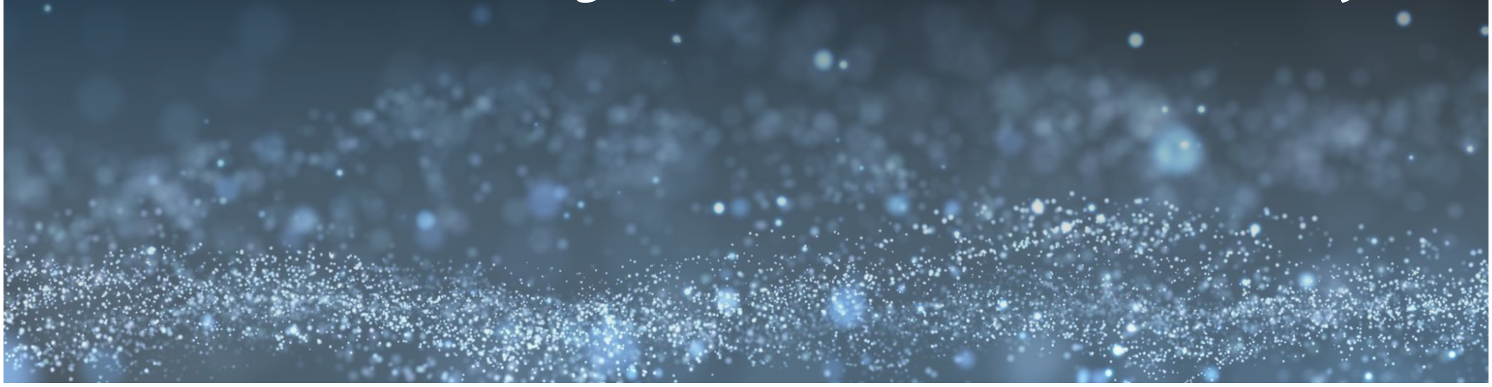
WINSTON & STRAWN LLP

CLIENT ALERT

The 2023 Banking Crisis – Considerations for Companies, Funds and Asset Managers After a Week of Uncertainty



MARCH 17, 2023

At the conclusion of a seven-day period that saw the two swiftest bank failures in U.S. banking history, an unprecedented "system risk exception" rescue from U.S. financial regulators, and the creation by the Board of Governors of the Federal Reserve System (the "Federal Reserve") of a term loan facility available to practically all depository institutions in the United States in an amount sufficient to backstop the aggregate amount of U.S. deposits nationally, U.S. and global markets witnessed another unprecedented action orchestrated by Washington: a "bail-out" of a bank by the nation's largest banks. On March 16, 2023, the Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation and the U.S. Department of the Treasury announced that 11 of the largest banks in the United States would deposit $30 billion in deposits into another mid-size California-based bank. This action is the first of its kind and represents the need by U.S. financial policy-makers to (i) restore confidence in the U.S. banking system and (ii) implement creative solutions that avoid of moral hazard and the perception of government intervention.

The events of the last week and ongoing market uncertainty have caused larger companies, funds and asset manager that place large deposits (i.e., deposits well in excess of the current $250,000 federal deposit insurance limit per depositor applicable to all insured depository institutions in the United States) to ask what they should do with their deposits going forward. We believe that the following steps will become important ones for cash-incentive companies, funds and asset managers to consider taking:

1. *Deposit Diversification Strategy*. The events of the last week have served as a wake-up call that not all eggs should be placed in one basket. This is not to say that firms should place deposits in hundreds of banks to have every deposit dollar insured up to $250,000 – which is impractical – but it is to say that it is prudent to examine critically where deposits are placed and mitigate bank failure risk by spreading deposits into at least a few banks and/or properly utilize cash management strategies such as sweep accounts to avoid undue concentrations in a single depository institution.

2. *Stress-Testing Your Depository*. Since time immemorial, banks, as part of their credit risk underwriting practices, have reviewed their borrower-customers' financial and managerial ability to repay loans or other extensions of credit. In more recent decades, banks, as part of their know-your-customer intake process, have done due diligence on new customers to mitigate money laundering and terrorism financing risk. However, the opposite –

i.e., the customer performing “reverse” due diligence *on its depository institution* – rarely takes place. Transaction deposits are effectively loans made by the customer (as lender) to the bank (as borrower), that are callable on demand by the customer-lender in part or in whole. Banks have a legal and contractual obligation to repay that “loan” when the customer demands it, based on the expectation that liquidity is available at the bank to honor that demand, but based on the concurrent hope that not all customers are going to demand repayment of their “loans” to the bank at the same time. We believe that, as a result of the 2023 Banking Crisis, many larger companies, funds and asset managers will begin, as a best practice, to conduct stress-testing and other financial due diligence of their own on banks that they deposit funds into – the exception of course, being the very largest money center banks that are identified as systemically important banks that are subject to federal regulatory stress-testing. This due diligence should be done pursuant to policies and procedures where a firm’s deposit decision, based on an assessment of publicly available financial information, is documented, and then annually revisited and risk-appetite adjusted, as appropriate.

3. *Cash Collateral Review*. Entities that are borrowers should review whether they maintain large cash deposits pledged as collateral to secure an extension of credit from a bank and in what types of accounts such cash collateral is maintained, in order to assess to what extent the security would be deemed to be “a deposit account” for FDIC deposit insurance purposes. If in the event of the bank’s failure. If the depository institution fails, will the borrower be able to direct the failed institution to set-off against the entire portion of cash collateral that is uninsured against the unpaid principal and accrued but unpaid interest on the credit?

4. *Sweep Accounts*. Entities should review their overnight sweep account arrangements at their banks and ascertain how these arrangements are treated on the books and records of their bank, such that if the institution fails, would the FDIC consider the account to be a deposit account subject to the federal deposit insurance limit of $250,000 – or an off-balance-sheet item that is not subject to deposit insurance but is also not treated as a deposit account?

Please consider these items and contact your Winston & Strawn attorney if we can answer any questions.

John Huang, Founding & Managing Partner, YuandaWinston, also contributed to this client alert.

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