Will Another Bank Fail?

Identifying Legal and Business Risks from Banking Turmoil

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Does First Republic represent the beginning of the end of a banking crisis or is it merely the end of the beginning stage of banking turmoil set in motion by the run on Silicon Valley Bank (SVB)?

To successfully navigate the uncertainty, below are five areas of concern and the tools to address them.

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1) What are the risks if extraordinary efforts are not used or a savior does not appear, if another bank fails?

In each of the recent bank failures, the federal government has taken extraordinary measures to protect all deposits or relied on a savior to purchase the failed bank.

- The FDIC must ordinarily follow the least costly method of saving a failed bank unless it invokes the Systemic Risk Exception, where it believes necessary to prevent damage to the nation's financial system.
- The Systemic Risk Exception was applied to insure all deposits at SVB and Signature Bank.
- However, invoking the exception requires the FDIC to run a gauntlet of approvals up to the President and there is no guarantee it will be applied again. Treasury Secretary, Janet Yellen, all but warned so.
- JPMorgan Chase was granted a waiver of the prohibition against any bank controlling post-acquisition more than 10% of U.S. deposits (it had already surpassed that), in order to purchase substantially all of the assets of First Republic, but there is no guarantee an exception to the market share cap will be allowed in the future.

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At any time prior to the Systemic Risk Exception being applied or a purchase of the failed bank, the following parties and bank counterparties are at risk:

- Commercial depositors will generally be insured up to only $250,000 per account (per type of account and more than one account may be held) and receive a claim for an uncertain amount above that amount.
- Borrowers may be unable to access a line of credit to fund payroll and other expenses. At the same time, they may be prohibited from terminating any agreement with the failed bank for a period of 90 days following receivership.
- Based on FDIC statements made in connection with the 2008 financial crisis, landlords may not be able to draw on letters of credit issued by the failed bank.
- Intermediaries may be subject to clawback of funds received from a failed bank despite obligations to pay third parties.
- Various service providers and executives of the failed bank may be subject to clawbacks as a result of the corporate parent's bankruptcy or Title II receivership or the failed bank's receivership.

Uncertainty will likely exist for an extended period and agreements will need to be analyzed to determine whether certain assets, rights and obligations of the failed bank are subject to the receivership.

2) How will the risk of bank failures change banking relationships?

Given the risks of a bank failure and the prohibition on terminating agreements with a failed bank, counterparties can be expected to negotiate for certain protections and incentives:

- Borrowers may resist banks' exclusivity requirements.
- Banks may need to offer higher interest and other accommodations to counter any borrower's plans to spread accounts.
- Borrowers and landlords may negotiate for reciprocal "material adverse effect" clauses.

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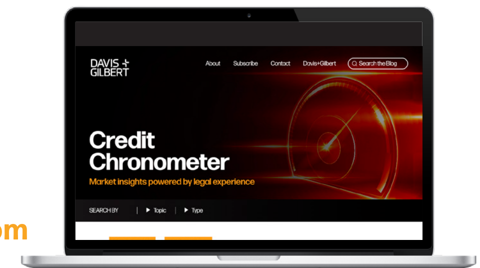

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3) How can parties recover losses from a bank failure?

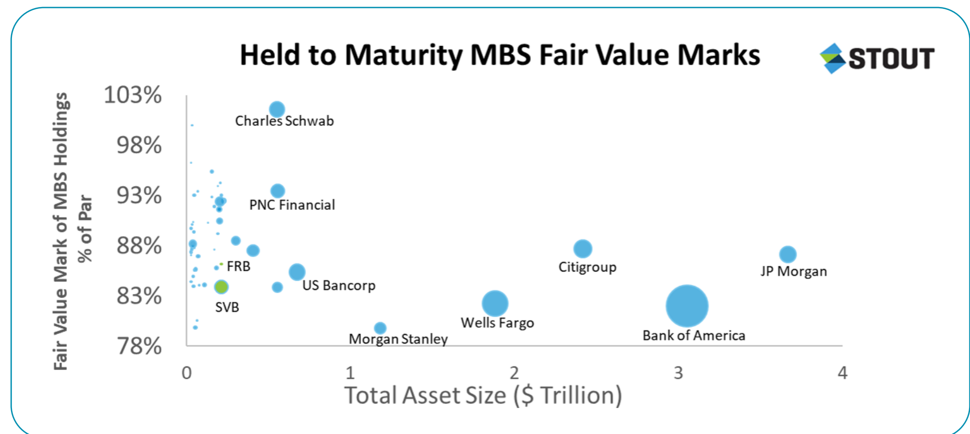
- Securities class actions will continue to be filed against a failed bank's executives for misrepresentations and mismanagement based on the theory of fraud on the market.
- Investigations are already underway related to trading activity of executives of failed banks. Private actions may follow against investors and others who made negative statements and accelerated outflows. At issue will be the timing of those statements relative to any trading activity.
- Following a trend seen in other markets, bank parties may also pursue investors and others who made positive statements and endorsed the bank, claiming they were in position to know or should have known of the problems. At issue will be the defendants' intent, any duty owed to plaintiffs and reasonableness of diligence.

4) How can bank vulnerability be identified?

Though many cite to SVB's large uninsured deposits or its concentration of startup customers as the reason for its failure, there were at least ten factors that combined to lead to its demise. These factors should be analyzed to identify warning signs going forward.

Fair Value of Assets / Unrealized Losses

SVB's mortgage-backed securities were marked at .83; such a discount may mean losses when assets are sold to meet liquidity needs driven by deposit outflows. **[See Chart: Held to Maturity MBS Fair Value Marks]**



Concentration in Depositors (Insured vs Uninsured; Average Deposit Size)

Over 93.8% of SVB's deposits were uninsured; such a high level of large deposits creates perceived risk and combined with other factors can accelerate outflows.

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Deposit Outflows

SVB expected to see $100 billion in outflows on March 10, the day it was seized by regulators. There could be earlier warning signs: First Republic reported losing 58% of deposits in Q1 2023, precipitating JPMorgan Chase's acquisition.

Concentration of Assets (Duration/Types)

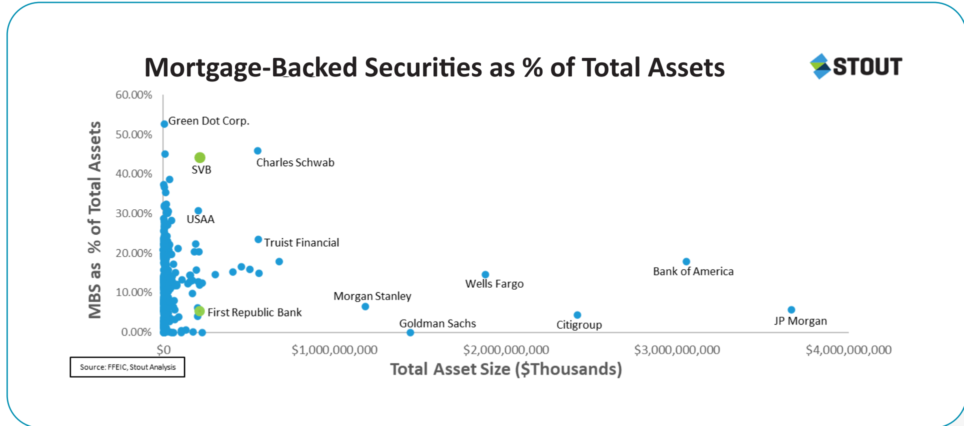
SVB's assets were heavily concentrated (44%) in mortgage-backed securities. Concentration in any sector, especially those facing headwinds such as commercial real estate (CRE), increases risk.

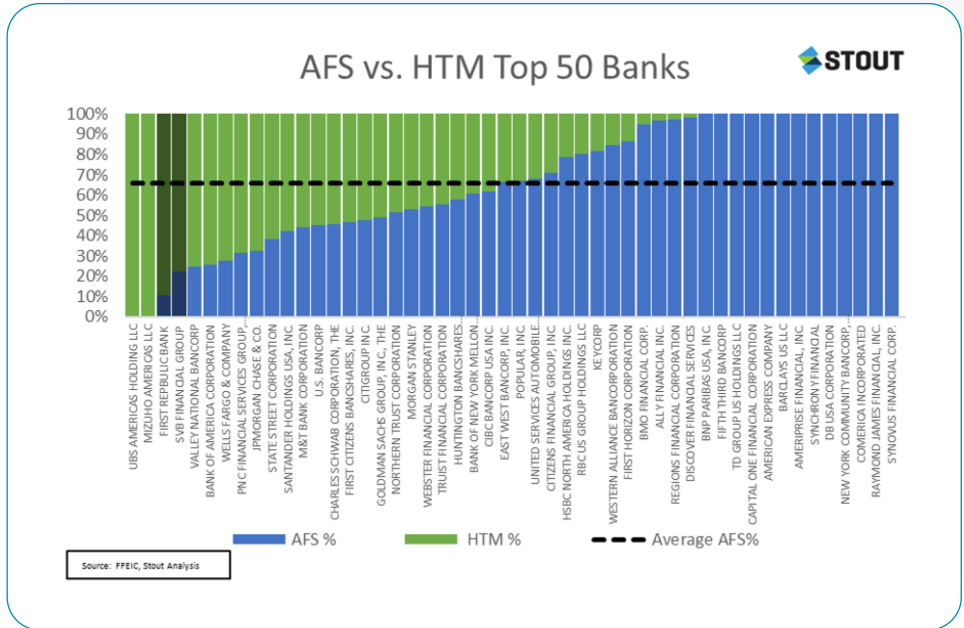
[See Chart: Mortgage-Backed Securities as % of Total Assets]

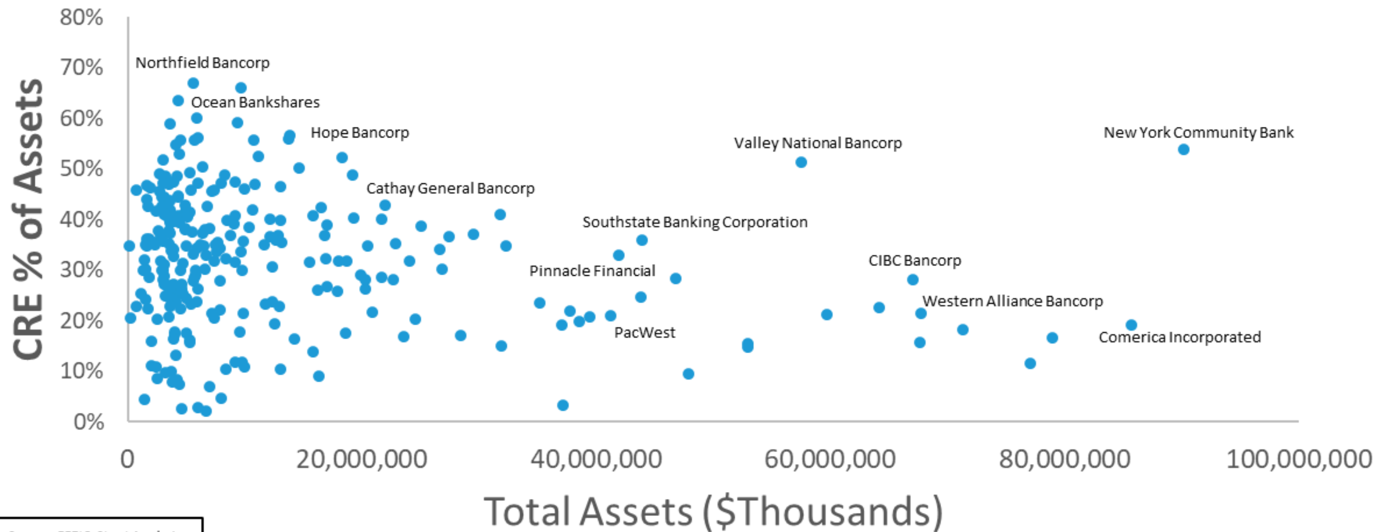
Available for Sale (AFS) / Held to Maturity (HTM) Ratio

Nearly 80% of SVB's assets were in the HTM category; such a high level combined with low value can indicate risk of losses if asset sales are required for liquidity.

[See Chart: AFS vs. HTM Top 50 Banks]







Sector Concentration

SVB had touted that over 50% of VC-backed startups were customers; the corollary to this is high concentration by other banks in risky or out of favor markets, such as CRE, which can be observed in several regional banks.

[See Chart: Commercial Real Estate Loans % Assets]

Management Experience and Structure

SVB reportedly had no Chief Risk Officer for most of 2022, yet maintained executives in charge of diversity, equity, and inclusion and environmental, social, and governance programs.

Going forward, the market will want to see risk management properly emphasized and appropriately experienced risk officers in place.

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Market Perception / Credit Default Swaps (CDS)

SVB's Google Trend Score had reached 40 on March 10. This is a critical point that may also flash trouble for other banks with similar attributes. In addition widening CDS spreads will indicate an increased perception of risk.

[See Chart: Google Trend Score vs. Stock Price]

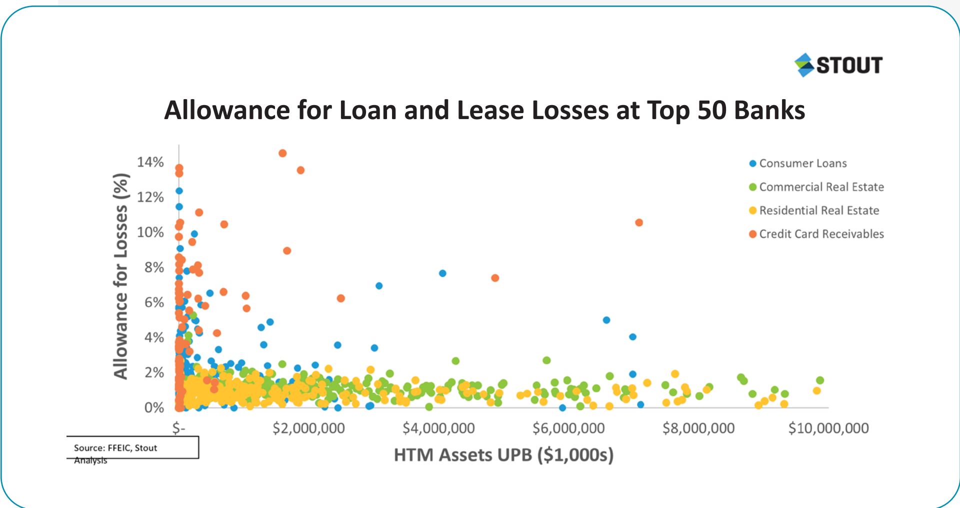
Hedging / Asset Liability Management (ALM)

SVB appears to not have hedged its mortgage-backed securities. ALM, including efforts to match duration of assets and liabilities, should be evaluated.

Allowance for Loan and Lease Losses vs. Chargeoffs

SVB had only 0.8% allowance for credit losses; a determination of reasonableness must be made on a case-by-case basis. Many banks are reporting approximately 2% allowance for losses related to CRE, which seems low given market conditions.

[See Chart: Allowance for Loan and Lease Losses at Top 50 Banks]



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5) What are the best protective practices for businesses?

The best protection during the banking turmoil is a comprehensive treasury framework that encompasses cash management (establishing accounts to ensure cash is available for business needs), liquidity risk (including through ALM) and capital efficiency (including effective forecasting and modeling).

Final Thoughts: Opportunities

In addition to the changes coming to banking as noted, there will also be opportunities for growth post-SVB. Regional and large banks will gain market share filling the voids left behind by failed banks in certain markets, as has already begun with respect to startups and CRE. Private debt will find more opportunities to fund riskier deals that banks may be reluctant to touch. Investors may obtain favorable loss sharing agreements with the FDIC in connection with purchases of a failed bank's assets.

These opportunities will create a new banking and lending order in the post SVB-world.

What can be done?

To protect against losses related to any bank failure, bank counterparties, depositors, landlords and investors, as applicable, can:

- negotiate for flexibility and protections in new banking relationships, including reciprocal material adverse effect clauses, non-exclusivity, and replacement letters of credit
- analyze bank attributes for vulnerability, know the limits of FDIC protection and protect cash and manage liquidity accordingly
- carefully review any purchase and assumption agreements between the FDIC as receiver and purchaser to determine rights and obligations and any restrictions on termination of contracts

Further, parties may consider pursuing claims where appropriate against responsible parties in connection with any misrepresentations or other actions, including possible market manipulation, that may have contributed to losses.

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Christine helps creditors protect their rights in bankruptcy cases and supports borrowers and lenders in negotiating credit agreements. She also defends clients in asset-backed securities litigation, including RMBS.

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