Silicon Valley Bank and Signature Bank Fail; Regulators Move to Limit Systemic Risk

PUBLISHED ON
March 13, 2023

On Friday, March 10, the largest bank failure since the 2008 financial crisis occurred. As events unfolded over the weekend, it became clear that the U.S. financial system was facing an extraordinary situation.

Bank failures are exceptionally rare - and as a result, most people and businesses have no experience with troubled banks and failures. But since Silicon Valley Bank ("**SVB**"), the country's 16th-largest bank, was placed into receivership on Friday after an astonishingly rapid decline, it has been impossible to escape the headlines and discussions surrounding the bank's failure. For SVB's customers and those in the tech industry, the collapse had immediate effects - but what does SVB's failure mean for the rest of the business world?

As industry participants waited for news over the weekend, unexpected news broke on Sunday night: Signature Bank, a cryptocurrency-focused bank based in New York, had also failed, and federal regulators had decided to take the extraordinary step of invoking the so-called "systemic risk exception" to protect the U.S. banking system.

What happened to SVB?
SVB was closed by the California Department of Financial Protection and Innovation, which appointed the Federal Deposit Insurance Corporation ("**FDIC**") as receiver. In order to protect insured depositors, the FDIC created the Deposit Insurance National Bank of Santa Clara ("**DINB**"). At the time of closing, the FDIC as receiver immediately transferred all insured deposits of SVB to the DINB.

The failure came at unusual speed. Less than two days before the failure, SVB had tried to convince clients - many of which were startups with large volumes of deposits -- not to pull their money over concern regarding the bank's liquidity. On Thursday, it announced plans for a capital raise. However, amid concerns over SVB's health, panicked depositors raced to withdraw their cash, causing a classic run on the bank.

In a departure from its typical practice of waiting until close of business to seize a troubled bank, the FDIC closed the bank around noon on Friday. The FDIC could not immediately find a buyer for the bank's assets and continues to work to find one or more acquirors. SVB's failure triggered volatility in the stock market, and partly in an attempt to limit the fallout, regulators closed Signature Bank on Sunday.

Why do bank runs still happen? Aren't deposits insured by the FDIC?
Bank deposits are insured by the FDIC, but only up to $250,000.

SVB had about $175 billion in total deposits, a significant percentage of which were uninsured. The FDIC had initially advised that the DINB would begin paying out insured deposits to depositors on Monday, March 13.

But because of SVB's customer base (i.e., startups and tech companies) a significant percentage of SVB's deposits were uninsured. For example, Roku announced on Friday that about 26% of its cash - $487 million, most of which was uninsured - was deposited at SVB.

Initially, the FDIC had planned to take the typical step of issuing receivership certificates for deposits in excess of the $250,000 limit, but there was no guarantee as to when, or whether, depositors with deposits in excess of the $250,000 limit would have access to their money. As depositors wondered if they would have access to their cash, on Sunday the U.S. government took the extraordinary step of invoking the "systemic risk exception," an attempt to strengthen public confidence in the banking system.

What is the "systemic risk exception"?

Generally, when a bank fails, federal law requires the FDIC to resolve the bank at the lowest cost to the Deposit Insurance Fund ("**DIF**"). While insured depositors are made whole, uninsured depositors and debt holders incur losses. By transferring some of those losses, there is less cost to the DIF.

Congress authorized one exception to the lowest-cost requirement: the systemic risk exception, or SRE. The SRE can be used if complying with the lowest-cost requirement could have serious adverse effects on the economy or financial stability. To invoke the exception, the boards of the FDIC and Federal Reserve must recommend it, and the Secretary of the Treasury, in consultation with the President, must agree with the recommendation.

The exception has only been used three times: it was used to resolve three of the four largest bank failures in late 2008 and early 2009. Now, both SVB and Signature Bank will be resolved pursuant to the SRE. This means that all depositors - not just insured depositors - will be made whole, and no losses will be borne by taxpayers. Instead, the DIF will absorb the losses.

Why are these failures significant?

Initially, SVB's failure had a ripple effect on the Silicon Valley economy because many depositors did not know when, or if, they would have access to their money. Understandably, this threw the tech industry - and the banks that service it - into turmoil.

Notably, SVB's failure followed on the heels of another announcement. On Wednesday, March 8, the holding company of Silvergate Bank, another cryptocurrency-focused bank, announced its plans to wind down and voluntarily liquidate the institution.

When news broke on Sunday night that Signature Bank, too, had been closed and placed into receivership, it became clear that the U.S. federal banking regulators had decided to move aggressively to limit the effect on the financial system. The longer-term effects of the failures will become evident in the coming days and weeks, as the FDIC resolves the banks and the public waits to see whether more banks will fail.

The failures serve as a warning for banks with operations heavily concentrated in a single industry. Both banks had concentrated customer bases - SVB in the startup and tech industries, and Signature Bank in the cryptocurrency industry. Companies including Roblox Corp. and Roku said they had hundreds of millions of dollars in deposits at SVB, almost all of which were uninsured. As a result, share prices have dropped significantly. As the details of the receiverships are sorted out, we can expect to see the impact on other companies.

What happens next for SVB and Signature Bank and their customers?

Usually, the transition from a failed bank to a new institution is seamless. For the banks' customers, most banking activities will resume on Monday, March 13.

From a legal standpoint, SVB and Signature Bank have ceased to exist. In the case of SVB, all of its assets, liabilities, and operations now belong to the DINB. In the case of Signature Bank, the FDIC created Signature Bridge Bank, N.A., a full-service bank that will be operated by the FDIC as it markets the institution to potential buyers.

The FDIC has been working to quickly identify an acquiror for the SVB DINB. Assuming one or more acquirors is identified, it is likely that the acquiror will purchase DINB and assume all deposit liabilities (both insured and uninsured). The FDIC will sell the assets of SVB, and resulting future dividends may be distributed to uninsured depositors.

Is there a risk of contagion?

Yes, but at this time, we expect the effects to be limited.

Overall, the banking industry remains healthy, and the regulatory reforms enacted as a result of the 2008 financial crisis have placed the industry in a different position than it was fifteen years ago. SVB and Signature Bank were in relatively unique positions because their customer bases were highly concentrated. There is a risk that other banks serving similar industries - startups, tech, and riskier industries such as crypto - will suffer liquidity events or other triggers resulting in their failures. Larger banks, as well as regional and community banks operating outside of those industries, tend to be more liquid and diversified, and as a result they are in a less risky position.

However, at least in the case of SVB, a bank failure is a tangible reminder to the Federal Reserve that rapid interest rate hikes can have unintended consequences. SVB was unusually sensitive to interest rate risk, but other banks may be in a similar position. Specifically, SVB bought large amounts of Treasury bonds shortly before the Federal Reserve began to raise interest rates last year, then failed to make appropriate provisions for the possibility that interest rates would rise rapidly. As the return on those bonds slowed, the availability of funding for startups also slowed, and SVB depositors began withdrawing more of their money. To pay its depositors, SVB was forced to sell some of its holdings at a loss. As more depositors requested their money back, the bank faced a classic run. While this scenario is less likely for more diversified banks, it is a reminder that despite the safeguards enacted by the Dodd-Frank Act, banks do still fail.

How does this affect banks and businesses in our region?

As previously mentioned, bank failures are exceedingly rare. There are over 4,700 FDIC-insured institutions, the vast majority of which are healthy. For the average bank customer, there is no cause for panic. Both SVB and Signature Bank served specialized, concentrated, and relatively risky industries. Most banks and financial institutions in the Mid-Atlantic region have very different customer bases and therefore are less exposed to the risks posed by a single industry.

The bank failures are a reminder, however, that individual and business bank customers should be aware of whether their deposits exceed the FDIC insurance limit. Businesses should also remain up to date on what is happening in their industries, as well as in the financial sector, to identify potential risks as they arise.

***

Barley Snyder has a team of experienced bank regulatory attorneys and business attorneys who advise all types of businesses including startups and those who may be affected by the recent bank failures. If you have questions, please contact me or any member of the Barley Snyder Business Practice Group.

WRITTEN BY:

Amanda Jabour Kowalski

Counsel

Tel: (717) 399-1515

Email: akowalski@barley.com