

## **Regulatory Considerations For Businesses Following Recent Bank Failures**

Sam Gandhi, Michael Lewis, and Teresa Wilton Harmon  
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### **Sam Gandhi:**

Bank failures have roiled the financial sector, leaving consumers and businesses to brace for economic fallout. How did we get here, and how will policymakers respond? What are the tools businesses can use to mitigate risk, and could a crisis like 2008 be repeated? In today's podcast, we'll find out just how steady the banking system is, and whether regulators can make it any safer.

### **Michael Lewis:**

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### **Teresa Wilton Harmon:**

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### **Michael Lewis:**

This was, in a lot of ways, a classic bank run, but it was a modern-day classic bank run, and people don't have to stand in line at their branches to withdraw money. They can do it on their phone.

### **Sam Gandhi:**

Are we at the Bear Stearns moment?

### **Michael Lewis:**

I think, and I hope, that we're in a different situation than we were in 2008.

### **Sam Gandhi:**

From the international law firm Sidley Austin, this is *The Sidley Podcast*, where we tackle cutting-edge issues in the law, and put them in perspective for businesspeople today. I'm Sam Gandhi.

Hello, and welcome to this edition of *The Sidley Podcast*, episode number 33. Today, we speak with two of Sidley's thought leaders on banking and financial services, Michael Lewis and Teresa Wilton Harmon, about how the current uncertainty with banks is shaping the financial industry, the regulatory considerations, and important tools clients can harness in this new landscape.

Michael represents financial institutions, their investors, and their counterparties in connection with federal and state banking laws. He counsels clients on regulatory compliance and licensing matters, as well as on the regulatory aspects of mergers, acquisitions, and a wide range of other transactions. His experience includes advising on complex investment authority and regulatory structure questions, prudential regulation of banking organizations, and bank resolution and receivership issues.

Teresa's the managing partner of the Sidley Chicago office, a member of the firm's executive committee, and a partner in the firm's Global Finance practice. She focuses on financial transactions and commercial law, and her financial transactions experience includes secured and unsecured loans, workouts and restructurings, structured finance, and securitization. Michael, Teresa, great to have you both on the podcast today.

**Michael Lewis:**

Thanks, Sam, it's good to be on the podcast with you.

**Teresa Wilton Harmon:**

Thanks, Sam.

**Sam Gandhi:**

Michael, let me start with you. *The Financial Times* put it this way in a recent article, global dealmaking suffered its weakest start to the year in a decade, as a darkening economic outlook depressed activity, and a transatlantic banking crisis put the brakes on risk-taking. So, set the stage for us, Michael, in broad terms. What is happening, and how did we get here?

**Michael Lewis:**

So, most immediately, during the month of March, we began going through what I would call a distinct banking crisis. There were several bank failures, including Silicon Valley Bank and Signature Bank. There is a voluntary liquidation of a bank called Silvergate Bank, and we've experienced what essentially was a forced merger of the two largest Swiss banks, Credit Suisse and UBS, and that was both forced and supported with Swiss government assistance.

SVB and Signature were the second and third-largest bank failures that we've seen in U.S. history. So, these are significant failures. The FDIC-insured banks are being resolved under the Federal Deposit Insurance Act, where the FDIC comes in as receiver, and they're using a special kind of structure that we call a bridge bank, which I'll talk about later.

You know, the point of a receivership is ultimately to get assets and parts of the business that are viable back into the private sector, and that has started to occur. But there are still significant parts that are left behind, and that have to be either liquidated or sold to other buyers. So, it's an ongoing process with a lot of complexity.

For both SVB and for Signature, the FDIC invoked a special exception under the Federal Deposit Insurance Act called the systemic risk exception, where they took the very unusual step of guaranteeing the otherwise uninsured depositors at these banks. And that really has been due to the fact of the perceived market pressures that these failures were putting on the wider market.

In SVB's case, there's also a holding company and significant non-bank businesses that are being resolved separately through a bankruptcy code process. So naturally, all this turmoil with these four institutions that have failed or are being rescued has put a lot of pressure on other banks that are perceived to be at increased risks of financial distress, and that has largely in the U.S. been for regional banks, particularly regional banks with certain kinds of business models, although it has also, to some extent, affected other organizations.

Regulators and the government are naturally trying to calm the markets and stabilize things, and they've had some success doing that, and we'll talk about the methods and the programs that they're using to do that. But

also, in the more immediate term, we're getting just a slew of questions from our clients, both on the bank side and on the counterparty or customer or investor side, for how people should be thinking about what's going on in the market, how to manage their banking relationships, and how to manage credit exposure to banks if they have it.

You mentioned, Sam, how did we get here, and that's obviously a complicated story. The sort of overall, you know, process of assigning blame, or responsibility, or however you want to characterize it, is going to require some time. But there are some trends that I think have been pretty clear, at least for some of the bank failures that we've seen already, and some of the concerns in the market.

And the two that I would really point to as significant are the rising interest rate environment and the issue of bank outflows or withdrawals of deposits. So, I'll talk about rising interest rates briefly first. I think part of the problem that you had for SVB is that it held a pretty significant portion of long-maturity assets, that it acquired when interest rates were low, like treasuries and agency securities from during and shortly before the COVID pandemic. And as rates rise, those kinds of assets lose value.

Investors have an easier time finding similar securities at higher returns, with similar credit worthiness, so there's just less demand for the lower interest rate versions that were issued earlier. Of course, depending on how banks book those assets under accounting rules, whether they're held to maturity or available for sale, or held for trading, they get different accounting treatment, and they may not be required to recognize the decreased value of those assets in a rising interest rate environment.

So, effectively, what some of these banks had on their balance sheets, in the billions of dollars of value is unrealized losses that they weren't required to recognize. So, it's not that they were doing the accounting in any way that was inappropriate. It's just that that's how the accounting rules worked, and they didn't have to recognize these losses, if they were holding these assets to maturity.

Now, normally, that's not a problem, because these are good assets, putting aside discussions around the debt ceiling. People expect the U.S. government to make good on its obligations. And so it's pretty likely that

you're going to get paid your principle and interest if you can hold those kinds of assets to their maturity.

But that's where the second factor comes in that I mentioned, which is deposit outflows, bank depositors essentially withdrawing their money. And the short version of it is, if you have a lot of depositors withdrawing at once, the bank has to fund those withdrawals, and it may force them to sell some of these assets that they otherwise didn't intend to sell. And when they do that, they have to recognize their losses.

That can create, in the very short term, capital liquidity issues for those banks. Now, I do think it's worth a minute just to explain the basics of a bank deposit. I think it's relevant for this question about withdrawals, but I also think it underlies some of the discussions around FDIC receiverships that we'll have later. Basically, when you put your money in a bank account, you are entering into a debtor/creditor relationship with the bank.

The bank has your money. They owe you that money when you want to withdraw it, and in the meantime, they can use that money to fund their business activities. For example, they can make loans, or they can invest in securities. Banks, of course, are supposed to manage their liquidity risks. They are supposed to make sure that in normal times, including in other than normal times, they're supposed to be able to pay their depositors back when they withdraw, and they have to plan for that.

But we have fractional reserve banking in the United States. It's not like 100% of your money is just sitting in the bank deposit account, untouched. Banks use it to fund their businesses. And so, essentially, what you have is an IOU from the bank. Some banking laws, particularly the Federal Deposit Insurance Act, provide protections to people who are depositors, so you don't have the same kind of IOU that a general unsecured creditor of the bank would have.

But, you know, it is fundamentally that kind of a relationship. So, if a large number of depositors end up withdrawing their money in a short period of time, the bank may have to sell a lot of assets to pay for those withdrawals, and that may include some of these government and agency securities that have declined in value. In fact, that is what happened in both the SVB case and in some of the other bank failures.

It was a very fast process, and we can talk about the reasons for why it was so fast, but more than \$40 billion of deposits were withdrawn, or attempted to be withdrawn, from SVB in a single day. And the regulators really had no choice but to come in and take over the bank at that point, because clearly the losses that it would experience in trying to meet those withdrawals were going to put it into a position of not having the liquidity to be able to pay, and it would also erode their capital.

So, people may have been aware of that risk, and in fact, I think we've already seen some comments from senior leaders at the banking agencies saying that bank management and regulators were aware of these risks. But it happened in such an accelerated way, that people didn't ultimately plan for it effectively.

**Sam Gandhi:**

Michael, one of the things I wanted you to comment on is the acceleration of this that happened so quickly. We saw, in the case of WaMu in 2008, we saw this happen over the course of about 10 days, and in this case, it happened almost instantaneously, in a very short period of time, driven by digital banking. If you can comment on that, and do you think that there's any authority of the banking authorities to actually shut down an app of a bank where they think that there could be a bank run, just kind of like they'd be shutting the physical bank in that case?

**Michael Lewis:**

I think you're exactly right to raise that, Sam, because this was, in a lot of ways, a classic bank run, but it was a modern-day classic bank run, and people don't have to stand in line at their branches in person to withdraw money anymore, right? They can do it on their phone, they can do it on their computer, and settlement may take some time, but the withdrawal request can be done instantaneously.

And that was a big part of this. So, I think digital banking accelerates the pace, and you know, of course, there's also a question of, what kinds of deposits does a bank have, right? Some deposits are what we call stickier deposits, that are less likely to be withdrawn quickly. FDIC-insured deposits, for example, below a \$250,000 threshold, are stickier, because

people know that the FDIC is going to guarantee their money if they leave it in the bank, even if the bank fails.

Now, here, the FDIC ended up guaranteeing after the fact even all the uninsured deposits, but you can't count on that in every bank failure. So, retail branch banking, consumer banking, you know, people don't tend to withdraw their money as quickly. People used to have to go in person to do it. In the digital space, in the social media age, when there's Twitter and other forms of social media, where people can quickly spread rumors or fears that cause other people to withdraw their money, again, in very short notice. You can really have, I think we've realized, accelerated bank runs, which are classic in a sense, but sort of transformed in the modern era.

And as for your question about whether they can shut down an app, I think they have the authority — the FDIC has the authority under the Federal Deposit Insurance Act — to come in and shut down the bank, same way that they would do physically. I mean, they do both at the same time, and you know when that happens, they have to actually put the bank into receivership.

I'm not sure they can just stop people from withdrawing on an app without taking over the bank, but they have the authority to do that when it reaches a point where receivership is appropriate.

**Sam Gandhi:**

What's the next shoe to drop here? There are news reports that there are over \$600 billion of unrealized losses in the U.S. banking system. Is SVB and Signature a unique situation, given their deposit base and assets, or do we think that this is a pause before the next crisis?

**Michael Lewis:**

The answer is both, right? There are unique things about these two banks that exacerbated some of these risks for them. There were concentration risks in the types of clients and types of businesses that they had, cryptocurrency being one. That was especially true for Silvergate, somewhat true for Signature. Tech and venture capital clients in SVB's case, they tend to hold large amounts of uninsured deposits, which are more susceptible to these kinds of issues.

That said, I don't think these issues are entirely unique to these organizations. I think there are broader concerns in the market, particularly for other banks that have similar profiles, similar kinds of risks, with large amounts of uninsured deposits, or concentration risks in particular industries. And obviously, market participants are taking a really close look at that in a way that they haven't been up to this point.

And to your point, Sam, you said there are over \$600 billion of unrealized losses in U.S. banking system by some accounts, and that's consistent with my understanding. And that really goes back to this point we talked about, these are assets that might be credit-worthy assets, but they decline in value in this high-interest-rate environment. And that is a problem that a large number of banks have, so regulators and market participants have been looking at ways to help stabilize the system.

And we'll get to some of those issues. The Federal Reserve has the bank term funding program, which is meant to help. They've expanded the way that collateral is valued for some kinds of discount-window borrowing, and there have been efforts to bring more funding and capital to certain institutions that are at perceived increased risk.

**Sam Gandhi:**

Teresa, I want to go to you. What are the current major market issues that you see on the horizon as a result of the banking crisis?

**Teresa Wilton Harmon:**

Sam, in some ways, these events were really just a big reminder of everyday risks. They just played out in a certain set of circumstances. These risks are hidden, but they're there, right? Investment risk, counterparty risk, liquidity risk, all those issues are still facing our clients. There's also this risk that Michael alluded to, that a crisis in confidence in any part of the market, whether it's justified or not, can have an outsized effect, not just in a particular pocket, but on the global system as well.

We saw that with CS. The events are also a powerful example of two driving factors, Michael alluded to both a little bit, in our financial markets, and these risks, we have to deal with every day. The first is the legacy of managing low interest rates and the Fed's policies, monetary policies, and the second is the impact of technology. And in this circumstance, that



played out in everything, from cryptocurrency and alternative banking, to the incredible access we have now to information and to our deposits.

And also, as Michael mentioned, to social media itself. So it's not surprising that these risks bubbling through to the surface, and the crisis mentality that faced the market at that moment, really sent participants back to their toolkits. And to their lawyers, honestly, in the short run, to discover where protections were, what rights parties had under their agreements, what rights they had with respect to their accounts, and where the laws that Michael's been teaching us about might provide some protection.

And then, there's also this next step for all of us, Sam, which is trying to work out the pieces of the system that were broken. It was remarkable how quickly the FDIC, and the Fed, and the government, and the markets responded and pivoted, and tried to get back to business as usual, but there are some broken pieces that still need to get resolved and cleaned up in the receivership itself, in the insolvency proceedings that are happening, including with the Holdco of SVB, and in terms of the government intervention.

And when we look at the market, when we look at what clients need, when we look at what has to come next, that's really a big part of it.

**Sam Gandhi:**

Michael, are we back to 2008-style banking meltdown? Are we at the period where this is the Bear Sterns moment, and we've got a few more months before the larger moment happens?

**Michael Lewis:**

I think, and I hope, that we're in a different situation than we were in 2008. I mean, 2008 was fundamentally a credit crisis. People had direct or indirect exposure to certain kinds of assets, like commercial real estate and other mortgage-related assets, that turned out to be, you know, non-performing, or ended up defaulting in a lot of cases, and it created a broader problem in the system.

There was some contagion risk, obviously, with the concerns, but fundamentally, the risks that have caused some of these failures, I think, are different. As Teresa said, many of them are very traditional banking

risks. How do you manage changes in interest rates? How do you do liquidity risk management? And those are issues that a lot of banks have been on top of for a long time, and that doesn't mean that they don't need to continue paying attention and making improvements.

But that's something that banks have a little bit more control over than hidden but massive credit exposures to assets that turn out to be bad. I'm cautiously optimistic that some of the early steps the regulators have taken will help make sure that we aren't going to have a 2008-like crisis. There still may be additional bank failures, of course. I can't guarantee that there wouldn't be, but the problem with unrealized losses that we talked about is being addressed by some of the programs that the Fed has put out there.

So, the bank term funding program, for example, allows banks to pledge those assets at par value, without having to recognize those losses. So, they get funding, which they might need to fund withdrawals of depositors, or for otherwise funding their businesses, but rather than having to sell those assets at a loss, they can pledge them at their par value and get the full amount.

Similarly, under the Fed's discount window, some of those same assets can be pledged at par value now, at least temporarily, which provides similar kinds of funding. So, hopefully, that will help stabilize things for a number of institutions that have that problem. It doesn't mean there aren't other concentration risks and liquidity risks out there, but I think it's fundamentally different than 2008.

And I also think we're going to start to see, in addition to some of these broader market solutions, heightened supervisory attention, right, to particular banks. The Federal Reserve, the FDIC, and the OCC, and maybe even some of the state banking regulators, are going to be much more on top of following up with their supervised institutions on these issues in the short term.

**Sam Gandhi:**

Michael, before we move on to other issues, can you talk a little bit about receiverships, and how they've been used in some of the most recent bank failures, and maybe say a little bit more about how they actually work generally? It's not quite the same as a Chapter 11 case.

**Michael Lewis:**

You're right. It's very different, and FDIC receiverships are only applicable to the actual bank itself, the FDIC-insured bank itself, not to the holding company, or non-bank affiliates, which is why you see Chapter 11 proceedings in SVB, and why you could see them if there are other bank failures that have significant non-bank activities. Fundamentally, what happens in an FDIC receivership is, the FDIC comes in and takes over the business of the failed bank. They get rid of the senior management.

They usually get rid of the board, and they come in and actually operate the bank. They succeed by operation of law to the assets and liabilities, and the rights and obligations of that bank, and they have all the powers that the shareholders, and the board, and the senior management team would have had.

The FDIA, the Federal Deposit Insurance Act, which is the statute under which this all happens, provides some special powers to the FDIC as a receiver, including staying the exercise of remedies by counterparties in certain circumstances, allowing the FDIC to choose to perform or repudiate certain contracts, if they meet conditions about it being burdensome to execute on those contracts.

So, the FDIC can come in and kind of pick and choose what are the viable parts of the business, what are the parts of the business that have value, and they try to maximize that value in the interests of protecting the bank's depositors, and to some extent, creditors. When they do this, the ultimate goal is to get assets or the business back into the private sector, in some way.

The FDIC's not in the business of operating failed banks permanently, although historically, of course, they've had to do it for different periods of time. And they take the value they realize from selling things back into the private sector, and they pay out the bank's remaining creditors, and if there's anything left over, shareholders. There's usually not much left over, but there's a waterfall of priority that's important to understanding what people's risks are when they're dealing with a bank that is failing or has failed.

And senior, secured creditors that have perfected security interests come first, because the assets securing those credits are not really part of the bank's receivership estate. Then, the FDIC's own administrative expenses in the receivership get paid next, then they pay the insured depositors, people who have up to \$250,000 subject to the FDIC's deposit insurance rules.

After them, the bank's uninsured depositors, and then only after the uninsured depositors do general unsecured creditors get paid anything, and finally, any equity-holders would come last, and by that point, there's often nothing left over. Normally, when the FDIC goes through this process and tries to maximize the payouts to these various claims-holders, they're required to do a least-cost resolution, where they maximize the value of the bank's receivership estate.

But in the case of SVB and Signature, they actually invoked the systemic risk exception, which gets them out of having to comply with some of those requirements, so that they could guarantee not only the insured depositors get paid, but also the uninsured depositors. That was a very unusual step, and there's no guarantee that we would see that if there are future bank failures, although some of the comments from Secretary Yellen and other leaders have suggested that that might be appropriate in some cases.

So, there's a whole detailed regime, and that's administered by the FDIC under the Federal Deposit Insurance Act.

**Sam Gandhi:**

Teresa, we certainly have been dealing with this crisis when it comes to non-bank clients. It certainly was not only banks that are being affected by this crisis. What are the issues that these non-banking clients are facing?

**Teresa Wilton Harmon:**

Sam, we're seeing this play out across really a broad spectrum of our clientele. It's got such a broad reach. Our emerging company clients and our tech company clients, especially those in Silicon Valley, are really thinking about where to hold and where to deploy cash, where are there liquidity sources, where's their next set of liquidity coming from, bread and butter issues, right?

Nobody wants to have to worry about whether they can make payroll again because their bank's not available. And even for those lender banks who really want to make sure that their borrowers hold all of their cash at the bank, that's a common concept, right, because it's easier to get that loan paid back if the cash is within the reach of the bank. Even for those lender clients who were strict, strict about that, we're seeing more permission now for a percentage of a borrower's cash to be held at a different bank, at least a percentage that matches payroll or daily cash flows, just to give people that comfort.

People are looking for security. In fact, we're seeing that for all of our deposit-holder clients, right? They're looking at their counterparty risk, they're looking at their liquidity. They want to just make sure that they're in a good position. Our fund clients, including those with capital facilities, they were especially active with regional banks. They've been especially affected by this, at least in terms of their risk profile and their concerns, so they're very focused on liquidity, too.

So far, those liquidity facilities seem to be working pretty well, and we're just keeping an eye on things. It's not just bank lenders. Remember, our banks and our non-bank, commercial lenders are looking at how their bank syndicates work. A lot of bank risk happened when these banks that failed were part of a bank syndicate with other lenders. There's rules set forth. The credit facility tells you what to do.

The parties had to really understand and put those provisions into play. Lenders are thinking about how their collateralized accounts work, and they're also looking, especially non-bank lenders, Sam, at whether there are new opportunities in this market. Diversification and size are obviously seen as strengths right now, and someone who's not a bank, a private credit lender, for example, has an ability to differentiate itself from what may have happened here.

There are a lot more alternatives to banking than we had in the system in the last financial crisis. That includes those private credit lenders. It includes some technology-based solutions, and it even includes insurance companies and private equity companies, who have become more involved in providing liquidity, and all of them are looking for opportunities right now.

We've also been talking with folks, Sam, in the structured finance space and the securitization space. They're watching interest rates. They're looking for some predictability on whether rates are going down, and whether market risk is going up or down on a broader scale. They're also watching servicing and collecting in some of those deals. It is key in a securitization or a structured-finance transaction to get that cash.

If your collecting bank, if your servicer or back-up servicer is involved in a bank insolvency, that could create an interruption in cash flows, and people are looking at that. And then, Sam, there's just this ongoing waiting game. We've been playing this for a couple of years. When are we going to get off the shoulders of the economy, and either see it really heat up or really slow down?

That's important to our M&A clients. That's important to our capital markets clients, and we're still raring to go, as soon as that clarity comes in, and we'll keep watching it. We're talking a lot with our clients about that, and that includes bringing in M&A, and capital markets lawyers, and it includes bringing in restructuring lawyers, to make sure that our clients are poised either way the market goes.

**Sam Gandhi:**

You're listening to *The Sidley Podcast*, and we're speaking with two of Sidley's thought leaders in the banking sector, Michael Lewis and Teresa Wilton Harmon, about how the current crisis came about, and the issues businesses are experiencing. Let's talk about some of the regulatory considerations relating to the current climate.

*The New York Times* recently reported that an easing of regulations on mid-sized banks by the Trump administration may have contributed to the current crisis, and in fact, the Biden White House issued a statement saying the weakening of commonsense bank safeguards and supervision during the Trump administration for large regional banks should be reversed in order to strengthen the banking system.

Michael, first, is that true? And what's your view, separately, about the current regulations, and do you believe that they will be strengthened, and where do you see regulators going to try to address this problem?

**Michael Lewis:**

I think that most bank regulatory lawyers think of bank regulation as a pendulum that swings back and forth in response to political pressures and current events. And I think that there's a very long version of that, but the sort of shorter version of it is, looking at since the 2008 financial crisis, right, we had Dodd-Frank in 2010, which was a comprehensive reaction to the '08/'09 crisis.

It was a wide-ranging statute, but one of the things that it established was a \$50 billion asset threshold above which banks would be subject to a range of enhanced prudential standards, things like capital and liquidity requirements that were more robust, risk-management requirements that were more robust, resolution planning for some institutions, and things like that. That was a little bit of an arbitrary threshold, the \$50 billion threshold. I mean, it obviously, it took into account the different sizes of banks at that time.

As the industry recovered, though, in the following years, and the financial system stabilized, people came around to the view that banks were in a much stronger financial position. They had more and better kinds of capital and stronger balance sheets in the mid-2010s, and people started to also become concerned that if they were subject to too much regulation, they wouldn't be willing to lend up and down the market, and they wouldn't be able to serve their traditional and useful roles as financial intermediaries.

And so, looking at that \$50 billion threshold as banks were growing, it started to pick up a lot of institutions, and during the Trump administration, there was legislation that made its way through Congress, and was signed into law, called the Economic Growth, Regulatory Relief, and Consumer Protection Act.

And what that did is it effectively changed the \$50 billion threshold to a \$250 billion threshold, and then it gave the banking regulators the rulemaking authority to also tailor those regulatory requirements for institutions that were between \$100 billion and \$250 billion in assets, right? So, for everybody over \$250 billion, the requirements were still pretty robust. For people between \$100 and \$250 billion, it depended on the rule-making from the regulators, but it wasn't required by statute to be as robust.

And if you look at where Silicon Valley Bank and Signature Bank were, well, they were between the \$50 billion and \$250 billion thresholds at the times of their failure. So, I think there is something to that point, but you know, it obviously doesn't tell the full story. There are a lot of other factors, not just size, that impact these kinds of considerations.

But that period of the pendulum swinging back toward less regulation on the largest and mid-sized banks, you know, at least on the mid-sized banks, I should say, certainly happened. And now that we're going through another banking crisis, I think it's reasonable to expect, and I would be surprised if we don't see it swing back the way that it did with Dodd-Frank after '08, there's certainly going to be a lot of close evaluation of some of these same issues that had been debated for the last 15 years, and there are going to be things that the regulators do about that using just their rulemaking authority.

There are likely going to be things that Congress does about that through legislation, and then, there are going to be supervisory things. I mean, there's a difference between supervision and regulation. The regulators do both, but one is a public rule-making process, that's regulation, and the other, supervision, is the sort of case-by-case monitoring by the regulators of each of the banks that they supervise, and that happens largely confidentially.

It's sort of below the tip of the iceberg, the underwater part, that the regulators will certainly be doing. Now, what are some of the things that we might see that could change? People are already talking about revisiting some of those asset thresholds that I mentioned, and within that, right, we're most likely to see stronger liquidity and capital requirements, at least in terms of how you manage those risks and plan for changes in capital. We may see more robust stress testing.

We may see more robust living wills or resolution planning for some of the banks that fall in these middle thresholds. The largest banks already have the more robust standards. And the one other thing I'll just mention before I pause is, there's been a discussion about what we called the TLAC rules, the Total Loss-Absorbing Capacity rules, which apply already to the largest banks, the G-SIBs, before this immediate crisis has just happened, there



was an advanced notice of proposed rulemaking from the federal banking regulators that asked a lot of questions suggesting that they were going to apply some version of those TLAC rules to the large regional banks as well.

And I think that the crisis certainly is going to be momentum for that process, which means that at some point, we will see a proposed rule on that, and eventually a final rule on that.

**Sam Gandhi:**

Teresa, a recent analysis by *Reuters* said that as a result of the banking crisis, now big banks may get better, small banks may strain to keep up, and more regional lenders may shutdown. Do you think it's inevitable that that will happen, that smaller banks will be gobbled up by the bigger banks because of regulatory pressure? And if so, what does that mean for small depositors, and even both businesses and individuals?

**Teresa Wilton Harmon:**

Well, Sam, I think the big banks will gain some business, for sure, whether it's through acquisitions or whether it's through people moving their deposits. And the stronger small and regional banks will probably emerge ahead of the others, right? They're not all the same. There's significant differentiation in terms of strength, in terms of business models, and in terms of management among those small and regional banks.

And that's going to make a difference. The most successful small and regional banks will be able to focus on areas where they have core strength, where they have core relationships. But Sam, I don't think this is the end of small or regional banks. I've been studying them for over 30 years. They play a really important role in our economy, and they offer relationships that big banks can't.

They offer flexibility, and they offer some local market benefits that customers want. When we tilt too far towards the larger banks, people lose those benefits. They miss them, and they pull back in the other direction. You know, we learned in 2008, and again this year, that even the larger banks are vulnerable. So, size doesn't fix all of these problems, just as Michael was talking about, the pendulum or the tide of bank regulation going back and forth.

I think that the pendulum or the tide of our love of big banks versus our love of small or regional banks moves back and forth. Remember, too, that there are different levels of relationships between our large banks and our small and regional banks. Correspondent banking has been around forever, spread deposits have been around forever. There are a lot of ways that larger banks can partner and work with small and regional banks, short of shutting them down.

**Sam Gandhi:**

Michael, I'm going to ask you what you're hearing from clients regarding the current landscape, and what are they expecting from regulators, and how they expect to mitigate their risks going forward?

**Michael Lewis:**

There are sort of three categories of an answer to that question. There's the market-wide question, then there's the bank-side question, and then there's the customer/counterparty-side question. On the market-wide question, I think this is going to revive some of the debates that we've had in the past. So, for example, the debate over whether deposit insurance should stay at \$250,000, or whether it should be at some higher amount, or unlimited, or whatever.

The Dodd-Frank Act removed the statutory authority for the FDIC to raise that cap for reasons other than inflation. So, that would actually require Congressional action, I think, but nonetheless, right, Secretary Yellen and others have suggested that they can use tools like the systemic risk exception to do that on a case-by-case basis where that's warranted, to prevent wider panics or to protect depositors who should be protected for systemic reasons.

So, we're seeing that. We're seeing some of the emergency lending tools, like the bank term funding program, which is a Section 13(3) program under the Federal Reserve Act. Those tools are like what we saw for some of the tools in the '08 crisis. They're like some of the funding programs we saw during the COVID pandemic, and we'll continue to see market-wide tools like that.

On the bank side, what people are expecting and what we've been hearing from clients, you know, there are a lot of short-term efforts to shore up

balance sheets and liquidity profiles, of course. As I mentioned, the supervisory process is going to get more intense, more robust, on some of these issues, like interest rate risk, concentration risk, and the like, how much of a bank's deposits are insured versus uninsured, the idea being that uninsured is much more likely to experience a run.

And banks have come to us asking how do they get out in front of these issues? And I think, often, it comes back to governance and risk-management processes, which we help our clients with. Banks need to have comprehensive, enterprise-wide risk-management frameworks that address these kinds of risks, but in a way that's tailored to the complexity, and business activity, and size of each organization.

But there's certainly a supervisory expectation that banks will identify, measure, monitor, and manage and control those kinds of risks. We are seeing, also, on the bank side, there are some unique risks in certain areas, like with respect to cryptocurrency clients, or crypto-asset clients. Even before the immediate crisis, the federal banking regulators have been very skeptical of crypto, at least insofar as it intersects with the banking ecosystem.

And there's been a lot of guidance, including guidance that they issued just in February, the month before the crisis really kicked into gear, on the liquidity risks related to banks having concentrations of crypto-asset customers or counterparties. And they said, specifically, there's heightened liquidity risk, because the deposit inflows and outflows can be hard to predict, and unfortunately, that proved prescient.

And so, I think there are larger implications for both banks, who want to bank crypto clients, also on the customer side, right, for our clients that are crypto companies or involved in the digital-asset space. We are hearing from them that they're having trouble with their banks. I mean, the FDIC is closing, and excluded from the acquisitions of SVB and Signature back into the private sector, with First Citizens and Flagstar, they excluded the crypto businesses from those deals.

And the FDIC has forcibly closed the bank deposit accounts of crypto customers, including clients of ours, and you get mailed a check, and you have to find a new bank to deposit it. And it's been really problematic, and it

also raises questions about, will you be able to have access to the loans, and credit facilities, and other banking-type products that you need? So, there's a balance, because the regulators are clearly trying to put some hurdles between that industry or that ecosystem, and the traditional banking ecosystem.

But nonetheless, those companies are in need of banking products and services. It may come down to balancing concentration-risk issues, as a way of solving that problem for both sides. Some of the other things that we're hearing from customers and counterparties of banking organizations are, and Teresa alluded to some of these earlier, how do they manage their credit exposure to banks?

What are the actual banking products and services that they use, and how are those kinds of things documented? So, for example, you have terms and conditions for your bank deposit account. Have you read them? You may have a custody agreement. You know, a lot of our hedge fund clients, a lot of our institutional investor clients, have custody relationships with banking organizations. What does your custody agreement say?

Does it really require cash to be held separately from the bank's other assets, or can the bank deposit that in a deposit account, which raises the question of credit exposure. We've been reviewing a lot of those things for our clients. There are products that people use, and banks are often happy to offer these products, that can help limit some of that credit exposure to the bank, like sweeping money into a money market fund overnight instead of leaving it in a bank deposit.

Because if that's documented and done properly, then you effectively have, outside of the bank's receivership estate, those money market fund securities that you as the customer owned and swept into, whereas if you just have a bank deposit account, you have an IOU from the bank. There are also insured deposit-sweep programs, where you have a bank network, and you have one relationship bank, or you may have a third party that kind of acts as your agent.

But you basically syndicate out the deposits in amounts of \$250,000 or less to a large bank network, so that instead of having \$50 million in an operating account that has only \$250,000 of insurance, you actually have

all \$50 million insured, and, if you're a company that needs to make sure you can meet payroll and pay your other expenses, you can feel more confident that that money will be there.

So, there are those kinds of products and services that people are looking at, and people are interested in understanding whether their agreements provide for those things.

**Sam Gandhi:**

Teresa, let me ask you your thoughts as well. What are you hearing from clients, and what actions can they take to mitigate risk?

**Teresa Wilton Harmon:**

Sure. Well, look, like most crises, Sam, this one is played out in phases, right? There were some real adrenaline days at the beginning, reminiscent of earlier financial crises we've lived through, not our first rodeo, and reminiscent of the early days of the COVID pandemic, when we worked with the Federal Reserve Bank and with clients to forestall a crisis that some people had predicted then, that never fully played out in the financial markets.

But the market players that we work with, our clients, reset pretty quickly, shoring up their positions, as Michael talked about, looking into and using their protections to address risks that became more prominent, and looking for opportunities, whether it was opportunities to buy assets, to gain competitive advantage or to profit in the next cycle. So, now, in this phase, what we're seeing is really all hands on deck to make the most of this moment for people who can, who can capitalize on it, or at least to limit the damage for those who are most at risk.

And even though we say it's business as usual in many ways, no one can ignore what happened, and as we really touched on earlier in this discussion, no one can say that it's not going to happen again. So, going forward, we're seeing some clients right-size their risk portfolios, diversifying liquidity sources, changing the way they hold cash, reviewing worst-case scenarios in their investments, hedging, and definitely making sure they understand that their legal exposure and practical exposure is not just the words in their agreements, but it's also what might happen in an insolvency proceeding or a receivership, what words on the page don't

really play out the way we think they do when an insolvency or a receivership is involved.

Whether it's the stay Michael was alluding to earlier, or whether it's government intervention. So, as we look ahead, what we're continuing to see is some clients say, I'm hungry to buy additional investments. They're looking at the assets that are being sold, they're looking at assets that may be weak and could be shored up in the new system. Several players are having to work through integration strategies now.

They're all of a sudden the owners of new assets, whether they bought them, whether it was through a merger. They're figuring out what the next season of those businesses might look like, and we're looking again to figure out how to keep the juice moving in the financial markets, how to calm nerves, how to preserve the value of assets, this business-as-usual concept people keep coming back to.

And we're seeing it in a lot of our days, days where no one new fails, no surprises come through, and parties just continue to digest what happened, and move forward to promote their business.

**Sam Gandhi:**

I want to wrap the podcast up by asking both of you a question, which is that at the end of the day, do you think after we get a little bit past the recent situation, you see what the bank and regulators and the government tries to do, do you think there's going to be more confidence in the banking system, or do you think this is a permanent damage?

I say that only because, since the financial crisis, the price of Bitcoin has gone up substantially, and you're seeing more and more pessimism about putting your money in the banking system. Where do you see this playing out in the long run?

**Teresa Wilton Harmon:**

Sam, I think we'll see more confidence in the long run. Awareness and managing risk matter, that's what people were able to do. That scary feeling the Friday morning in the middle of the day when SVB closed, we're past that, and we know the world kept turning, and we know the markets kept moving. And yes, there were some losses, yes, there's some damage,

we can't ignore that, but we know that the system works, and we know that there are protections. Michael, what do you think?

**Michael Lewis:**

Completely agree, Teresa. I think that in the long run, there's always going to be a place for banks, and it's always going to be a significant role as financial intermediaries. It's kind of hard to envision a society existing without banks serving as financial intermediaries. And of course, to your point, Sam, people are thinking of Bitcoin and other cryptocurrencies as possible alternatives, but I don't think we've seen the real-world applications that can sort of replace the banking system.

I mean, people are going to have to be comfortable with the banking system for as long as I can see.

**Sam Gandhi:**

We've been speaking with two of Sidley's thought leaders, Michael Lewis and Teresa Wilton Harmon, about how regulation will play a role in calming the market during the current volatility in the banking sector. Michael, Teresa, great look at the financial landscape, and thanks for sharing your insights on the podcast.

**Michael Lewis:**

Thanks for having me on, Sam.

**Teresa Wilton Harmon:**

Happy to be here, Sam, thanks.

**Sam Gandhi:**

You've been listening to *The Sidley Podcast*. I'm Sam Gandhi. Our executive producer is John Metaxas, and our managing editor is Karen Tucker. Listen to more episodes at [Sidley.com/SidleyPodcast](https://www.sidley.com/SidleyPodcast), and subscribe on Apple Podcasts, or wherever you get your podcasts.

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