RegCORE Client Alert

In the (European) eye of the storm – securing clarity and certainty in times of crisis and market turmoil

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Financial Services

Key legal considerations following first quarter 2023 failures of fintech focused financial services firms

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QuickTake

This Client Alert is dated as of 13 March 2023 and comes after a range of resolution actions that have been taken in the US, the UK and equally certain measures that have been taken in the EU-27 since Friday 10 March 2023 in response to three bank closures including the US' largest bank failure since the 2008 financial crisis (**GFC**). The speed of collapse has roiled global markets, left billions of euros belonging to companies and investors stranded along with a raft of (competing) contractual claims in need of clarity. While such recent failures during the first quarter of 2023 may, in itself, not (currently) be a signal of systemic risk nor widespread contagion, they are not just a storm in a teacup but rather a stark reminder of idiosyncratic risk. They are also a reminder of the necessity of firms to proactively apply good counterparty and credit risk along with legal and regulatory risk management in limiting concentration risk in direct/indirect exposures. This Client Alert assess some of the key legal and regulatory considerations from an EU-27 perspective in particular as the post-GFC crisis management playbook may need some tweaking and firms should consider their legal options.

This time is however different to the GFC, in that the financial services supervisory architecture in place today has contributed to (comparably) greater resilience of complex as well as systemically important financial institutions. Despite that, small and/or non-complex financial institutions (**SNCIs**) are at times no less risky than their global peers. They too can contribute to risk propagation channels i.e., from traditional but more recently cryptoasset markets as well as tech/fintech specialists focused exposures to the real economy (i.e., from Wall Street/Silicon Valley to Main Street) and thus market turmoil. Compounding this problem is the issue that a greater number of SNCIs but also corporates are failing, at a more rapid pace and faster downfall speed although this in particular may be the first social media driven bank run.

EU and national competent authorities (**NCAs**) as well as their global peers are expected to step up supervisory scrutiny and engagement across all corners of financial markets more generally and not just SNCIs. Lending standards across the board may tighten further and counterparty (credit) risk appetite for traditional and digital asset focused financial markets will remain very much a priority. This will likely apply regardless of how the markets play out in processing the most recent failures. That being said, these developments may also present a number of interesting commercial opportunities for better positioned firms.

This time is different…

The current situation unfolding in traditional and digital asset markets is different to that of the GFC. A widespread fallout in traditional financial services and notably amongst larger banks is unlikely but further pressures may continue for SNCIs and corporates (large and small – in particular start-ups and small to medium sized enterprises (**SMEs**) relying upon them).

Nevertheless, several types of market participants are facing a breadth of differing (often competing) contractual conditions and counterparty exposures to SNCIs as well as broader commercial dangers as the current scenario and supervisory response continues to evolve. Rising interest rates have affected traditional securities and for many this has meant uncrystallised losses have grown. The same is also true in respect of even higher volatility across digital asset markets. This, coupled with higher levels of uninsured deposits (i.e., above the applicable depositor and/or investor compensation scheme protection levels) at specialist smaller banks with a tech, fintech and/or digital asset focus and non-diversified business model have compounded the speed of the most recent failures. This comparably faster speed has blindsided the (traditional) banking industry after years of stability since the GFC.

Equally, corporate defaults have been rising as pandemic economics have been phased out. With defaults rising, the focus is also firmly on less visible private debt markets which have grown to record levels. During a low-rate world, the predominant floating rate nature of financing on offer appealed to borrowers (low cost) and investors (higher yield) alike but in tackling inflation central bank rate rises has introduced new challenges across financial markets including real estate markets and mark downs of valuations.

All of this has equally raised concerns about the stability as well as adequacy of supervision of the tech sector overall, notably in respect of BigTech firms, many of whom have been gradually reversing pandemic-era exuberance, cutting jobs after years of hiring. This is particularly, the case as tech sector companies are often not cashflow positive during their growth phase and often are required to rely on cash on deposits to cover their day to day costs.

Many businesses and founders are concerned about the availability of credit lines and day-to-day cash management decisions, as well as potentially significant cash deposits maintained with US, UK but also EU-27 operations of already failed banks or those other financial services firms at risk of being caught up in the initial wake from the 10 March 2023 weekend or any subsequent spillover effects. In addition to their concerns about their portfolio firms, institutional investors are concerned about their own cash deposits, practical issues about risk management, and the concerns of their limited partners in the current scenario.

Different to the GFC, the most recent failings are unlikely to cause contagion across the traditional banking sector, although pressures on market prices may remain, the immediate concern is that the fallout from failures may adversely impact tech firms – in particular start-ups and a range of institutional as well as non-institutional investors in that sector. This could cause adverse risks and a ripple effect.

The tech sector is highly interconnected. The loss of (uninsured/non-segregated) deposits has the potential to hamper the tech/start-up sector as many businesses could be at risk of technical insolvency. That could cause further woes if a wave of insolvencies drive (further) failures across the sector. That can and already has spilled over to non-tech (at least in the traditional sense) companies which many households around the world use. Ecommerce company Etsy, which sells products made by its customers, sent out an email stating that scheduled deposits would be halted. Streaming company Roku disclosed it had over 25% of cash and cash equivalents at one of the failed banks under US receivership proceedings. This comes in addition to a range of non-tech companies emerging with direct exposures, but prospects may worsen if further tech companies and in particular cryptoasset focused companies run into direct difficulty with recent failed banks and thus case further direct and indirect risk exposures for further non-tech companies and the “real economy”. Funding rounds may come to a (temporary) pause but also layoffs/furloughs may follow at certain companies.

In addition, many investors may seek to move from finger pointing on who contributed when to market confidence breakdowns in traditional as well as digital asset markets, thereby accelerating the speed of recent failures, to instead sue tech firms as well as possibly regulators for possibly not having been fast enough to step in. The same will also focus on commencing contentious proceedings against the executive management of respective failed banks. Regulators may also seek to investigate and possibly commence enforcement on whether certain institutional investors may have acted inappropriately in terms of market communications and whether that, in particular with respect of material non-public information constituted market abuse breaches.

What firms should consider doing now

The following presents a non-exhaustive list of considerations that firms will want to review, apply or otherwise speak to their usual PwC Legal Business Solutions or PwC contacts to review, update and then execute a playbook tailored to their specific circumstances as they unfold for the weeks and months that follow the 10 March 2023 weekend. Such playbook may differ in the EU-27 (in particular given the multitude of Member States involved) than applied outside of the EU, notably in the UK and US.

Considerations of clients with exposures to recently failed firms

The following considerations however are likely to be relevant in light of common problems for all counterparties that have used any of the recently failed banks and financial services firms, whether in respect of their EU operations, their UK entities or their US headquarters. Affected parties should consider that:

1. Cash deposits (whether uninsured or insured) held with a failed bank in resolution or other form of regulatory led action are expected to be frozen, restricting a business' ability to access cash and make payments;

2. Whilst any loans/revolving facilities from a failed bank may not become automatically repayable, undrawn facilities are likely to be frozen;

3. Businesses with broader banking relationships with a failed bank may find other services and transactions impacted, severely restricting operational capability (e.g. payroll, payment processing, etc. but also through to financing research and development in the fields they may be active in i.e., ranging from tech to life sciences). This also has "second order impacts" in particular where those firms also themselves service wider aspects of the real economy as well as regulated financial services firms. As an example an impacted cyber-security firm that has trapped deposits with a failed bank may itself be (a) technically insolvent; and/or (2) required to cease or cancel services that it offers its own clients – in particular financial services firms, thus making the latter more prone to challenges. For cryptoasset services providers, in particular stablecoin issuers with reserves formerly held with failed banks that are now trapped deposits at recently failed banks, this may cause instability in confidence and stability of stated stablecoin pegs as well as more broadly the proof of reserves of such cryptoasset service providers;

4. In the immediate term, we recommend that management teams and owners focus on the short-to-medium term liquidity needs of their business, following five key actions:

    a. Create and maintain a daily receipts and payments cash flow which forecasts at least a month ahead, and ideally 13 weeks;

    b. Identify upcoming cash inflows and urgently consider new banking relationships to ensure they are redirected to deposit accounts held with more robust providers;

    c. Review and prioritise cash outflows to preserve liquidity and create sufficient time to prepare a contingency plan;

    d. Engage with key stakeholders as early as possible - provide regular updates to investors, lenders, suppliers, customers and staff. Engage proactively to communicate an action plan; and

    e. Consider options for alternative banking providers, sources of capital and emergency bridge financing. Prepare your own onboarding and KYC documentation now and also consider possession of material non-public information regarding adverse exposure in connection with insider trading policies, ad hoc notification and disclosure requirements in particular as planned capital raises must be reviewed carefully to confirm all material information is being disclosed accurately.

Considerations for financial services firms as well as institutional investors in the failed banks or portfolio companies that rely on the failed banks

Firms should rapidly (to the extent they have not already done so) take remedial and preventive measures to shore up their own management of direct and indirect exposures to banks in resolution or those that could be at risk of becoming subject to resolution, moratorium or other temporary stays on enforcement (which themselves may be subject to territorial limitations). This may include:

Counterparty relationship and documentation inventory

1. Evaluating depository, cash management as well as lending arrangements and updating a documentation inventory to capture and monitor all relevant contractual and non-contractual arrangements (segmented by the governing law of the contract and the jurisdiction of the counterparty and/or execution venue, as well as the booking centre for relevant transactions) that therefore allows to map "proof of claims" as these may have to be submitted to liquidators (where appointed) in respective proceedings as applicable to failed banks. For lending arrangements, any amounts outstanding to a failed bank will typically continue to have to be paid in the usual way to avoid being in breach of contract. Subject to the terms of a financing arrangement, a borrower may be able to replace a defaulting lender with another lender or in the case of a syndicated/club facility to disenfranchise the defaulting lender for voting purposes;

2. Reviewing relationship-specific documentation[1] and transaction specific documentation[2] and in particular hedging arrangements in particular concerning close-outs, termination as well as set-off rights in particular where no temporary stay period may apply that would prevent close-out and related rights relating to certain contracts being exercised – similar to point 1, a defaulting hedge counterparty such as failed bank may be cable of being replaced;

3. Assessing custodial arrangements and location of where assets are (actually) held and subject to which rights and considerations similar to point 2 above;

4. Assessing in the context of exposures in points 2 and 3 above, which positions are marked-to-market and which are marked-to-model and what fallbacks could be put in place as well as the timing, thresholds and extent of margin call requirements to be provided and by whom, along with type of collateral and whether any haircuts need to be amended. The same applies in respect of the amount of collateral assets provided and/or received that are subject to activated and/or potential rights of re-use and/or rehypothecation and the amount which is segregated (at what type of segregation) and how much of a party and/or its counterparty's funding is reliant on collateral assets rehypothecated from others and the possibility that such collateral assets may be withdrawn;

5. The documentation inventory referenced in respect of the above should also set a documentation hierarchy as well as mapping of critical path dependencies as well as capturing which documents and/or specific terms take precedence over one another i.e., transaction specific documentation is typically subject to the terms of relationship specific documentation but may also include carve-outs for certain types of transactions etc., but equally assess whether linked documentation i.e., hedging and loan documentation terms are connected and/or whether there are any material divergences in agreed terms to those that are considered market standard. Such documentation inventory should also capture and set out clear actionable paths on what type of service of notice and differing permitted methods of notification are required and with respect of whom;

Diversify funding channels and liquidity

6. Tap or otherwise set-up bridge financing lines to shore-up contingency funding and/or standby capital as well as liquidity;

7. Engage with providers alternative financing options, including factoring companies, which can help companies get advances against their receivables;

[1] such as (prime-) brokerage (or other trading relationship general terms and conditions) as well as clearing and netting arrangements.
[2] such as those that are transacted under or based on master agreement (for example GMRA, GMSLA, ISDA – or other types such as DRV, FBF) documentation suites, but equally may also include bilateral agreement (for example LMA) documentation suites, as well as any array of protocols, side letters and any other documented or undocumented arrangements that are relevant to the exposure(s).

No regret moves

8. Diversify the capital base across different accounts/wallets with larger providers with a more diversified business;

9. Ensure a suitable ratio of insured to total of (uninsured deposits) and/or ensure client asset and client money segregation protections (where available);

10. Place excess non-insured cash deposits into high quality liquid cash equivalents such as highly rated government bonds;

11. Ensure consistency, clarity and certainty on exposures to failed firms to internal and external stakeholders. Observe compliance with respective market abuse regulations and similar requirements in particular if such exposures exist and are adverse to the financial health or prospects of the solvency, acknowledge the situation (within compliance of the legal and regulatory requirements) and look to reassure but do not obfuscate the situation as this could cause liability. This applies to everything from payroll to engagement with external stakeholders/investors.

In respect of the above, financial services firms will need to consider their own obligations when communicating with their peers and counterparties at other firms as well as the supervisory expectations to engagement with respective regulatory authorities.

Financial services firms with strong and resilient balance sheets, sufficient liquidity, diversified deposits and multiple contingent funding sources and robust asset liability management practices

Well positioned firms may see further opportunities to acquire new customers, portfolios or entire banks as the wake of the 10 March 2023 weekend unfolds. Such well-positioned firms should consider assessing their readiness for rapid client onboarding from stronger inflows as well as capabilities to acquire targets. This includes:

A. Conducting market analysis and target evaluation, in particular:

   i. Developing marketplace intelligence and identifying banks that might be experiencing balance sheet stress;

   ii. Preparing a cursory acquisition analysis for each identified target, including the potential target's core business and capabilities and whether that would be a strategic fit;

   iii. Embedding financial information from identified target into one's own asset-liability management and liquidity scenario analysis to model whether such acquisition would adversely affect the existing business model viability or strengthen its analysis;

   iv. Preparing necessary core documentation necessary for shareholder control as well as change in control clearances to be obtained from relevant regulators;

B. Assessing integration readiness of an identified target, in particular:

   i. Deploying a cross-functional integration team capable of rapidly assimilating treasury, cash management, compliance and risk frameworks;

   ii. Assessing operational risks and potential staff attrition;

   iii. Preparing a communications plan to respond to internal and external stakeholders including customers of the identified target bank;

C. Preparing for rapid customer onboarding, in particular:

   i. Enhancing (digital) client onboarding strategy and considering options targeted outreach capabilities to ensure retention of newly acquired customers;

   ii. Testing onboarding processes and systems to ensure they are resilient to rapid customer acquisition, whether it is organic or inorganic;

iii. Understanding and managing risks associate with rapid customer growth, in particular consumer/investor protection compliance as well as heightened financial crime risks;

D. Preparing for increased regulator cooperation during acquisitions/transfers, in particular:

i. Understanding options and impacts following regulator assisted transactions/transfers and unique attributes of each regulator-led tool as applied;

ii. Developing a corporate development process that can operate within the constraints of any regulatory-led transaction process, including adjusted due diligence requirements and procedures for limited data and access; and

iii. Preparing board and committee approvals to allow for compact deal timelines from initial deal packet provision through to deal closing.

Never let a good crisis go to waste – supervisory pressures ahead

Supervisors (globally and not just in the EU) are likely going to revisit their assessment and level of scrutiny of individual regulated financial services firms' interest rate risk management, exposures to non-diversified business models, assessment of and exposures to risks to corporates and (tech) start-ups that were reliant on easy (comparably cheaper) funding conditions as well as ultimately regulated firms' recovery and resolution plans. Supervisors are likely to focus more broadly on the wider market and participants in:

- **Assessing the overall health of banak, corporate and household balance sheets**: in particular as consumer debt has increased and loan growth has accelerated, therefore driving an increase in loan-loss reserves. Deposits may come under further pressure if interest rates continue to rise and as some firms pursue aggressive deposit gathering strategies. Some longer term dated assets, especially where acquired with lower interest rates, may become subject to below market margins and credit risks associated with leveraged commercial and industrial loans that remain high. Overall funding strategies and an emphasis on greater diversification and emphasis on resilience is likely to become more important and in scope of supervisory dialogue;

- **Declining liquidity and volumes of government securities**: continue to be an issue for discussion across global financial markets. The slowdown may continue to worsen, particularly if rates rise further and more banks and financial services firms need to make up for deposit outflows. Trading volumes and yields may be leading indicators of influencing the need to generate liquidity even it if it results in crystallising a loss; and

- **Forward-planning for further central bank and regulatory rulemaking responses**: further pressures on the pace, amount and overall direction of interest rate policy may come under pressure. In particular, US and UK authorities have, as this Client Alert went to press, had announced plans for various "rescue plans" to support the tech sector. Whether this constitutes a "bail out" – in most instances, this may not be permitted under current laws – remains to be seen in the details as they are announced and potentially even challenged – whether politically or in respective courts. One question however may take a longer time to play out, namely the impact of the recent bank failures on further central bank rate hikes around the globe.

More importantly global supervisory authorities that allowed certain business models, such as those of the recently failed banks, to apply global and jurisdiction-specific rules on a proportionate basis given the perception such firms were SNCIs were less risky and thus systemically not important, may be revisited if such approach means it can lead to conditions that do not contain and control adverse idiosyncratic risk and/or risk propagation channels.

In the EU, notably in the Banking Union, respective supervisory authorities, whether in the banking sector but also in the securities and investment management, asset management and other regulated funds as well as the insurance and pensions sector will likely apply greater scrutiny to those that are considered SNCIs generally as well as specifically those that are treated, for Banking Union purposes, as "less significant institutions", which are only indirectly supervised by the European Central Bank (**ECB**) in the context of the Banking Union's Single Supervisory Mechanism (**SSM**), as well as the smaller amount of such firms that are subject to indirect supervision but closer scrutiny by the ECB-SSM as "high-impact and high-risk" LSIs. Criticism has already begun to emerge that a number of SNCIs may not have had sufficient staffing of key function holders and lack of robust and resilience control procedures throughout the respective three lines of defence model, which while fit for purpose on paper at the point of authorisation may not have been put into practice as robustly as regulators require and supervisors expect.

Supervisors will also probably redouble their efforts in engaging with market participants (whether regulated or non-regulated) to revisit their own diversification of exposures and prevent concentration risks with SNCIs but perhaps more broadly.

Outlook

The current developing market and regulatory environment presents a number of novel as well as known risks (perhaps with a different flavour to the GFC) but it also presents significant opportunities for those firms that are well-positioned and with sustainable growth strategies. Short of any outright transactions, some firms may experience growth as counterparties, clients and customers of recently failed banks potentially (rapidly) shift relationships. Firms on the incoming end should be prepared to process requests but also model how this aligns with existing strategy and balance sheet risk management. The age-old adage of planning for the worst and hoping for the best will likely need to be applied in particular if the EU is currently at the eye of the storm of the recent bank failures and regulatory-led actions taken in response in the US and the UK.

While uncertainty remains high, we are confident that complacency will not be a winning strategy. We, along with our global colleagues, in particular in the US, UK, across the EU-27 and further afield, remain available to assist our clients to navigate challenges and seize opportunities.

About us

PwC Legal is assisting a number of financial services firms and market participants in forward planning for changes stemming from these developments. We have assembled a multi-disciplinary and multijurisdictional team of sector experts to support clients navigate challenges and seize opportunities as well as to proactively engage with their market stakeholders and regulators.

If you would like to discuss any of the developments mentioned above, or how they may affect your business more generally, please contact any of our key contacts or PwC Legal's RegCORE Team via de_regcore@pwc.com or our website.

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