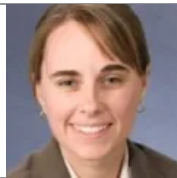


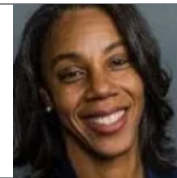
**John C. Coffee, Jr. –
The Trump Indictment:
Right Man, Wrong Crime**

1 *By John C. Coffee, Jr.*



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Skadden Discusses the Impact of Banking System Turmoil

By Sven G. Mickisch, Bao Nguyen and Simon Toms June 9, 2023

Comment

The runs on Silicon Valley Bank (SVB) and Signature Bank in March 2023 created a “very high” risk of contagion in the U.S. banking system, according to Treasury Department officials. The intervention by banking regulators, using tools approved in response to the 2008 global financial crisis, bought some time for Congress and the Biden administration to consider whether existing tools are adequate.

But the deposit outflows and resulting government-arranged takeover of First Republic Bank on May 1, 2023, have fueled continuing concerns about regional U.S. banks and have kept this issue front of mind. For now, the likelihood is quite low that new banking legislation will be enacted in the near term, but the continuing turmoil could affect the U.S. banking landscape in a number of ways.

The European banking industry has not so far been subject to the same pressures, but the U.S. problems and the failure of Credit Suisse in Switzerland are forcing a reevaluation of banking regulation and resolution processes in Europe, as well.

Here’s a high-level overview for directors of the fallout and possible regulatory responses.

Short-to-Medium-Term Concerns

Currently, the key risks to U.S. banks are:

- Continued tightening of monetary policy will likely reveal the institutions best and least able to manage interest rate risk.
- Continued high interest rates may adversely affect the commercial real estate sector and the mid-sized banks that lend to it.
- The concentration of uninsured deposits, particularly at mid-sized and regional banks (sometimes as high as 90%), will likely keep liquidity demand elevated and markets attentive to any sign of deposit flight.
- Social media and digital banking may pose existential risks to the traditional banking system, perpetuating volatility and instability for some institutions. These will not be effectively addressed by the Dodd-Frank Act process of systemic risk designation developed after the 2008 financial crisis.

M&A Implications: ‘Too Big To Fail’ or ‘Too Small To Survive’

Following the recent failures, the conversations in regional and community bank board rooms have turned toward assessing the need for more consolidation. The “too big to fail” theme that surrounded the 2008 financial crisis has shifted to a “too small to survive” theme, as smaller banks look for ways to achieve more scale.

Several forces could converge to produce more consolidation in the U.S. banking industry.

- U.S. regional banks will likely bear the brunt of regulatory “reforms,” facing more scrutiny during normal examinations and perhaps an increased compliance burden if the regulatory requirements applicable to large institutions are applied to regional banks. That could raise their operating costs and create pressure to seek economies of scale.
- One unexpected outcome may be greater willingness on the part of regulators to allow mergers by regional banks. The 2008 financial crisis and the legislation that followed accelerated consolidation. At the end of 2022, there were almost 50% fewer banking institutions with Federal Deposit

Insurance Corporation (FDIC) insurance than in 2002.

- The historical lesson is that mergers and consolidations can strengthen and enhance the stability of the regional banking sector without a corresponding increase in complexity. Additionally, allowing combinations and arrangements between community banks and financial service providers may enhance their competitiveness and long-term viability.
- Depositor flight following SVB's failure benefited the largest depository institutions, in part, due to the perception that their size and the greater regulatory scrutiny they face made them safer. Such a perception may be a factor in allowing more mergers at the regional bank level, especially if the resulting size of the institution leads to enhanced supervisory scrutiny and a larger, stronger institution.

Depositor Protections

Depository institutions with unstable depositor bases will likely keep pressure on policymakers to expand federal deposit insurance coverage or create new types of depositor protections, such as the "targeted coverage" included in the FDIC's "Options for Deposit Insurance Reform" that would provide "higher or unlimited" coverage for business payment accounts. However, while that might reduce or stop the destabilizing flight of uninsured deposits to larger banks considered too big to fail, or to money market funds, it remains unclear who would bear the cost. Consensus may be difficult to achieve.

Possible Role for Private Equity

In contrast to the aftermath of the 2008 financial crisis, we have not yet seen private equity investors play a significant role during the recent turmoil. However, given the need for new capital to support the banking sector, we expect that private equity will ultimately participate in a meaningful way. Some large private equity firms have said publicly that they are interested in providing capital to regional banks by buying loan assets.

However, we expect that financial sponsors will be selective in making investments and may be opportunistic in providing equity financing for M&A transactions that create larger and more diversified franchises.

Regulatory Recalibration

The Federal Reserve, in particular, will likely be under increasing pressure to respond to the supervisory deficiencies highlighted in its own review of the SVB failure. However, as the year progresses, it will become more challenging to balance tougher regulation of regional banks against the possibility that could cause them to contract lending.

Meanwhile, the FDIC resolution process may encounter greater congressional scrutiny as some policymakers question the bidders allowed to participate and the cost of rescues, asking if resolutions are conducted as fairly, openly and cost-effectively as possible.

The European Dimension

The three failures in the U.S. did not have a direct impact on banks in Europe, apart from the failure of SVB's U.K. subsidiary. But, together with the takeover of Credit Suisse by UBS orchestrated by the Swiss government in March 2023, they have prompted a reassessment of European bank regulation.

Credit Suisse's failure was very different from those in the U.S. It was not the result of mismanaging interest rate risk. Instead, the bank was bedeviled by a series of scandals over several years that left it in a parlous financial situation.

The implications are likely to be different in Europe. It has not seen a wave of banking consolidation because, while banking is highly concentrated in most country markets, it is fragmented across the region, with no truly pan-European institutions. And protectionist impulses tend to militate against national banking champions falling under foreign ownership.

Nonetheless, bank failures on both sides of the Atlantic have called into question the efficacy and reliability of post-financial crisis bank regulatory reforms, as well as the quality of supervision by regulatory agencies.

- The wipe-out of subordinated bondholders of Credit Suisse without shareholders first being zeroed out, under the aegis of Swiss governmental action, has led to much angst and uncertainty about the valuation of contingent convertible (CoCo) bonds and the respect for the creditor hierarchy in a distressed situation. The hierarchy was inverted in the Credit Suisse case, which has led to litigation by the bondholders. In order to shore up market confidence, other European authorities were quick to reaffirm their adherence to the creditor hierarchy, but the market is not yet convinced that governments would not interfere with the rights of creditors beyond that prescribed in legislation. As a result, broader question marks have arisen about bank resolution regimes that are designed manage bank failures and mitigate their broader effects on financial stability.
- There is also renewed focus on the depositor protection. Both the amount of depositor protection as well as the contributions to depositor compensation funds are under scrutiny. The caps on insured deposits are lower Europe than the \$250,000 per depositor in the U.S.: up to £85,000 per depositor in the U.K.; and €100,000 in Germany and France as a general matter. Any increases could be funded by one-off payments from banks, by way of levy.
- In addition, the liquidity requirements for banks are now being revisited. Rapid digital bank runs like those seen at SVB as well as concentrated and non-diversified depositor bases have almost completely blind-sided regulators, and have highlighted the inadequacies of the current regulatory standards regarding both short term and longer term bank liquidity. We expect reforms in this area at an international level to make the rules more granular and sensitive to the composition of the depositor base as well as to the nature of liquid assets maintained by a bank.

- Altering the treatment of assets poses more difficult issues, particularly where rising interest rates have left banks saddled with unrealized losses on sovereign bond holdings. Current bank regulations generally treat sovereign debt as very low risk, making it eligible for use in liquidity buffers and as high quality collateral for derivatives and other trades. If the market risks of those assets are recognized in a bank's capital base, or greater haircuts are required when they are used as collateral, that would diminish the utility of sovereign bonds for many banks, which in turn could impact the sovereign debt market. This is clearly a politically charged issue.

Conclusion

The turmoil in the banking system in both the U.S. and Europe seems far from over. The need for more capital and liquidity in the system, and the possibility of a recession, along with the regulatory and political response to the recent bank failures, make for a challenging environment for banks on both sides of the pond. Greater supervisory scrutiny may be directed at the selection of bank directors and the composition of bank boards, and encouraging their more active involvement in addressing unresolved supervisory concerns.

This post comes to us from Skadden, Arps, Slate, Meagher & Flom LLP. It is based on the firm's article, "The Impact of Banking System Turmoil: What's Next?" dated Spring 2023 and available [here](#).