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USA: Trends & Developments

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Trends and Developments

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Implications of the Recent Banking Sector Turmoil for the Syndicated Loan Market

Spring 2023 saw three of the four largest bank failures in US history. After over a decade of significant reforms in the regulated financial sector, the US government was once again faced with balancing the trade-offs between the costs and consequences of providing unprecedented government backstops, on the one hand, and the risks of potential financial contagion on the other. All involved parties – including borrowers and lenders of syndicated credit facilities – faced immediate questions that for many years had been more theoretical than practical. Many of these challenges arose from the role of the Federal Deposit Insurance Corporation (FDIC) as receiver charged with resolving these failed banks.

Much has been written about the underlying causes of the failures of Silicon Valley Bank (SVB), Signature Bank (Signature) and First Republic Bank (FRB). While each has its own unique story and fact pattern, they have in common the backdrop of extraordinary fiscal and monetary policies at the time and "run on the bank" consequences hyper-charged by technological developments allowing almost instantaneous movement of a deposit base. Another unifying characteristic is their lack of similarity to the large bank failures of 2008. The issues related to mortgage origination at play in 2008 for even the largest banks no longer held true in 2023. Instead, in 2023, the failed banks' roles as agents and lenders in syndicates was at the fore.

For many borrowers and lenders who found themselves facing either the FDIC, as receiver, or a third-party purchaser from the receiver of the failed bank's assets and liabilities, navigating the contractual and statutory complexities was largely an issue of first impression. This article explores the interplay between the mechanics of an FDIC resolution and the customary contractual provisions of syndicated loan documents, and how that interaction has altered common assumptions regarding the application of those provisions in that environment. To the extent future failures of large banks reflect similar characteristics, consideration now of this interplay is even more essential for market participants.

Bank failures in spring 2023

A primary mandate of the FDIC is to insure deposits at depositary institutions. This insurance, of course, has limits, and amounts beyond those limits are not FDIC-insured. Depending on the nature of their customer and deposit base, many US banks have recently carried large balances of uninsured deposits. In 2022, the Federal Reserve initiated a steep escalation of the federal funds target rate from the near-zero rate environment that had prevailed since 2008, which subjected many portfolios of long-term fixed-rate assets to "mark-to-market" decreases. At the same time, depositors with large sums of uninsured deposits concerned about the impact of this revaluation on a bank's solvency, along with other depositors recognising an opportunity for higher return on their investment, could readily withdraw their balances away from the banks under pressure. When these withdrawals happened at scale – as they did at all three failed institutions (and as was threatened at others) – the result was a liquidity crisis. By 1 May 2023, the FDIC had taken into receivership a combined USD560 billion in assets from these three banks and announced its commitment to backstopping billions of dollars of otherwise uninsured deposits of SVB and Signature. Ultimately, the assets and liabilities of SVB were largely acquired by First Citizens Bank, those of Signature by Flagstar Bank and, finally, those of FRB by JPMorgan.

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Mechanics of FDIC receivership

A failing bank is most typically closed by its state or federal chartering authority. That regulator, in turn, appoints the FDIC as receiver. In this role, and as described in depth by John L. Douglas and Randall D. Guynn, the FDIC is required to choose a "least cost" resolution to the Deposit Insurance Fund, unless a systemic risk exception is invoked. The systemic risk exception was, in fact, invoked for SVB and Signature, but not for FRB. In most cases, the FDIC seeks bids from potential acquirers, each of which submits an offer for a specified combination of the failed bank's assets and liabilities. Historically, most banks taken into receivership by the FDIC have been smaller institutions for which the FDIC generally has time to work with potential bidders on a confidential basis for 90 days before the closure of the bank. In this typical scenario, the bank's closure and the related Purchase and Assumption Agreement (P&A Agreement) are announced contemporaneously at the close of business on a Friday. This model works well for smaller institutions, particularly ones with a retail-focused business, more limited inter-relationships with other financial institutions and perhaps a smaller institutional deposit base. SVB, Signature and FRB presented a different balance of considerations given their more complicated institutional client base and heightened risk of deposit flight. Those considerations have generally not been present in other large bank failures where the FDIC acted as receiver and, as a result, led to less awareness and opportunity to prepare for many market participants. For SVB and Signature, the FDIC took the interim step of first transferring substantially all assets and liabilities to a "bridge bank" to continue business-as-usual (to the extent possible) of the predecessor bank and to allow the FDIC additional time to conduct an orderly sales process. A bridge bank is a temporary national bank chartered by the Office of the Comptroller of the Currency (OCC) and operated by the FDIC to take over and maintain banking services for the customers of a failed bank. While the FDIC used a bridge bank for resolution of SVB and Signature, this interim step has not been the norm.

The failed bank acquisitions of 2023 were effected through P&A Agreements among the FDIC as receiver (for the failed bank or the bridge bank, if applicable), the FDIC in its corporate capacity and the acquiring bank. The assets and liabilities not purchased by the acquiring bank pursuant to the P&A Agreement remained with the FDIC. In its role as receiver, the FDIC was charged with liquidating these remaining assets, with the goal of maximising recoveries for the benefit of claimants against the receivership. Importantly, the FDIC executed the P&A Agreements with the support of its "superpowers", including the power to transfer assets and liabilities from the failed or bridge bank to the acquirer without regard to otherwise binding contractual restrictions on transfer, including contractually required consents of the borrower, agent or other parties to a loan agreement subject to transfer. In the case of SVB, the bridge bank was preceded by a deposit insurance national bank (often referred to as a DINB), which is similar to, but more limited in operations than, a bridge bank and primarily functions to provide depositors access to their insured deposits. In support of a resolution, the FDIC also has the power to disaffirm or repudiate any contract or lease if it determines that the contract would be burdensome. Likewise, it has the right to enforce contractual rights without regard to provisions that purport to terminate or alter those rights upon the institution of receivership proceedings with respect to the affected bank – so-called ipso facto clauses.

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Counterparties to failed institutions

A cornerstone of the receivership process is that, once a bank has failed, creditors of the failed bank have privity with either the FDIC, as receiver, or the acquirer. Speed is of the essence in a taking a bank into receivership, given the damage to the failed institution and the risks to counterparties and the financial system. The FDIC, thus, seeks to act as expeditiously as practicable to obtain bids, negotiate a P&A Agreement and announce a go-forward plan to restore depositor and market confidence. One consequence of this necessarily frenetic pace is that the terms of P&A Agreements – in particular the precise list of assets and liabilities transferred to the acquiring bank – may be less precise than in a similar agreement executed in a more typical, non-distressed bank acquisition. The heightened urgency of the events of 2023 only underscores that point. Working through the final allocation of assets and liabilities often takes considerable time and effort by the parties, and typically requires extensive and commercial co-operation among the FDIC, the acquiring institution and affected market participants, including lenders and borrowers. Liabilities of the failed bank may be transferred piecemeal. The precise contours of the pieces left behind in the receivership will depend upon the applicable P&A Agreement and will often not be resolved quickly, with affected market participants sometimes surprised at the resolution.

Impact on syndicated credit facilities

Most modern syndicated loan facilities include extensive provisions regarding the ability of a lender to assign or otherwise transfer its rights and liabilities under the credit agreement. These agreements also contain detailed terms and conditions regulating the relationship between an individual lender and the rest of the syndicate, including the agents administering the facility and individual lenders providing "syndicate backstopped" credit extensions, such as letters of credit and swing-line loans. They also contain certain other features that may be impacted by the failure of one of their relationship banks.

Defaulting lender

If a lender – here, a regulated bank – fails, the first-order question of that failure is whether the failed bank will continue to honour its contractual funding and other obligations. If the facility is a fully funded term loan, those obligations may principally be a backstop indemnity of the agents. But, if it is a revolving credit facility or an as-yet unfunded "delayed-draw" term loan commitment, those obligations may include funding future loans, issuing letters of credit (for a revolver) and satisfying other syndicate-level obligations as a lender. Credit facilities have long anticipated and addressed the possibility that a lender may not perform, or may not be able to perform, its obligations through the inclusion of customary "defaulting lender" provisions. Under most credit agreements a "defaulting lender" is defined to include, in addition to one that simply fails to perform its funding obligations, a lender that is subject to insolvency or receivership proceedings. Credit agreements permit borrowers to exercise various remedies against a defaulting lender, including redirecting unused commitment and other fees otherwise payable to such lenders (on the grounds that commitments of the defaulting lenders are not meaningfully "available"), "yanking" such lenders by forcing them to assign their loans and commitments to a new or existing syndicate member and stripping their ordinary course voting rights. These actions are, collectively, intended to ensure that the borrower maintains ready, regular and full access to its revolving commitments and credit facility, and to limit the adverse effect on the other lenders and agents. The credit agreement will typically

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contain similar provisions permitting lenders and a borrower to replace administrative and collateral agents under these circumstances to, again, assure the continuing function of a credit facility in accordance with its terms. This latter right takes on particular significance if a large syndicate of lenders is required to initially fund loans to the administrative agent who, in turn, transfers the collected amounts to the borrower. Where an agent is subject to a receivership, the other lenders may hesitate to send funds to the agent as intermediary if they are uncertain of if and when the funds will be transferred to the ultimate borrower. The combination of a clear contractual direction (here, lenders make funds available through an account of the administrative agent) and an uncertain legal or practical result may inhibit even the most straightforward effort by a borrower to access funds under its loan facility.

But having a contractual right and being able to enforce it can be two separate things. In the recent bank failures, borrowers and other lenders were, in practice, unable to avail themselves of defaulting lender rights and remedies, with many concluding that exercise of these ipso facto clauses was effectively stayed by the laws governing the FDIC receivership process. In the immediate aftermath, borrowers – and non-defaulting lenders and agents – were uncertain as to the ongoing operating status of the receiverships and bridge banks, including their continuing undertaking and ability to fund commitments and perform critical agency functions, yet unable to exercise the defaulting lender remedies.

In this case, the FDIC confirmed that the receiverships and bridge banks would comply with all lending and agency commitments, while strongly advising lenders and borrowers against taking any actions detrimental to the value of the failed bank assets. The uncertainty arising from the FDIC's initial silence on the treatment of SVB's assets and deposits in receivership as well as the inability of borrowers and lenders to exercise their contractual defaulting lender remedies (including with respect to SVB as agent under many facilities), however, surprised many and caused much confusion in the lending market.

Transfer restrictions

A second impact of the banking turmoil on credit facilities was the ability of the FDIC – using its "superpowers" – to assign bank assets and liabilities (including unfunded revolving commitments) first to the FDIC as receiver, to a bridge bank, and ultimately to an acquirer, without obtaining contractually required consents. A fundamental tenet of the syndicated loan market has long been that a borrower maintains tight controls over its – especially revolving – lender syndicates to ensure that only "friendly" and creditworthy institutions have access to their detailed financing reporting, the ability to exercise remedies upon a default and an obligation to fund loans subject to the contractual terms and conditions of their agreement. In particular, credit agreements almost always provide the borrower with a consent right over assignments of loans and revolving commitments, subject to limited exceptions. The FDIC's right to override this strict consent requirement in transferring assets and liabilities under a P&A Agreement resulted in borrowers, as well as agents and lenders, facing – without any notice, consent or objection rights – the credit risk of institutions with which they may have had no previous association. First Citizens Bank and Flagstar Bank (and certainly JPMorgan Chase) have, in practice, funded their commitments, acted as administrative agent and otherwise complied with the contractual obligations they acquired. While the actual fallout has thus been limited, the practical limitations on a borrower's control of its lending relationships in the context of a receivership process was an unexpected consequence to many.

Other issues

There were a number of other issues relating to credit facilities that arose from the bank failures. First, issuers of letters of credit under revolving facilities are often granted the right to refuse to issue new letters of credit to the extent there is a defaulting lender in the syndicate. While, as noted above, a borrower may generally be prohibited from exercising remedies directly against a lender as a result of an FDIC receivership, whether an issuing bank is similarly constrained by the FDIC from exercising rights against the borrower that arise as a result of the affected lender's receivership remains an open question. Second, the time between the announcement of SVB's closure and the decision to insure all deposits raised the question whether the uninsured portion of any deposits prior to any transfer to an acquirer could be viewed as unrestricted, and a "permitted" investment. Many credit agreements allow a borrower to "net" (or deduct) unrestricted cash and cash equivalents against (or from) outstanding indebtedness in computing leverage ratio covenants and conditions. These leverage ratios – which are used in syndicated (primarily leveraged) credit facilities both as a condition to the incurrence or making of debt, lien, investments and restricted payments as well as the basis of financial maintenance covenants – measure the ratio of the outstanding indebtedness of the borrower and its subsidiaries (either in total or a specific type or ranking) to the consolidated EBITDA of the borrower group. While not expressly addressed in credit agreements, lenders were forced to consider whether uninsured deposits at the receiver should be viewed as unrestricted and available as a "cash equivalent". Similarly, agreements often impose limits on a borrower's investment activities, but generally permit deposit accounts with banks with a particular credit rating. Failures of the type seen in 2023 usually occur before a bank's credit rating is downgraded, but that downgrade happens quickly after the problem is recognised. And, where the deposit is transferred to a bridge bank, even on an interim basis, that bridge bank may not have a rating at all or otherwise qualify as the issuer of a permitted investment.

Implications for the syndicated loan market

One outcome of the banking turmoil of 2023 is that it has provided market participants with a better understanding of the FDIC receivership process and greater sensitivity to the superpowers of the FDIC, including the resulting impact on the terms and conditions of and remedies under credit facilities. An open question is what the longer term implications to the syndicated lending market will arise from these new realisations.

One potential reaction of borrowers is to continue – or even accelerate – recent trends to broaden their lending relationships from banks to private credit and other institutional lenders. While, historically, such lenders were far smaller and less creditworthy than banks – and unable to provide multi-currency loans, letters of credit and other customary banking products – the private direct lending universe has grown enormously over the past few years in size, participants and the array of traditional "bank" products offered. The largest private credit institutions now rival many banks in lending capacity and have developed the infrastructure to provide (directly or in collaboration with a third party) many of the same lending products as banks. Importantly, a failure of these institutions will generally not be subject to FDIC supervision and resolution and the resulting restrictions, limitations and rights discussed above. In practice, many failed private credit lenders would likely be subject to the US Bankruptcy Code or another regime that would likely include many of the same "stay" and other prohibitions on limiting or altering the debtor's rights or exercising remedies against it. These processes – at least for Chapter 11 of the Bankruptcy Code – are, however, generally better understood by market participants than FDIC receivership/bridge bank mechanics have proved to be.

Conclusion

The bank failures of 2023 have brought into focus the interaction of the FDIC receivership and resolution process with some common features of syndicated loan documents. Market participants will want to re-examine the effectiveness of some of these provisions and consider alternative approaches to achieving the desired result. Although the FDIC had executed hundreds of P&A Agreements over the past two decades, the profile of these particular failed banks – including their size, product offering and lack of any meaningful warning signs – underscored the strength of the FDIC's statutory superpowers over a broad range of contractual counterparties and agreements. While lenders and borrowers under syndicated credit facilities will certainly seek to address the issues highlighted in 2023, the next failure or stress at a large banking organisation, will, without doubt, test a new set of assumptions for the syndicated loan and other markets.

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