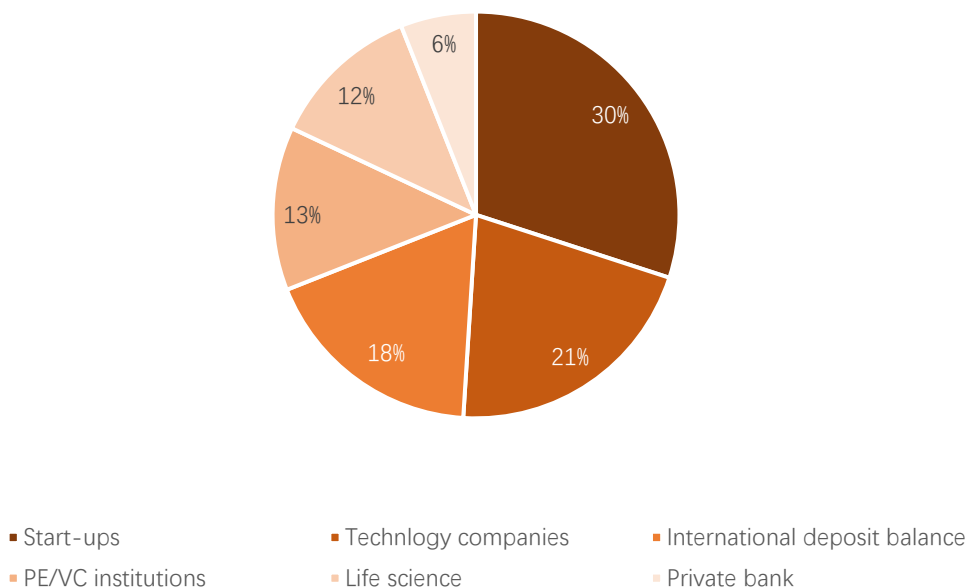


Figure 5. Proportion of SVB's Deposit Customers

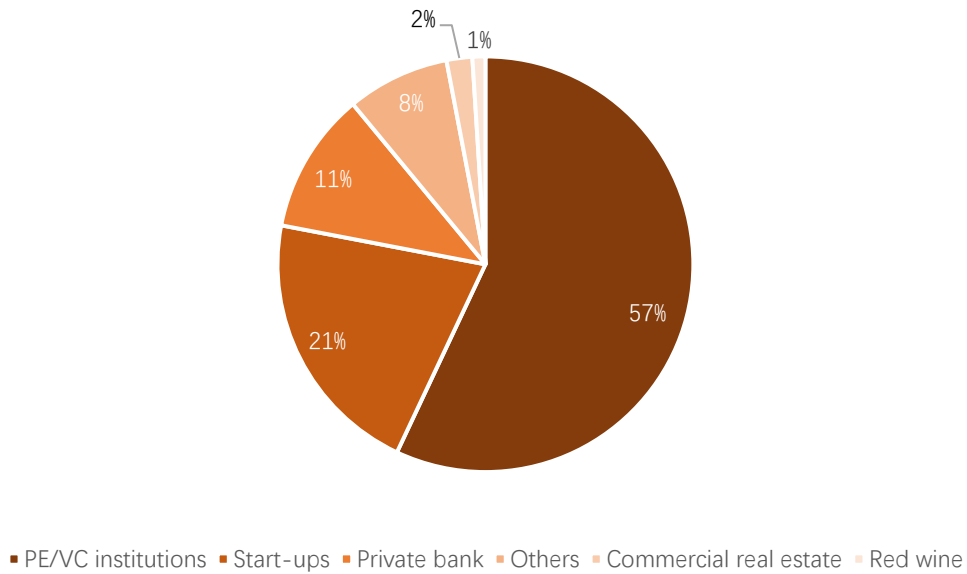


Figure 6. Proportion of SVB's Loan Customers

On the other hand, there is a high concentration of assets, mainly manifested as a high concentration of asset types and term structures. As it shown in the Figure 7, by the end of 2022, the net loan assets of SVB accounted for about 33%, and the fixed income securities accounted for about 55%, of which the U.S. treasury bond and MBS accounted for 14% and 55% respectively. The Figure 8 is the asset maturity

structure of SVB at the end of 2022, it was mostly concentrated in assets more than five years maturity, while the one-year assets with high liquidity accounted for only 23%. In the situation of loose monetary policy, abundant liquidity and lower market interest rates, SVB purchased a large number of relatively low-risk mortgage-backed securities, but ignored the serious imbalance of its asset structure.

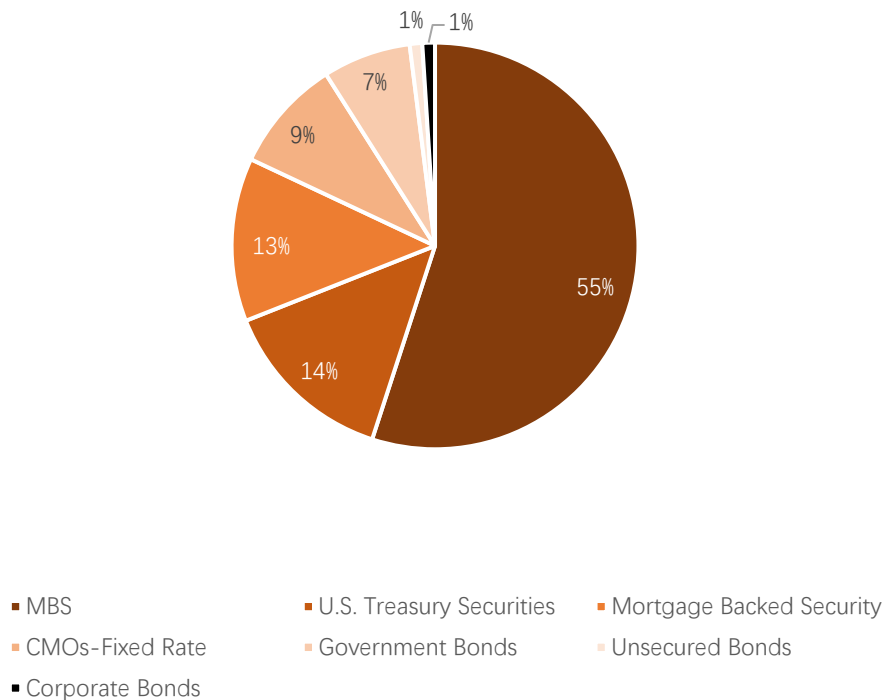


Figure 7. Fixed income securities investment structure of SVB at the end of 2022

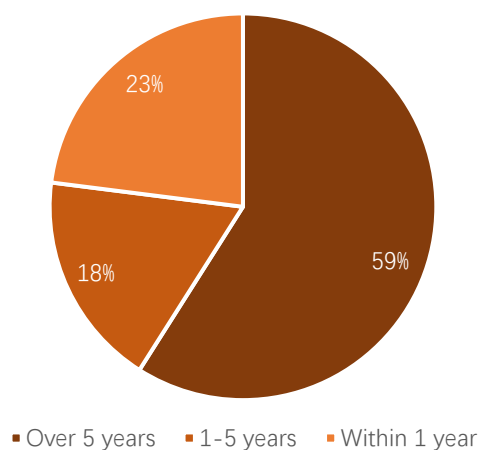


Figure 8. Asset maturity structure of SVB at the end of 2022

5.2. Poor regulation by the Federal Reserve

On April 28, 2023, the Federal Reserve released a review report on the Federal Reserve's supervision and regulation of SVB, which systematically analyzed the reasons for the bankruptcy of SVB and specifically pointed out the deficiencies in the Federal Reserve's supervision and regulation.

Firstly, the Federal Reserve has not fully recognized the serious vulnerability that rapid expansion and other factors bring to SVB. From 2019 to 2021, SVB's asset size grew rapidly, but the bank was not subject to stricter regulatory constraints. The Federal Reserve is not aware of the severity of its deficiencies in corporate governance, liquidity, and interest rate risk management, even still gave it a good rating.

Secondly, a customized regulatory framework weakened the binding force and timeliness of regulatory measures to some extent. In 2018, the Federal Reserve revised the regulatory standards for financial institutions based on the *Economic Growth, Regulatory Relief, and Consumer Protection Act*, raising the threshold for regulatory standards from \$50 billion to \$250 billion. This led to a significant relaxation of regulation for those banks with total assets below \$250 billion. The act divides US banks into five tiers based on several indicators including total bank asset size, cross-border business size, non-bank assets and so on, and establishes corresponding regulatory requirements for each tier. The capital and liquidity requirements for banks in fourth and fifth tier were relaxed. SVB, which ranked 16th in the United States, has been classified in the fourth tier, becoming one of the biggest beneficiaries of regulatory easing in 2018.

According to regulatory requirements, SVB do not need to set up countercyclical capital buffers, and accumulated other comprehensive income (AOCI) projects are no longer included in Tier 1 regulatory capital. SVB, which belong to the fourth tier and have short-term wholesale funds below \$50 billion, were allowed to lower its liquidity requirements, with no regulatory requirements for its Liquidity Coverage Ratio (LCR) and Net Stable Funds Ratio (NSFR). Besides, the fourth tier banks can conduct regulatory capital stress tests every two years and do not need to conduct their own capital stress tests. The relaxation of AOCI regulatory policies on fourth tier banks made them a tool for small and medium-sized commercial banks to cover up the fragility of their balance sheets, which planted seeds for the crisis events of SVB. In fact, by the end of 2022, the unrealized losses of SVB exceeding its capital equity and technically gone bankrupt

already.

6. Ring the Alarm: The Enlightenment of The SVB Incident

The main business and model of SVB have enabled it to operate successfully for nearly 50 years. Its investment loan linkage model has incubated numerous outstanding technology giants, which help it become a benchmark in the field of technology finance. However, due to interest rate risk, liquidity risk, and weak expected management level, it unfortunately went bankrupt. The SVB crisis has the following implications for the development of Chinese commercial banks and financial regulatory agencies:

6.1. Enlightenment for Chinese banks

Firstly, it is necessary to build a sound risk governance system. Risk governance is the prerequisite for effectively carrying out risk management work. A risk governance system should be constructed based on the principles of incentive compatibility, complete system, and clear division of labor. The board of directors and senior management should bear ultimate and direct responsibility for the effectiveness of risk management, ensuring their deep and extensive participation in risk management. Banks should always adhere to the three principles of safety, liquidity, and profitability in their business management, and pursue maximum profitability while ensuring safety and liquidity. SVB's excessive emphasis on profitability and neglect of safety and liquidity management ultimately led to the outbreak of the crisis. In view of this, commercial banks should prioritize safety and liquidity throughout the entire risk management process, and they pursue profitability only when ensure operational safety and sufficient liquidity.

Secondly, it is necessary to establish a prudent risk appetite. The deposit and loan business of banks carries a natural risk of mismatched terms, and excessive risk appetite can highlight the fragility of the bank in a bad operating environment. Therefore, it is particularly important to set a prudent risk preference, which is to set a reasonable risk structure and optimal boundary based on the needs of asset liability portfolio management while meeting capital constraints, in order to achieve a balance between risk and return, short-term profit and long-term value. SVB chose an aggressive risk appetite in a loose monetary environment, and the initial issues of mismatched maturity and high concentration were not obvious at that time; As the Federal

Reserve raised interest rates and tightened monetary policy, the failure to adjust risk preferences in time ultimately led to the exposure of problems and triggered a liquidity crisis. Therefore, commercial banks should continuously optimize their risk management organizational structure and develop reasonable risk strategies under a prudent risk preference.

Thirdly, reasonable and effective risk strategies should be adopted. On the one hand, banks need to enhance their awareness of cross-cycle operations, strengthen the management of macro risks, structural risks, maturity risks and currency risks of their assets and liabilities, play the role of risk management strategy committees and risk management departments to achieve stable business operations across cycles. On the other hand, the banks need to strengthen liquidity management. SVB has taken liquidity risk stress tests lightly in recent years and has been somewhat hasty in emergency response, which is also one of the reasons for this crisis. Commercial banks should attach great importance to the normalized use of risk management tools such as stress testing, and fully evaluate the customer's ability to repay loans and willingness to withdraw deposits. At the same time, preparing emergency plans to deal with short-term liquidity shortages and manage information disclosure during emergencies is also a very significant thing. In addition, it is necessary to do a good job in concentration management. SVB has a high concentration of customers on both the asset and liability sides, greatly reducing its risk resistance ability. On the basis of fully utilizing their comparative advantages, commercial banks can appropriately diversify the concentration of assets and liabilities at various industries, regionals and customer levels, closely monitoring the risk concentration within the industry and region, as well as the correlation between important customers, to ensure that the concentration risk is within a reasonable range.

6.2. Enlightenment for financial regulatory agencies

Firstly, financial regulatory agencies should increase the speed, intensity, and sensitivity of regulation. One is to introduce more continuity between different supervision categories for banks, so that as they expand in scale, they can apply higher standards more quickly. The second is to focus on the specific risks of banks with rapid growth, concentrated business models, or other special characteristics, rather than just considering asset size. The Federal Reserve has begun to establish a dedicated new type of business supervision team, focusing on risks such as fintech and cryptocurrency activities, as a supplement to the existing supervision team. Thirdly, once banks and regulatory agencies discover problems, they should solve them more quickly. For banks with insufficient capital, liquidity management, and internal controls, higher capital or liquidity requirements can serve as important safeguard measures until risk control improvements are made.

Secondly, the collapse of SVB indicates that more banks should be required to apply stricter standards. The Federal Reserve plans to re-examine its customized regulatory framework, including reassessing regulatory rules for banks with assets of over \$100 billion. The new regulatory framework has reference significance for the supervision of China's banking industry, specifically involving the following aspects: first, interest rate risk management. Interest rate risk is a core risk in the banking industry and is not unfamiliar to

banks or regulatory agencies, but SVB didn't properly handled interest rate risk, and regulatory agencies have not forced banks to quickly correct it. The second is liquidity risk management. The liquidity management model of banks should better reflect the liquidity risk of non-guaranteed deposits. The third is capital requirements. Financial regulatory authorities should make more banks pay attention to unrealized gains and losses on convertible securities, in order to better align their capital strength with their financial condition and risk. The fourth is stress testing. The customized regulatory framework would reduce the coverage and timeliness of stress testing, so it needs to be reexamined. The fifth is the incentive mechanism for bank management. The executives of SVB responded to the incentive measures approved by the board, stating that they have not received compensation for managing bank risks, therefore consideration should be given to setting stricter minimum standards for incentive compensation plans.

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