



## Whitepaper On The Federal Reserve's Main Street Business Lending Program

As of April 3, 2020\*

On March 23, the Federal Reserve announced new measures it would be taking to support the credit markets and the broader economy in the face of the economic and credit disruption caused by the COVID-19 pandemic and related governmental interventions. Those measures include expanded purchases of treasury and agency MBS securities as part of open market operations, as well as several new credit facilities to support US credit markets.

Beyond these interventions in the capital markets, the most novel of the Federal Reserve's announced new measures is the Main Street Business Lending Program (the "MSBLP")—a Federal Reserve credit program to encourage expanded lending activity to small- and medium-sized businesses. The proposed MSBLP would fill the gap between (1) the small businesses that would be assisted by the Paycheck Protection Program (the "PPP") along with other existing and expanded SBA lending activity contemplated by the Coronavirus Aid, Relief and Economic Security (the "CARES Act") and (2) the large investment grade corporations that would be supported by the Federal Reserve's announced primary and secondary market corporate credit facilities.

Unlike the SBA lending assistance, which is limited to the amounts appropriated for that purpose under the CARES Act, the MSBLP utilizes an initial invested amount from the U.S. Treasury along with leverage from the Federal Reserve to greatly expand the amount of credit extension that may be supported under the program. Based on an expected U.S. Treasury contribution of \$85 billion and a 10 to 1 leverage ratio indicated by precedent, this would imply a total potential size of \$1 trillion for the MSBLP.

The Federal Reserve has indicated that additional details about the MSBLP—its timing, eligibility and other features—will be forthcoming. In the interim, below we present:

1. What we know about the MSBLP, based on the Federal Reserve's announcement of the program and the relevant provisions of the CARES Act;
2. What we expect, based on Federal Reserve statements, market knowledge and historical precedent; and
3. Significant open issues, the resolution of which will be important to how targeted borrowers are able to access the system and the broader effect the MSBLP may have on the current economic disruption.

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## WHAT WE KNOW

Beyond the name of the program and the targeting of the credit to small- and medium-sized businesses, the Federal Reserve's March 23 release contained no substantive details about the program. However, the CARES Act includes some provisions that define key aspects of the program:

- Financing would be provided to banks and other lenders to make loans to eligible businesses or non-profits that (1) are organized under U.S. law and have significant operations and majority of employees in the U.S. and (2) have between 500 and 10,000 employees.
- Loans to eligible borrowers would have an interest rate not higher than 2% and would be principal and interest deferred for at least 6 months.
- Eligible borrowers shall make good faith certifications in their applications to the effect that, in addition to the above-stated eligibility criteria:
  - Economic uncertainty makes the loan request necessary to support ongoing operations;
  - Funds will be used to retain or restore at least 90 percent of workforce at full compensation and benefits until at least September 30, 2020 and to restore full compensation within 4 months after termination of the public health emergency;
  - The recipient is not a debtor in a bankruptcy proceeding;
  - It will not engage in buybacks of listed stock or dividends to common stock while the direct loan is outstanding;
  - The recipient will not outsource or offshore jobs for the term of the loan plus two years; and
  - The recipient will not abrogate existing collective bargaining agreements for the term of loan plus two years and will remain neutral in any union organizing effort for the term of the loan.
- Recipient borrowers must comply with certain limitations on compensation for the term of the loan plus one year:
  - Employees or officers with total compensation greater than \$425,000 in 2019 could not receive total compensation greater than their 2019 total in any consecutive 12 month period and receive no severance or other termination benefits greater than 2x their total 2019 compensation; and
  - Employees or officers with total compensation greater than \$3 million in 2019 would effectively have their total income reduced by half of their 2019 excess over \$3 million for any consecutive 12 month period.
- Loans to recipient borrowers may not be reduced through forgiveness.

## WHAT WE EXPECT

Based on market discussions in advance of the CARES Act and implementation of the Federal Reserve's initiatives from its March 23 release, we expect the following broad outlines of the MSBLP program:

- Treasury will use a portion of its \$454 billion appropriation under Section 4003(b)(4) of the CARES Act, with secondary sources citing an expectation of \$85 billion dedicated to MSBLP, to contribute to a Federal Reserve special purpose vehicle ("SPV") set up for this purpose. That SPV would then extend credit to banks and other lenders who lend to eligible

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borrowers—meaning that with the Federal Reserve's leverage, the total extension of credit supported could be around \$1 trillion assuming full utilization.

- Based on other similar programs and the wording of the Federal Reserve release and related CARES Act provisions, we expect the MSBLP to function by the SPV extending credit on a non-recourse basis to banks and other lenders, using loans to eligible borrowers as collateral and with a predetermined collateral valuation percentage or haircut that may differ by the loan terms (e.g. a smaller haircut for shorter term loans).
- An important aspect of this structure is intermediation through banks and other lenders, versus a Federal Reserve direct lending model as in the case of the Federal Reserve's Primary Market Corporate Credit Facility for investment grade corporate borrowers. This intermediation through the financial market's existing middle market lending infrastructure may mean a quicker and smoother process of credit extension for the large number of businesses that would potentially fall into this category.

## SIGNIFICANT OPEN ISSUES

As the market awaits additional details on how the MSBLP will be implemented, there are several key open issues that we expect to play out in the further development of the MSBLP program:

- The Federal Reserve's March 23 release cited its existing authority under Section 13(3) of the Federal Reserve Act as authorizing the credit facilities being announced, and the CARES Act explicitly incorporates lending criteria from Section 13(3) into the MSBLP.

A key feature of Section 13(3) is the intended protections for taxpayers in Federal Reserve assistance given to private businesses, including the requirement for sufficient security for loans. There will be a natural tension between ensuring that the MSBLP credit is available as broadly as possible to distressed small and medium-sized businesses that need assistance and complying with Section 13(3) to require adequate security to ensure that the Federal government doesn't experience losses on this extension of credit.

A strict reading of the Section 13(3) requirements would likely mean that potential borrowers that are in severe financial distress or that have limited access to collateral to pledge would be shut out from this program.

- As noted above, we expect the MSBLP to provide non-recourse financing of eligible loans—so in this model where credit underwriting is delegated to the bank or other lender originating the loan but the Federal Reserve and U.S. Treasury effectively bear the credit risk beyond some haircut applied to the loan as collateral, it's not clear how the implementing guidelines will pass through the appropriate credit risk mitigation incentives to the banks or other lenders who will be originating and underwriting the loans.
- SBA lending is based on an established process with financial institutions experienced in making SBA loans—so while the PPP is a significant new feature in terms of size and substance, it is built upon an existing foundation. The MSBLP, in contrast, would appear to require the creation of a new process and new relationships between the Federal Reserve and participating financial institutions. Because of the novelty of the MSBLP structure it is possible that the PPP will be able to be rolled out more quickly and with fewer issues than the MSBLP.
- The CARES Act makes explicit that no obligations related to Section 4003(b) assistance, including the MSBLP, shall be reduced through forgiveness, whereas the PPP allows for loan forgiveness to small businesses that meet the criteria of workforce retention. While the CARES Act MSBLP provisions would require eligible borrowers to certify an intent to retain or restore at least 90% of their workforce, it's not clear whether that certification and any related enforcement will be as

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strong as an incentive for employee retention/rehiring as the PPP's forgiveness option, or that MSBLP borrowers will be able to sustain that workforce level relative to PPP borrowers that have been partially recapitalized by loan forgiveness.

- The CARES Act provisions refer to a facility to extend credit to “banks and other lenders that make direct loans to eligible businesses.” A significant point of uncertainty is whether the implementing guidelines will allow the MSBLP facility to be available to private lenders, including traditional private lenders as well as fintech or crowdsourced lenders.

*\* Note that this whitepaper is based on information available as of the date above. We expect additional details to be released with respect to this program and will update this whitepaper in due course. The Main Street Business Lending Program is still being developed and the terms of the program as finally enacted may differ substantially from those described herein.*

