SQUIRE PATTON BOGGS

Recent Bank Failures

Practical Considerations and Bank Resolution Procedures

US – March 12, 2023

On Sunday evening, March 12, 2023, the US Department of the Treasury, Board of Governors of the Federal Reserve Board (Federal Reserve) and Federal Deposit Insurance Corporation (FDIC) released a joint statement announcing various actions to stabilize the US banking system, in light of the widely publicized failures of Silicon Valley Bank (SVB) and Signature Bank (Signature Bank), each of which was closed by their respective state chartering authorities, with the Federal Deposit Insurance Corporation (the FDIC) appointed as receiver.

The actions announced by the US Treasury and Federal Reserve include (1) enabling the FDIC to complete the resolution of SVB and Signature Bank in a manner that provides both insured and uninsured depositors with full access to their deposit accounts, and (2) making available additional funding through the Federal Reserve to eligible depository institutions to help assure banks have the ability to meet the needs of all depositors.[1]

These actions follow the extraordinary events over the last several days resulting in the failure of SVB, Signature Bank and Silvergate Bank. While the root causes of these failures are still being analyzed, they appear to represent (at least in the case of SVB) a classic "run on the bank," driven by a rising rate environment where securities held needed to be liquidated at a loss in order to stem the tide from unprecedented outflow of deposits.

This client alert highlights several practical considerations that financial institutions should undertake.[2] We also outline in Annex A to this alert the standard procedures followed by the FDIC in resolving failing banks.

Although the extraordinary actions taken by federal regulators have been designed to stop runs on banks and prevent a liquidity crisis in the US banking system, the circumstances surrounding the failure of SVB and Signature Bank and their ultimate resolution remain dynamic. We will continue to provide updates as to actions undertaken as they develop.

Practical Considerations for Financial Institutions

Senior management teams for financial institutions should undertake a close evaluation of current business lines and potential risks that current customer relationships may ask of their counterparties in the coming days and weeks. In the short term, banks should consider undertaking the following steps:

- Be prepared to draw on available sources of funding, including the newly available funding source announced by the Federal Reserve, as well as other sources, such as the Federal Home Loan Bank, and consider new borrowings with longer durations and review collateral requirements needed to support advances.
- Determine the amount of liquidity existing liquidity resources can provide in the event of a run and pre-arrange expedited access to these funds, should the need arise.
- Operational execution in the coming days and weeks will be critical. Wirerooms and payment teams should be ready with all available resources. Any "foot-fault" payments may set off unfounded speculation as to the ability of a financial institution to meet its obligations, which speculation spreads fast on social media and other media.
- Consider whether to conduct outreach to the largest depositors and other key customer relationships (and the form of that outreach) to reassure them as to the health of the bank and its business and minimize panic, being mindful of not disclosing confidential supervisory information and for publicly traded banks/holding companies, material non-public information.

1 As reported by the Federal Reserve, the additional funding will be made available through the creation of a new Bank Term Funding Program (BTFP), offering loans of up to one year in length to banks, savings associations, credit unions, and other eligible depository institutions pledging US Treasuries, agency debt and mortgage-backed securities, and other qualifying assets as collateral. These assets will be valued at par. The BTFP will be an additional source of liquidity against high-quality securities, eliminating an institution's need to quickly sell those securities in times of stress.

2 This alert is focused on practical considerations for financial institutions in addressing concerns of customers and relationships, as compared to risks and considerations for borrowers and other counterparties with respect to their banking relationships, which questions can be directed to your relationship partner at the firm.

- Develop a comprehensive crisis response playbook for speaking with (i) customers, (ii) employees and (iii) vendors, such as financial technology partners (banking as a service, core processors, etc.), about the health of the financial institution.
- For publicly traded banks/bank holding companies, make certain that any crisis response playbook described above does not include selective disclosure and if any material non-public information is planned for dissemination, that it occurs in a manner compliant with Regulation FD, including an evaluation of whether any information should be communicated in a Current Report on Form 8-K. Investor relations teams must be fully equipped to respond to inbound inquiries, consistent with the crisis response playbook referenced above.
- For publicly traded banks/bank holding companies, stock market volatility is likely to continue, along with short selling, which may put pressure on share prices, notwithstanding performance. Continued monitoring of market activity and implementing share buyback programs in light of decreased prices should be carefully considered and closely evaluated.
- Closely evaluate loan concentration risk and evaluate allocations between available-for-sale and held to maturity securities portfolios, and the transparency of those determinations to the market, as well as related capital implications, to ensure appropriate alignment and duration of existing assets to liabilities.
- Evaluate near-term and long-term liquidity and capital planning needs and if raising capital is necessary, start planning early with investment banking and legal advisors to ensure all options are carefully considered.
- Ensure that the board of directors is appropriately updated on a regular basis with regard to the financial institution's risk profile and response to recent failures. We know most institutions have begun this process in earnest.

Further Information

For further information relating to this alert and other financial regulatory topics, please contact the lawyers listed below.

Contacts

James J. Barresi
Partner and Financial Services
Practice Group Chair
Financial Services
T +1 513 361 1260
E james.barresi@squirepb.com

Alison N. LaBruyere
Partner
Financial Services
T +1 678 272 3228
E alison.labruyere@.squirepb.com

Raymond Natter
Of Counsel
Financial Services
T +1 202 445 4408
E raymond.natter@squirepb.com

Aaron A. Seamon
Partner
Financial Services
T +1 614 365 2759
E aaron.seamon@squirepb.com

James C. Sivon
Of Counsel
Financial Services
T +1 202 262 4271
E james.sivon@squirepb.com

Derrick Cephas
Of Counsel
Financial Services
T +1 212 872 9811
E derrick.cephas@squirepb.com

Annex A

FDIC Resolution Process

The following summarizes the FDIC's standard resolution process, which is illustrative of the steps that the FDIC, as receiver, will likely take in connection with recent bank failures, although the process used in SVB and Signature Bank are specialized and subject to the recent and any subsequent pronouncements made by federal bank regulators.

The FDIC's standard resolution process is initiated when the primary federal or state regulator for a bank[3] notifies the FDIC of the potential failure. Then, the FDIC will analyze the bank's condition to determine potential resolution structures, and will invite other banks, on a confidential basis, to submit bids to purchase the assets and liabilities of the failing bank.

Least Cost Test

The FDIC is required to pursue a resolution that poses the least cost to the deposit insurance fund, unless the bank qualifies under the "systemic risk" exception.[4] This least cost analysis involves a comparison of the cost of liquidating the bank to the cost of the bids received from other interested institutions to purchase all or part of the assets and assume all or part of the deposit liabilities of the bank. Liquidation requires the FDIC to pay off insured depositors up to the current insured amount and dispose of the assets. As noted below, because other banks may view the failed bank as having valuable assets, including low-cost deposits, the acquisition option will typically result in the least cost to the FDIC.

P&A Transactions

Currently, the FDIC uses two basic resolution methods for resolving a failing bank: (1) a purchase and assumption (P&A) transaction; and (2) a deposit payoff. Of these two options, the most common is a P&A transaction. Since 2008, roughly 95% of these resolutions conducted by the FDIC have involved the sale of the institution's franchise and assets to another institution in an assisted P&A transaction, generally involving a single acquirer assuming nearly all of the failed institution's liabilities, including all of its deposits, both insured and uninsured.[5] All deposit P&A transactions have become common since 2008 because the deposit insurance limit was increased from US$100,000 to US$250,000, reducing the amount of uninsured deposits in banks.[6]

The P&A Agreement and Credit Card Operations

The FDIC has a standard P&A agreement and bidders have little opportunity to modify the terms and conditions contained in this agreement. The current standard agreement includes an express provision requiring the acquiring bank in a P&A to maintain the credit card operations of the failed bank. That provision reads as follows:

> "The Assuming Institution will honor and perform, from and after the Bank Closing Date, all duties and obligations with respect to the Failed Bank's credit card business (including issuer or merchant acquirer), debit card business, stored value and gift card business, and/or processing related to credit cards, if any, and assumes all extensions of credit or balances outstanding as of the Bank Closing Date with respect to these lines of business. The obligations undertaken pursuant to this Section do not include loyalty, reward, affinity, or other similar programs related to the credit and debit card businesses."

In some P&A transactions, the acquiring bank will assume all deposit liabilities except for specified brokered deposits or all brokered deposits. Often excluded are deposits placed by Cede & Co. as nominee for the DTC.[7] However, in other instances, all brokered deposits are omitted. In these cases, the FDIC will pay off the insured brokered deposits directly or through another institution acting as agent.

P&A Transactions With Large Banks

Banks with more than US$50 billion in assets are required to file resolution plans with the FDIC.[8] These plans must ensure that depositors receive access to their insured deposits within one business day of the institution's failure (two business days if the failure occurs on a day other than Friday), which maximizes the net present value return from the sale or disposition of its assets and minimizes the amount of any loss realized by the creditors in the resolution.

The FDIC has acknowledged, however, that the P&A structure becomes more challenging with larger banks, as the number of potential acquirers is reduced and legal limitations on concentration are triggered. The FDIC's sole experience with resolving a failed institution over US$50 billion through a P&A structure was Washington Mutual Bank, and the FDIC has stated that this resolution strategy cannot be assumed for future failures of banks over US$50 billion.[9]

3 For a state chartered bank, the primary state regulator is the state banking authority and the primary federal regulator is either the FDIC or the Federal Reserve. For a national bank, the primary regulator is the Office of the Comptroller of the Currency.

4 The "systemic risk exception" allows the FDIC to use another resolution method (such as open bank assistance) if the Secretary of the Treasury, in consultation with the President and with the written recommendation of two-thirds of the Federal Reserve Board and two-thirds of the FDIC Board, determined that use of the least-cost resolution would have serious adverse effects on economic conditions or financial stability and that use of an alternative method can mitigate these adverse effects. This "systemic risk exception" was invoked on March 12, 2023, in connection with guaranteeing uninsured depositors of SVB and Signature Bank with access to their deposit accounts.

5 84 Fed. Reg. 16621 (April 22, 2019).

6 FDIC Resolutions Handbook, p. 17. One noted commentator believes that adverse publicity following the failure of IndyMac Bank in 2008 has also made the FDIC reluctant to leave uninsured depositors unprotected. See Appendix A, footnote 1, *infra.*

7 See, e.g., failure of Commonwealth Norfolk Bank in which the acquiring institution assumed all deposit liabilities except for deposits placed by Cede & Co.

8 12 C.F.R. 360.10.

9 84 Fed. Reg. 16622 (April 22, 2019).

Depositor Payoffs and Liquidation

If the FDIC does not receive a P&A bid that meets the least costly resolution test, it will pursue a deposit payoff and liquidation of the bank. In a deposit payoff, the FDIC pays all the insured depositors of the failed financial institution, up to the current insurance limit (US$250,000 per depositor).[10] As receiver in payout liquidations, the FDIC retains substantially all of the failed bank's assets for later sale, and the franchise value of the failed insured depository institution is lost. Uninsured depositors and other general creditors are issued receivership certificates entitling each to a portion of the FDIC's collections on the failed bank's assets, if any.[11] Depositor payoff and liquidation is almost always the most costly method for resolving a failed bank, as the FDIC must liquidate all of the bank's assets, bear the upfront cost of paying off all insured depositors and monitor the estate for the creditors. No franchise value is recovered. This method is, therefore, only used if the FDIC does not receive a bid for a P&A transaction or for a less costly insured deposit transfer transaction.

There are three types of deposit payoffs. The first is a straight deposit payoff, where the FDIC pays deposited amounts due up to the insured limits. The second type is an insured deposit transfer, which allows the FDIC to transfer the insured deposits to a healthy institution to limit service interruptions for insured depositors. The third type is the creation of a new limited-life depository institution in the same community of the failed bank in order to conduct an orderly payout of the insured deposits, also referred to as a deposit insurance national bank.[12]

Identification of Insured Depositors and Reconciliation of Accounts

In a payoff, the FDIC must promptly determine the insurance coverage for all deposit accounts and reconcile them. This is not a simple task. Owners of multiple accounts aggregating more than FDIC deposit insurance coverages, holders of beneficial interests in "pass through coverage accounts" (i.e., brokered deposits and common pooled trust funds), available setoffs, accounts subject to security interests, closing balances reflecting overdrafts and unposted deposits and withdrawals must be made promptly and as of resolution. To facilitate this process, the FDIC requires banks that have two million or more deposit accounts to put in place mechanisms to facilitate prompt deposit insurance determinations.[13] These banks must configure their information technology systems to be able to calculate the insured and uninsured portion of each deposit account by ownership right and capacity, and maintain complete and accurate information needed by the FDIC to determine deposit insurance coverage for each deposit account.

Bridge Bank

The FDIC also may organize a bridge bank to acquire assets and liabilities of a failed bank if it determines that continuing the operations of the failed bank is less costly than a payout liquidation, after considering the costs of operating the bridge bank. The bridge bank is initially chartered for a two-year life, with possible extensions for up to three additional years. Once the FDIC has transferred assets from the failed bank to the newly established bridge bank, the FDIC will manage and operate the new institution.

Receivership

If a whole bank P&A is not arranged, and the bank is placed into receivership (either by the state or federal primary regulator), the FDIC is automatically appointed receiver. This event usually occurs on a Friday at the end of the business day, which gives the FDIC time to work over the weekend.

If another institution has assumed the deposits of the failed bank,[14] the customers of the failed bank automatically become customers of the acquiring institution with access to their insured funds on the next business day. If the FDIC does not transfer the deposits, it will either mail a check to each depositor, or arrange for another institution to act as the agent of the FDIC, which can place the funds into a new account if the depositor so desires.

The FDIC, as receiver, is then responsible for settling the affairs of the closed bank. Such activities include balancing the accounts of the institution immediately after closing, transferring certain assets and liabilities to an acquiring institution, and determining the exact amount of payment due to the acquiring institution, uninsured deposits and other claimants. The settling of various accounts between the receiver and the acquiring institution takes from 6 to 12 months, depending on the size of the failed bank. The payment to other claimants ("dividends") can take much longer.

Receiver's Authority to Repudiate Contracts

Federal law gives the FDIC, as a receiver, special powers upon failure of an institution. These powers include the ability to repudiate contracts of the failed bank that the receiver deems burdensome. The power to repudiate contracts granted to the FDIC is similar, but broader, than the power of a debtor-in-possession or trustee appointed by the Bankruptcy Court to reject unwanted executory contracts. Unlike a traditional Chapter 11 proceeding, the FDIC can simply repudiate a contract or lease by letter to the affected counterparty without court approval and with no prior notice. In the traditional bankruptcy proceeding, only "executory" contracts can be avoided by a trustee in bankruptcy. The FDIC can, however, repudiate any contract it finds burdensome.

---

10 It is important to note that the limit applies to the aggregate deposits held by the depositor in all accounts held in the failed bank. Funds held in custodial accounts are aggregated with other deposits in that institution held by the same individual. However, funds held in other types of accounts, e.g., IRA accounts, are separately insured. 12 C.F.R. 330 and www.fdic.gov/deposit/covered/categories.html.

11 See Appendix A for examples of how uninsured depositors fared when the FDIC liquidated a failed bank.

12 By statute, a deposit insurance national bank is limited to two years, but as a practical matter is usually open for only 90 days.

13 12 C.F.R. Part 370.

14 As noted, the second institution may assume all of the deposits or just the insured deposits.

The FDIC may repudiate any burdensome contract within a "reasonable time" of its appointment, generally 180 days, but subject to the specific circumstances of the failed institution. While the receiver may be liable for damages resulting from the repudiation of a contract, those damages are limited to actual direct compensatory damages determined as of the date of the receiver's appointment. Actual direct compensatory damages do not include punitive or exemplary damages, damages for lost profits or opportunity, or damages for pain and suffering. Any claim for damages due to the repudiation of a contract is subject to the receivership's claim process.

Receiver's Authority to Enforce Contracts

In addition to being able to repudiate or disaffirm contracts, the receiver has the limited ability to enforce a contract and prevent the other party to the contract from terminating the agreement if keeping the contract in place is in the best interest of the receivership. Any contract clause that allows the termination of the agreement due to insolvency or appointment of the receiver (or similar language) is unenforceable against the receiver with the contract remaining intact.

Termination of Interest Due on Deposits

The amount of the insured deposit includes interest unconditionally credited as of the date of default, plus interest accrued that the bank would have paid if the deposit had matured on the date of default.[15] Post-insolvency interest may be paid once a receivership has paid 100% of the original claim amounts of uninsured depositors and unsecured creditors.

Depositor Preference

The priority for paying allowed claims against a failed depository institution is determined by federal law.[16] Claims are paid in the following order of priority:

- Administrative expenses of the receiver
- Deposit liability claims (the FDIC claim takes the position of all insured deposits)
- Other general or senior liabilities of the institution
- Subordinated obligations
- Shareholder claims

Payments on these claims are known as dividends. Customers with uninsured deposits are sometimes issued advance dividends based on the estimated recovery value of the failed institution's assets. This provides customers with uninsured deposits a portion of their uninsured funds early in the receivership process but maintains market discipline. However, the FDIC does not pay advance dividends when the value of the failed institution's assets cannot be reasonably determined at closing. Federal law applicable to all depository institution receiverships provides that a receiver's maximum liability to a claimant is an amount equal to what the claimant would have received if the institution's assets had been liquidated.

15 12 C.F.R. 330.3 states that the "amount of a deposit is the balance of principal and interest unconditionally credited to the deposit account as of the date of default of the insured depository institution, plus the ascertainable amount of interest of to that date, accrued at the contract rate (or the anticipated or announced interest or dividend rate), which the insured depository institution in default would have paid if the deposit had matured on that date and the insured depository institution had not failed. In the absence of any such announced or anticipated interest or dividend rate, the rate for this purpose shall be whatever rate was paid in the immediately preceding payment period."

16 The depositors' preference legislation was adopted as part of the Omnibus Budget Reconciliation Act of 1993.

The opinions expressed in this update are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

© Squire Patton Boggs. All Rights Reserved 2023

61445/03/23