

Navigating Bank Distress:  
*Key Considerations for  
Customers and Counterparties*

April 11, 2023



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# Overview of Financial Institution Insolvency Regimes

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# Overview of Financial Institution Insolvency Regimes

Most financial institutions are **not** eligible for traditional Bankruptcy Code proceedings.

Rather, Congress has enacted a number of different insolvency regimes for U.S. financial institutions.

These regimes are all designed to protect customers, but they have different rules and key considerations.

Some of these regimes are entirely independent of the Bankruptcy Code, while others incorporate or supplement the Bankruptcy Code.

## ALPHABET SOUP OF FINANCIAL INSTITUTION INSOLVENCY REGIMES

FDIA      SIPA      NYBL      SIPC  
IBA      OLA      FDIC      DFS

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# Two Main Kinds of Exposure

## CUSTODIAL RISK

- Risk of not recovering assets posted to, or carried by, the financial institution.
- Examples:
  - Cash deposited with a bank
  - Securities held at a bank or broker-dealer
  - Futures, cleared swaps, and associated margin held at an FCM
  - Margin pledged under an uncleared swap
- The nature of the risk depends principally upon (1) the assets at issue and (2) the insolvency regime to which the financial institution is subject.

## COUNTERPARTY RISK

- Risk that the financial institution will fail to perform its obligations under a bilateral contract.
- Examples:
  - Swaps
  - Repo
  - Securities Loan
- In this context, the principal question is whether the non-defaulting party will be able to (1) terminate, liquidate, and accelerate the transaction; (2) net amounts owing; and (3) liquidate and apply any collateral.

# Key Considerations for Customers and Counterparties

— The applicable insolvency regime will generally depend on the type of financial institution at issue.

## WHAT KIND OF INSTITUTION AM I FACING?

FDIC-Insured Bank	→	Federal Deposit Insurance Act (12 U.S.C. Ch. 16)
U.S. Broker-Dealer	→	Securities Investor Protection Act (15 U.S.C. Ch. 2B-1)
Futures Commission Merchant	→	CFTC Part 190 Rules (17 C.F.R. Part 190) and Subchapter IV of Chapter 7 of the Bankruptcy Code
NY Branch of a Foreign Bank	→	New York Banking Law
Federal Branch of a Foreign Bank	→	International Banking Act (12 U.S.C. Ch. 32)
General Corporate Entity	→	Bankruptcy Code (11 U.S.C.)

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# Federal Deposit Insurance Act (the “FDIA”)

## APPLICABLE TO

— FDIC-insured banks

## WHO TAKES OVER?

- The FDIC is appointed receiver and succeeds to all rights and powers of the bank.
- Courts only become involved in the event of litigation.

## WHAT TYPICALLY HAPPENS?

- The FDIC transfers the bank’s insured deposits, operations, and assets to another banking institution.
  - The other banking institution may also acquire the bank’s uninsured deposits.
- If the FDIC cannot immediately find a transferee, it may effect a transfer to a Deposit Insured National Bank (DINB) for a limited period of time.
- If the FDIC cannot immediately find a transferee, it may effect a transfer to a “bridge bank” for a limited period of time.
- Very rarely, the FDIC will liquidate the bank’s assets and distribute to creditors.

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# Orderly Liquidation Authority (“OLA”)

## APPLICABLE TO

- U.S. financial companies, but not banks
- OLA is **not** automatically applicable; rather, “three keys” must be turned:
  - Supermajorities of the Federal Reserve Board and of the FDIC (or SIPC in the case of a broker-dealer) must recommend OLA.
  - The Treasury Secretary must then make certain determinations, including that otherwise applicable insolvency proceedings would have serious adverse financial consequences in the U.S.

## WHO TAKES OVER?

- The FDIC will act as receiver for the institution with powers similar to those under the FDIA.
- Courts only become involved in the event of litigation.

## WHAT TYPICALLY HAPPENS?

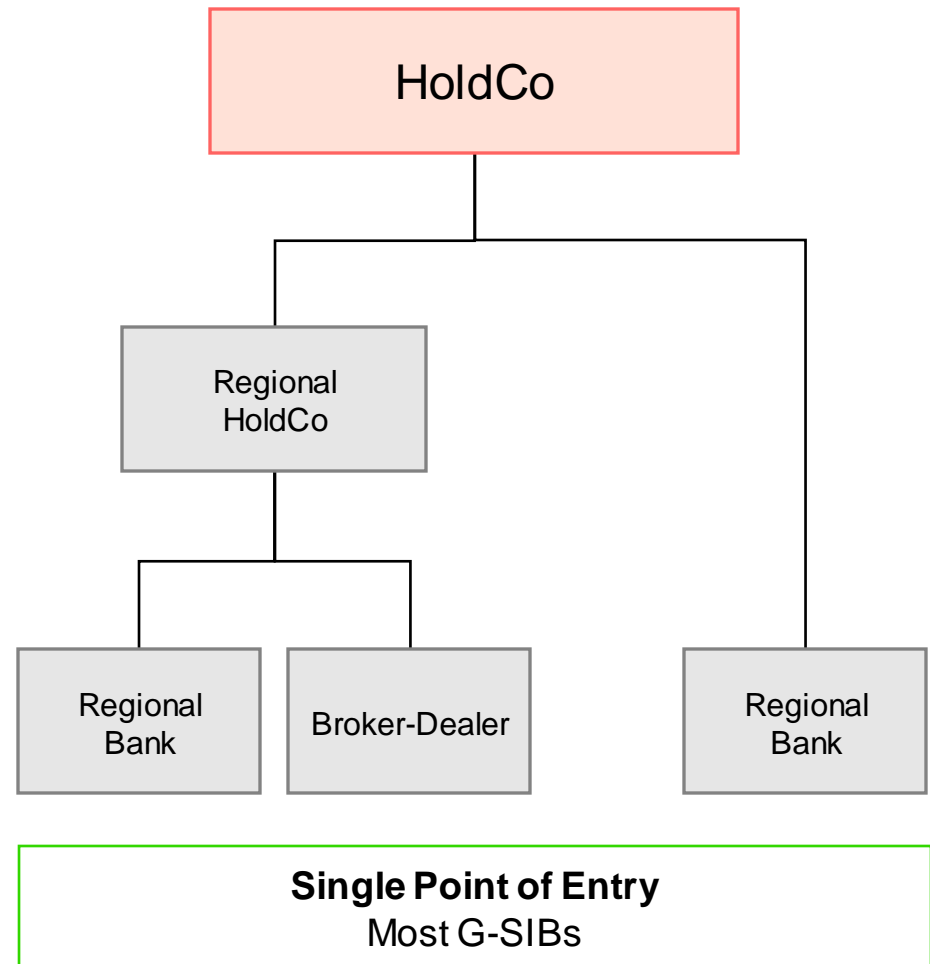
- OLA is new and was adopted as part of the Dodd-Frank Act following the 2008 financial crisis.
- U.S. financial regulators have indicated that they would only plan to use OLA to resolve the top-tier holding company of a financial company.
- In such an instance, the operating subsidiaries (*e.g.*, the bank, broker-dealer, FCM) would continue operating without disruption.



# Resolution Plans and Single Point of Entry

## SINGLE POINT OF ENTRY STRATEGY

- The Dodd-Frank Act requires large financial institutions to develop “resolution plans” that describe how the institution can be resolved in an orderly manner.
- Nearly all of these resolution plans adopt a “single point of entry” (“SPOE”) strategy under which only the top-tier holding company enters into proceedings.
  - Under these plans, the operating subsidiaries would continue providing services and meeting obligations, either in connection with a transfer to a third party or an orderly wind-down.
  - If successful, these strategies generally will limit disruption and losses to customers of the sort seen following Lehman’s bankruptcy.



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# The Bankruptcy Code (the “Code”)

## APPLICABLE TO

- General corporate entities (including bank holding companies and swap dealers that are not banks or broker-dealers).

## WHO TAKES OVER?

- The bankruptcy court administers the proceedings.
- A trustee appointed by the court or (more commonly) a “debtor in possession” operates the company.

## WHAT TYPICALLY HAPPENS?

- The debtor will be reorganized and creditor claims written down; or
- The debtor’s assets will be liquidated and distributed to creditors.

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# Securities Investor Protection Act (“SIPA”)

## APPLICABLE TO

— Most U.S. broker-dealers

## WHO TAKES OVER?

- A court-appointed trustee named by the Securities Investor Protection Corporation (“SIPC”) operates the broker-dealer.
- A bankruptcy court oversees the proceedings.

## WHAT TYPICALLY HAPPENS?

- The SIPC trustee will often seek to transfer the securities positions that the broker-dealer carries for customers to another broker-dealer.
- The trustee will liquidate the positions it is unable to transfer and all other assets of the estate and use the proceeds to pay off creditors.
- Otherwise, the proceedings are largely typical to other proceedings under the Bankruptcy Code, except that the broker-dealer is liquidated rather than reorganized.
  - Chapter 7 of the Bankruptcy Code applies to the proceedings (except to the extent inconsistent with SIPA).

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# The CFTC’s Part 190 Regulations (“Part 190”)

## APPLICABLE TO

- Futures commission merchants (“FCMs”), including dually registered broker-dealer-FCMs (“BD-FCMs”).

## WHO TAKES OVER?

- If the FCM is a standalone FCM, the bankruptcy court will appoint a trustee to operate the FCM.
- If the FCM is a BD-FCM, the SIPC trustee will operate the FCM.
- A bankruptcy court will oversee the proceedings.

## WHAT TYPICALLY HAPPENS?

- The trustee will seek to transfer all of the futures and cleared swap positions the FCM carries for customers and associated margin to another FCM.
- The trustee will liquidate the positions it is unable to transfer and all other assets of the estate and use the proceeds to pay off creditors.

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# The New York Banking Law (“NYBL”)

## APPLICABLE TO

- New York branches of non-U.S. banks.

## WHO TAKES OVER?

- The New York Department of Financial Services (“DFS”) will seize the assets of the bank in New York.
- Courts play a limited role.
- The non-U.S. bank will also be subject to proceedings in its home jurisdiction.

## WHAT TYPICALLY HAPPENS?

- Under New York’s “ring fence,” DFS will pay out creditors of the branch and return any excess to the bank’s home office.
- Due to the value of assets that banks generally maintain in New York, there are often enough funds to pay off all creditors of the New York branch.
- Any excess is returned to the bank’s home office.

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# International Banking Act (“IBA”)

## APPLICABLE TO

— Federal branches of non-U.S. banks.

## WHO TAKES OVER?

- The Office of the Comptroller of the Currency may appoint a receiver, which will likely be the FDIC.
- Courts only become involved in the event of litigation.
- The non-U.S. bank will also be subject to proceedings in its home jurisdiction.

## WHAT TYPICALLY HAPPENS?

- There have not to our knowledge been receivership proceedings under the IBA to date.
- However, similar to the New York ring fence, the receiver will likely seize all bank’s assets in the United States and use those assets to satisfy the claims of the branch’s creditors.

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# Basics of FDIA Proceedings

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# Dual Role of FDIC

## FDIC AS INSURER

- FDIC insures deposits up to \$250,000 per depositor. Insured depositors will recover their insured funds (i.e., funds up to the insurance limit) in full.
- For deposits established by a third-party broker, the FDIC may need additional time to determine the amount of deposit insurance coverage and may request supplemental information from the depositor in order to complete the insurance determination.

## FDIC AS RECEIVER

- FDIC assumes the task of selling/collecting the assets of the failed bank and settling its debts, including claims for deposits in excess of the insured limit.
- FDIC may sell the whole bank or assets of the bank in a bidding process.
- Depositors with uninsured deposits may recover all or some portion of their uninsured funds from the proceeds from the sale of failed bank assets.



# Resolution Strategies Under the FDIA

LESS LIKELY

MORE LIKELY

## LIQUIDATION

The winding down of the business affairs and operations of a failed bank through the orderly disposition of its assets after it has been placed in receivership.

## DEPOSIT INSURANCE NATIONAL BANK

The establishment of a “new” bank called a DINB to assume the insured deposits of a failed bank. The FDIC provides the depositors of a failed bank access to these deposits through the DINB. Depositors of a DINB are given a short period of time (although can be up to two years) to move their insured accounts to other institutions.

## BRIDGE BANK

A temporary national bank established and operated by the FDIC on an interim basis to acquire certain assets and assume certain liabilities of a failed bank and to operate as a “going-concern” until final resolution can be accomplished.

## PURCHASE AND ASSUMPTION

A resolution method in which a healthy institution purchases some or all of the assets and assumes the deposit liabilities of a failed bank, either out of the receivership or a bridge bank. An assuming institution’s bid may be sufficient to allow assumption of all the deposit liabilities of the failing institution, including the uninsured deposits.

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# Cash Held at a U.S. Bank

## BASIC RULES

- Customer deposits are insured up to \$250,000.
- Claims for amounts in excess of \$250,000 will have priority over the bank's general creditors.

## PRACTICAL CONSIDERATIONS

- The FDIC frequently transfers both insured and uninsured deposits to another bank or bridge institution.
- As a result, depositors generally face minimal disruption.
- However, if the FDIC does not transfer the uninsured deposits, a customer may incur losses and delays.
- One possible way to limit potential losses to uninsured deposits is to use a program that sweeps amounts in excess of \$250,000 into securities, which would not be subject to the claims of the bank's depositors or general creditors.

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# Sweep Programs

## INTERNAL SWEEPS

- Internal sweeps move funds **within** a bank (*e.g.*, from a deposit account to a money market fund account at the bank, or into a repo sweep account).
- FDIC recognizes these transfers based on the bank's end-of-day ledgers for deposit insurance purposes.

## EXTERNAL SWEEPS

- External sweeps move funds **outside** a bank (*e.g.*, from a deposit account to a money market fund account at a different bank).
- FDIC recognizes these transfers based on the **earlier of** the bank's normal cutoff time for the transfer **or** a time the FDIC itself establishes after it is appointed receiver.

- Whether the sweep is a “same-day” sweep or a “next-day sweep” also crucially affects how the FDIC views accounts on its appointment.
- It is advisable to review the particular sweep program offered by the bank to ensure the FDIC will view the securities as belonging to the customer.

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# Securities Held at a U.S. Bank or Branch

## BASIC RULES

- Securities custodied at a bank are **not** considered property of the bank and are therefore not subject to claims of the bank's general creditors.
- However, if the securities are no longer at the bank (*e.g.*, due to fraud), the claim for the return of the securities would be a general unsecured claim.

## PRACTICAL CONSIDERATIONS (U.S. BANK)

- The FDIC generally transfers a bank's custody business to another banking institution or bridge bank to preserve continuity for customers.
  - Exceptions limited to situations in which the bank engaged in fraud.
- In the event of fraud or rehypothecation, customers may not recover since their claims are unsecured claims subordinated to those of depositors.

## PRACTICAL CONSIDERATIONS (U.S. BRANCH)

- A customer will likely need to make a claim on the DFS/federal receiver to recover its securities.
- Due the large amount of assets foreign banks hold in U.S., there are often sufficient assets to meet all claims against the branch (even if the securities have been rehypothecated).

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# Margin Delivered Under an Uncleared Swap

## BASIC RULES

- The treatment of margin posted in connection with an uncleared swap generally depends on how the margin at issue is held:
  - If held with a third-party custodian, then the margin will not be considered part of the swap counterparty's estate and should be recoverable by the pledgor in the event the swap counterparty becomes insolvent.
  - If delivered to the swap counterparty and not rehypothecated, then the assets will not be considered part of the swap counterparty's estate and should be recoverable by the pledgor if identifiable.
  - If delivered to the swap counterparty and rehypothecated, the counterparty will have a general unsecured claim for the return of its assets.

## PRACTICAL CONSIDERATIONS

- Initial margin required under the uncleared swaps margin rules recently adopted by CFTC and EU regulators must be segregated at a third party.
- Variation margin is almost always rehypothecated, but claims for the return of such margin can be offset against amounts owed under the swaps.
- Any margin not required by regulation (other than variation margin) is normally rehypothecated if it consists of cash, but not if it consists of securities.

# QFC Close-Out

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# Qualified Financial Contracts in an FDIC Proceeding

QFCs are broadly defined to include securities contracts, commodities contracts, forward contracts, repos, swaps, and similar agreements.

FDIA has a safe harbor like that under the Bankruptcy Code for QFCs; however, limited by a one-business-day stay.

After being appointed receiver, the FDIC has until **5 p.m. on the following business day** to decide whether to transfer **all** the QFCs a party and its affiliates have with the bank to a bridge bank or third-party acquirer.

- If notice of transfer is received prior to 5 p.m., the party **may not** terminate its QFCs because of the appointment of FDIC as receiver.
- If notice is not received prior to 5 p.m., the party **may** terminate its QFCs because of the appointment of FDIC as receiver.
- If the FDIC sends notice that it is **repudiating** the QFCs, the party **may** terminate its QFCs at that time.

**STAY**



**TRANSFER NOTICE**



**REPUDIATION NOTICE**



**NO NOTICE**

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## QFCs in an FDIC Proceeding (cont'd)

Requirement to perform obligations under QFCs are suspended during the one-business-day stay.

— If notified of transfer, then must begin performing to the bridge bank or third-party acquirer.

It is possible the FDIC may place a bridge bank into receivership and transfer QFCs to the acquiring bank.

— The one-business-day stay also applies to this receivership.

— This occurred in the SVB resolution.

FDIC generally expects parties to continue business as usual activity under the QFCs when transferred to a bridge bank in order to preserve franchise value for auction.

— Practically speaking, the bridge bank or DINB may perform its functions more slowly than desired.

— If the bridge bank does not perform, the counterparty is permitted to terminate.

— Develop direct contacts at the FDIC to understand whether they intend to perform or terminate in case of late payment flows.



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# Credit Default Swaps

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# Credit Default Swaps Considerations

Is the distressed financial institution traded in the CDS market?

- Single name
- CDX Index
- Itraxx Index

Is the CDS cleared?

- If so, on which clearinghouse?
- Who is your clearing member?

What is the transaction type and what documentation applies?

- Obligation
- Deliverable Obligation
- Supplements (e.g., 2014 Coco Supplement to the 2014 ISDA Credit Derivatives Definitions)
- Credit Events

Is there a standard reference obligation?

- Senior
- Subordinated

Has there been a Credit Event?

- Failure to Pay
- Bankruptcy
- Governmental Intervention

How will Settlement be Affected

- Deliverable Obligations; Auction Settlement and Asset Package Delivery

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## The 2014 Definitions are hereby Amended by the Addition of New Sections 4.12, 4.13 and 4.14 as Follows:

**Section 4.12. CoCo Provision.** “CoCo Provision” means, with respect to an Obligation, a provision which requires (i) a permanent or temporary reduction of the amount of principal payable at redemption, or (ii) a conversion of principal into shares or another instrument, in each case, if the Capital Ratio is at or below the Trigger Percentage.

**Section 4.13. Trigger Percentage.** “Trigger Percentage” means the trigger percentage specified in the Confirmation (or if no such trigger percentage is specified, 5.25% per cent.).

**Section 4.14. Capital Ratio.** “Capital Ratio” means the ratio of capital to risk weighted assets applicable to the Obligation, as described in the terms thereof in effect from time to time.

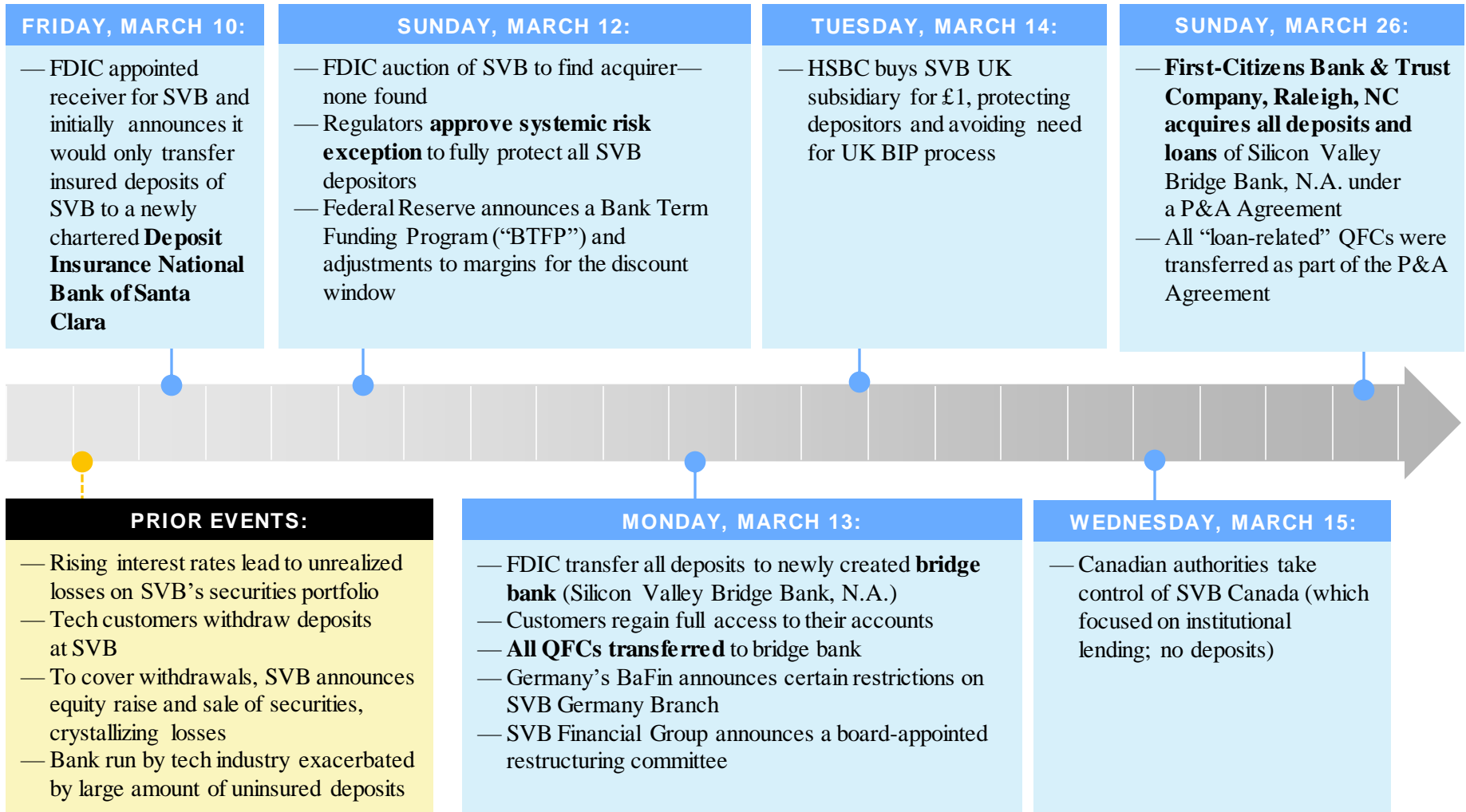
A CoCo Provision shall be deemed to be a provision which permits a Governmental Intervention for all purposes under the Definitions.

If, with respect to one or more Obligations and in relation to an aggregate amount of not less than the Default Requirement, the operation of one or more CoCo Provisions results in (i) a permanent or temporary reduction of the amount of principal payable at redemption or (ii) a conversion of principal into shares or another instrument, such event shall be deemed to constitute a Governmental Intervention falling within Section 4.8(a).

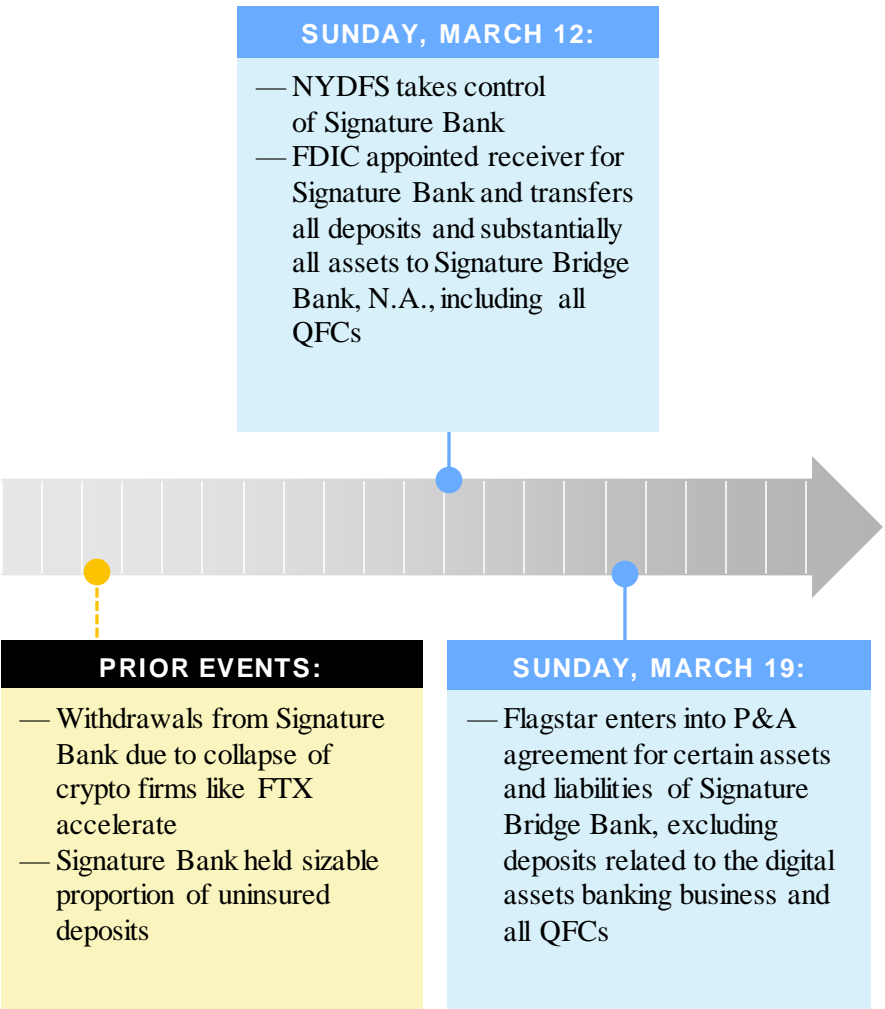
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# Case Study: Silicon Valley Bank and Signature Bank

# Case Study: Silicon Valley Bank Resolution



# Case Study: Signature Bank Resolution



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# Practical Tips

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# Summary of Practical Tips

Investigate the possibility of sweep arrangements at FDIC-insured banks for amounts on deposit in excess of \$250,000.

Diversify banking relationships to minimize uninsured deposits

Establish multiple FCM and broker-dealer relationships to facilitate porting either in the event of, or immediately preceding, insolvency.

Explore use of custody accounts (beware that cash deposited at a bank may still be considered a deposit liability)

Examine whether banks that custody securities have rehypothecation rights.

Prepare forms of close-out notices, including required affidavits for SIPC, to prevent last-minute scrambles.



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## Summary of Practical Tips (cont'd)

Review ISDAs to determine whether automatic early termination applies

Review ISDAs to determine whether the customer is a party to a multi-branch ISDA with a federal branch of a non-U.S. bank.

Ensure capability to deliver all required forms of close-out notices, including in-person delivery and that correct mailing addresses are known

Review Credit Support Annexes to understand how counterparty holds collateral that is posted to it.

If dealing with a U.S. branch of a non-U.S. bank, consider any non-U.S. insolvency regimes that may be implicated when bank defaults.

Review the public sections of your counterparty's resolution plan to see how the counterparty will be treated in the event the parent incurs distress.

For credit default swaps, check the Physical Settlement Matrix for all terms and relevant documentation that applies (e.g., 2014 Coco Supplement to the 2014 ISDA Credit Derivatives Definitions)

Check bespoke credit default swap transactions

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