TRENDS AND LEGAL MECHANICS OF BANK BAILOUTS

THE NEW FRONTIERS

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By **Jeffrey Brochin, Esq.**

GreenPoint> ESR

EXECUTIVE SEARCH AND RECRUITMENT

william.anderson@greenpointglobal.com | pranav.menon@greenpointglobal.com

International Corporate Center, 555 Theodore Fremd Avenue, Suite A102 Rye, NY 10580

www.gpesr.com

Notwithstanding the use of the term 'bailout' in the title of our article, there are those in both the banking industry and in government who insist that the rescue of Silicon Valley Bank (SVB) is not a bailout at all but rather a mechanism quite different from the bank bailouts of 2008.

Others are not so sure and point out that even if there are distinctions between the 2008 rescue plans and those of 2023, the result will be the same in terms of cost to taxpayers. We will examine the legal mechanism at work this time around and what all of this portends for the future of depositors' financial security.

Aren't All Banks FDIC Insured?

All banks must carry FDIC insurance through the Federal Deposit Insurance Company. The fund (Deposit Insurance Fund or DIF) is funded through assessments that are charged to the banks. In case of a bank failure, the FDIC steps in to take managerial control over the bank, to possibly sell off parts of the banking operations, and to ensure that depositors have timely access to their FDIC-insured deposits. Deposits funds are insured up to $250,000.

But therein lies the rub: what happens in cases where a depositor's deposits exceed the $250,000 cap? For most of us, we are simply out of luck and have to eat the losses incurred due to bank mismanagement. But, to paraphrase from George Orwell's Animal Farm, 'all depositors are equal, but some are more equal than others...'

Financed Half of Venture-backed Technology Firms

Both SVB and Signature Bank primarily served high-tech businesses and wealthy individuals rather than your everyday, average depositor. In fact, SVB financed nearly half of the venture-backed technology as well as healthcare firms, and Signature Bank was considered a 'politically connected' bank serving private equity firms and the cryptocurrency sector. While it is true that most SVB depositors had much less than the $250,000 FDIC limit amount on deposit, it is the losses to millionaires and billionaires that the FDIC was primarily concerned with.

Dallas Mavericks owner Mark Cuban had a reported $8-10 million on deposit, and TV streaming platform Roku was on the hook for a whopping $500 million. We can't just let that kind of financial loss go unrecompensed like we could, for example, the $260,000 depositor who just happened to step $10,000 over the FDIC cap, can we?

Enter the Backstop

According to financial terminology, a backstop is a financial arrangement that creates a secondary source of funds in case the primary source is not sufficient to meet current needs. In other words, it is essentially an insurance backup behind the insurance to cover losses when the first source is inadequate to cover those losses. And that is the mechanism put into play to resolve the current bank failures so that the "$250,000-plus" crowd would be

Executive Summary

> The Issue

What was extraordinary about the government's rescue of two failed banks within the span of a few days?

> The Gravamen

By agreement of the Federal Reserve, the FDIC, and the Treasury Department, government guarantees as to depositor losses have, for the first time, gone well beyond the FDIC insurance cap.

> The Path Forward

The protections against bank failure put in place after the 2008 banking crisis were not adequate to protect against two major bank failures in one week, and new safeguards will have to be studied.

protected against loss and not just regular FDIC insureds. In what was characterized as an 'extraordinary measure', the Treasury Department, Federal Reserve, and FDIC agreed to resolve the SVB failure and the Signature Bank failure so as to 'fully protect all depositors'—including FDIC-uninsured deposits—and by taking that step, the regulators undertook to provide an implicit government guarantee against depositor losses incurred at a certain class of banks.

In addition, they announced a new "Bank Term Funding Program" offering a one-year loan to banks under terms described as easier than what is typically provided. $25 billion loans are reportedly available. The agencies cited the Federal Deposit Insurance Act as the authority for these extraordinary measures. In the midst of the current panic, another potentially troubled bank, First Republic Bank, turned to funding from the Fed and JPMorgan Chase to bolster its own financial health.

Who Will Foot the Bill?

According to some industry observers, the DIF is not a typical insurance fund but rather an emergency fund that gets drawn down when there is a bank failure and then topped off later on. The DIF itself is backstopped by taxpayer money in the form of working capital and a line of credit from the Treasury, according to a 2016 FDIC Staff Paper.

Advocates of the backstop claim that this action is different from that of the 2008 bank bailout because, in this scenario, only depositors are protected and not investors in bank shares nor unsecured creditors. However, critics see it differently. According to EJ Antoni, research fellow in regional economics with The Heritage Foundation's Center for Data Analysis, "The very idea of bailing out SVB, Signature Bank and others, without costing taxpayers, doesn't even pass the smell test. The government is spending taxpayer dollars. By definition, that costs the taxpayer."

Mr. Antoni further elaborated as to how taxpayers could be impacted: "The FDIC doesn't have enough funds to cover these losses; if it did, the Federal Reserve would not have had to establish an emergency lending fund on a Sunday evening to backstop the operation. The Fed can simply create the money to cover the losses at these failed banks, which will cause inflation, or the FDIC can do what they did in the last financial crisis and simply get the money from the Treasury, which is a direct cost to taxpayers. Either the American people are on the hook through the hidden tax of inflation or explicit taxes sent to the Treasury."

Other Bank Failures Looming?

As is always the case with major financial crises, the impact is never localized but rather becomes global. Following the SVB and Signature failures, shares of Credit Suisse fell by 30% after the bank's largest shareholder, the Saudi National Bank (SNB), decided against providing the institution with additional funding. SNB claimed

Action

1 Don't Bank on It: Just because two high-tech sector banks were bailed out far beyond FDIC limits, the average depositor should not assume that his or her own deposits will be covered against losses over $250,000.

2 Shareholders and Creditors Beware: Clients should be counseled as to the difference between the 2008 bailout and that of March 2023 as to the risk of loss for shareholders and unsecured creditors.

3 Bank Fee Pass-Alongs: As the DIF needs replenishing, both individual and commercial bank customers should expect that some of the cost will be passed along—possibly in the form of higher fees and compromised service—and the client should plan accordingly.

4 Beware the Underwater Bonds: As part of the bailout, the government took as collateral all of SVB's securities 'at par', meaning a price well beyond what they were currently worth. Should such 'underwater' securities end up being offered on the market—caveat emptor.

that regulations cap its stake at 10% and that its current 9.9% stake is approaching the limit. The SNB announcement and the resultant share plunge compounded panic about fragility in the global banking sector. However, Swiss regulators tried to assuage mounting fears, indicating that they stood ready to provide Credit Suisse with further liquidity if necessary. The regulators also emphasized that the problems facing two banks in America did not pose a 'risk of contagion' for Swiss financial markets.

Although it is hard to say whether the step taken by U.S. regulators will, in fact, become a 'trend', and whether or not it technically constitutes a 'bailout', the fact remains that the pandora's box of a new legal mechanism has been opened, and it is a mechanism that flaunts the historical role of the FDIC. Whether the government backstop will be universally applied or selectively applied depending upon the nature of a bank's primary depositors is anybody's guess.

"THE DEPOSIT INSURANCE FUND IS NOT REALLY AN INSURANCE FUND, IT IS A RAINY-DAY FUND, WHICH GETS DRAWN DOWN FOLLOWING A BANK FAILURE AND REPLENISHED THEREAFTER."

— WILLIAM LUTHER, DIRECTOR OF THE AMERICAN INSTITUTE FOR ECONOMIC RESEARCH'S SOUND MONEY PROJECT.

Further Reading

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Jeffrey Brochin, Esq.

GREENPOINT STAFF COUNSEL AND CONTENT EDITOR

After receiving his Juris Doctor degree from The John Marshall Law School in Chicago, Mr. Brochin served as an Administrative Law Judge with the Illinois Department of Labor for six years where he presided over cases dealing with job separation issues and matters pertaining to contested Unemployment Insurance claims. He also co-wrote the agency's administrative rules, and periodically served as a 'ghost writer' for Board of Review decisions.

Following that position, he was Director of Development for a Chicago-area non-profit college where he was responsible for High Net Worth donations to the institution. For the next eighteen years he practiced as a solo practitioner attorney with an emphasis in the fields of Real Estate law and Commercial Contracts transactions, and was an agent for several national title insurance agencies.

In 2003 he was recruited to head up a U.S. title insurance research office in Israel, a position he held for four years, and between 2007-2017 he participated in litigation support for several high-profile cases. He has taught Business Law as a faculty member of the Jerusalem College of Technology, and has authored a wide variety of legal White Papers and timely legal articles as a professional legal content writer for GPL clients. Separate from his legal writing, he has co-authored academic articles on Middle East security topics that have been published in peer-reviewed publications.

William H. Anderson, Esq.

MANAGING DIRECTOR

William Anderson is Managing Director and Head of Law & Compliance. He leads the GreenPoint practice in providing regulatory, legal, and technology solutions to law firms, legal publishers, and in-house law departments around the world, overseeing our team of experienced US attorneys and data and technology experts. Will has over 25 years' experience working with corporations to improve the management of their legal and corporate compliance functions. Will began his legal career as a litigator with a predecessor firm to Drinker, Biddle LLP. He then served as in-house counsel to Andersen Consulting LLP, managing risk and working with outside counsel on active litigation involving the firm.

Will has leveraged his legal experience interpreting regulations and appearing before federal (DOJ, SEC, FTC) and state agencies (NYAG) to oversee research and other areas at Bear Stearns. In this capacity, he counseled analysts on regulatory risk and evolving compliance requirements. Will also consulted on the development of a proprietary tool to ensure effective documentation of compliance clearance of research reports. Will then went on to work in product development and content creation for a global online compliance development firm pioneering the dynamic updating of regulated firms' policies and procedures from online updates and resources. Will holds a Juris Doctorate with High Honors from the Washington University School of Law in Saint Louis and is admitted to state and federal bars. He lives in Pawling, NY, with his wife and daughter.

Sanjay Sharma, PhD

FOUNDER AND CHAIRMAN

Pranav Menon, Esq.

LEGAL RECRUITMENT MANAGER AND DATA PRIVACY SPECIALIST – LAW & COMPLIANCE | GPESR

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International Corporate Center, 555 Theodore Fremd Avenue, Suite A102, Rye, NY 10580