

## Making Main Street Work

The Committee on Capital Markets Regulation (the “Committee”) believes that small and medium sized businesses (“SMEs”) will need continued financial support for a prolonged period to recover from the impact of the COVID-19 pandemic. A key part of this support should come from the Treasury-Federal Reserve’s Main Street Lending Program (“MSLP”) authorized by the Coronavirus Aid, Relief, and Economic Security Act (“CARES Act”).<sup>1</sup> The MSLP comprises five facilities, three of which are targeted at for-profit business and two of which are targeted at non-profits.<sup>2</sup> This statement is focused on the three for-profit facilities. So far these facilities, which have been operating for almost two months, have not delivered the anticipated results.

We therefore recommend that the MSLP be significantly restructured to: (1) take on more credit risk, by providing that the Federal Reserve make 100% of the loans, leaving banks and other financial institutions as processors; and (2) provide below market terms for borrowers. For clarity, the Fed would be the lender; banks or other financial institutions would not underwrite loans or extend credit under the revised MSLP; they would just be processors. However, to the extent feasible, the Fed’s Main Street facilities could lend to borrowers directly. This would be preferable since it would speed up the process by eliminating the need for detailed and ongoing instructions from the Fed to the processors, and the concerns of processors with liability.

The MSLP must be on first-come first-serve basis to ensure that the government is not picking winners and losers. Policymakers must also reach out to the hardest hit and underserved communities so that businesses in these communities can take advantage of the program. Clearly our approach would lead to more credit risk—but it is necessary to take such risk for the program to reach needy borrowers, and the funds have already been appropriated by Congress to support such risk. However, the Fed should not lend to businesses that are beyond salvation. That risk can be mitigated by borrower certifications of solvency and borrower certification that the funds will be used in their business, together with the use of objective metrics by the Fed to identify firms that can and cannot benefit by additional borrowing.

The impact of the COVID-19 pandemic on SMEs has been, and will continue to be, far-reaching. There is no guarantee that the changes to the MSLP that we recommend here will succeed in meeting the financial needs of SMEs that have been jeopardized by the pandemic. But the current approach has clearly fallen short and, in our view, the reforms that we propose here are worth an attempt. Moreover, our recommendations can be enacted *now* under the CARES Act, as SMEs continue to suffer while Congress debates further appropriations for the Paycheck Protection Program (“PPP”).

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<sup>1</sup> Pub. L. 116-136, Coronavirus Aid, Relief, and Economic Security Act (CARES Act), § 4003(c)(3)(D)(ii) (March 27, 2020), <https://www.congress.gov/bill/116th-congress/house-bill/748>; Board of Governors of the Federal Reserve System. Federal Reserve takes additional actions to provide up to \$2.3 trillion in loans to support the economy (April 9, 2020), available at <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200409a.htm>.

<sup>2</sup> Board of Governors of the Federal Reserve System, Main Street Lending Program (August 10, 2020), available at <https://www.federalreserve.gov/monetarypolicy/mainstreetlending.htm>.

However, extraordinary federal intervention such as the MSLP must end as soon as the need for such a program has dissipated. We therefore support the current end-date of December 31, 2020, which can be reevaluated in the coming months.

The Committee is an independent 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations. The Committee's membership includes thirty-six leaders drawn from the finance, business, law, accounting, and academic communities. The Committee Co-Chairs are R. Glenn Hubbard, Dean Emeritus of Columbia Business School, and John L. Thornton, Chairman Emeritus of the Brookings Institution. The Committee's President is Hal S. Scott, Emeritus Nomura Professor of International Financial Systems at Harvard Law School and President of the Program on International Financial Systems. Founded in 2006, the Committee undertook its first major report at the request of the incoming U.S. Secretary of the Treasury, Henry M. Paulson. Over ten years later, the Committee's research continues to provide policymakers with an empirical and non-partisan foundation for public policy.

## **1. The Economic Plight of SMEs**

The available data on SME need for economic support are mainly focused on mid-sized firms. As of mid-June, Moody's Analytics reported that middle market corporations had experienced across-the-board increases in their expected default frequency.<sup>3</sup> And the default rate on private debt rose to 8.1% in Q2 from 5.9% in Q1, according to the Proskauer Private Credit Default Index, which measured 546 private loans issued mainly to private-equity-backed mid-sized businesses.<sup>4</sup>

As credit conditions at middle market firms deteriorate, these companies are finding it harder to borrow to meet their liquidity needs. The Federal Reserve – July 2020 Senior Loan Officer Opinion Survey on Bank Lending Practices reported that 71% of respondents reported tightening their lending standards on loans to large and medium-size firms. The Fed's survey also reported that demand for such loans from borrowers had decreased; likely due to the unattractive terms that banks must offer to offset the credit risk posed by such loans.<sup>5</sup> Indeed, the Association for Corporate Growth has reported that 81% of its middle market members that tried to get a loan though the MSLP could not.<sup>6</sup> The pandemic has also affected the direct lending market, with middle market syndicated loan issuance falling to \$14.1 billion in Q2, the lowest issuance since 2009.<sup>7</sup>

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<sup>3</sup> Moody's Analytics, COVID-19 Impact on United States Middle Market Corporate Firm Credit Risk (July 17, 2020), available at [https://www.moodyanalytics.com/-/media/whitepaper/2020/Whitepaper\\_RiskCalc\\_USCorp\\_COVID\\_Analysis\\_July2020.pdf](https://www.moodyanalytics.com/-/media/whitepaper/2020/Whitepaper_RiskCalc_USCorp_COVID_Analysis_July2020.pdf).

<sup>4</sup> Proskauer, Proskauer Releases Q2 Private Credit Default Index (July 29, 2020), available at <https://www.proskauer.com/release/proskauer-releases-q2-private-credit-default-index>.

<sup>5</sup> Board of Governors of the Federal Reserve System, July 2020 Senior Loan Officer Opinion Survey on Bank Lending Practices (August 3, 2020), available at <https://www.federalreserve.gov/data/sloos/sloos-202007.htm>.

<sup>6</sup> Thomas Bohn, Testimony before the CARES Congressional Oversight Commission (August 7, 2020), available at <https://coc.senate.gov/sites/default/files/2020-08/BOHN%20Testimony%20COC%20Hearing%208-7.pdf>.

<sup>7</sup> Julie Segal, There Are No Deals — and No Sign of Them — in Middle-Market Lending (July 10, 2020), available at <https://www.institutionalinvestor.com/article/b1mfp6mt67f88v/There-Are-No-Deals-and-No-Sign-of-Them-in-Middle-Market-Lending>.

Small businesses have also been hard hit. Dun & Bradstreet's Small Business Health Index reported a decline for June 2020 reflecting an increase in business failure and payment delinquency rates at small businesses during Q2.<sup>8</sup> Certain sectors have been disproportionately affected: as of early August, revenues at transportation businesses have declined by 68% compared to the same week last year; revenues at arts and entertainment business have decreased by 48%; and revenues at hotels and restaurants have declined by 20%.<sup>9</sup> Through the end of July, 57% of local arts and entertainment businesses, and 38% of bars and lounges, had not processed a single transaction for three straight days.<sup>10</sup> In a recent letter, more than 100 current and former CEOs of some of America's largest companies, major trade associations and small businesses warned that without longer-term support from the federal government, small business owners are facing financial ruin.<sup>11</sup>

A V-shaped recovery, meaning that the economy will within the next year or so bounce back to a pre-COVID level, is unlikely.<sup>12</sup> Such a recovery is inconsistent with the predictions of the Fed and most economic forecasters, given the path of the virus, elevated unemployment and concern over a possible cascade of business failures in the services sector.<sup>13</sup> According to the latest economic projections from Fed officials, the economy will contract by anywhere between 4% and 10% this year.<sup>14</sup> Though their projections for next year exhibit a wide range, with at least one official projecting an additional 1% contraction, most do not expect the economy to recover completely until 2022.<sup>15</sup>

Nor is the generally buoyant U.S. public equity market a sign that all is well. The market indices are dominated by large-capitalization firms, some of which—especially in the technology sector—remain strong despite the pandemic lockdown. Sectors that have been hardest hit by the pandemic, such as department stores, airlines and travel services, make up a small fraction of the major market indices, and the vast majority of SMEs are not publicly traded at all.<sup>16</sup> Moreover,

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<sup>8</sup> Dun & Bradstreet, U.S. Economic Health Tracker (August 2020), available at [https://www.dnb.com/content/dam/english/economic-and-industry-insight/DNB\\_Economic\\_Health\\_Tracker\\_AugustV2\\_2020.pdf](https://www.dnb.com/content/dam/english/economic-and-industry-insight/DNB_Economic_Health_Tracker_AugustV2_2020.pdf).

<sup>9</sup> Womply, Data dashboard: How coronavirus / COVID-19 is impacting local business revenue across the U.S., available at <https://www.womply.com/blog/data-dashboard-how-coronavirus-covid-19-is-impacting-local-business-revenue-across-the-u-s/>.

<sup>10</sup> Womply, Report: How many local businesses have had to close due to COVID-19?, available at <https://www.womply.com/blog/report-how-many-local-businesses-have-had-to-close-due-to-covid-19/>.

<sup>11</sup> Letter to Congressional leaders (August 3, 2020), available at <https://www.howardschultz.com/lettertocongress/>.

<sup>12</sup> Paul Hannon and Saabira Chaudhuri, Why the Economic Recovery Will Be More of a 'Swoosh' Than V-Shaped, Wall Street Journal (May 11, 2020), available at <https://www.wsj.com/articles/why-the-economic-recovery-will-be-more-of-a-swoosh-than-v-shaped-11589203608>.

<sup>13</sup> Rich Miller, Bernanke Doesn't See V-Shaped U.S. Recovery After Steep Fall, Bloomberg news (April 7, 2020), available at <https://www.bloomberg.com/news/articles/2020-04-07/bernanke-doesn-t-see-v-shaped-u-s-recovery-after-steep-fall?sref=2lCQoM0A>; Caitlin McCabe, Corporate America Isn't Betting On a V-Shaped Recovery, Wall Street Journal (May 13, 2020), available at <https://www.wsj.com/articles/corporate-america-isnt-betting-on-a-v-shaped-recovery-11589399846>.

<sup>14</sup> Board of Governors of the Federal Reserve System, Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, under their individual assumptions of projected appropriate monetary policy (June 2020), available at <https://www.federalreserve.gov/monetarypolicy/files/fomcproptabl20200610.pdf>.

<sup>15</sup> Id.

<sup>16</sup> Barry Ritholtz, Why Markets Don't Seem to Care If the Economy Stinks, Bloomberg Opinion (August 4, 2020), available at <https://www.bloomberg.com/opinion/articles/2020-08-04/why-markets-don-t-seem-to-care-if-the-economy-stinks?sref=2lCQoM0A>.

while Fed liquidity and low interest rates might help support equity values, they do not necessarily portend a quick economic recovery.

Some have expressed concern that distressed SMEs will not want to borrow from the MSLP. While it is true that in many cases their condition has worsened since the enactment of the CARES Act, SMEs, if solvent, will likely still borrow if it is their only hope of maintaining their business as a going concern. Of course, such loans will be risky but, as addressed in the next section, the Treasury needs to be prepared to take that risk.

Another concern is that the Fed should not pick winners and losers. In other words, for businesses that qualify under the MSLP's terms and objective criteria for determining businesses that could benefit from MSLP borrowing, the Fed should not decide which business receive credit and which do not. In order to allay concerns about its exercise of discretion, the Fed should commit to making eligible MSLP loans on a first-come, first serve basis—much as the Small Business Administration did in the case of the PPP.<sup>17</sup> So far, due to low demand for the facility, there has been no issue of picking winners and losers. However, concerns about the Fed picking winners and losers could arise for a more attractive facility. Accordingly, the Fed should report weekly on how the facility is operating to avoid picking winners and losers.

In summary, SMEs face balance sheet stress and need financial support from the government. Given the importance of these firms to the U.S. economy—middle market businesses, in particular, represent one-third of private sector GDP and employ approximately 44.5 million people—such support is key to economic recovery.<sup>18</sup>

## **2. The MSLP and Credit Risk**

When the CARES Act was enacted over five months ago, Treasury Secretary Steven Mnuchin and Fed Chairman Jerome Powell said the Act's \$454 billion in appropriations could be levered by the Fed to support up to \$4 trillion of loans.<sup>19</sup> The Treasury announced on April 9 that it would set aside \$75 billion of this appropriation to support \$600 billion in loans to SMEs under the Main Street facilities.<sup>20</sup> These programs, after several revisions, became operational on July 6.<sup>21</sup> As of August 26, the Fed had purchased \$855 million in loans through the MLSP, implying that approximately \$900 million in loans had been made under the MSLP (as banks are required

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<sup>17</sup> Small Business Administration, Business Loan Program Temporary Changes; Paycheck Protection Program, 85 Fed. Reg. 20811, 20813 (April 15, 2020).

<sup>18</sup> National Center for the Middle Market, Middle Market Indicator Overview, available at <https://www.middlemarketcenter.org/middle-market-indicator-overview>.

<sup>19</sup> Jeanna Smialek, How the Fed's Magic Money Machine Will Turn \$454 Billion Into \$4 Trillion, New York Times (March 27, 2020), available at <https://www.nytimes.com/2020/03/26/business/economy/fed-coronavirus-stimulus.html>.

<sup>20</sup> Board of Governors of the Federal Reserve System. Federal Reserve takes additional actions to provide up to \$2.3 trillion in loans to support the economy (April 9, 2020), available at <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200409a.htm>.

<sup>21</sup> Federal Reserve Bank of Boston, Boston Fed announces Main Street Lending Program is Fully Operational (July 6, 2020), available at <https://www.bostonfed.org/news-and-events/press-releases/2020/boston-fed-announces-main-street-lending-program-is-fully-operational.aspx>.

to retain 5% of each loan).<sup>22</sup> The Federal Reserve currently discloses transaction-specific data about the MSLP monthly. As of July 31, 2020, the latest report available, the program had only purchased participations in thirteen loans, ranging in size from \$1.5 million to \$50 million.<sup>23</sup> Excluding the two largest loans, of \$50 million and \$12.3 million respectively, the average loan size was just over \$2.7 million.<sup>24</sup> The loans went to businesses in five states, though the majority of them were issued by a single bank in Miami, Florida, which also engaged in significant lending under the PPP.<sup>25</sup> In testimony to Congress on September 1, Secretary Mnuchin estimated that between \$25 and 50 billion in loans would ultimately be issued through the MSLP.<sup>26</sup> This level of lending is far short of the MSLP's lending capacity and what is needed for economic recovery.

One of the major reasons for the performance shortfall has been the policy of the Treasury to avoid taking credit risk. While the Main Street facilities are operated by the Fed, the Treasury, pursuant to Dodd-Frank amendments to Section 13(3) of the Federal Reserve Act, must approve them and therefore controls their terms.<sup>27</sup> Secretary of the Treasury Mnuchin stated in April, "I think it's pretty clear if Congress wanted me to lose all of the money, that money would have been designed as subsidies and grants as opposed to credit support."<sup>28</sup> The terms of the MSLP reflect the Treasury's view by requiring banks to retain 5% of all loans and to apply normal credit standards (which they would do anyway given their exposure).<sup>29</sup>

On August 4, Senator Crapo, Chairman of the Senate Banking Committee, offered the following amendment to the "shell" rescue bill submitted by Senate Majority Leader McConnell, which would amend the CARES Act to provide: "In making loans, loan guarantees, and other investments...the Secretary shall prioritize the provision of credit and liquidity to assist eligible businesses, States and municipalities, even if the Secretary estimates that such loans, loan guarantees, or investments may incur losses."<sup>30</sup> Senator Crapo and Congressman Patrick McHenry have

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<sup>22</sup> Board of Governors of the Federal Reserve System, H.4.1 – Factors Affecting Reserve Balances (August 20, 2020), available at <https://www.federalreserve.gov/releases/h41/current/>. A week earlier, Eric Rosengren, the President of the Boston Federal Reserve Bank, which is charged with operating the MSLP, announced that more than \$250 million in loans had been committed or settled under the program, with an additional \$600 million under review. Eric S. Rosengren, *The COVID-19 Pandemic, the Economic Outlook, and the Main Street Lending Program* (August 12, 2020), available at <https://www.bostonfed.org/news-and-events/speeches/2020/the-covid-19-pandemic-the-economic-outlook-and-the-main-street-lending-program.aspx>.

<sup>23</sup> Board of Governors of the Federal Reserve System, *Periodic Report: Update on Outstanding Lending Facilities Authorized by the Board under Section 13(3) of the Federal Reserve Act (Transaction-specific Disclosures)*, Aug. 10, 2020, <https://www.federalreserve.gov/publications/files/msplf-msnlf-transaction-specific-disclosures-8-10-20.xlsx>.

<sup>24</sup> *Id.*

<sup>25</sup> Ashley Portero, *In study of Florida's top retail banks, this Miami company ranked high for PPP lending*, *South Florida Business Journal*, July 13, 2020, <https://www.bizjournals.com/southflorida/news/2020/07/13/city-national-bank-ranks-high-for-ppp-lending.html>.

<sup>26</sup> Secretary Steven Mnuchin, *Testimony before the House Select Committee on the Coronavirus Crisis* (Sep. 1, 2020).

<sup>27</sup> Federal Reserve Act, § 13(3)(B)(i), (iv).

<sup>28</sup> Jeanna Smialek and Alan Rappeport, *Fear of Risk Could Diminish the Economic Rescue by the Treasury and Fed*, *New York Times* (May 18, 2020), available at <https://www.nytimes.com/2020/05/18/business/economy/economic-stimulus-treasury-fed-risk.html>.

<sup>29</sup> *Main Street Lending Program: Frequently Asked Questions* (July 31, 2020), available at <https://www.bostonfed.org/mslp-faqs>.

<sup>30</sup> Senator Mike Crapo, S.Amdt.2542 to S.Amdt.2499, *Congressional Record* Vol. 166, No. 138, S4856 (August 4, 2020).

also written to Secretary Mnuchin and Chairman Powell, urging them to use funds appropriated under the CARES Act to expand the MSLP.<sup>31</sup>

The Committee strongly supports Senator Crapo's amendment and the use of unallocated CARES Act funds to backstop potential losses from the MSLP. Government-backed loans to borrowers that cannot meet normal credit standards unavoidably involves credit risk, but taking such risk is necessary to support an economic recovery that would be slower without such lending.

### 3. Revision of Main Street Terms

For the MSLP to support SMEs, two major changes need to be made: (a) the Fed should make 100% of the loans, with banks and other financial institutions acting as processors, if necessary; and (b) the loan terms must be below market.

#### *a. Fed and Treasury Bear Credit Exposure, Lenders as Processors*

For the MSLP to work, banks cannot be required to hold 5% of each loan. The requirement that lenders bear credit risk has hampered the effectiveness of the MSLP. As of August 10, only 522 financial institutions registered to participate in the MSLP.<sup>32</sup> That number represents less than 5% of eligible lenders.<sup>33</sup> More than five times as many lenders participated in the PPP.<sup>34</sup> Moreover, of those 522 financial institutions, only 160 of them stood willing to publicly accept loan applications from new customers that lack a preexisting relationship with the lender.<sup>35</sup> Larger banks have played a minimal role in MSLP lending thus far: the vast majority of lenders registered to participate in the MSLP have less than \$50 billion in assets and those lenders have been responsible for nearly all MSLP lending.<sup>36</sup>

In addition to deterring participation by banks, requiring them to bear credit risk also affects the terms under which they will lend. Once saddled with credit risk, lenders will rightly apply normal credit standards with the effect that the borrowers who need financial assistance will not qualify for loans. While 5% of each loan may not seem significant, multiple small stakes in risky loans add up. Indeed, borrowers that can meet normal credit standards do not need the MSLP at all. We therefore agree with the recommendation of Senators Loeffler, Braun, Cornyn, and Tillis,

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<sup>31</sup> Letter from Senator Mike Crapo and Congressman Patrick McHenry to Secretary Mnuchin and Chairman Powell (August 10, 2020).

<sup>32</sup> Eric S. Rosengren, The COVID-19 Pandemic, the Economic Outlook, and the Main Street Lending Program, Remarks to the South Shore Chamber of Commerce (Aug. 12, 2020), <https://www.bostonfed.org/news-and-events/speeches/2020/the-covid-19-pandemic-the-economic-outlook-and-the-main-street-lending-program.aspx>.

<sup>33</sup> According to the most recent available data, there are more than 10,000 FDIC-insured depository institutions and credit unions. Credit Union National Association, Monthly Credit Union Estimates, (Aug. 3, 2020), [https://www.cuna.org/uploadedFiles/Global/About\\_Credit\\_Unions/CUMonthEst\\_Jun20.pdf](https://www.cuna.org/uploadedFiles/Global/About_Credit_Unions/CUMonthEst_Jun20.pdf); Federal Deposit Insurance Corporation, Institution Directory, <https://www7.fdic.gov/idasp/advSearchLanding.asp> (Aug. 15, 2020).

<sup>34</sup> U.S. Small Business Administration, Paycheck Protection Program - Participating Lenders, June 25, 2020, [https://www.sba.gov/sites/default/files/2020-06/PPP\\_Lender\\_List\\_200625.pdf](https://www.sba.gov/sites/default/files/2020-06/PPP_Lender_List_200625.pdf).

<sup>35</sup> Eric S. Rosengren, The COVID-19 Pandemic, the Economic Outlook, and the Main Street Lending Program, Remarks to the South Shore Chamber of Commerce (Aug. 12, 2020), <https://www.bostonfed.org/news-and-events/speeches/2020/the-covid-19-pandemic-the-economic-outlook-and-the-main-street-lending-program.aspx>.

<sup>36</sup> Id.; Statement of Eric Rosengren, President and CEO, Federal Reserve Bank of Boston, Congressional Oversight Commission hearing on the Main Street Lending Program, 116th Cong. (Aug. 7, 2020), <https://coc.senate.gov/sites/default/files/2020-08/ROSENGREN%20Testimony%20COC%20Hearing%208-7.pdf>.

in their August 4 letter to Secretary Mnuchin and Chairman Powell, that the most effective solution to the bank credit standard obstacle is to eliminate the risk retention feature altogether.<sup>37</sup>

To the extent that the infrastructure already put in place by the Federal Reserve is sufficient, the Fed could lend to borrowers directly, circumventing processors entirely. If that is not feasible, then banks—and other nonbank financial institutions certified by the Fed—should remain in place solely as processors. Banks and other financial institutions that act as processors should be paid a fee for processing loans. Of course, such fees must be reasonable given the costs.

*b. Specific Terms*

As for specific terms, we would suggest the following, consistent with the below market approach:

- Loans should be unsecured, since the most distressed borrowers do not have collateral.
- Under the current terms, which tie maximum loan size to the borrower's outstanding debt relative to earnings (four or six times the borrower's 2019 EBITDA, depending on the Main Street facility), many SMEs are excluded from participation as a result of their current leverage. Working with participating financial institutions, the Fed and Treasury should consider increasing the maximum loan size to an amount that is based on the reasonable needs of the borrower. One way of implementing this approach would be to tie the maximum loan size to the borrower's business expenses as reflected on its most recent federal tax return.
- The minimum loan size should be reduced to \$100,000 (from \$250,000), consistent with the average size of PPP loans.<sup>38</sup>
- The interest rate on MSLP loans should be lowered to a fixed interest rate of 1% per annum (currently, MSLP loans have an adjustable rate of LIBOR plus 3%) with no fees charged to borrowers (currently, borrowers can face fees of up to 200 basis points).<sup>39</sup>
- The term should be extended to 10-years (from 5 years).<sup>40</sup>
- Prepayment should be without penalty (consistent with current terms).<sup>41</sup>
- Amortization should be on a 30-year schedule with the balance due after 10 years.
- Eligible borrowers should be required to certify that:
  - they are solvent;
  - their need for credit arises from the pandemic;
  - the amount borrowed is related to their actual cash business needs;

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<sup>37</sup> Letter from Senators Kelly Loeffler, John Cornyn, Mike Braun and Thom Tillis to Secretary Mnuchin and Chairman Powell (August 4, 2020).

<sup>38</sup> Main Street Lending Program: Frequently Asked Questions, p. 34 (July 31, 2020), available at <https://www.bostonfed.org/mslp-faqs>; Small Business Administration, Paycheck Protection Program – Additional Program Information (August 6, 2020), available at <https://www.sba.gov/funding-programs/loans/coronavirus-relief-options/paycheck-protection-program#section-header-11>.

<sup>39</sup> Main Street Lending Program: Frequently Asked Questions, pp. 33, 35 (July 31, 2020), available at <https://www.bostonfed.org/mslp-faqs>.

<sup>40</sup> Id at p. 76.

<sup>41</sup> Id at p. 78.

- the funds borrowed will be spent on the business; and
  - that they could not obtain funds in the amount applied for under the MSLP from their existing bank. (This certification would prevent creditworthy borrowers to which banks would otherwise lend from obtaining below-market loans from the MSLP.)
- Loan documentation, which is currently complex and lengthy, should be simplified. Currently, borrowers have to digest more than 160 pages of documentation, supply more than 140 data fields, and are subject to quarterly reporting requirements.<sup>42</sup> These information and reporting requirements are a significant obstacle for smaller borrowers and exceed what borrowers typically provide to banks for standard business loans.

Some have suggested that what is needed for the most distressed firms is an equity injection rather than increased borrowing. In principle, this may be true but it is impractical to restructure the capital of SMEs on any scale in a timely way. That would require the consent of existing investors and significant legal costs. The terms we recommend for the Fed's lending would be similar to patient equity given the significant risk of nonpayment. To the extent that bank supervisors are concerned that MSLP loans will add to a borrower's leverage and thus banks should not further extend credit to that borrower, bank supervisors should treat MSLP loans as equity.

Another potential concern is that extending loans on below market terms will cause the Fed to prop up businesses that are no longer viable. As we have argued above, the risk that viable businesses will go under en masse without additional support generally warrants greater risk-taking by the Fed and Treasury. But the Fed can also mitigate the risk of lending to nonviable businesses by consulting private data, including from providers like Dun & Bradstreet, to screen out businesses that are unlikely to survive even with additional credit support. The Fed, or the banks and financial institutions acting as processors can ensure that borrowers meet viability requirements, although such requirements must be clear and straightforward to avoid confusion and delay. In addition, the borrowers must make certifications as to their solvency and that the amount borrowed is related to their cash needs and will be used in the business—such certifications will be difficult to make for unviable businesses.

The MSLP must also ensure that owners cannot siphon off the proceeds of government loans to themselves through executive compensation, dividends or share repurchases. The CARES Act establishes certain limits on owners from doing so.<sup>43</sup> Businesses that receive MSLP loans are prohibited from paying dividends or repurchasing shares until one year after the loan is no longer outstanding.<sup>44</sup> During the same period, MSLP borrowers cannot pay annual compensation, over any 12 consecutive months, to officers or employees in excess of the sum of \$3 million plus half the amount by which an officer or employee's 2019 compensation was over \$3 million.<sup>45</sup> For example, an employee whose 2019 compensation was \$5 million cannot be paid more than \$4

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<sup>42</sup> The current legal forms and agreements for eligible borrowers are available at Main Street Lending Program Forms and Agreements, available at <https://www.bostonfed.org/supervision-and-regulation/supervision/special-facilities/main-street-lending-program/information-for-lenders/docs.aspx>.

<sup>43</sup> CARES Act, §§ 4003(c)(3)(A)(ii), 4004; Main Street Lending Program: Frequently Asked Questions, p. 44-50 (July 31, 2020), available at <https://www.bostonfed.org/mslp-faqs>.

<sup>44</sup> CARES Act, § 4003(c)(3)(A)(ii).

<sup>45</sup> CARES Act, § 4004(a)(2).



million - \$3 million plus half of \$5 million minus \$3 million – over any 12 consecutive months.<sup>46</sup> MSLP borrowers also cannot increase compensation over any 12-month period for any employee who was paid more than \$425,000 in 2019.<sup>47</sup> In addition, as set forth in the proposed terms above, borrowers should be required to certify that they will use the proceeds of any MSLP loan solely for the benefit of the borrower’s business.<sup>48</sup> The proceeds of an MSLP loan may not be used to repay liabilities of the company which are personally guaranteed by any of the shareholders.

The Committee generally opposes government intervention in private business. Extension of MSLP loans should therefore only be tolerated in the short-term. The Committee therefore supports the CARES Act’s time-limited approach to the MSLP, as funds appropriated under the CARES Act can only be used to backstop loans made before December 31, 2020.<sup>49</sup>

#### 4. Expansion of Treasury Support for MSLP

Given the increased credit risk that would result from our suggested redesign of the MSLP, Treasury may have to increase the \$75 billion in equity that it has committed to the program. Fortunately, the Treasury has ample ability to do so. As of August 26, the CARES Act facilities held only \$17.4 billion in loans backed by \$102.5 billion in Treasury funds, as shown by **Figure 1**.<sup>50</sup> The Treasury therefore has \$351.5 billion in CARES Act funding that it has not yet used—a significant portion of which can be added to support a redesigned MSLP. Congress should keep in mind that a redesigned MSLP may relieve the need for what might otherwise be larger appropriations for a new round of PPP.

**Figure 1**

<b>Facility</b>	<b>Amount Purchased</b>	<b>Treasury Support</b>
<i>Corporate Credit Facilities</i>	\$12.62 billion	\$37.5 billion
<i>Municipal Liquidity Facility</i>	\$1.65 billion	\$17.5 billion
<i>Main Street Lending Program</i>	\$855 million	\$37.5 billion
<i>Term Asset-Backed Securities Loan Facility</i>	\$2.26 billion	\$10 billion
<b>Total:</b>	<b>\$17.4 billion</b>	<b>\$102.5 billion</b>

#### 5. Ensuring Targeted and Equitable Access to Credit

According to one estimate, businesses eligible for the MSLP employ an estimated 45 million workers, almost 40% of all private-sector workers.<sup>51</sup> Yet the MSLP has seen limited take-up. That is in part attributable to the program’s current terms, which warrants the changes described

<sup>46</sup> CARES Act, § 4004(a)(2).

<sup>47</sup> CARES Act, § 4004(a)(1).

<sup>48</sup> This would be similar to the certification currently required for borrowers that are subsidiaries of foreign companies. See, for example, Main Street New Loan Facility: Borrower Certifications and Covenants (June 11, 2020).

<sup>49</sup> CARES Act, § 4027(c).

<sup>50</sup> Board of Governors of the Federal Reserve System, H.4.1 – Factors Affecting Reserve Balances (August 27, 2020), available at <https://www.federalreserve.gov/releases/h41/current/>.

<sup>51</sup> Nick Timiraos and Kate Davidson, Fed, Treasury Disagreements Slowed Start of Main Street Lending Program, Wall Street Journal (July 12, 2020), <https://www.wsj.com/articles/fed-treasury-disagreements-slowed-start-of-main-street-lending-program-11594558800>.

above. But it is also, in part, a product of a widespread lack of knowledge about the MSLP; many small businesses do not even know about the MSLP or that they are eligible for it. One recent survey of middle-market companies found that more than one-fifth of respondents were unaware of the MSLP; others know about it but mistakenly think they are ineligible.<sup>52</sup> Using data supplied by Dun & Bradstreet, and possibly other sources, about which businesses would benefit most from access to the MSLP and those for which such borrowing is too late, the Treasury and Federal Reserve should coordinate outreach to, and enrollment assistance for, eligible borrowers with a chance of survival.

These outreach efforts can also help to ensure that the MSLP supports equitable access to credit. Although the PPP succeeded in channeling critical funds to hard-hit small businesses and their employees, there is evidence that minority-owned businesses were less likely to apply for and receive PPP loans. According to one survey of more than 1,700 small business owners, 79% of Black-owned businesses applied for PPP loans compared to 91% of businesses overall, and only 40% were approved for funding compared to 52% overall.<sup>53</sup> This is despite data suggesting that minority-owned businesses have been especially hard-hit by the pandemic.<sup>54</sup> To ensure equitable access to the credit that is available through the MSLP, the Treasury and Federal Reserve should also target eligible minority-owned businesses, especially those that may not have pre-existing relationships with private lenders.

## **6. Loans for New Businesses**

The COVID-19 pandemic may permanently alter the structure of the U.S. economy. But this is not a reason for Treasury and the Federal Reserve to sit on the sidelines while SMEs fail because of cash-flow disruptions. Rather they should seek opportunities to facilitate a quicker transition to a new, post-pandemic economy. To that end, Treasury and the Federal Reserve should also explore the possibility of adding a new facility, perhaps under the MSLP, to support access to credit for new businesses.<sup>55</sup> A facility of this sort would not provide equity to new start-up businesses; once a new business has secured equity financing from private sources, however, it would be eligible for debt financing on appropriate terms.

## **7. Conclusion**

Main Street's recovery is crucial for the U.S. economic recovery. We recommend that Congress enact Senator Crapo's proposed amendment, which clarifies Congress's intent in enacting the CARES Act to take credit risk, and that the MSLP be revised in the ways that we have set out above. If such legislative action cannot be achieved, we would recommend that the Senate

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<sup>52</sup> Thomas Bohn, Testimony before the CARES Congressional Oversight Commission (August 7, 2020), available at <https://coc.senate.gov/sites/default/files/2020-08/BOHN%20Testimony%20COC%20Hearing%208-7.pdf>.

<sup>53</sup> Goldman Sachs, Survey: US Small Business Owners Need More Funding and Immediate Legislative Action (April 27, 2020) available at <https://www.goldmansachs.com/citizenship/10000-small-businesses/US/infographic-small-business-relief/>.

<sup>54</sup> Robert Fairlie, The Impact of Covid-19 on Small Business Owners: Evidence of Early-Stage Losses from the April 2020 Current Population Survey, Stanford Institute for Economic Policy Research (May 23, 2020), available at <https://siepr.stanford.edu/research/publications/impact-covid-19-small-business-owners-evidence-early-stage-losses-april-2020> (number of Black business owners declined by 41% between February and April 2020, compared to 22% of the overall population).

<sup>55</sup> Businesses that were established after March 13, 2020, are currently excluded from participation in the MSLP. Main Street Lending Program: Frequently Asked Questions, p. 23 (July 31, 2020), available at <https://www.boston-fed.org/mslp-faqs>.

Banking Committee, in a bipartisan letter to Secretary Mnuchin, make such clarification on credit risk and also advocate the revision of the program as we suggest.

There is no guarantee that the extraordinary measures we recommend here will succeed in saving America small and medium-size businesses. But the current approach has been tried and found wanting; the recommendations set out here would give many small and medium-sized businesses in America a fighting chance. Each day that we wait to help Main Street further damages the prospect for economic recovery.