Fourth Report of the Congressional Oversight Commission on the Use of CARES Act Funds

By Steven Kelly and Rosalind Z. Wiggins

Original post here.

This post provides an overview of the findings contained in the Commission's fourth report - click here to access the full report.

On August 21, the Congressional Oversight Commission—charged with overseeing the implementation of Title IV, Subtitle A of the US Coronavirus Aid, Relief, and Economic Security (CARES) Act and the related programs established by the Federal Reserve ("Fed") and the Treasury (collectively, "the agencies")—published its fourth report. In its fourth report, the Commission updated the status of the programs under its purview—including the programs established by the Federal Reserve ("Fed") with equity investments from the Treasury—with a specific focus on the Main Street Lending Program (MSLP) facilities.

Title IV, Subtitle A (subtitled the Coronavirus Economic Stabilization Act (CESA)), provides the Treasury with $500 billion for direct lending to businesses in the aviation industry and businesses critical to national security ($46 billion) and for supporting Fed emergency lending programs to be established under section 13(3) of the Federal Reserve Act ($454 billion). The Commission is to submit reports every 30 days to Congress on the use, effectiveness, and other specified issues of these funds. See this YPFS blogpost for further discussion of the Commission's composition and mission.

Status of Federal Reserve Programs with Treasury Equity Support

The Treasury has pledged $195 billion of the $454 billion available to capitalize Fed emergency lending vehicles. See this YPFS blog post for a description of the allocation of the pledged funds to the various vehicles.

As of August 19, the Fed lending programs with capitalization from CESA funds stood at the following amounts:

- The Secondary Market Corporate Credit Facility (SMCCF) had made $12.5 billion of individual corporate bond and corporate bond ETF purchases in secondary markets. The Primary Market Corporate Credit Facility (PMCCF) remained unused.
- The Municipal Liquidity Facility (MLF) had purchased $1.7 billion of short-term notes, from two borrowers.
- The MSLP had purchased $472 million—its share of $497 million of MSLP-supported loans to small and medium-sized businesses. The nonprofit component of the MSLP had yet to open.

- The Term Asset-Backed Securities Loan Facility had lent $2.3 billion.

As of the August 21 publication date, the Fed had established six entities (the PMCCF and SMCCF operate from the same entity) with equity from the Treasury. All of these facilities are now operational: those mentioned above and two additional facilities—the Money Market Mutual Fund Liquidity Facility (MMLF) and Commercial Paper Funding Facility (CPFF)—that received their Treasury funding from separate Exchange Stabilization Fund (ESF) funds, not the CARES Act funds. The Commission is not responsible for reporting on the Treasury's funding of the MMLF and CPFF.

See this YPFS blog for a discussion of usage of the Fed's liquidity programs during the COVID-19 crisis, including the CESA programs, as of August 26.

Fed Program Updates

The report mentions several updates to Fed facilities since the third report.

The Fed has extended the expiration dates of seven emergency liquidity programs, including the CARES Act facilities, from September 30 to December 31, 2020; see this YPFS blog post. The Fed has also announced that it would reduce the interest rate spreads charged by the MLF by 0.5% and lower the conversion factor for determining interest rates on taxable notes; see this YPFS blog post.

The Commission noted that TALF lending activity accelerated in July. (The facility opened June 17 and had no other subscription dates—dates where participants can pledge collateral to the TALF—that month.) The facility's loans grew in July from $252 million to $1.6 billion. The Commission also briefly discussed a recent Fed report that concluded that the TALF announcement and subsequent expansion were effective in reducing spreads in the securitization market, particularly in the markets for assets eligible to be pledged to the TALF.

The MLF made its second extension of credit—purchasing $451 million of three-year notes from New York's Metropolitan Transportation Authority. The Commission plans to hold a hearing on the MLF in the coming weeks.

The Fed announced the addition of two facilities to the MSLP to expand access to non-profit firms. See this YPFS blog post for details. (See this YPFS spreadsheet for the full timeline of MSLP developments.) The MSLP, being the primary focus of this installment of the Commission's reporting, is discussed more below.

Loans to firms with National Security Interests

Subtitle A allocated $46 billion to the airline industry and firms essential to national security. The $29 billion allocated to the airline industry remained unused as of the date of the report. The report notes, however, that the Treasury has signed letters of intent to lend funds with ten passenger air carriers so far. One of those—Southwest Airlines—has since announced that it will not participate. The Commission also mentioned an August 4 Bloomberg article reporting that Treasury is asking airlines seeking Subtitle A funds to first apply to the MSLP.

From the $17 billion allocated to firms essential to national security interests, the Treasury has made one loan, a loan for $700 Million to YRC Worldwide Inc. ("YRC") on July 1. The terms of the YRC loan (including the Treasury's equity stake) are described here. The Commission discussed this loan at length in its third report and continues to investigate concerns over the firm's viability, its loan terms, and the process by which it became eligible for funding.

On July 30, the Treasury sent the Commission a letter (see Appendix A of the report) responding to the concerns the Commission raised regarding YRC in its third report. The Commission reviewed the letter and sent its own letters to Treasury Secretary Steven Mnuchin and Defense Secretary Mark Esper with clarifying questions and requesting additional information (Appendix B and C). The Commission requested responses by August 27.

Main Street Lending Program

On August 7, the Commission held a hearing on the MSLP. The hearing consisted of two panels: one with Eric Rosengren—President of the Boston Fed (which runs the MSLP)—and one with four MSLP stakeholders. A video of the hearing is available here as well as participant names, affiliations, and prepared testimonies. Per the Commission, the hearing "explored potential reasons for the program's currently low utilization rate and whether the potential utilization rate would increase in the future. It also explored whether modifications to expand access to the Main Street Lending Program are advisable and whether the Main Street Lending Program adequately encourages banks to make loans that they would not have otherwise made."

Following the August 7 hearing, the August report contains a lengthy discussion of the MSLP. As a result, this report relays much more disagreement amongst Commissioners than previous reports, but it contains a detailed discussion of such—in addition to reaching some conclusions.

The Commission first points out that it is not clear that there is a strong unmet demand for new credit from eligible medium-sized businesses. The Commission cites surveys from the Fed and from the National Federation of Independent Businesses that show limited demand for new credit among the targeted firms.

That concern notwithstanding, the Commission discussed a few major themes and issues that might make the MSLP more effective. The Commission noted that banks have tightened credit in recent months; it also reported in its third report that Secretary Mnuchin and Fed Chair Jay Powell suggested MSLP usage may increase given such tightening. The Commission also stated that, given the diversity of end-borrowers and lack of standardization in the loan market (as noted by President Rosengren), the mere presence of the MSLP (irrespective of the amount utilized) may not provide an effective backstop to the targeted lending market the way the corporate bond facilities do via the capital markets. The Commission noted that at $472 million, the MSLP's holdings are 0.07% of its stated capacity of $600 billion in loan purchases.

Too Slow

In several instances, the Commission noted the relatively slow rollout of the MSLP. The MSLP lending programs for for-profit businesses, which were announced on April 9, began purchases only on July 6. The Fed first discussed its intention to create the nonprofit facilities on April 30, and these facilities remain nonoperational. In his testimony, President Rosengren noted that the length of the implementation period was due to the complicated nature of "a program that purchases participations in loans from diverse borrowers in a decentralized market that lacks standardization."

The Commission pushed for future activity to be expedited, including the rollout of the nonprofit MSLP facilities. The Commission suggested the Boston Fed enlist the other regional Fed locations if necessary to alleviate the administrative burden.

New Lending?

The report contained extensive discussion—though no conclusion—on whether the Main Street facilities were actually encouraging loans that banks otherwise wouldn't have made. The Commission noted that the Fed has relied on banks as partial-risk-bearing conduits for this program—in contrast to doing direct lending itself—as a means to leverage their expertise, relationships and infrastructure. It questioned whether this was the most effective structure for the program given that its purpose under Section 13(3) of the Federal Reserve Act—which outlines the Fed's nonbank emergency lending authority—is to facilitate lending to firms that are unable to secure adequate credit from lenders.

Thus, the Commission notes that the MSLP's structure—which leaves 5% of the loan on the lending bank's balance sheet—may inhibit lending to firms unable to secure credit privately. The MSLP asks banks to apply their own underwriting standards to the loan—standards which, as mentioned, have tightened during the pandemic. Bank supervisors are to treat MSLP loans as they would regular commercial loans as well. Furthermore, the MSLP loans come with executive compensation and equity distribution restrictions that outlive the life of the loan.

The Commission also noted, however, that given that the fees banks earn are based on the total amount of the loan, not just the retained portion, these fees rise to 15-20% of the retained portion. President Rosengren, however, was of the view that, because the Fed was purchasing 95% of the loan, banks which might not have been able to bear the risk of 100% of the loan can now make that loan.

The Commissioners agreed that the Treasury did not need any further statutory guidance to increase its risk tolerance—including to incur losses—with its equity investment in the MSLP.

As of August 7, 509 banks—less than 5% of the nation's lenders (but representing 58% of United States banking assets)—had registered to participate in the MSLP. The Commission noted that by comparison, the number of lenders (banks and nonbanks) participating in the Paycheck Protection Program—the Congressionally-funded program that guaranteed whole loans to small businesses—was more than ten-fold greater. The report notes that some of the nation's largest lenders have said they will only make MSLP loans to existing customers. The Commission also shared Chair Powell's and Secretary Mnuchin's comments from their July meeting that both were not aware of "any philosophical or administrative reason why nonbank lenders could not be made eligible to participate in the Main Street Lending Program."

Possible improvements?

Though not totally in agreement on the idea that the effectiveness and prevalence of MSLP loans can be salvaged by reform, the Commission discussed several possible fixes to encourage new lending and make the new debt not overly burdensome for the borrowers. This discussion saw some Commissioners suggesting a further stretching of the term sheet: extending the five-year maturity of the loans and the current two-year delay on loan amortization (though the question was raised of whether long-term loans fit the intent of the CARES Act), lowering minimum loan amounts, easing affiliation restrictions and loosening leverage standards—perhaps via higher lender retention or collateral-based lending. Notwithstanding Chairman Powell and Secretary Mnuchin telling the Commission in advance of the third report that the agencies were looking at an asset-based addition to the MSLP facilities lineup, President Rosengren testified that there is "no [asset-based lending] term sheet that is imminent."

The Commission is composed of five members, four members appointed by the leaders of the House and Senate and a chairman jointly appointed by the speaker of the House and the Senate majority leader, after consultation with minority leaders. As of the publication of the fourth report on August 21, the chairman position remains unfilled.