ADVANCED TOPICS IN PRIVATE FUND PRACTICES CONFERENCE

Manager and Investor Perspectives

BOSTON

Thursday, June 15, 2023

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Bank Failures and Financial Contracts

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Introduction

- A Fund has a financial contract with a Federal Deposit Insurance Corporation (FDIC)-insured bank
  - Securities contract, repurchase agreement, swap agreement, forward contract, commodity contract, or master netting agreement
- The insured bank fails, as we have seen with Silicon Valley Bank, Signature Bank, and First Republic Bank
- The FDIC comes in as a receiver (FDIC-R) of the failed bank under the Federal Deposit Insurance Act, 12 U.S.C. § 1821 (the FDIA)

Goals of the FDIC

The main goal of the FDIC is to protect insured depositors

As assets of the failed bank are liquidated, the proceeds are used to pay:
secured creditors out of their collateral, administrative costs, deposits payable in the US (FDIC is subrogated to the rights to depositors whose insured claims are paid by the FDIC), general unsecured creditors, subordinated creditors, and equity

Historically, the general unsecured creditors have no or nominal recoveries (Fund does not want to be in this category)

Strategies of the FDIC

Ideally:

- Takeover is usually on a Friday evening
  - But, see Silicon Valley Bank
- Bridge bank or buyer lined up in advance
- Purchase and assumption transaction
- Business as usual on Monday morning

However:

- Buyer may not be available
- Bridge may assume only insured deposits
- Some financial contracts might not be transferred

General Powers of the FDIC-R and Related Stays under the FDIA

1	FDIC-R steps into the shoes of the failed bank and may exercise any right that the failed bank may exercise. 12 U.S.C. § 1821(d)
2	FDIC-R may enforce any contact to which the failed bank is a party notwithstanding that the appointment of the FDIC-R is a default or creates a termination right under the contract. 12 U.S.C. § 1821(e)(13)(A)
3	FDIC-R may repudiate any contact that it believes to be burdensome. 12 U.S.C. § 1821(e)
4	The FDIA imposes an automatic stay for 90 days following the appointment of FDIC-R on the power of any person, without the consent of FDIC-R, to terminate, accelerate, or declare a default under any contract to which the failed bank is a party or affect any contractual right of a failed bank. 12 U.S.C. § 1821(e)(13)(A)

Special Provisions for Financial Contracts

- One business-day stay on the right of a qualified financial contract counterparty to terminate and closeout on account of the appointment of the FDIC-R. 12 U.S.C. § 1821(e)(10)(B);
  - Stay lasts until 5:00 pm Eastern time on the business day following the appointment of the FDIC-R
  - Importance of having an insolvency default in the financial contract that will include the appointment of the FDIC-R
- During stay period, a financial contract may be transferred by the FDIC-R to a third-party buyer or bridge bank formed by the FDIC so long as all financial contracts between the Fund and the bank are transferred to the buyer or bridge bank. 12 U.S.C. § 1821(e)(9)(A)
- If the financial contracts are transferred, the termination right based on the appointment of the FDIC-R would no longer be effective.
- If the financial contracts are not transferred by the end of the stay period, the stay expires, and termination and closeout, whether automatic or discretionary, is permitted to the extent enforceable under other applicable law.

What happened with SVB, Signature, and FRB?

Silicon Valley Bank

Financial contracts were transferred first to a bridge bank and then to First Citizens Bank

Signature Bank

Financial contracts transferred to Flagstar Bank

First Republic Bank

Financial contracts transferred to JPMorgan Chase

US QFC Stay Rules and Non-US Stay Regulations

1

The US Banking Agencies* issued the US QFC Stay Rules in 2017 to improve the resolvability and resilience of the GSIBs.

2

Similar stay regulations enacted in non-US jurisdictions, all meant to address the issue of a court in one country not recognizing a resolution stay arising under the laws of another country.

3

The QFC Stay Rules required Covered Entities (GSIBs) to include contractual stay language in certain of the qualified financial contracts (QFCs) to mitigate the risk of destabilizing closeouts of those contracts.

4

ISDA Resolution Stay Jurisdictional Modular Protocol can be used to update such contracts.

* The US Banking Agencies are the Board of Governors of the Federal Reserve System, the FDIC, and the Office of the Comptroller of the Currency

US QFC Stay Rules

Require GSIBs to amend their in-scope QFCs to include provisions that limit their counterparties' termination rights and other default rights in certain circumstances.

If a GSIB enters bankruptcy, the US QFC Stay Rules eliminate contractual terms that might limit the ability to transfer the QFC to other solvent institutions during a short stay period.

A temporary stay on the counterparty's ability to access its assets/collateral could last the longer of one business day or 48 hours following the commencement of bankruptcy proceedings.

Required express recognition of the stay-and-transfer provisions by counterparties (mitigating risk of challenges in non-US jurisdictions).

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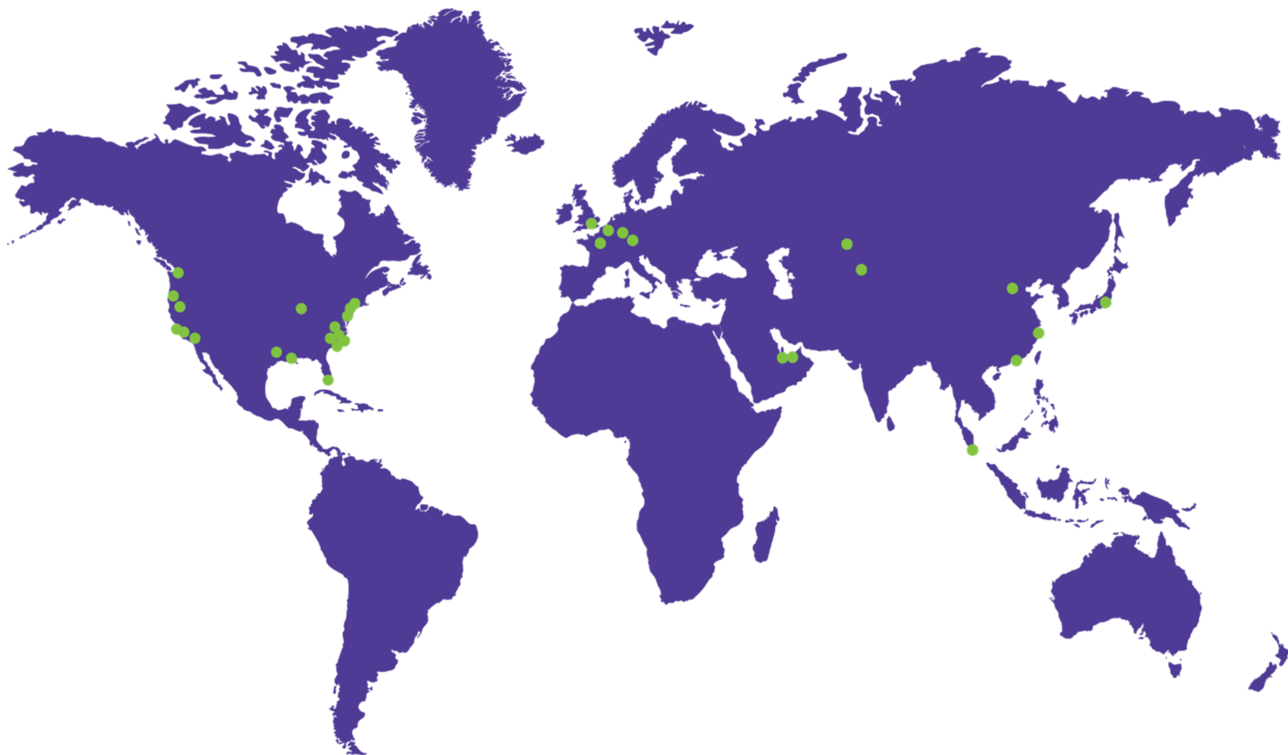

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