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Top Questions, And Lessons, After Banking's Wild Weekend

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When the California Department of Financial Protection and Innovation declared Silicon Valley Bank insolvent on March 10 and the Federal Deposit Insurance Corporation was appointed as receiver, there was a general panic around the availability of deposits — especially uninsured deposits — of the bank.

This panic may well have worsened and accelerated into this week as a result of the New York State Department of Financial Services also closing Signature Bank and appointing the FDIC as receiver on Sunday, March 12.

History will help judge whether a broader and larger scale run on deposits was averted because of the actions on March 12 by the U.S. Department of the Treasury, Board of Governors of the Federal Reserve System and FDIC to guarantee the ability of all depositors at SVB and Signature Bank to access their funds on the next business day.

While these actions provided relief to some of the immediate concerns related to the failure of both SVB and Signature Bank, outstanding questions remain, and the answers are not always clear. This article breaks down the current landscape related to those events and highlights some lessons learned from this tumultuous week in banking.

Where Are We Now?

Much has happened since Friday, when SVB was declared insolvent and the FDIC appointed receiver. Initially on Friday, the FDIC as receiver created the Depository Insurance National Bank of Santa Clara, a new bank to which all the insured deposits of SVB were immediately transferred and the main purpose of which was to facilitate access to insured deposits. At the time, the vast majority of SVB's deposits, including uninsured, as well as loans and other assets, remained at SVB.

On March 12, the NYDFS declared Signature Bank insolvent, and the FDIC was again appointed receiver.

Then, later that same day, upon the recommendation of the boards of the FDIC and the Federal Reserve, and after consulting with President Joseph Biden, Treasury Secretary Janet Yellen approved use of the systemic risk exception, which allows the FDIC to resolve SVB and Signature Bank "in a manner that fully protects all depositors" and that enables them,

regardless of whether their deposits are insured or insured, to have access to all their deposits as of Monday, March 13.

This represents the first time the systemic risk exception has been used since the financial crisis of 2008.

In connection with invoking the systemic risk exception, and to ensure that U.S. taxpayers do not bear the burden of protecting uninsured depositors, the agencies stated that any additional costs to the FDIC's depository institution fund related to this protection "will be recovered by a special assessment on banks, as required by law."

This essentially means that to the extent the FDIC does not realize sufficient funds through the sale of the assets of SVB and Signature Bank to cover 100% of the amount of both insured and uninsured deposits at the banks, other insured depository institutions will be assessed an additional charge to make up the difference to the depository institution fund.

Currently, the FDIC has established a separate bridge bank, which is a temporary, full-service national bank that is chartered by the Office of the Comptroller of the Currency, with new management and controlled by the FDIC for each SVB and Signature Bank.

All the deposits and "substantially all" the loans and other assets of each institution have been transferred to the respective bridge bank. Additionally, the FDIC has transferred all "qualified financial contracts" to each bridge bank.

In another action with shades of 2008 — as well as 2020 — the Federal Reserve announced on March 12 the creation of a new Bank Term Funding Program, a liquidity facility created under the Federal Reserve's authority to address "unusual and exigent circumstances" under Section 13(3) of the Federal Reserve Act.

The BTFP will make liquidity available to insured depository institutions, credit unions and other eligible depository institutions by lending against eligible collateral owned by the borrower as of March 12. These funds will be available for a term of up to one year, and borrowers will have to pledge eligible collateral on a 1:1 basis for any loan, with assets pledged as collateral valued at par.

The BTFP may best be seen as intended to provide additional liquidity to banks and similar borrowers to help relieve pressure they may feel to sell otherwise high-quality securities at a loss in a time of stress, similar to what occurred at SVB last week. The BTFP will be supported by up to $25 billion from the Exchange Stabilization Fund, which was made available with the approval of Yellen.

Despite the regulators' actions, there is currently continued pressure on bank stocks, especially certain regional bank stocks. It also remains to be seen whether the insolvency of SVB and Signature Bank will result in concerns over availability and positioning of funds — including uninsured deposits — at other institutions, although there is a distinct difference between loss in value of stock of a bank and loss of actual deposits at such institutions, as we have recently seen.

Regardless, the actions over the weekend demonstrate that the federal government is making efforts to help ensure the safety and soundness of banks, and hopefully these actions achieve a stated purpose of "strengthening public confidence in our banking system," as the regulators stated.

What Is a Borrower to Do?

Borrowers need to comply with their loan agreements. If there are payments due, they need to make those payments. If there is a line of credit available, it is unlikely that the FDIC as receiver will honor a draw on the line, especially because the FDIC may, as receiver, repudiate contracts that it deems to be burdensome.

The bridge banks for each of SVB and Signature Bank continue to advance funds in certain cases. Unfortunately, the borrower is at a point where it needs to perform, but the receiver doesn't necessarily need to perform.

As part of the receivership, the FDIC can sell both performing and nonperforming loans. On a practical basis, the FDIC can be expected to work with borrowers that need funds for emergency purposes such as to ensure the short-term viability of a borrower, but many borrowers are looking elsewhere to find capital to continue operating.

If a loan has been transferred from SVB or Signature to a new bridge bank established by the FDIC, there is a greater chance that the bridge bank will fund the draw.

What About My Money?

The Federal Deposit Insurance Act establishes a specific order of priority for claims and requires that insured depositors be paid "as soon as possible." After that, the priority of claims is as follows: (1) secured claims, with proper documentation; (2) administrative expenses of the receiver; (3) insured deposits; (4) uninsured deposits; (5) unsecured debt-holders and general creditors; and (6) shareholders.

Historically, general creditors and shareholders often do not realize the full amount of their claim and may receive only a fraction of what they are owed.

It is again worth noting that because the systemic risk exception was invoked on Sunday, all depositors of SVB and Signature Bank should have had access as of Monday to their deposit accounts, both insured and uninsured, including to help meet their payroll and other obligations.

Vendors

If there are insufficient assets of the relevant failed bank as compared to depositor claims — including reimbursement to the depository institution fund for payments on insured deposits — general creditors are unlikely to receive any recovery.

However, vendors that provide ongoing services related to SVB and Signature Bank should establish a contract directly with the FDIC or the relevant bridge bank to help ensure they are paid for their services.

The Importance of Account Types

First and foremost, it is important to distinguish between having an account at a bank, i.e., SVB or Signature Bank, and an account at a broker-dealer, registered investment adviser or other affiliate of a bank.

This can be an important difference when it comes to determining how an account is treated when a bank is in receivership.

With respect to accounts at a bank, SVB and Signature Bank, like many other institutions, offered a number of different products with so-called sweep features. Not all sweep products are designed the same, however, and it is important to know the difference and the types of protections offered by each product.

Some sweep products only moved cash from one type of deposit account to another type of bank account — a money market account — either at the same bank or a different bank that paid interest tied to certain Treasury securities.

A different product swept into a repo program that used customer cash to facilitate security repurchase transactions where cash would flow back to a customer's deposit account once the repo matured. These products are different than a product that sweeps cash into a money market mutual fund, which is a security and generally not subject to receivership when structured correctly, although is still subject to other risks.

Some SVB or Signature Bank customers may not have realized which product they held or which program they were enrolled in. Generally, when assessing exposure for customers, there is no better way to know what type of product or account a customer has than through review of the specific account and program documentation, which may include documentation involving other entities besides just the failed bank.

Those statements and documents should typically clearly reflect whether excess funds are held in money market mutual funds or in a deposit account at the bank, or, potentially, another bank.

With respect to money market funds, it is important to note that SVB was an intermediary between its customers and the money market mutual fund complex, holding customer assets in a commingled manner as nominee. While these assets are still bank customer assets, it is the bank and not the money market mutual complex that maintains ownership records for such funds.

So, while customer positions in these money market funds will typically be better protected than uninsured deposits, in a typical bank receivership, customers may not be able to immediately access those money market mutual funds until the FDIC develops a redemption process.

Once that happens, customers may end up having to redeem their shares and move the proceeds to a new financial institution that will meet their cash management needs.

Increased Scrutiny Around Public Disclosures and Public Companies

There will likely be a significant uptick in scrutiny on public companies' disclosures with respect to cash management and risks both from the U.S. Securities and Exchange Commission and investors. Over the weekend, we saw an evolution of the type of disclosures that public companies were providing in response to SVB's collapse.

For example, on March 10, there was a significant number of current reports on Form 8-K and press releases that largely fell in three categories: (1) no exposure or deposits with SVB; (2) possible exposure, but likely minimal; and (3) possible significant exposure.

While there are some similar filings early this week that fall under those three buckets, most disclosures are now acknowledging the different circumstances that companies are facing after the federal actions on March 12.

Prudence and careful consideration is paramount in this evolving space. Companies should evaluate facts and circumstances with their boards and trusted advisers to consider what disclosure obligations are necessary. While there are certain events that trigger required disclosure, many disclosures thus far are voluntary or are being done to comply with Regulation Fair Disclosure concerns.

Overall, many public companies' immediate concerns may have been eased by the federal actions on March 12, but these events and the continued volatility in the market remain concerning.

Every public company in the U.S. should consider revisiting their disclosures, especially risk factor disclosure, in upcoming periodic reports or prospectuses and augment them as necessary to reflect the recent turmoil. Such consideration should be made even if the company has minimal exposure to SVB because the economic uncertainty and turmoil caused by SVB's collapse is an example of a macro risk that all companies face today.

For public companies that are still facing significant, and possibly material, liquidity concerns in light of SVB's collapse and are determining what disclosure may be required, trading blackouts should be considered.

Some other questions to ask when revisiting disclosure include the following:

1. Does SVB's collapse and resulting turmoil have a material impact on your financial position, your customers or your counterparties?

2. Do you have material financing and liquidity concerns in light of SVB's collapse?

3. What steps, if any, have you taken to safeguard your assets?

4. Has your board or management identified gaps related to risk management policies, including cash management, and, if so, what changes have you made to address those gaps?

When approaching these questions, consider mapping out the specific risks, e.g., from payroll to credit facilities, and then determine how those risks could be further mitigated.

Conclusion

In a matter of days, the failures of two U.S. federally insured banks sent ripple effects throughout the financial services and emerging business sectors.

Moving in swift action, government agencies have taken significant steps to protect uninsured depositors and reinforce the stability of the banking system. At the same time, we may see policy changes to hedge against more and future fallouts, including increased scrutiny around cash management and the positioning of funds at other institutions, and enhanced scrutiny on risk disclosures for public companies.

With developments taking place, often in a less-than-24-hour cycle, the full scope and impact of this situation remains to seen.

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