Testimony of

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Emeritus Professor, Harvard Law School;

President of the Committee on Capital Markets Regulation

Before the

Committee on Banking, Housing and Urban Affairs

United States Senate

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Thank you, Chairman Crapo, Ranking Member Brown, and members of this Committee for inviting me to testify before you today on the Treasury/Federal Reserve Main Street Lending Program (MSLP). My testimony today regarding the MSLP is based on the September 3 statement of the Committee on Capital Markets Regulation (CCMR), of which I am the President. With respect to other issues, the testimony is my own, and does not necessarily represent the views of CCMR.

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

CCMR believes that small and medium sized businesses ("SMEs") will need financial support for several years to recover from the impact of the COVID-19 pandemic. A key part of this support should come from the MSLP authorized by the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act"). The MSLP comprises five facilities, three of which are targeted at for-profit business and two of which are targeted at nonprofits. My testimony is focused on the three for-profit facilities. So far these facilities, which have been operating for over two months, have not delivered the anticipated results.

CCMR therefore recommended that MSLP be significantly restructured to: (1) take on more credit risk, by providing that the Federal Reserve make 100% of each loan, rather than 95% as presently provided, leaving banks and other eligible financial institutions as processors; and (2) provide below market terms for borrowers who are unable to obtain credit from their existing lenders. The MSLP loans from the Federal Reserve should be on a first-come first-serve basis, based on objective criteria, 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 they can take advantage of the program. Extraordinary federal intervention such as the MSLP must end as soon as the need for such a program has dissipated. CCMR supports the current end-date of December 31, 2020, which can be reevaluated in the coming months.

The need for expanded support for small and medium sized businesses has been intensified by the current Congressional deadlock over new appropriations for these firms. Congress has already appropriated $454 billion in the CARES Act to back Fed lending facilities. This appropriation should be used now to help Main Street.

1. Small and Medium Sized Businesses (SMEs) Need Government Help

Small businesses have been hard hit by the COVID-19 pandemic. 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 2020. Certain sectors have been disproportionately affected by the pandemic: as of mid-August, revenues at transportation businesses had declined by 67% compared to the same week last year; revenues at arts and entertainment business had decreased by 44%; and revenues at restaurants had declined by 19%. Also through mid-August, 64% of local arts and entertainment businesses and 39% of bars and lounges had not processed a single transaction for three straight days. 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.

Medium sized businesses have also been hard hit. Moody's Analytics reported that, as of mid-June, middle market corporations had experienced across-the-board increases in their expected default frequency. And the default rate on private debt rose to 8.1% in Q2 2020 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.

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, making it harder for these firms to obtain bank financing. 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. 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.

A V-shaped recovery, meaning that the economy will within the next year or so bounce back to a pre-COVID level, is unlikely. Such a recovery is inconsistent with the predictions of the Federal Reserve 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. According to the latest economic projections from Fed officials, the economy will contract by anywhere between 4% and 10% this year. Most officials do not expect the economy to recover completely until 2022. While the latest unemployment figures have improved, the unemployment level is still very high at 8.4%, and as Chairman Powell observed last week, there are still 11 million fewer Americans working than there were in February.

The generally buoyant U.S. public equity market is not 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. Moreover, while Fed liquidity and low interest rates might help support public 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 I shall shortly expand upon, the Treasury needs to be prepared to take that risk.

In summary, SMEs face prolonged 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.

2. The MSLP and Credit Risk

When the CARES Act was enacted over four 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. The Treasury subsequently announced that it would set aside $75 billion of this appropriation to support $600 billion in loans to SMEs under the Main Street facilities on April 9. These programs, after several revisions, became operational on July 6. As of September 2, the Fed had purchased about $1.2 billion in loans through the MLSP, implying that $1.3 billion in loans had been made under the MSLP. The Federal Reserve currently discloses transaction-specific data about the MSLP monthly. As of July 31, 2020, the program had only purchased participations in thirteen loans, ranging in size from $1.5 million to $50 million. Secretary Mnuchin has estimated that between $25 and 50 billion in loans will ultimately be issued through the MSLP. This level of lending, if it does occur, will be far short of the MSLP's lending capacity of $600 billion 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. 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." The terms of the MSLP reflect the Treasury's view by requiring lenders to retain 5% of all loans and to apply normal credit standards (which they would do anyway given their exposure).

On August 4, Chairman Crapo 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 guaran-tees, or investments may incur losses." Senator Crapo and Congressman Patrick McHenry have also written to Secretary Mnuchin and Chairman Powell, urging them to use funds appropriated under the CARES Act to expand the MSLP.

CCMR strongly supports Senator Crapo's amendment, to remove any doubt of Congressional intent. We urge 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. Required Changes in MSLP

For the MSLP to support SMEs in an effective manner, two major changes need to be made: (a) the Fed should make 100% of the loans with financial institutions acting as only processors; and (b) the terms for borrowers must be below market.

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

For the MSLP to work, lenders cannot be required to hold 5% of each loan. The requirement that lenders bear credit risk is a major obstacle to the effectiveness of the MSLP. Lenders are unwilling to lend to the neediest borrowers who are uncreditworthy under normal standards. And borrowers that can meet normal credit standards do not need the MSLP at all.

As of August 10, only 522 financial institutions had registered to participate in the MSLP. That number represents less than 5% of eligible lenders. Moreover, of those 500 financial institutions, just 160 of them stood willing to publicly accept loan applications from new customers that lack a preexisting relationship with the lender. Larger banks had played a minimal role in MSLP lending as of early August; more than 90% of lenders registered to participate in the MSLP had less than $50 billion in assets and those lenders were responsible for more than 95% all MSLP loans.

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. We therefore agree with the recommendation of Senators Loeffler, Braun, Cornyn, and Tillis, 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.

To the extent that the infrastructure already put in place by the Federal Reserve is sufficient, the Fed could lend to borrowers directly, circumventing banks 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 reasonable fee, based on their costs, for processing loans.

b. *Specific Terms*

As for specific terms, CCMR suggests the following, consistent with the below market approach:

- Loans should be unsecured, since the most distressed borrowers do not have collateral.
- The maximum loan size should be increased. Under the current terms, which tie maximum loan size to the borrower's outstanding debt relative to earnings, many SMEs are excluded from participation as a result of their current high leverage. One way of avoiding such disqualification is 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.

- 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).
- The term should be extended to 10 years (from 5 years).
- Prepayment should be without penalty (consistent with current terms).
- 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;
    - the funds borrowed will be spent on their business; and
    - 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. 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 lending. 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 debt would be similar to patient equity, given the significant risk of nonpayment.

Another potential concern is that extending loans on below-market terms will lead the Fed to prop up businesses that are no longer viable. But the risk that viable businesses will go under en masse without additional support generally warrants greater risk-taking by the Fed and Treasury. And the Fed can 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 objective 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 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. Businesses that receive MSLP loans are prohibited from paying dividends or repurchasing shares until one year after the loan is no longer outstanding. 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. MSLP borrowers also cannot increase compensation over any 12-month period for any employee that was paid more than $425,000 in 2019. In addition, as set forth in the CCMR proposed terms, 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. The proceeds of an MSLP should not be used to repay liabilities of the company which are personally guaranteed by any of the shareholders.

CCMR generally opposes government intervention in private business. Extension of MSLP loans should therefore only be tolerated in the short-term. CCMR 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.

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 September 2, the CARES Act facilities, apart from Main Street, held only $17 billion in loans backed by $65 billion in

Treasury funds. The existing backing of non-Main Street facilities is excessive given the low number of loans, so some of this backing could be redeployed to Main Street.

Apart from this existing backing, the Treasury has $351.5 billion in CARES Act funding that it has not yet used—a significant portion of this unused amount can be added to support a redesigned MSLP.

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. Yet the MSLP has seen limited take-up. That is in part attributable to the program's current terms, which warrants the changes we recommend. 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. This is a particular problem for minority-owned businesses. Using data supplied by Dun & Bradstreet, 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, along with private lenders, outreach to and enrollment assistance for eligible borrowers with a chance of survival.

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, the Treasury and Federal Reserve should also explore the possibility of adding a new facility, perhaps under the MSLP, to support access to credit for new businesses. A facility of this sort would not provide equity to new start-up businesses; but once a new business has secured equity financing from private sources it could be eligible for debt financing on appropriate terms.

7. Conclusion

Main Street's recovery is crucial for the U.S. economic recovery. CCMR recommends that Congress enact Senator Crapo's proposed amendment to remove any doubt that Congress's intent in enacting the CARES Act was for the Treasury to take credit risk. If such legislative action cannot be achieved, we would recommend that the Senate Banking Committee clarify Congress's intent in a bipartisan letter to Secretary Mnuchin.

There is no guarantee that the extraordinary measures recommended by CCMR will succeed in saving American 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.