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The Fed's $4 billion gift to Silicon Valley Bank's bondholders

By Thomas Moers Mayer | January 16, 2024

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On March 10, 2023, the day regulators seized Silicon Valley Bank, the $3.3 billion in bonds of its holding company, SVB Financial Group (SVBFG), traded in the low to mid 30s. When SVBFG filed its Chapter 11 a week later, SVBFG bonds traded up 30 points to the low 60s — because SVBFG reported $4 billion in holding company assets, including a $1.93 billion bank deposit after Treasury Secretary Janet Yellen waived the $250,000 limit on deposit insurance.

So, the parent company bondholders look to walk away with $4 billion when the Federal Deposit Insurance Corp. projects a loss of $16.1 billion.

The Federal Reserve could get that $4 billion for the FDIC. Since 1983, Regulation Y has required holding companies to serve as a "source of strength" for their banks. In 1990 the Fed used Reg Y to compel MCorp to contribute $17 million to its bank.

Or at least, the Fed could try. In 2010, Section 616(d) of the Dodd-Frank Act directed the Fed and the FDIC to require holding companies to serve as a source of strength for their banks.

The Fed has done nothing.

The Fed claims to have closely monitored Silicon Valley Bank throughout 2022. In December of 2022, Silicon Valley Bank borrowed an unprecedented $15 billion from the Federal Home Loan Bank of San Francisco, and the Fed had to know about that because Home Loan bank loans impair collateral otherwise pledged to the Fed. In February 2023, The Fed's staff used Silicon Valley Bank in a presentation to the Fed's Board of Governors as an example of interest rate risks to banks.

And the Fed knew that SVBFG had substantial assets other than its stock in the bank, including its huge deposit at the bank, because SVBFG, like all large holding companies, files stand-alone holding company financial statements on Form FR Y-9LP.

Yet at no time did the Fed require SVBFG to execute an enforceable agreement to maintain the capital and liquidity of Silicon Valley Bank. This is only the latest Fed failure to enforce its own source-ofstrength requirement.

The FDIC has been getting capital and liquidity maintenance agreements for 40 years, and in 1990 Congress made those agreements specifically enforceable against a bankrupt holding company: The agreement must be assumed by a holding company immediately in its Chapter 11 case. The agreement must involve the holding company, the regulator of its bank and the FDIC.

The Fed has often obtained a "memorandum of understanding" for a holding company to serve as a source of strength. The Fed has often obtained a stipulated "cease-and-desist order" compelling compliance with an FDIC capital plan.

But the Fed has been incapable of drafting a memorandum of understanding or a cease-and-desist order to meet the simple requirements for enforcement in bankruptcy.

The Fed agreements do not bind the holding company to maintain bank capital — the Fed agreements bind the board of directors to cause the bank to maintain its capital. As one court put it, that's a statement of managerial intent — not an agreement binding the holding company to support the bank.

Worse, the Fed may get the holding company directors' agreement to cause compliance with an FDIC plan — but the Fed does not make the FDIC a party to the agreement or cease-and-desist order, so the FDIC cannot enforce it. Only the Fed can. And the Fed doesn't.

The Fed does not show up in bankruptcy court to enforce its own orders — even though the Supreme Court, in the 1990 MCorp case, held that the Fed's administrative proceedings are not stayed in bankruptcy.

In light of this dismal record of bad lawyering, it's not surprising that the Fed presented SVBFG with a draft "memorandum of understanding" that did not even purport to be a binding agreement, was directed to SVBFG's board (not SVBFG itself), did not make the FDIC a party and was never signed.

Finally, when the Dodd-Frank Act of 2010 directed the Fed and the FDIC to require holding companies to serve as a source of strength, it also directed the agencies to adopt rules enforcing that requirement no later than 2012. No agency did so until the FDIC in 2020 adopted a regulation which requires holding companies of industrial loan banks to transfer assets to their banks at the FDIC's direction.

The Fed has, again, done nothing — it has adopted no rule even though every year the Fed's "regulatory agenda" predicts the adoption of a rule in the coming year.

What the Fed has done is propose a new rule requiring each large holding company ($100 - $700 billion of assets) to issue long-term debt in an amount approximately equal to its required capital, and then on-lend that amount to its bank on a deeply subordinated basis.

This proposed rule would effectively require each holding company to prepay its source-of-strength obligation to its bank. It is a return to long-repealed "double-liability" bank statutes which had required shareholders to make good any capital shortfall, up to the par value of their stock.

The proposed rule does not apply to bank holding companies under $100 billion or to the giant "global systemically important banks" over $700 billion. The most that can be said is that each GSIB has pledged some liquid assets to the support of its material subsidiaries pursuant to internal support agreements. As publicly described, these agreements would not qualify for immediate enforcement under the Bankruptcy Code, would not necessarily support a GSIB's bank (as opposed to nonbank subsidiaries) and do not provide any "strength" to a GSIB's bank from the value of the unpledged equity in the GSIB's nonbank subsidiaries.

The Fed needs no additional authority to enforce the source-of-strength doctrine. The Fed can simply require bank holding companies to sign capital and liquidity maintenance agreements enforceable by the FDIC in bankruptcy. This requirement would surprise no investor. Publicly traded bank holding companies have disclosed that their obligation to serve as a source of strength "could require [the holding company] to provide financial assistance to its bank subsidiary at a time when it would not wish to do so."

In sum: Congress dealt the Fed enough cards to enforce the source-of-strength doctrine. The only mystery is why the Fed does not use the cards it was given and directed to play.

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