Business Better (Season 3, Episode 8): Know The Facts: Silicon Valley Bank Receivership FAQs for Swaps

Speakers: Scott Diamond and Matthew Summers

Steve Burkhart:

Welcome to Business Better, a podcast designed to help businesses navigate the new normal. I'm your host, Steve Burkhart. After a long career at global consumer products company BIC – where I served as Vice President of Administration, General Counsel, and Secretary – I'm now Special Counsel in the Litigation Department at Ballard Spahr, a law firm with clients across industries and throughout the country.

The recent collapse of Silicon Valley Bank has caused concern across the country among investors, consumers, and businesses. Today, our lawyers recap on the series of events that unfolded since March 10, 2023, and answer the most frequently asked questions regarding SVB's receivership. Leading the discussion is Matthew Summers, Co-Leader of Ballard's Bankruptcy and Restructuring Group, and of the Distressed Digital Assets Team. Matt is joined by Scott Diamond, Co-Leader of Ballard's Derivatives, Structured Products, and Secondary Markets Team, and of the firm's Distressed Digital Assets team. So now, let's turn the episode over to Matt Summers.

Matt Summers:

Good morning and welcome to this podcast. I'm Matt Summers, I co-lead the Bankruptcy Group and the firm's Distressed Assets and Opportunities Initiative. With me today is Scott Diamond, a colleague in the firm's New York office, and a member of the firm's Distressed Assets and Opportunities Initiative Steering Committee. Scott is the resident expert in the firm with respect to derivatives in bankruptcy and FDIC receiverships. Prior to joining Ballard, Scott spent significant time as general counsel for a major swap dealer where he was responsible for the implementation of the Dodd-Frank Act and as well as rules with respect to qualified financial contracts, and the banks, and its affiliates' living wills required by the FDIC under the under the Dodd-Frank Act. Today we're going to be talking about how swaps will be treated in the Silicon Valley Bank receivership. Scott, could you start by giving some background on the Silicon Valley Bank situation?

Scott Diamond:

Sure, Matt, and thanks for the introduction. For the listeners, Matt and I get to work together on a number of very interesting issues. My practice revolves around derivatives and swaps. Matt's practice revolves around bankruptcy and insolvency. That is where the rubber meets the road, so to speak. In terms of background with SVB, prior to 2023, SVB had grown a significant deposit base, mostly of tech industry startups, and needed to do something positive with the money so they decided to buy long-term fixed income treasuries and mortgage bonds. On March 8th, SVB announced a $1.8 billion loss on the sale of those long-term fixed income treasuries and mortgage bonds because rates were now higher, and so in a high rate environment, the bonds that you purchased in a low rate environment are worth less. The bank also announced plans on that day to raise $2 billion in equity.

Apparently, the relatively homogenous and close deposit base decided that they did not like that. On March 9th, there were rumors of mass withdrawals and SVB's shares dropped by approximately 60% in the market. By March 10th, SVB couldn't meet withdrawal requests and the FDIC took over as the insurer. On March 12th, Treasury, the Federal Reserve Board, and the FDIC announced that SVB will be treated as an institution, which has put the U.S. economy at significant systemic risk and announced FDIC protection above $250,000 per account. March 13th, FDIC announced the creation of a bridge bank called Silicon Valley Bridge Bank, not very creative on that part but gets the point across, and transferred all of, among other things, the qualified financial contracts to that new bridge bank. For our listeners, we're recording this on March 20th, 2023.

Matt Summers:

Scott, to help our listeners level set for those that may not be as familiar with qualified financial contracts generally and swap agreements specifically, could you explain what a swap agreement generally is?

Scott Diamond:

Sure, Matt. I'm happy to do that. Actually, the last person who asked me that question was my mother about a week ago. Hopefully, she's no longer confused about the whole thing. What's a swap? It's a contract to pay the difference between two rates in the future. I'll say it again because it's a lot to take in. It's a contract. You pay the difference between two rates, rate one and rate two, in the future. It's used to hedge, manage risk, or to speculate, essentially hope to profit by future movements. I know that this is a big word, but it synthetically replicates an actual deal. What do I mean by that? Let's take an actual deal that's really easy to understand. Gold. You can buy gold at $2,000 an ounce. You can wait. If the price goes up, you can sell that gold and make a profit.

If the price goes down, you can sell that gold and lose a little bit of money. That's an actual transaction where you put your $2,000 down and then wait while that money is out there. The swap replicates that deal without putting the $2,000 down. Basically, gold is trading it $2,000 an ounce, party one agrees to pay party two $2,000 per ounce in one year. Party two agrees to pay party one, whatever the rate is, at that one year anniversary. If gold is over $2,000, party two pays party one the difference. If gold is under $2,000, party one pays party to the difference. It synthetically replicates the purchase of gold, and that can go for any asset.

Matt Summers:

What kind of swaps are we dealing here with Silicon Valley Bank?

Scott Diamond:

Here, we're dealing with a type of swap called an interest rate swap. It's very common and it is used to change a floating rate loan payment obligation into a fixed rate loan payment obligation. It works almost the same way as the very easy to understand gold swap. But since gold is tangible and interest rates aren't, it seems a little bit more confusing, although the mechanics are just exactly the same. The vast majority of commercial loans are floating rate loans, but the borrowers don't like that because they don't really know what their payment's going to be from month to month or quarter to quarter. The bank risk managers don't like that very much either because it leaves the borrowers exposed to high rate environments. The borrower agrees to pay a fixed rate of interest, let's say it's three and a half percent, depending on where it's at, at any given time, for the life of the loan.

On each loan payment date, if the rate is higher, the then quoted rate is higher than that 3%, the swap counterparty, the bank, SVB, in this case probably, agrees to pay the difference. If the rate is lower, then 3.5%, then the borrower pays the difference. Essentially, the borrower has fixed its rate, because what happens is the borrower takes that payment from SVB and use it to repay the floating rate loan. He always pays, he or she, as the borrower, his 3.56%. But the important part for this discussion is that that's an agreement that extends into the future, and that's why it's a qualified financial contract.

Matt Summers:

You mentioned that on March 12th, the Treasury Department, the FDIC, and the Federal Reserve announced that Silicon Valley Bank was systemically important. What was the effect of that announcement generally and specifically with respect to swaps?

Scott Diamond:

That decision was not one that was lightly taken because it requires a consultation amongst those agencies and it requires a consultation between the Secretary of the Treasury, which is Janet Yellen, and President Biden, in order to come to a decision to label an institution systemically important. In this particular case, that decision and label was necessary in order to lift the deposit insurance limit from $250,000 per account to anything, to infinite number.

Matt Summers:

What happens to the open interest rate swap agreements with SVB?

Scott Diamond:

To the extent that SVB had open agreements, or otherwise known as qualified financial contracts or QFCs, per the March 13th announcement, those swaps were transferred to the bridge bank. That transfer basically made the bridge bank the new counterparty to the swap and borrower. That transfer obviously required notice, and that notice was given broadly in the announcement on March 13th and will be followed up by a personal announcement to each swap counterparty or borrower.

Matt Summers:

Can interest rate swap agreements with Silicon Valley Bank be terminated because of the appointment of the FDIC as receiver?

Scott Diamond:

I would answer this one under the category of you don't always get what you pay for, but you might like what you get anyway. The answer is that no, you cannot terminate them just because of the appointment of receiver. When the swaps were negotiated, they included a provision that allowed the borrower to terminate the swap in the event of an appointment of the receiver of SVB, but the Federal Deposit Insurance Act or FDIA effectively disables that event of default by imposing a stay on the counterparty. The counterparty or the borrower here is stayed or prevented from terminating that swap.

Matt Summers:

How does the stay operate?

Scott Diamond:

Initially, there's a one-day stay from the time of the announcement of the appointment of receiver. The way it works is that they, the FDIC, usually makes these announcements on Friday afternoon, not so much to ruin everyone's weekend, which definitely has that effect, but more to give them time under the stay to create the new bridge bank. Here they announced on a Friday and the stay ran out Monday afternoon, but over the weekend, they created the bridge bank. Here, the transfers of those QFCs were made to the bridge bank during the one-day stay period. That stay then becomes permanent and indefinite in the new bridge bank. You can't look back and say, "Oh, the one-day stay is over. Now it's day three, I want to terminate the swaps that I have with the bridge bank.

Matt Summers:

Does the Federal Deposit Insurance Act require that all qualified financial contracts be transferred to a bridge bank?

Scott Diamond:

No, it does not require that all of them be transferred to a bridge bank, although that's what happened here. The FDIA, federal Deposit Insurance Act, and the rules allow for the FDIC to selectively transfer by counterparty, but 100% of the swaps of any given counterparty must be transferred and retained. There's some degree of potential, what's called cherry-picking here. That could happen where one counterparty is singled out to not be transferred to the bridge bank and have their swaps remain with the presumably insolvent bank. That's not a good outcome for that party generally. Yes, they can terminate the swap, but as a general matter, the entity that they're left with for purposes of a claim is not all that credit worthy. You'd almost prefer that your swaps get transferred. The limit to that, obviously, is that the FDIC can't cherry-pick between the swaps that a party has. Here, that's important, not so much for the borrower swaps, but for arrangements where there are multiple swaps between SVB and a counterparty.

Matt Summers:

It's interesting to me, Scott, that the treatment of swap agreements and other qualified financial contracts under the Federal Deposit Insurance Act is different than the treatment of those agreements under the Bankruptcy Code. Under the Bankruptcy Code, commodity contracts, interest rate swaps, forward contracts, and a whole list of contracts that are qualified financial contracts under FDIC parlance are specifically accepted from the stay. Why are qualified financial contracts treated differently in an FDIC receivership than they are in bankruptcy?

Scott Diamond:

I think it's a policy question. For the most part, it is very clear that they are treated differently. Commercial transactions, the policy was decided that the commercial participants deserve protection in terms of their swap so they can terminate it immediately. There's no stay with respect to bankruptcy. But we have just the opposite conclusion in the FDIC receivership that your termination rights are stayed. I think evidence is a preference for preserving the financial system and protecting depositors, in the FDIC case, that's just not present in the standard commercial bankruptcy of a swap party.

Matt Summers:

Can the swaps ever be terminated once they're moved to the bridge bank?

Scott Diamond:

Yes, there can be a termination if there's a post transfer event of default that's not directly related to the transfer itself. For example, if SVB is unable to make a payment on the next payment period, then that swap, even with the new bridge bank, would be subject determination. But you can't look back, as I mentioned earlier, at the transfer itself and say that that transfer, was the cause for your termination. I think that's probably the most interesting where there's a credit rating downgrade provision in the swap agreement. Sometimes, in these swap agreements, we'll build in a trigger that in the event that a counterparty has bad credit or the credit deteriorates below a certain point, then they can either terminate that swap or demand additional collateral. But here, since those credit downgrades relate back to the appointment of the receiver, they're disabled effectively under FDIA and the qualified financial contract rules.

Matt Summers:

What other types of contracts are also subject to the stay against termination?

Scott Diamond:

The FDIA defines these QFCs, or qualified financial contracts, to include securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements, anything else defined by the FDI\C. That term includes, interestingly, security arrangements, credit enhancements and guarantees, or reimbursement obligations, which means, in essence, that when the FDIC announces that all QFCs are being transferred to the bridge bank, that announcement effectively not only transferred the swaps, but it also transferred related loan agreements that act as credit enhancements to the swaps, as well as guarantees and collateral arrangements. The limit on that is that contracts that have something called neither default rights nor transfer rights are excluded from the definition of a qualified financial contract. A default right is a right to declare an event to default on the appointment of receiver, and a transfer Is the ability to transfer your contract in the event of an appointment of receiver.

Matt Summers:

Is the stay a good thing or a bad thing in your view?

Scott Diamond:

You know what, I kind of go back and forth on this and I think a lot of it depends on your perspective. It's definitely good in the sense that the stay allows for the orderly liquidation and probably a higher yielding resolution of the banking business.

There's no run on the banks. The depositors get paid off. It's more quick and there's a lot of benefits to that. On the other hand, viscerally, it's bad. It interferes with an agreed upon contractual right, and it creates a bit of an uneven playing field. On the whole, I think it's a good thing for the government to step in, and get a chance to breathe, and make things right for the depositors.

Matt Summers:

Thank you, Scott. Certainly is an interesting time in finance right now. We appreciate your time today. I want to thank the listeners for listening. We hope that you found this informative. If you have follow up questions or need assistance in any matters relating to the topics here or otherwise, you should feel free to reach out to Scott or me. Also, you can look at the distress banking and counterparties subpage under the firm's Distressed Assets and Opportunities Initiative. Again, thank you for your time and this brings us to the conclusion of this podcast.

Steve Burkhart:

Thanks again to Matt Summers and Scott Diamond. Make sure to visit our website, www.ballardspahr.com where you can find the latest news and guidance from our attorneys. Subscribe to the show in Apple Podcasts, Google Play, Spotify, or your favorite podcast platform. If you have any questions or suggestions for the show, please email podcast@ballardspahr.com. Stay tuned for a new episode coming soon. Thank you for listening.