# Table of Contents

## INTRODUCTION ..................................................................................................................... 8

## COVID-19 FINANCIAL RESPONSE TRACKER ................................................................. 9

## RESOURCE GUIDES ............................................................................................................. 10

## KEY PROGRAM SUMMARIES ............................................................................................. 10

## 2020 YPFS PRELIMINARY DISCUSSION DRAFTS ............................................................. 11

## CONTACT ............................................................................................................................ 11

## CRITICAL INDUSTRIES ..................................................................................................... 13

### ANALYSIS ......................................................................................................................... 14

Aid to Airlines and other Critical Industries During Crises .................................................. 14
Usage of the Defense Production Act throughout history and to combat COVID-19 .......... 21

### CASE STUDIES AND POLICY CHANGES ....................................................................... 29

US Provides Aid to Airlines in Historic Relief Bill .............................................................. 29
US Begins Airline and Aviation Interventions ..................................................................... 31
Aviation Interventions Continue Internationally ................................................................. 37
More Aid Offered To Airlines as Pandemic Continues to Depress Demand .................... 39
USDA Announces $14 Billion in Aid to Farmers ................................................................. 44

## LIQUIDITY AND MARKET LIQUIDITY .............................................................................. 48

### ANALYSIS ......................................................................................................................... 49

Central Banks Introduce Programs to Improve Liquidity in Key Markets ......................... 49
Treasury Backstop for Fed Lending under CARES Act: Lessons from 2008 TALF .......... 54
Barriers to Access Impede Utilization of Municipal Liquidity Facility ............................. 57
Federal Reserve Programs Involve More Risk than in GFC ............................................ 61
Federal Reserve to Report Monthly on CARES Act Program ....................................... 66
How Available Is the ESF for New Fed Facilities? ......................................................... 68

### FEDERAL RESERVE PROGRAM USAGE ....................................................................... 73

Early Use of Federal Reserve Programs ........................................................................... 73
Use of Federal Reserve Programs as of May 7 ................................................................. 77
May 14 .................................................................................................................................. 82
May 21 .................................................................................................................................. 85
May 28 .................................................................................................................................. 88
June 4 ................................................................................................................................... 92
June 11 ................................................................................................................................. 98
June 18 ................................................................................................................................ 103
CASE STUDIES AND POLICY CHANGES ........................................................................................................ 203

Fed Introduces Modified Primary Dealer Credit Facility 203
Fed Reintroduces Commercial Paper Funding Facility 204
Fed Provides Liquidity Options to Cities and States 205
Fed Reintroduces Term Asset-backed Securities Loan Facility 207
Bank of England activates the Contingent Term Repo Facility 208
Federal Reserve Supports Corporate Bond Markets 209
ECB Unveils Pandemic Emergency Purchase Programme 211
Federal Reserve Expands Support to Corporate Bond Markets 213
Federal Reserve Broadens Range of Eligible Collateral for TALF 215
Federal Reserve Announces New Municipal Liquidity Facility 217
Bank of Canada Establishes Series of Programs to Promote Market Liquidity 219
Federal Reserve Expands Eligibility for Municipal Liquidity Facility 221
India Extends Special Liquidity Facility to Mutual Funds 223
Bank of Japan Increases Liquidity Measures 225
The Bank of Mexico Plans to Inject $30 billion to Provide Liquidity 226
Federal Reserve Expands Support to Corporate Bond Markets Again 229
Japan Begins Capital Injections for Financial Institutions in Response to COVID-19 230
ECB Announces New Eurosystem Repo Facility to Provide Euro Liquidity 232
Brazil’s central bank injects liquidity in financial markets 234
RBI to provide liquidity to non-bank financial firms 238
Implications of the German Constitutional Court’s Objection to the ECB’s Public Sector Purchase Program 242
The Federal Reserve expands eligible counterparties and agents in three emergency facilities 246
Federal Reserve Extends Lending Programs to December 31 247
Bank of England Rapidly Expands Asset Purchase Facility 248
UK Introduces Covid Corporate Financing Facility 252
Fed introduces Money Market Mutual Fund Liquidity Facility 253
Federal Reserve Announces $2.3 trillion Lending Package 255
Federal Reserve further expands access to Municipal Liquidity Facility 258
Federal Reserve Lowers Pricing for Municipal Liquidity Facility 261
RBI announces further liquidity measures in response to COVID-19 263
RBI reinforce liquidity measures while keeping the interest rate constant 265

MACROPRUDENTIAL POLICY .................................................................................................................. 274

ANALYSIS ................................................................................................................................................. 275
## Analysis

<table>
<thead>
<tr>
<th>Topic</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Multinational Organizations’ Efforts to Assist Countries through COVID-19 crisis</td>
<td>431</td>
</tr>
<tr>
<td>The Limits of the G20’s Debt Service Suspension Initiative</td>
<td>442</td>
</tr>
<tr>
<td>Multilateral Development Banks in Latin America and the Caribbean</td>
<td>447</td>
</tr>
<tr>
<td>Who’s afraid of some (not so big or bad) debt relief?</td>
<td>452</td>
</tr>
<tr>
<td>The G20’s impasse on Special Drawing Rights (SDRs)</td>
<td>464</td>
</tr>
</tbody>
</table>

## Case Studies and Policy Changes

<table>
<thead>
<tr>
<th>Topic</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asian Development Bank Increases Funds for Producers of Critical Medical Supplies</td>
<td>470</td>
</tr>
<tr>
<td>The IMF makes funds available in response to the COVID-19 crisis</td>
<td>472</td>
</tr>
<tr>
<td>World Bank Support to Developing Countries</td>
<td>474</td>
</tr>
<tr>
<td>The IMF Expands and Expedites Lending in Response to the COVID-19 crisis</td>
<td>476</td>
</tr>
<tr>
<td>IFC Provides $8 Billion in Fast-Track Financing to Private Sector</td>
<td>479</td>
</tr>
<tr>
<td>EU Programs Supporting non-EU Countries</td>
<td>481</td>
</tr>
<tr>
<td>EU Programs in Support of Member Countries</td>
<td>484</td>
</tr>
<tr>
<td>Update on the progress of the World Bank’s COVID-19 response efforts</td>
<td>489</td>
</tr>
<tr>
<td>European Stability Mechanism Establishes Pandemic Support Credit Lines</td>
<td>494</td>
</tr>
<tr>
<td>EU Member States Reach Unanimous Deal on Historic EUR 750 billion Fiscal Stimulus Package</td>
<td>496</td>
</tr>
<tr>
<td>European Council finalizes Multiannual Financial Framework and Additional COVID-19 Response Measures</td>
<td>500</td>
</tr>
<tr>
<td>Argentina’s Path to Debt Relief from Private Creditors</td>
<td>503</td>
</tr>
<tr>
<td>Chile’s Central Bank Injects Liquidity in Financial Markets</td>
<td>508</td>
</tr>
</tbody>
</table>

## Small and Medium Enterprises (SMES)

### Analysis

<table>
<thead>
<tr>
<th>Topic</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Guarantee Programs for Small and Medium-Sized Enterprises</td>
<td>517</td>
</tr>
<tr>
<td>Loan Guarantee Programs May Include Nonbanks</td>
<td>519</td>
</tr>
<tr>
<td>Making SME Credit Guarantee Programs Affordable: Subsidized Interest Payments for an Initial Period</td>
<td>520</td>
</tr>
<tr>
<td>Large-Scale Assistance Programs for Small Businesses</td>
<td>521</td>
</tr>
<tr>
<td>Lessons Learned in Designing and Implementing Support for Small Businesses</td>
<td>533</td>
</tr>
<tr>
<td>Countries Provide Support to Workers in the Informal Economy</td>
<td>539</td>
</tr>
<tr>
<td>Governments Provide SMEs with Relief for Non-Wage Fixed Costs</td>
<td>543</td>
</tr>
<tr>
<td>Governments Encourage SMEs to Adopt New Technology</td>
<td>548</td>
</tr>
<tr>
<td>Countries Continue to Adopt and Update Credit Guarantee Schemes for Small Business Lending</td>
<td>552</td>
</tr>
<tr>
<td>Governments Support Businesses through Equity Investments</td>
<td>557</td>
</tr>
<tr>
<td>78% of US Small Businesses Negatively Impacted by the COVID-19 Pandemic</td>
<td>561</td>
</tr>
</tbody>
</table>

### Case Studies and Policy Changes

<table>
<thead>
<tr>
<th>Topic</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>MicroFinance Ireland: Targeted Lending for Microenterprises Impacted by COVID-19</td>
<td>563</td>
</tr>
<tr>
<td>Direct Lending to SMEs - Canada’s Business Credit Availability Program</td>
<td>564</td>
</tr>
<tr>
<td>Federal Reserve Announces Main Street Lending Program</td>
<td>566</td>
</tr>
<tr>
<td>Federal Reserve Introduces Paycheck Protection Program Liquidity Facility</td>
<td>568</td>
</tr>
<tr>
<td>Germany Launches New Support Program After Partial Guarantee Insufficient to Promote Lending to Small Businesses</td>
<td>569</td>
</tr>
<tr>
<td>Federal Reserve Waives Restriction on Wells Fargo to Allow Lending to Small Businesses</td>
<td>571</td>
</tr>
<tr>
<td>Italy Expands and Updates its Credit Guarantee Programs</td>
<td>572</td>
</tr>
<tr>
<td>UK Expands Support for Small Businesses After Limited Impact of Initial Program</td>
<td>574</td>
</tr>
</tbody>
</table>
Switzerland Programs Serve as Model for Quick Support to Small Businesses 576
Congress Expands Support to Small Businesses 578
Germany Provides Public Funding for Recapitalization and Startup Equity 580
ECB Considers Adopting EU Bad Bank 582
UK Announces Support to Innovative Firms 583
Federal Reserve Announces Changes to Main Street Lending Program 585
UK Announces New 100% Loan Guarantee Program Targeted at Smallest Businesses 588
Federal Reserve Expands Access to Paycheck Protection Program Lending Facility to Non-Depository Institution Lenders 589
PPP Rules Changed to Better Target Funds 590
Denmark Extends Duration of COVID-19 Support Programs and Introduces New Measures 592
FHFA Allows Federal Home Loan Banks to Take PPP Loans as Collateral 594
US Businesses Navigate Multiple Government Support Programs 597
The Philippines Provides Support to Workers in the Informal Economy 602
EU Expands Temporary Framework For State Aid to Allow Recapitalization 604
Nepal Expands Public-Works Program 608
Bank of Japan Introduces New Facility to Support Bank Lending to Small and Medium-Sized Firms 609
Poland’s Financial Shield Provides Support to Businesses 610
Bank of Mauritius Granted Permission to Make Equity Investments in Companies 613
United States Congress Passes Amendments to Paycheck Protection Program 614
SBA and Treasury Issue Guidance on PPP Loan Forgiveness 615
Federal Reserve Amends Main Street Lending Program 617
Germany Introduces Fixed Cost Support for SMEs 620
Main Street Lending Program Opens for Lenders 622
Small Business Administration Announces Updates to Small Business Support Programs 623
SBA Will Disclose Certain Recipients of Paycheck Protection Program Aid 625
European Commission Expands Eligibility for SME Support and Increases Incentives for Private Recapitalization 627
US Treasury Extends $700 Million Loan to YRC Worldwide Inc. under CARES Act Provision 630
US Extends Paycheck Protection Program by 5 Weeks 632
Fed Expands Main Street Lending Program to Include Nonprofits 633
Utilization of Credit Support Programs for SMEs 635
Portugal Announces SME Debt Securitization Program 637
One-Quarter of SMEs Closed During the COVID-19 Lockdown 639
Paycheck Protection Program spread loans widely, if not evenly 641
Direct Lending to SMEs - Canada’s Business Credit Availability Program 651
Paycheck Protection Program Loan Forgiveness Rules Eased for Smallest Borrowers 653
As Need for Additional Small Business Aid Intensifies, Preliminary Evaluations of the PPP Suggest It Improved Business Survival 654

SUPPORT FOR INDIVIDUALS............................................................................................ 658

ANALYSIS ........................................................................................................................... 659

Government Support to Individuals and Households During Crises 659
US Supports Individuals and Households in Response to COVID-19 671
Programs Support Individuals through Unemployment Insurance and Wage Subsidies 673
Programs Support Individuals through Direct Payments and Tax Cuts 677
Programs Support Individuals through Tax-Deadline Extensions and Penalty Waivers 680

YALE PROGRAM ON FINANCIAL STABILITY | 6
<table>
<thead>
<tr>
<th>Unemployment Insurance and Short-Time Compensation in the US and abroad</th>
<th>683</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pandemic catalyzes transition to cashless benefits</td>
<td>692</td>
</tr>
</tbody>
</table>

**CASE STUDIES AND POLICY CHANGES** ................................................................. 701

- EU Proposes Support for Short-Time Work Schemes | 701
- Korea Announces New Deal Budget Proposal Aimed at Developing its Post-COVID Economy | 703
- Debate over new stimulus plan continues as unemployment benefits near expiration | 706
- Cross-country Comparison of Economic Outcomes and Policy Responses to Support Individuals in June | 709
- With Phaseout of Wage Subsidy Scheme, UK Announces Rehiring Bonus | 721
- President Trump Takes Executive Action as Further Stimulus Bill Talks Stall | 723
- Barriers to Wage Replacement Schemes | 726

**SWAPS** ............................................................................................................ 733

**ANALYSIS** ........................................................................................................ 734

- Central Banks Use Swap Lines to Maintain the Flow of US Dollar | 734

**CASE STUDIES AND POLICY CHANGES** ................................................................. 741

- Fed Creates Dollar Repo Facility for Central Banks, Extending Liquidity to Central Banks that Don’t Have Fed Swap Lines | 741
- Reserve liquidity facilities shift from advanced economies to emerging markets | 743
- Federal Reserve extends temporary US dollar liquidity swap lines and FIMA repo facility to March 31, 2021 | 746
- ECB Announces New Eurosystem Repo Facility to Provide Euro Liquidity | 748

**OVERSIGHT & COMMUNICATION** ..................................................................... 750

**ANALYSIS** ........................................................................................................ 751

- Communicating in a Crisis: Lessons Learned from the Last One | 751
- The Uncertain Future of the Fed’s CARES Act Facilities | 759
- Redux: Outlook for 13(3) and Fed Crisis Response | 763

**CASE STUDIES AND POLICY CHANGES** ................................................................. 767

- First Report of the Congressional Oversight Commission on the Use of CARES Act Funds | 767
- Federal Reserve to Report Monthly on CARES Act Program | 770
- Mnuchin Clarifies that Treasury is Prepared to Lose Money on Fed Programs | 772
- Paycheck Protection Program highlights numerous oversight concerns even as the SBA makes first disclosures | 775
- Second Report of the Congressional Oversight Commission on the Use of CARES Act Funds | 786
- GAO Report Highlights Opportunities to Improve Federal COVID Response and Recovery Efforts | 791
- Third Report of the Congressional Oversight Commission on the Use of CARES Act Funds | 796
- Fourth Report of the Congressional Oversight Commission on the Use of CARES Act Funds | 801
- Disagreements over the Municipal Liquidity Facility Erupt | 806
- Congressional Oversight Commission Scrutinizes National Security Loans | 811

**POLICY PROPOSALS & MARKET COMMENTARY** .............................................. 815
Founded in 2013, The Yale Program on Financial Stability’s mission is to create, disseminate, and preserve knowledge about financial crises. We currently have four major projects: Systemic Risk Institute, New Bagehot, Global Financial Crisis, and the Financial Crises Archives. The diagram below represents how each project correlates with the YPFS:
In its early years, researchers at the YPFS authored dozens of case studies on these topics, and hosted an annual set of meetings to bring together policymakers from around the world. These activities covered both “peacetime” policies designed to prevent crises, and “wartime” policies designed to fight crises in progress.

More recently, it became clear that the biggest knowledge gaps existed for wartime policies. During the Global Financial Crisis, nations around the world had attempted hundreds of crisis interventions, only a fraction of which had been studied by researchers. Going back further in time, most research on past crises focused on macroeconomic issues, with much less attention paid to the mechanics of crisis-fighting tools. To fill this gap, the YPFS launched the New Bagehot Project in 2017, made possible by generous support from Jeff Bezos, Bloomberg Philanthropies, Bill Gates, the Peter G. Peterson Foundation, and an anonymous donor.

The New Bagehot Project was named in honor of Walter Bagehot, the author of Lombard Street (1873), still considered the seminal text on crisis fighting. Bagehot’s advice for central bankers in a crisis can be summarized as “lend freely at a penalty rate against good collateral”. This advice is still considered near-gospel by many central bankers, but it is insufficient to guide the complex policy actions necessary to stabilize a 21st century financial system. The New Bagehot Project aims to expand the crisis-fighting playbook through detailed case studies of specific interventions, synthesizing these case studies into best practices, and then presenting this synthesis across a variety of media.

Beginning in March 2020, the New Bagehot project shifted its focus to real-time analysis of financial policies created in response to the ongoing COVID-19 pandemic and its economic consequences. Posts are regularly published on YPFS’ Systemic Risk Blog, where individuals can follow to read examinations of policies around the world—including lessons learned as programs develop and are utilized.

**COVID-19 Financial Response Tracker**

In March 2020, YPFS launched the COVID-19 Financial Response Tracker (CFRT) to record interventions enacted by central banks, fiscal authorities, financial regulators, and international
organizations. We are interested in programs designed to mitigate the effects of the coronavirus pandemic and restore financial stability. Each CFRT entry provides summary information and links to relevant sources (e.g. press releases or articles) about adopted or proposed interventions. The companion COVID-19 Financial Response Tracker Visualization (CFRTV) graphically depicts the CFRT’s entries according to country and type of program.

To date, YPFS has logged over 7,600 logged proposals, policy changes, and amendments to existing policies related to COVID-19. While our database is not comprehensive, we aim to track as many relevant interventions as possible both within and across 60+ countries. Access the CFRT and accompanying Visualization platform here.

Resource Guides

Finally, YPFS is putting together resource guides that gather and synthesize materials on crisis response topics that are of particular interest in the present situation. A resource guide consists of an overview and a spreadsheet that catalogs past and current examples of the intervention type, identifies interesting program features, summarizes existing evaluations of programs, and shares general resources on the topic. New resource guides will be added as they become available.

Current

- Market Liquidity Programs
- Measures of the European Union
- Multinational Institutions
- Swaps
- Residential Mortgage Relief

Former

- Bankruptcy Law and Macroprudential Policy as of August 1, 2020
- Insurance Regulation Measures as of August 1, 2020
- Macroprudential Policy: Capital as of September 1, 2020
- Macroprudential Policy: Liquidity as of September 1, 2020
- Macroprudential Policy: Non-performing Loan Relief as of May 14, 2020
- Macroprudential Policy: Regulatory Relief as of April 17, 2020
- Macroprudential Policy: SMEs as of May 1, 2020
- SME Credit Guarantee Programs
- Support to Individuals

Key Program Summaries

YPFS will be maintaining documents that provide up-to-date summaries of certain key programs adopted in response to the current pandemic. Depending on the program, these documents may
include things like detailed timelines showing when a program was introduced and when and how it was amended. They may also include data on usage to date.

- View Paycheck Protection Program (PPP) Timeline
- View Main Street Lending Program (MSLP) Timeline
- View Paycheck Protection Program Lending Facility (PPPLF) Timeline
- View Comparing Fed programs GFC and COVID-19

2020 YPFS Preliminary Discussion Drafts

Over the past few years, YPFS has written thousands of pages of summary materials on past interventions, including the key design decisions that policy makers must consider. While not all our case studies are complete, we are making our materials available at this time. The case studies are written from a policymaker’s point of view and are meant to inform current decision-makers. Most case studies have links to the relevant primary documents generated by the financial institution that initiated the program as well as other documents relevant to the design and implementation of the program.

- Explore YPFS Preliminary Discussion Drafts in our Resource Library
- View a list of our case studies of previous interventions

Contact

Authors on any piece can be contacted at the email address below:

Shavonda Brandon shavonda.brandon@yale.edu
Mallory Dreyer mallory.dreyer@yale.edu
Lily Engbith lily.engbith@yale.edu
Greg Feldberg greg.feldberg@yale.edu
Manuel Leon Hoyos manuel.leonhoyos@yale.edu
Sean Fulmer sean.fulmer@yale.edu
Steven Kelly steven.kelly@yale.edu
Adam Kulam adam.kulam@yale.edu
Aidan Lawson aidan.lawson@yale.edu
Natalie Leonard natalie.leonard@yale.edu
Christian McNamara christian.mcnamara@yale.edu
Sharon Nunn sharon.nunn@yale.edu
Alexander Nye alexander.nye@yale.edu
Kaleb Nygaard kaleb.nygaard@yale.edu
Junko Oguri junko.oguri@yale.edu
June Rhee june.rhee@yale.edu
Corey Runkel corey.runkel@yale.edu
Priya Sankar priya.sankar@yale.edu
Due to the nature of our program, some authors no longer work at the New Bagehot project. To contact the Yale Program on Financial Stability, please email ypfs@yale.edu.
Critical Industries

Critical industries play key roles in supply chains and transportation and are often vital to keep the economy running smoothly. However, due to high fixed costs, these industries are also highly vulnerable to targeted economic shocks. Policies targeted to aid these critical industries must take account of the tools available, as well as obligations to protect taxpayers by attempting to guarantee recuperation of funding.
Analysis

Aid to Airlines and other Critical Industries During Crises

By Rosalind Z. Wiggins and Vaasavi Unnava

Original post here.

The air transportation industry across the globe has been dramatically affected by the outbreak of COVID-19. Government-issued travel bans and warnings to self-quarantine have forced the cancellation of trips. Passengers are down more than 90%. Airplane manufacturers, such as Boeing in the US, are facing assembly line shutdowns and possible delays of ordered planes. Related businesses such as suppliers, airports, and duty-free stores are also facing serious impacts.

Since February, several countries have provided support to help their airlines absorb the economic impacts. These actions include: direct cash subsidies (China), tax rebates and forgiveness (Australia), loan guarantees (Sweden, Finland), exemption from airport fees (Taiwan), loss support, and direct aid to cover employee wages (Denmark). Several countries offer a combination of interventions, such as South Korea and the US.

We consider the recent actions in the context of past assistance to airlines and other critical industries and discuss what other countries might consider in providing such assistance.

Critical Industries

Airlines are critical industries that play key roles in transportation and supply chains for passengers and cargo. Yet, they are characterized by high fixed costs and variable income streams. The ability to adjust current expenses does not directly align with drops in revenue creating cash flow challenges and making them especially vulnerable to economic shocks. (Nolan, Ritchie and Rowcroft 2004). The terrorist attacks of 9/11, in which the US closed its airspace, showed that the industry may need state aid to avoid bankruptcy and restore operations to pre-shock levels. (Nolan, Ritchie and Rowcroft 2004). With credit markets drying up, private liquidity was difficult to come by, layoffs began, leading the government to provide assistance in the form of direct grants and loan guarantees through the Air Transportation Safety and System Stabilization Act (ATSSA). Similar economic factors justified the government’s facilitating mergers to stabilize the industry in the 1980s.

Other modes of transportation have also been deemed critical industries. During the current COVID-19 pandemic, the UK has temporarily nationalized its railways in a preemptive move to “provide stability and certainty” and ensure that they are available for essential travel. Contractors will continue to operate their routes, but the government will collect all revenues and take on all risk. In the US, the government provided $1 billion in grants to its government-owned passenger railroad, Amtrak, 50% of the company’s 2020 budget.
Beyond transportation, governments have assisted other nonfinancial industries whose failure might pose a systemic risk to the economy. During the global financial crisis (GFC) of 2007-09, the US rescued two of its “Big Three” auto manufacturers, General Motors (GM) and Chrysler. Factors cited in the decision to provide aid in those cases were the size of the firms; the concentration of the industries within a specific region; the potential job losses; the potential knock-on effects to suppliers in the highly integrated industry that might destabilize other manufacturers; and the broader economic impacts in the midst of the financial crisis.

France, Russia, and Sweden also provided assistance to their auto industries during the GFC. France provided a package of loans to manufacturers (Renault and Peugeot/Citroen), auto finance companies, and suppliers. Russia provided a one-year interest-free loan and facilitated the refinancing of investment projects. Sweden guaranteed significant loans.

**Tools Available**

Once a government decides to assist a critical industry, it needs to consider what tools it has available, and how and when it will use them. Possible tools include loans, equity or warrant purchases, loan guarantees, or some combination of these, to provide the necessary capital for companies to maintain or achieve solvency. Equity can be especially useful to protect taxpayers, although governments are often reluctant to take over the management of private companies, as noted below.

In general, approaches appear to fall into three loose categories: (i) short-term liquidity relief, where the aim is to provide liquidity and support wages; (ii) mid-term aid, which focuses on providing liquidity relief for longer periods and or in larger quantities, through loans or loan guarantees; and (iii) longer term aid, which provides sustained support and protects companies’ solvency through operational recovery and structural reform. Example of this last tool include the multifaceted packages implemented by South Korea, the US, and Italy, which re-nationalized Alitalia after efforts to find a buyer failed.

The COVID-19 pandemic is unique in that the economic shock has been largely government-induced. Countries quickly deployed targeted relief focused on the airline industry. Their earliest responses included:

- Direct cash subsidies or grants ([China](#) and [US](#))
- Suspension or refund of taxes and or fees ([Australia](#), [South Korea](#), Taiwan)
- Direct absorption of losses
- Grants for payment of wages ([Denmark](#)).

Because the air travel industry is highly taxed, waiving, refunding or reducing some or all of these taxes is a particularly quick way to funnel cash to the industry amidst the sudden drop in ridership. Tax relief can be quickly implemented because it requires minimal administrative
start-up costs. Once airlines recover, taxes and fees can be reinstated gradually to provide a soft cushion for recovery efforts.

Given the unique factors of the pandemic, other first-wave support has taken the form of grants to support the continuation of wages for air industry workers or financial support for furloughed workers. These may be in narrow targeted efforts (as in the case of the US) or as broad-based plans that also apply beyond the industry (as Denmark has provided).

Governments also use loans or loan guarantees have to provide longer term and more substantial support. Loans can also be used to “buy time” for private funding sources to recover, to bridge temporary distortions to cash flows. Several countries made loans to industries affected by 9/11. The US and France provided loans to the auto industry during the GFC. The US used bridge loans to keep Chrysler and GM afloat during a presidential transition in 2008; the government used the transition period to assess if the companies would need further assistance.

In extending loans, governments must decide:

- Amount of loan
- Interest rates
- Collateral
- Maturity
- Other commitments such as reporting, governance restrictions

Loans can be flexible, subject to the government’s capacity, and easily tailored, extended, or increased as circumstances change.

Loan guarantees represent a commitment rather than an actual loan. They allow governments to leverage their resources to extend more funding than they can directly. However, loan guarantees depend on there being private lenders willing to lend. This may not always be the case if banks are also distressed, as during the GFC. When there is no financial crisis, a guarantee may help a distressed industry get the funds it needs.

Loans and loan guarantees may also be bundled with other forms of assistance and are often a step-up from initial actions. In the current crisis, for example, Denmark first provided support for wages, and then later announced (along with Sweden) up to $302 million in credit guarantees for Scandinavian Airlines.

South Korea has also bundled the availability of loans into a comprehensive package of airline industry support measures. Relief has been in place for Korea-China routes since early February. In mid-February, the government made a major announcement—up to 300 billion won in emergency loans, deferred fees for three months with gradual restart, guarantees to replace aircraft lease deposits, and support in reestablishing business. In March the government announced additional supports relating to the waiver of airport fees and assistance to terminal
operations for 3–6 months. The combined supports are designed not only to offset the cost of lost passengers but also to promote a quick return to operating and rebuilding capacity. It is formally divided into three phases: (i) emergency damage support, (ii) support for securing a new market, and (iii) management stabilization support.

The US coronavirus rescue legislation provides $78 billion to the airlines in the form of direct cash grants, loans, and loan guarantees available through March 2022. The bill also temporarily suspends excise tax and kerosene taxes for air carriers through January 1, 2021. In return for financial assistance, air carriers may not put employees on temporary furlough status, engage in share buybacks, or issue dividends. Also, highly compensated employees are subject to restrictions on their pay.

The current US assistance is similar in form but far surpasses the assistance provided to airlines in the wake of the 9/11 attacks the US, when the government closed all US airspace. (Lewinsohn 2005). At that time, the government provided aid for airlines through the Air Transport Safety and System Stabilization Act of 2001. That act provided $5 billion in direct grants for compensation for federal actions and subsequent losses related to the attacks and the subsequent shut down of air travel, and up to $10 billion in loan guarantees. Eligible airlines used approximately 10% of the available guarantees. Although there were still airline bankruptcies in the years that followed, some commenters believe that the assistance was successful in that it prevented immediate bankruptcies during an economic downturn. (Lewinsohn 2005).

Even if a crisis is short-lived, companies will need a period in which to recover to pre-crisis levels. The assistance packages and loans offered by Korea and the US seem to acknowledge this and anticipate challenges even after the epidemic subsides. Another example is Singapore Airlines which, in response to the COVID-19 crisis, announced that it had secured a loan of S$4 billion from DBS Bank to cover its near-term liquidity needs. It also planned to raise S$14 billion from its existing shareholders through a rights offering (to purchase shares and bonds) underwritten by its majority shareholder, the sovereign investment fund, Temasek Holdings. This would provide capital that would not only help it weather the pandemic but would also strengthen its return to operations after.

Should a crisis extend for longer than expected, governments may have to extend or increase aid to forestall the further decline of weakened companies. In such instances, tools that may be utilized include:

- additional or longer-term loans
- capital injections
- restructuring
- bankruptcy
- nationalization.
Some of these solutions, such as extended loans, are quicker to put in place than others, i.e., capital injections and restructuring. However, restructurings, whether through bankruptcy or not may require additional funding directly from the government or from private sources, potentially with further government guarantees. The availability and ease of implementation of these later solutions usually depend on what standing powers the government has. In other contexts, additional legislation may be needed, which would be more time consuming.

It should also be noted that there is always the possibility that the effects of a crisis may reveal preexisting fundamental financial weaknesses that would need to be addressed upfront if companies are going to be saved from collapse. Sometimes these are revealed upfront, as in the case of Italy—which in response to the COVID-19 pandemic, has re-nationalized Alitalia; the airline had been attempting to sell itself for a year and was thought to be unable to weather the pandemic without assistance.

There are several types of nationalization. Governments can take control of a company or industry e. through government fiat, using existing authority or new legislation; capital injections; or as the result of providing funding for a restructuring. Italy nationalized Alitalia by government fiat. The country had previously used a similar strategy in the aid provided to Parmalat, an Italian dairy company, when the Italian government issued an emergency decree to allow Parmalat to file for bankruptcy to receive financial aid and undergo intensive restructuring. During the GFC, the US took control of GM as a result of funding its bankruptcy and receiving equity in the company.

Taxpayer Protection

Another important issue for governments to consider is how to structure the intervention to ensure repayment and protect taxpayer funds. Several elements can address this:

- Rates and fees that incentivize repayment once private funding is available
- Loan provisions that restrict share buybacks and paying dividends
- Loan provisions that affect desired policies
- Restrictions on executive compensation
- Collateral that secures the loan
- An equity interest for the government

A simple protection for lent funds would be to set the rate and terms of loans to incentivize payoff when private credit avenues are again available. In accordance with Bagehot’s dictum to lend at a penalty rate, setting a rate above the usual market rate will incent borrowers to pay off or refinance the loan from private sources when the market recovers. Restrictive loan terms, such as those relating to buyback of shares and payment of dividends, prohibit the firm from misappropriating government funds. Terms may also require heightened government oversight and reporting, which a firm may find burdensome, incentivizing accelerated repayment.
In the US, during the GFC and since, the payment of executive compensation at firms receiving government assistance has been a controversial issue. Aid provided under the Troubled Asset Relief Program (TARP) during the GFC was subject to these types of restrictions. There is some evidence that these restrictions created incentives for companies to repay the government early. Terms of the aid offered in the current COVID-19 programs also restrict certain executive pay.

Loan terms have also been used as a means to interject industrial policy into a situation such as during the GFC, when the restructuring of GM and Chrysler were conditioned on lowering labor costs and producing energy efficient autos.

Loans may also be secured by collateral; however, this is not always available. A firm or industry may be highly leveraged, having already granted security interests on much of its assets. In this case, receiving equity interests may be an alternative that provides some potential upside to taxpayers.

The theory behind equity interests is that the taxpayers can share in the company’s recovery, which their assistance funded. This can be achieved through the grant of warrants that provide the opportunity to purchase shares at a nominal price, preferred shares that are convertible into common shares, or an outright purchase or grant of common shares.

US Treasury Secretary Mnuchin said that rather than make outright grants, the Treasury intends to take equity stakes in airlines in exchange for the cash grants (which must be used for employee wages, salaries, and benefits) contemplated by the COVID-19 assistance. Equity stakes are common in government bailouts. Such “equity stakes” would in theory permit taxpayers to benefit from the financial recovery of the firm. At this time, it remains unclear in what form this equity interest would take.

In the GFC, the government received warrants to purchase stock (GM) and convertible preferred stock (AIG). Another example is the actions of the New Zealand government which utilized equity purchases as a means of cash injection when refinancing Air New Zealand after the 9/11 attacks. Another successful example, not during a financial crisis, was the utilization of a combination of loan warrants and guarantees in the aid provided to Chrysler in 1980, which resulted in a net profit for the US government.

Developing countries may rely on sovereign wealth funds, which store capital in investment funds during high-income times to fund government policies in low-income times. Other rescues rely on private sector solutions, such as the formation of a lifeboat fund via private banks for the rescue of Pan Electric Corporation in Singapore. With the global demand shock progressing rapidly through various industries almost simultaneously, a private sector solution may not be the most effective in the current economic environment.

Some commenters have critiqued the use of warrants as financial injections for poorly managed firms. Another sees the possibility of bankruptcies as necessary to prevent moral hazard if only cash grants or loan programs are offered. (Casey and Posner 2015). Another critic argues that
one-off and full bailouts from the state are inefficient and should not be utilized; standard bankruptcies, perhaps with government assistance, are preferred. (Couwenberg and Lubben 2018). Consistent with this argument, the Congressional Oversight Panel found that the use of bankruptcy in the aid provided for GM and Chrysler prevented moral hazard as the companies faced disincentives to apply for aid. The panel estimated that up to 1.1 million auto-related jobs would have been lost if the companies had failed.

Conclusion

Various tools are available to countries that may need to provide assistance to critical industries that experience distress in a crisis. The COVID-19 crisis has shown that direct grants and industry-specific remedies such as the suspension or refund of taxes may be readily available as a first response to quickly provide liquidity. However, as the crisis persists, additional assistance may be needed to sustain companies. Loans and loan guarantees have often been applied at this juncture. A prolonged crisis or the existence of fundamentally weak organizations pose a risk that solvency issues may appear, requiring more intensive measures such as capital injections and restructurings, with or without government assistance, if firms are to recover from the crisis and avoid collapse.
Usage of the Defense Production Act throughout history and to combat COVID-19

By Aidan Lawson and June Rhee

Original post [here](#).

As the Federal Reserve and the Treasury launch programs to provide relief to individuals and businesses affected by the COVID-19 crisis, President Donald Trump has been using a tool that gives him considerable discretionary authority over private corporations: the Defense Production Act (DPA).

The DPA gives the president the authority to compel the private sector to work with the government to provide essential material goods needed for the national defense. The Act currently includes the following powers:

- **Title I: Prioritization and Allocation.** This allows the president to designate specific goods as “critical and strategic” and require the private businesses to accept and prioritize government contracts for these goods. Thus far, the government has used this to enhance production of key medical supplies and personal protective equipment (PPE), including $2.9 billion to purchase over 187,000 ventilators by the end of the year.

- **Title III: Expansion of Productive Capacity and Supply:** This allows the president to make loans and provide guarantees to businesses, directly purchase critical and strategic goods, and repurpose production facilities in order to increase production capacity. So far, the administration has spent $208 million under the direct purchase authority in Title III to increase capacity for nasal swabs and respirators in limited amounts. The other powers have not been used.

- **Title VII: General Provisions.** This allows the president to enter into voluntary agreements with private businesses to coordinate the production of critical and strategic goods. These are subject to some antitrust protection and have yet to be used.

In addition, the CARES Act provided some Title III reporting relief and appropriated $1 billion to the DPA Fund. However, comprehensive usage is hard to capture; DPA contract awards are kept confidential, since the Act has traditionally been used for military technology.

This post provides background for better understanding of available authorities under the DPA and a full picture of their usage in response to COVID-19 crisis. Additionally, it highlights some criticisms around the current usage of authorities.

**Background and Origination of the DPA**

While the original DPA was signed into law in 1950 by President Harry Truman, the president’s authority for industrial reorganization and prioritization can be traced back to World War I. The official declaration of war, signed on April 6, 1917, stated that the president could “employ...the
resources of the Government to carry on war against the Imperial German Government” (see here). President Woodrow Wilson used this authority to create two temporary federal agencies: the National War Labor Board and the War Industries Board. The former was primarily used to mediate labor disputes and the latter allowed the government to settle labor-management disputes, set quotas, and allocate and prioritize the production of critical wartime goods.

The advent of World War II saw the creation of even more expansive emergency authority: The War Powers Act. The first War Powers Act was passed on December 18, 1941, and gave the president broad powers to reorganize the functions of any executive agency for the purpose of fighting the war. President Franklin Delano Roosevelt issued a total of 75 executive orders under this act (see here, pp. 5710, 5729). The second War Powers Act, signed into law on March 27, 1942, allowed the president to allocate resources, acquire land and property, and compel businesses to take on government contracts for national defense. The second Act also permitted the Federal Reserve to purchase up to $5 billion in Treasury bonds directly from the U.S. government. Both of the acts expired either during World War II (the second Act), or shortly after (the first Act). While the basis for its authority was sewn in World War I, the two War Powers Acts are the predecessors to the DPA.

Dramatic defense budget cuts followed World War II due to a lack of need and an increased reliance on atomic weaponry. Additionally, demand for housing and consumer products shot up as wartime controls lapsed, culminating in a series of labor strikes in 1946. The onset of the Korean War amplified the need for dramatic industrial reorganization, and President Harry Truman quickly pushed for authority similar to what his predecessor had used. As such, the Defense Production Act ultimately was signed into law on September 8, 1950.

**What powers does the DPA grant the government over private industry?**

The DPA allows the president to “shape national defense preparedness programs and to take appropriate steps to maintain and enhance the domestic industrial base” (see here, pp. 2).

The Act’s three tools are allocation and prioritization of contracts for critical and strategic goods (Title I), expansion of productive capacity through financial incentives (Title III), and voluntary agreements with private industry (Title VII). The original act included four other titles that Congress allowed to expire. These authorities allowed the president to requisition private property (Title II), fix wages, prices and ration goods (Title IV), forcibly settle labor disputes (Title V), and control various aspects of consumer credit (Title VI).

The Act also includes a sunset provision that requires it to be reauthorized every few years, which allows changes to be made to ensure the law can account for new developments. When reauthorizing, Congress has occasionally amended the definition of “national defense.” It now extends beyond military application to homeland security and national emergencies, such as those invoked by a terrorist attack or pandemic.
Four major amendments to the definition have been made since the DPA’s inception. In 1975, the definition was expanded to include space activity. The 1980 reauthorization of the Act designated energy as an essential material good. In 1994, the scope of the DPA was significantly broadened to incorporate emergency preparedness during natural disasters or other events that caused national emergencies under Title VI of the Stafford Act (see pp. 71 - 85). The fourth amendment in 2003 added “critical infrastructure protection and restoration” to the definition of national defense.

Title I of the DPA gives the president the authority to compel businesses to prioritize and accept contracts for goods that are designated as “critical and strategic” for the national defense, much like in the second War Powers Act. These goods are designated as such by the president, who can allocate, distribute, and restrict their supply as needed. Any contracting decisions made under this must be made with a “strong preference” for small businesses, especially those in economically depressed areas. Title I also includes provisions to prevent the hoarding of materials.

Title III complements Title I’s allocation and prioritization authority by providing tools to expand domestic industrial capacity. It allows the president to incentivize private business to expand their production capacity of critical goods if more are needed. These incentives can include loans, loan guarantees, direct purchases and purchase commitments, as well as the ability to outright produce and install equipment in private facilities (see here, pp. 13 - 16). The president can also designate Federal Reserve banks as fiscal agents to administer guarantees (see here, pp. 9).

Generally, the incentives must be:

1. For goods designated as critical and strategic only
2. For institutions that cannot obtain credit elsewhere to produce critical and strategic goods
3. For businesses with sufficient creditworthiness and earning power
4. The most “cost-effective, expedient, and practical alternative”

There are additional requirements based on the form of the incentive. Both loans and guarantees are priced at rates that are commensurate to Treasury yields of similar maturities, while direct purchases of goods will be made at the ceiling price, or domestic market price if no ceiling price has been established. If the aggregate amount of any potential assistance exceeds $50 million the president must notify Congress and wait 30 days before disbursing any funds. Additionally, an Executive Order passed in 2012 requires an act of Congress for all Title III projects exceeding $50 million. Historically, very few of these projects were expected to exceed $50 million (see here, pp. 11).

However, the DPA gives the president a considerable amount of reporting flexibility. The $50 million congressional reporting threshold can be waived if the actions are taking place during a national emergency or if the president determines that doing so would “severely impair”
capability. This discretion can also be exercised when providing assistance that would prevent a company from becoming insolvent or undergoing bankruptcy proceedings, which is generally not permitted. The president can even set maximum amounts, interest rates, guarantee and commitment fees, and other charges.

The primary difference between Title I and Title III is that the former allows the government to direct industry to prioritize existing resources, while the latter allows the government to direct industry to expand these resources.

The Department of Defense (DoD) is the most frequent user of both Title I and Title III authority. It prioritizes about 300,000 orders each year under Title I and is the only federal agency with a standing Title III program (see here, pp. 8). It has primarily used Title III to “mitigate critical shortfalls in domestic defense industries;” most recently, it used Title III in July 2019 to expand production capacity for rare earth elements, which are essential components of key military technologies (see here).

Title VII includes a number of general provisions that grant the president additional reorganization capacity. The most noteworthy of these have to do with the power to create “voluntary agreements” between the government and private industry. During periods of severe stress, the president can consult and create renewable, five-year “voluntary agreements and plans of action” to coordinate the production of goods.

As originally written, Title VII also gave complete antitrust immunity to businesses engaged in these agreements. However, the DPA now provides them special legal defense if their actions violate antitrust laws instead of complete immunity. The government had used similar authority under the 1942 Small Business Mobilization Act, which mobilized small business production capacity for World War II and created a Smaller War Plants Corporation that would make loans to these businesses (see here, pp. 6 - 11).

Title VII also includes the authority of the President, generally through the Committee on Foreign Investment in the U.S., to unilaterally review any merger, acquisition, or takeover to assess its impact on national security (see here, pp. 39 - 40, pp. 45 - 46). If the review finds that the transaction could be harmful to national security or is foreign-government controlled, the president can suspend or outright prohibit a transaction from taking place. Title VIII also authorizes the president to establish a National Defense Executive Reserve to train members of private industry to be placed in higher-level government positions during periods of national emergency, though none currently are active (see here, pp 35).

Much of the allocation and spending under the DPA is done through the Defense Production Act Fund, which receives and manages appropriated money for the purposes outlined above. Up to $750 million may be kept there indefinitely, with any excess amounts from repayments, fees, or premiums being returned to the Treasury at the end of each fiscal year. Other government agencies are allowed to appropriate money to the Fund, with the Departments of Defense and
Energy being two recent examples (see here, pp. 16). Executive Order 13603, the most recent DPA amendment, assigned the Secretary of Defense as the manager of the DPA fund.

The DPA’s authority has often been delegated to the heads of government agencies and departments. President Truman was the first to do this through Executive Order 10161, issued a day after the DPA was signed into law (see here). Under this order the heads of government agencies were given Title I, III, and VII authority for national defense matters that fell within the scope of their respective agencies. The Secretary of Agriculture, for instance, was given prioritization authority over food resources and related facilities. Over the years, the authority given under Executive Order 10161 has been amended as the definition of national defense has developed and the U.S. industrial base has changed.

**DPA Usage during the COVID-19 crisis**

The Trump administration alluded to using the DPA on February 28 but did not officially invoke it until March 18, five days after the national emergency was declared. Shortly after, the administration issued Executive Orders 13909 and 13910, which gave the Secretary of Health and Human Services (HHS) Title I prioritization authority, as well as the ability to introduce hoarding restrictions for PPE and critical medical equipment. Management and coordination of all DPA programs were delegated to a White House trade advisor, Peter Navarro.

Executive Order 13911 (EO 13911) delegated Title III authority to the Secretaries of HHS and Homeland Security (DHS) to respond to the COVID-19 crisis. EO 13911 also granted the DHS Secretary Title I and anti-hoarding authority given to HHS in the previous executive orders.

Additionally, the president waived many of the Title III reporting requirements to provide loans and guarantees, or purchase items during the national emergency. Aid packages exceeding $50 million do not have to be reported to Congress and sales prices for direct purchases were made more flexible. Even goods that are not critical and strategic are eligible for Title III assistance.

EO 13911 also delegated the right to form voluntary agreements under Title VII to both Secretaries with the approval of the president. This may raise some antitrust concerns, but the DPA provides for some antitrust protection and federal regulators stated that the exceptional circumstances surrounding the crisis may necessitate joint ventures between businesses, and that they would take these into account when enforcing antitrust laws.

Executive Order 13922, issued on May 14, gave Title III authority to the CEO of the U.S. International Development Finance Corporation (DFC). The DFC, formed in October 2018, provides up to $60 billion annually in investment financing for developing countries across the world (see here). EO 13922 requires the CEO of the DFC to work with the HHS and DHS Secretaries to make loans that enhance the domestic COVID-19 response or that support “the resiliency of any relevant domestic supply chains.”

Section 4017 of the CARES Act provided additional Title III relief:
• Two-year exemption from the requirement that Congress approve loans and guarantees exceeding $50 million.
• Two-year exemption that allows the balance of the DPA Fund to exceed $750 million.
• One-year reporting relief of requirement to notify Congress and wait 30 days after notification to provide Title III assistance exceeding $50 million for one year.

On March 31, the Secretary of HHS used Title I authority to designate a number of health and medical resources, such as respirators with an N-95 effectiveness level, portable ventilators, disinfecting devices, and PPE, as “scarce or threatened” (see here). This designation lasts until the end of July.

The White House has issued a number of presidential memoranda to complement its executive orders. One memorandum, issued on March 27, required the Secretary of HHS to use Title I authority in compelling General Motors (GM) to prioritize contracts for a potentially unlimited number of ventilators. Another banned the export of scarce or threatened PPE.

Two months after the DPA was invoked, HHS finalized a number of contracts to provide over 187,000 ventilators by the end of the year. See Table 1 for a list of DPA ventilator contracts.

While DPA authority had been delegated to the Secretary of DHS, existing regulations meant that this responsibility had been delegated to Federal Emergency Management Agency (FEMA), which is the primary federal disaster relief agency in the U.S. (see here). Under this regulation, FEMA has the role of brokering sales to third parties to obtain critical health and medical supplies and directly prioritizing which businesses receive supplies (see here, pp. 28502, 28504). Additionally, HHS has worked out an arrangement under the DPA with The 3M Company to produce a total of 166.5 million masks over the next few months.

Table 1: Title I COVID-19 Ventilator contracts ($millions)

<table>
<thead>
<tr>
<th>Company</th>
<th>Contract Amount</th>
<th>Ventilators Produced (end of 2020)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Phillips</td>
<td>$646.7</td>
<td>43,000</td>
</tr>
<tr>
<td>Hamilton</td>
<td>$552</td>
<td>14,115</td>
</tr>
<tr>
<td>General Motors</td>
<td>$489.4</td>
<td>30,000</td>
</tr>
<tr>
<td>Vyaire</td>
<td>$407.9</td>
<td>22,000</td>
</tr>
<tr>
<td>Zoll</td>
<td>$350.1</td>
<td>18,900</td>
</tr>
<tr>
<td>General Electric, Ford</td>
<td>$336</td>
<td>50,000</td>
</tr>
<tr>
<td>GE Healthcare</td>
<td>$64.1</td>
<td>2,410</td>
</tr>
<tr>
<td>ResMed</td>
<td>$31.98</td>
<td>2,550</td>
</tr>
</tbody>
</table>
Hillrom  $20.1  3,400  
Medtronic  $9.1  1,056  

Source: Department of Health and Human Services press releases

The DPA Fund, according to the government’s most recent budget, had an estimated $228 million available (see here, pp. 276). The CARES Act has augmented this by providing an additional $1 billion for DPA activities out of $50 billion that was released for the COVID-19 crisis when the Trump administration declared a national emergency in March (see here).

Government agencies, such as HHS, have only used Title I authority thus far, but the lack of funding in the DPA Fund may prove to be a limitation if U.S. industrial capacity as a whole needs to be expanded through Title III, rather than repurposed.

Title III has only been used twice by the DoD since the DPA was invoked over two months ago. The DoD used Section 303 to scale up production of both nasal swabs and N-95 masks, investing an estimated total of $208 million. However, the loan and guarantee authority in Sections 301 and 302 of Title III has not been used in decades. The projects done under Title III are done each year under Section 303, which allows the government to make direct purchases of goods and repurpose production facilities for national defense matters (see here, pp. 14).

Criticism of the DPA during COVID-19

While the Trump administration has used the DPA to some extent, many have professed that its approach has been too little, too late. Shortly after the national emergency was declared, 57 members of the House of Representatives wrote a letter to the president imploring him to use the DPA, citing insufficient testing and widespread shortages of critical supplies. Even after activating it, the administration characterized the DPA as a break-the-glass authority, likening it to nationalization and as unnecessary since they argued businesses were voluntarily increasing production.

On March 30, the U.S. Conference of Mayors, which represents over 1,400 mayors in large and medium-sized cities, sent a letter to the president requesting full usage of Title III to increase the production of critical medical supplies that cities are having difficulty obtaining. These concerns have even prompted a legislative proposal to federalize the entire medical supply chain. The proposal would have the Secretary of Defense appoint an Executive Officer for Critical Medical Equipment and Supplies, who would use DPA authority to “oversee all acquisition and logistics functions related to the [COVID-19] response.” All requests for equipment would be directed to the Executive Officer, who would report weekly on the production capacity and supply needs of the U.S. and make recommendations based on these.

Concerns about the lack of medical supplies have persisted for years. A 2015 study by government researchers estimated the number of N-95 respirators that would be needed for a hypothetical flu outbreak. In the more conservative “base” scenario, the researchers found that respirator demand ranged from 1.7 billion to 3.5 billion over the course of the outbreak.
second study, conducted in 2017, evaluated the responsiveness of the U.S. medical supply chain based on previous experiences, such as the 2009 H1N1 and 2014 Ebola outbreaks. The researchers found that reliance on imported medical goods, a lack of “surge capacity”, and unclear government guidance and monitoring of these goods leaves the U.S. vulnerable. HHS estimated at the beginning of March that the U.S. would need about 3.5 billion N-95 respirators over the next year if COVID-19 developed into a “full-blown” pandemic. At the time, the government had a stockpile of about 35 million (see here).

The most notable example of the DPA’s usage has been to increase the production of ventilators through Title I authority. Usage of Title III authority, however, has been “totally inadequate”, according to a letter written by nine prominent U.S. Senators on May 6. There is still approximately $1 billion that could be used for Title III projects. Lack of fiscal capacity could pose a problem for Title III usage, but several members of Congress stated that they would be willing to advocate for additional funding (see here). Theoretically, delegating Title III authority to the HHS and DHS Secretaries should promote expediency, but that has not happened so far. Lawmakers have been critical of Title III delegation to the CEO of the DFC, citing its lack of experience in the medical supply chain, domestic markets and relevant industrial reorganization expertise (see here).

Another concern has been the lack of transparency around DPA contract awards, as there is no requirement for these to be reported. Secrecy is often necessary when discussing and developing military technology during wartime but some COVID-19 contracts have been given to companies that are in questionable financial status or have little-to-no background in medical supplies.

The U.S. medical supply chain is built to maximize efficiency and leave little room for excess supply, which slows manufacturers’ ability to scale up production in times of crisis. COVID-19 export restrictions have received some backlash, warning that these could lead to retaliation from trading partners and exacerbate shortages of other medical goods. In one case, a company contracted with the U.S. government decried the “significant humanitarian implications” associated with the administration’s export restrictions. The U.S. is a net importer of medical goods, and retaliatory trade policy, combined with existing production issues, could exacerbate already-known and serious flaws in the domestic medical supply chain. As the country begins to re-open, it is unclear how much more the administration plans to use the DPA.
Case Studies and Policy Changes

US Provides Aid to Airlines in Historic Relief Bill
By Vaasavi Unnava

Original post here.

The US coronavirus rescue bill that the Senate passed on March 25 provides $78 billion to the airlines in the form of loans, loan guarantees, and cash grants. The bill also temporarily suspends excise tax and kerosene taxes for air carriers.

Airline aid in the bill is split between passenger air travel, cargo air travel, and industries closely involved in national security:

- Passenger Air Carriers: $25 billion allocated in loan guarantees, $25 billion allocated in cash grants.
- Cargo Air Carriers: $4 billion allocated in loan guarantees, $4 billion allocated in cash grants.
- Air Industry Firms involved in National Security (implicitly allocated for Boeing): $17 billion allocated in loan guarantees,
- Contractors Providing Aviation-related Services: $3 billion allocated in cash grants.

In exchange for loan guarantees, the law also requires the government to receive warrants or other senior debt or equity of the business receiving aid. During negotiations over the bill, Treasury Secretary Mnuchin said that rather than make outright grants, the Treasury intends to take equity stakes in airlines in exchange for the cash grants (which must be used for employee wages, salaries and benefits). Such “equity stakes” would in theory permit taxpayers to benefit from the financial recovery of the firm. Equity stakes are common in government bailouts. At this time, it remains unclear how the Treasury would implement any such equity stake. In the most recent global financial crisis, the government received warrants to purchase stock (General Motors) and convertible preferred stock (AIG).

In the Senate bill, also, in return for financial assistance, air carriers may not put employees on temporary furlough status, engage in share buybacks, or issue dividends. Additionally, highly compensated employees with compensation exceeding $425,000 annually may not receive a raise in 2020. The bill would also prevent these employees from receiving severance pay that exceeds twice the compensation they received in 2019. Employees compensated above $3 million can receive $3 million plus 50% of the excess received compensation in the calendar year 2019.
The authority for the airline aid program expires on March 1, 2022. The suspension of excise and kerosene taxes regularly levied on air carriers extends to January 1, 2021.

The United States previously provided aid for airlines through the Air Transport Safety and System Stabilization Act of 2001. That act provided $5 billion in direct grants for compensation for federal actions and subsequent losses related to the 9/11 terrorist attacks and the subsequent shut down of air travel, and up to $10 billion credit assistance in the form of loan guarantees. Airlines used approximately 10% of the program’s loan capacity. Although airline bankruptcies emerged in the years that followed, some purport that the legislation succeeded in that it prevented immediate bankruptcies during the economic downturn that followed the terrorist attacks. With the assistance proposed in the Senate bill, the US joins other countries that have taken steps to support airlines during the COVID-19 pandemic. Countries have attempted to mitigate the economic impacts of the crisis in various ways. Some approaches, such as subsidies for continuing to operate (China), suspension and/or refunds of taxes (Australia), and support for laid-off employees (Denmark and Finland), appear to target short-term relief. South Korea has outlined a series of support measures, including emergency support measures, deferred payment of fees, loan screening measures for airlines requesting aid due to liquidity shortages, and guaranteeing lease deposits on leased aircraft.
US Begins Airline and Aviation Interventions

By Alex Nye, Vaasavi Unnava, and Rosalind Wiggins

Original post here.

On April 20, the U.S. Treasury Department announced that it had finalized agreements with six major airlines—Allegiant Air, American Airlines, Delta Air Lines, Southwest Airlines, Spirit Airlines, and United Airlines—for $20.5 billion in assistance under the Payroll Support Program (PSP) established by the CARES Act. It said five other airlines plan to participate, which would bring participation to 95% of U.S. air carrier capacity.

Four airlines—Hawaiian Airlines, United Airlines, American Airlines, and Spirit Airlines—have also announced their intent to apply for $10.4 billion under the Economic Relief Program (ERP). The government has disbursed an additional $9.1 billion in aid to aviation-related industries through other programs, which like the ERP, are authorized under the CARES Act.

Under the PSP, Treasury will provide grants and loans to support payroll for the carriers’ employees as the COVID-19 pandemic continues to depress demand. The PSP makes up to $25 billion available for passenger carriers in grants and loans. The ERP makes up to $29 billion available in loans and loan guarantees.

Presently, the CARES Act is one of the only broad-based grant and loan programs for airlines that governments have established during the current COVID-19 crisis. (See the earlier YPFS blog on the CARES Act here and our blog on aid to airlines around the world here).

The government has standardized its approach in providing aid to larger carriers. Treasury has decided to allocate 70% of funds through grants and 30% through low-interest, 10-year loans. This ratio was hotly negotiated, as airlines had expected that the support would exclusively come as grants. However, Treasury determined that larger airlines should compensate taxpayers for the large sums allocated.

The table below shows the terms of the PSP awards announced publicly or filed through the SEC, including announced expected agreements with the Treasury by Alaska Airlines, Hawaiian Airlines, and JetBlue Airways. Note that data are not yet available for Frontier Airlines and SkyWest Airlines, the two other airlines that Treasury expects to participate.

Airlines must use PSP funds exclusively to pay employee wages, salaries, and benefits. They must also agree not to conduct involuntary layoffs or furloughs, or reduce pay rates and benefits through September 2020; to not engage in stock buybacks or dividend payments through September 2021; and to limit certain executive compensation through March 2022. The government will not forgive PSP loans, which mature in ten years, but which may be prepaid without penalty at any time.
The CARES Act provides that the government “may receive warrants, options, preferred stock, debt securities, notes, or other financial instruments” from the airlines in exchange for PSP support. The Treasury has decided it will only take equity interests in airlines that receive more than $100 million in PSP aid. So far, the government has taken those equity interests in the form of warrants exercisable for common shares at their April 9, 2020 prices, at any point over a five-year period.
## Assistance under the CARES Act Payroll Support Program

<table>
<thead>
<tr>
<th>Airline</th>
<th>Grants (in millions)</th>
<th>Loans (in millions)</th>
<th>Warrants</th>
<th>Price per Share</th>
<th>Preferred/Common</th>
<th>Related Link</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alaska Airlines***</td>
<td>$725</td>
<td>$267</td>
<td>--</td>
<td>$31.61</td>
<td>Common</td>
<td>Form 8-K</td>
</tr>
<tr>
<td>Allegiant Air</td>
<td>$86</td>
<td>$21.6</td>
<td>25,898</td>
<td>$83.33</td>
<td>Common</td>
<td>Form 8-K</td>
</tr>
<tr>
<td>American Airlines**</td>
<td>$5,815</td>
<td>$1,714</td>
<td>13.7 million</td>
<td>$12.51</td>
<td>Common</td>
<td>Form 8-K</td>
</tr>
<tr>
<td>Delta Airlines</td>
<td>$3,800</td>
<td>$1,600</td>
<td>6.4 million</td>
<td>$24.39</td>
<td>Common</td>
<td>Form 8-K</td>
</tr>
<tr>
<td>Hawaiian Airlines**,<strong>,</strong></td>
<td>$233</td>
<td>$57</td>
<td>~ 1%</td>
<td>$11.82</td>
<td>Common</td>
<td>Form 8-K</td>
</tr>
<tr>
<td>JetBlue Airways***</td>
<td>$685.1</td>
<td>$250.7</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>Press Release*</td>
</tr>
<tr>
<td>United Airlines**</td>
<td>$3,500</td>
<td>$1,500</td>
<td>4.6 million</td>
<td>$31.50</td>
<td>Common</td>
<td>Form 8-K</td>
</tr>
<tr>
<td>Southwest Airlines***</td>
<td>~$2,300</td>
<td>~$1,000</td>
<td>2.6 million</td>
<td>--</td>
<td>--</td>
<td>Press Release*</td>
</tr>
<tr>
<td>Spirit Airlines**</td>
<td>$264.3</td>
<td>$70.4</td>
<td>143,541</td>
<td>$14.08</td>
<td>Common</td>
<td>Form 8-K</td>
</tr>
</tbody>
</table>

**Note:** Amounts shown indicate the maximums agreed to by Treasury and carrier. 

(--) indicates data is not available. 

(*) 8-K not yet available

(**) Airline has announced intent to apply or has applied (Hawaiian) for aid under ERP 

(***) Airline has announced details but has not signed an agreement with Treasury

On April 20, the Treasury announced that it had released initial disbursements under the PSP, totalling $2.9 billion, to two major airlines and 54 smaller ones. Over 230 airlines have applied for assistance under the PSP, and Treasury is still processing applications. If applications exceed the amount authorized for any category of eligible participants, the Treasury has stated that it may adjust award amounts and related components on a pro rata basis.

**Economic Relief Program**
Four airlines have said they intend to participate in the ERP. Treasury has accepted the application of one airline, Hawaiian Airlines; Treasury has yet to reach an agreement with two others, United Airlines, American Airlines, and Spirit Airlines.

Loans under the ERP are secured, would bear interest at the market rate before the COVID-19 outbreak, and would be for a five-year term. ERP participants must establish that they have exhausted other available credit. They must also agree to not engage in stock buybacks or pay dividends until 12 months after they pay off the loan; maintain workforce levels at 90% of their March 2020 levels until September 30, 2020; adhere to government restrictions on executive compensation; and maintain certain specified services. The ERP also mandates that Treasury receive warrants from participants whose stock trades on a national exchange (an optional stipulation under the PSP). For other participants, receipt of an equity interest in the form of a warrant or a senior debt instrument is at the secretary’s discretion.

Hawaiian Airlines applied for and received a secured loan of $364 million with a five-year term. Once finalized, the airline will issue warrants to the U.S. government that are convertible into 6.7% ownership and exercisable at the price of $11.82 per share. United Airlines announced its plans to apply for a secured loan of up to $4.5 billion, and it would issue warrants for up to 14.2 million shares in common stock, exercisable at $31.50 per share. American Airlines is seeking $4.75 billion, and plans to issue warrants for 38.0 million shares of common stock, exercisable at $12.51 per share. Spirit Airline expects to receive $741 million under the ERP and to issue warrants exercisable into 5.3 million shares at a strike price of $14.08. Each warrant agreement prices shares at market close as of April 9, 2020.

In line with requirements to exhaust all other sources of funding, two airlines, Alaska Airlines and United Airlines, have secured external funding from major banks. Wells Fargo lent Alaska Airlines $425 million via a senior secured loan with an interest rate based on LIBOR plus an increasing margin over the duration of the loan. The loan extends for 364 days. Similarly, Bank of American has lent United Airlines $250 million, with an interest rate no lower than 2% that increases over the duration of the loan, to be extended through April 6, 2021. Through Citibank, Spirit Airlines entered into a revolving credit facility for an initial commitment amount of $110 million, and borrowed an additional $25 million on April 20th.

Other Assistance

In addition to aid to airlines, the CARES Act allocates $17 billion for aid to Boeing (although not explicitly named), the largest national defense contractor and aircraft supplier. Manufacturers are feeling the reverberations of depressed demand, with cancelled orders for major suppliers and cuts in production, leaving many manufacturers requesting aid from governments around the world. The chart below visualizes the global connections between the top suppliers and the largest airlines, and the number of airlines they supply.
Still under negotiation with the Treasury, a potential aid package for Boeing has hit a roadblock as CEO Dave Calhoun opposed providing the US government an equity stake in exchange for aid. It’s unclear whether negotiations will resume or conclude in the near future.

The US’s CARES Act also suspends an array of airline excise taxes through the end of 2020. Although the tax relief is estimated to amount to $8 billion in aid, it is dwarfed by the other aid given to the industry under the CARES Act. Private jet companies are expected to be the greatest beneficiaries of the suspension in excise tax.

Source: SNL. Node size is weighted by the number of connections to other nodes.
Finally, Title XII of the CARES Act provides the Federal Aviation Administration (FAA) $10 billion in aid to be awarded as grants as economic relief to commercial service airports and general aviation airports. All airports receiving funding through the FAA must maintain, through December 2020, at least 90% of the individuals employed as of March 27. As of April 15, the FAA has awarded $9.1 billion to over 3,000 airports across the United States.
Aviation Interventions Continue Internationally

By Vaasavi Unnava and Alex Nye

Original post here.

Governments around the world have committed many billions of dollars to help the aviation sector survive the COVID-19 crisis. This aid comes in the form of grants, loans, loan guarantees, tax relief, and other subsidies. Some programs are targeted at specific firms and others provide broad-based support. The US is implementing what it expects to be the largest targeted package for the industry. Singapore's program appears to be the second most generous.

COVID-19 has buffeted the international and domestic aviation industries. On April 20, the International Civil Aviation Organization (ICAO) predicted airlines will lose at least $160 billion on international air travel over the first nine months of 2020. The suppliers for these airlines are also suffering. Some are shuttering manufacturing facilities to conserve funds.

The U.S. CARES Act provides the industry with up to $78 billion in loans, loan guarantees, and cash grants. Other countries have also begun to financially support their aviation industries (see the earlier YPFS blog). Few other countries took a comprehensive approach like the US; most offer one or two narrow facilities to their airlines instead of aiding the entire sector.

The United Kingdom has largely encouraged airlines to utilize the broader Covid Corporate Financing Facility (CCFF), which provides credit by buying commercial paper issued by businesses needing aid due to COVID-19 disruptions. Through the CCFF, the UK has awarded £600 million to the British budget airline group, EasyJet. The CCFF offers standardized terms on commercial paper purchases for any company requiring aid. In particular, all commercial paper purchases require that the commercial paper matures within a year and have at least an A- rating or the equivalent from a ratings agency as of March 1, 2020.

Nigeria has set up a Targeted Credit Facility, which aims to support companies especially impacted by COVID-19, including airlines.

Not all airlines requesting state aid have received it. Virgin Atlantic requested £500 million in the form of grants and loans from the UK government, but has yet to receive aid. Sir Richard Branson, the head of Virgin Atlantic, is a tax resident of the British Virgin Islands and pays no UK income tax. This has made the government hesitant to rescue Virgin Atlantic. UK manufacturers Rolls Royce and Airbus UK have supported the aid to Virgin Atlantic. They argued that the Virgin Atlantic plays an integral role in the UK’s manufacturing supply chain. Virgin Atlantic is a major customer for Rolls Royce parts and the Airbus A330 (whose wings are designed and manufactured in the UK).

A request for aid from Air France-KLM has hit a similar roadblock, resulting from a conflict between its two government shareholders; the government of France has a 14.3% stake and the government of the Netherlands has a 14% stake. The company appears to be nearing an
agreement with the French government. The rescue is reportedly an EUR 10 billion ($10.9 billion) deal under which the French government will guarantee 90% of bank loans to Air France-KLM and provide some loans to the airline through a government emergency fund.

Norway used a NOK 6 billion loan guarantee program to support its airlines. It provides a 90% government guarantee on lending to participants. Troubled carrier Norwegian Air Shuttle can receive up to NOK 3 billion under the program. The program also guarantees NOK 1.5 billion in loans for multinational airline SAS and NOK 1.5 billion for Widerøe and other airlines. In Norway, a private-sector analyst argued that the aid provided to Norwegian Air Shuttle is likely not large enough; he said it would only pay for 1.5 months of Norwegian Air Shuttle grounding its aircraft.

Similarly, Sweden has provided a credit guarantee framework for its airlines, with a maximum of SEK 5 billion ($500 million) to any airline. Finland has provided a €600 million state guarantee for Finnair, a state-owned airline.

Some multinational airlines have coordinated aid from multiple governments. One example is SAS, which is 14.82% owned by the Swedish government and 14.24% owned by the Danish government. SAS received an EUR 137 million guarantee on a revolving credit facility from the Danish government; a 90% credit guarantee worth NOK 1.5 billion from the Norwegian government; and credit guarantees worth SEK 1.5 billion (about $142 million) from the Swedish government (from its SEK 5 billion program).

Italy has chosen to re-nationalise Alitalia after the airline requested aid. The government plans to downsize the airline to a quarter of its current size. The government had attempted to turn around Alitalia and privatize it after a bankruptcy in 2009. That effort stalled until Etihad Airways took a 49% stake in Alitalia in 2014. The company briefly improved, but lapsed back into bankruptcy proceedings in 2017. The Italian government recently injected EUR 500 million into a state-owned company it plans to use to execute the nationalization in June.

Singapore has offered a large amount of aid to its aviation industry. The government plans to spend S$15.1 billion ($10.6 billion) on a program paying 75% of all employee wages in the industry up to S$4,600 ($3,200) per month. Singapore’s state-owned investment company, Temasek, said that it would underwrite the sale of S$15 billion worth of Singapore International Airlines shares and convertible bonds. Singapore’s biggest bank, DBS, will provide the airline with a bridge loan of S$4 billion ($2.8 billion). Temasek currently has a 56% stake in the airline. The government also said it would provide S$350 million (~$246 million) in relief from aviation taxes and fees.

Other governments have chosen to aid their airlines and aviation industries through their tax code. The Republic of Korea offered tax measures supplementing 300 billion won of liquidity support for budget carriers from the state development bank. Australia initially offered its ailing airlines A$715 million in tax relief ($457 million). The Australian government eventually offered A$160 million ($102 million) in other aid to its two biggest airlines (Qantas and Virgin
Australia) in exchange for the airlines maintaining a core set of regional flights. This was not enough to save Virgin Australia, which entered voluntary bankruptcy after the Australian government did not respond to its A$1.4 billion ($894 million) bailout request.

Around the world, governments and suppliers are still negotiating terms of any potential direct aid to suppliers and airports. Officials from Airbus have asked for funding from the French government, as the company cuts production by one third. So far, France has not allocated aid to Airbus. The Hong Kong Airport Authority (HKAA) allocated HK$50 million ($6.5 million) to fund retraining for up to 25,000 airport staff on unpaid leave. The HKAA also reduced rents by 50-70% for shops within airports in a HK$630 million program ($81 million).

More Aid Offered To Airlines as Pandemic Continues to Depress Demand

By Vaasavi Unnava

Original post here.

For four months, social distancing measures have hobbled the airline industry with depressed demand, grounded flights, and net losses. Ridership remains low, held down by travel prohibitions between countries that normally supply heavily trafficked routes. With persistent losses and pessimistic future forecasts, several European airlines have now received aid from their governments to maintain solvency for those companies critical to industry supply chains.

In March 2020, industry-wide revenue for passenger air fare dropped to nearly half the revenues a year prior. The dramatic shock, in an industry characterized by high fixed costs with little room for volatile revenues, immediately required interventions from governments around the world. For many privately owned air carriers, these interventions, typically in the form of tax reductions and payroll support, provided quick relief.

While some countries have stopped there, the United States and some countries in Europe have used the temporary relief provided by payroll support subsidies to negotiate more complex deals for aid in exchange for equity or warrants. By late April, many European airlines negotiated some form of aid from their home country governments; now two more airlines join the group, with an additional $10 billion in credit guarantees, state loans, and capital investment.

Figure 1. Allocated aid to airlines in Europe.

<table>
<thead>
<tr>
<th>Airline</th>
<th>Allocated in Local Currency*</th>
<th>Local Currency to USD</th>
<th>Aid in Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>EasyJet</td>
<td>£600</td>
<td>1.28</td>
<td>$768</td>
</tr>
<tr>
<td>Norwegian Air Shuttle</td>
<td>NOK 3000</td>
<td>0.11</td>
<td>$330</td>
</tr>
<tr>
<td>SAS (Norway)</td>
<td>NOK 1500</td>
<td>0.11</td>
<td>$165</td>
</tr>
<tr>
<td>Widerøe and other airlines</td>
<td>NOK 1500</td>
<td>0.11</td>
<td>$165</td>
</tr>
<tr>
<td>Company</td>
<td>Currency</td>
<td>Rate</td>
<td>Amount</td>
</tr>
<tr>
<td>-------------------------------</td>
<td>----------</td>
<td>------</td>
<td>--------</td>
</tr>
<tr>
<td>Swedish Credit Guarantee</td>
<td>SEK 5000</td>
<td>0.11</td>
<td>$550</td>
</tr>
<tr>
<td>SAS (Sweden)</td>
<td>SEK 1500</td>
<td>0.11</td>
<td>$165</td>
</tr>
<tr>
<td>FinnAir</td>
<td>€600</td>
<td>1.17</td>
<td>$702</td>
</tr>
<tr>
<td>SAS (Denmark)</td>
<td>€137</td>
<td>1.17</td>
<td>$160.29</td>
</tr>
<tr>
<td>Alitalia</td>
<td>€500</td>
<td>1.17</td>
<td>$585</td>
</tr>
<tr>
<td>KLM (The Netherlands)</td>
<td>€3,400</td>
<td>1.17</td>
<td>$3,978</td>
</tr>
<tr>
<td>Deutsche Lufthansa</td>
<td>€6,000</td>
<td>1.17</td>
<td>$7,020</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td>$14,423.29</td>
</tr>
</tbody>
</table>

(*) millions

The Netherlands has approved **€3.4 billion** in state loans and guarantees for KLM, part of the Air France-KLM travel group. Germany will provide a capital investment of **€6 billion** to Deutsche Lufthansa AG (DLH), the parent company for the Lufthansa Group. These measures complement the renationalization of Alitalia by the Italian government, which was announced in March.

The Netherlands has utilized a mixture of state loan guarantees and state loans to aid KLM. Of the allocated €3.4 billion, €2.4 billion will be state guaranteed bank loans while the last €1 billion will be a direct loan from the state. The direct loan from the state runs in tranches through 2025, with maturities ranging from nine months to five years.

For KLM, the loans come with a suite of additional terms. KLM must reduce costs by 15 percent. Employees who make more than three times the average salary at the company must reduce their salary by at least 20 percent. Employees who earn less are also asked to take salary reductions, though at a lesser rate. While the loans from this package are outstanding, KLM cannot pay dividends to shareholders or bonuses to its employees. The air carrier must also reduce its annual evening flights by 7,000 to 25,000. As an environmental requirement, KLM must reduce the aviation sector’s carbon emissions by 50% of 2005 levels by 2030. Finally, the Dutch government asked parent company Air France-KLM and both of its subsidiaries to substantively reorganize to reduce costs.

Unlike the Netherlands, Germany has injected capital into Lufthansa through Lufthansa’s parent company, DLH, in exchange for equity. Of the €6 billion allocated:

- €300 million is in new equity, equivalent to 20% of Lufthansa’s share capital,
- €4.7 billion is in non-convertible, non-voting equity, and
- €1 billion is in a non-voting convertible debt instrument.
The government will conduct the recapitalization through the Economic Stabilization Fund, a fund specifically set up to aid companies directly affected by the coronavirus outbreak. As part of its recapitalization plan, Deutsche Lufthansa AG will redeem all outstanding equity and debt by 2026. It must also suspend dividends and share buybacks while the German government has ownership over DLH debt and equity. Also, until the state redeems 75% of its outstanding capital, DLH cannot pay bonuses to management.

The agreement between DLH and the German government extends further than the arrangements that other governments have made. DLH is not permitted to purchase stakes in competitors or subsidize troubled subsidiaries. To help other carriers compete with the airline aided by the state, the government has required DLH to divest from 24 slots a day at two of its hub airports--Frankfurt and Munich--making the slots available to competitors. Accompanying the €6 billion state aid package is a €3 billion state guarantee of any private loans taken by DLH.

Some European airlines are already partially owned by governments in their home countries. Prior to the additional recapitalization, the Dutch government owned 14.3% of Air France-KLM shares, matching the French stake. FinnAir enjoys status as Finland’s flag carrier, with the Prime Minister’s office as the largest shareholder of the company, owning 56% of shares. Because of the extant government stakes in these carriers, the leadership of these companies might feel more comfortable with additional conditions imposed by new government assistance, as in the case of the Dutch assistance to KLM.

In comparison, Lufthansa’s CEO expressed concerns about government interventions affecting the airline’s ability to remain competitive if there were too many constraints. Leadership may have found comfort in the deal’s “silent participation” clause, which prevents the German government from selling Lufthansa shares on third-party markets.

In a related vein, Virgin Atlantic’s reluctance to rely on government funding has led its CEO and Founder, Richard Branson, to sell stakes in part of its parent organization to keep it profitable. After months of fundraising, the airline recently agreed to a $1.2 billion rescue deal funded exclusively by private markets.

A similar trend may be playing out in the United States, where airlines and suppliers have left billions of dollars in government aid outstanding while searching for other sources of funds. Executives originally balked at Treasury Secretary Mnuchin’s insistence that companies that took the available loans would be required to provide some form of equity to the government, a practice the government relied on during the Global Financial Crisis with positive outcomes.

Federal Reserve lending facilities remain untapped by major airlines, though the announcement of these facilities opened up private markets to debt issuances from troubled carriers. On June 25, American Airlines issued $2.5 billion in senior secured notes, due in 2025, at an 11.75% interest rate. United Airlines issued $1 billion of stock in April and an additional $1 billion worth of shares in late June. Southwest Airlines has improved its capital position by relying on a
mixture of equity and debt issuances. The airline sold $1 billion in common stock and $1.6 billion in convertible senior notes in late April.

Other airlines and air companies relied largely on bond issuances. Boeing Company issued $25 billion worth of corporate bonds in May, following Delta’s $3.5 billion bond issuance. Delta’s bond issuances come at a high cost—in addition to high interest rates, the company pledged landing slots at Kennedy, Heathrow, and LaGuardia airports as collateral.

As of June 25, Treasury had dispensed over $25 billion in support to passenger air, cargo air, and airline supply companies through its Payroll Support Program (PSP), a section of the CARES Act that provides grants to air carriers and affiliates to continue paying employees during depressed flight demand. Treasury has dispensed funds to over three hundred passenger air carriers of all sizes. Almost all of the support was in the form of grants. However, for the largest 13 carriers, which accounted for $6 billion in disbursements, a portion was in the form of loans and they were required to provide warrants for shares in exchange. In total, passenger airlines have claimed nearly all allocated aid to them by the PSP, with approximately $800 million still outstanding. Cargo air carriers have received $640 billion, while eligible contractors have received $1.4 billion.

Funding is still available through the Emergency Relief Program (ERP), through which the government may provide secured loans to eligible aviation industry participants that show they have exhausted market options. As of June 16, Treasury had received 190 applications for loans under the ERP. On July 2, Treasury announced five airlines were in line to receive loans under the ERP: American Airlines, Frontier Airlines, Hawaiian Airlines, SkyWest Airlines, and Spirit Airlines. Though terms aren’t finalized, American Airlines disclosed the same day that it expects to receive $4.75 billion in loans from the Treasury under the CARES Act, increasing its liquidity position to $15 billion. Other airlines have yet to disclose information on anticipated loan terms or size.

However, despite having raised funds from the market and received Treasury aid, US airlines are still struggling to stay profitable. United Airlines was the recipient of $3.5 billion in grants and a $1.5 billion loan in exchange for warrants through the PSP, however, it announced on July 8th that it would involuntarily furlough half of its US workforce—or 36,000 employees—beginning on October 1st, if demand stays depressed. Hawaiian Airlines also expects to reduce employee headcount largely based on its forecast of prolonged reduced ridership: it has a planning assumption that there will be a 10-15% reduction in its anticipated flight schedule for the summer of 2021 (as compared to historical averages). Even after receiving aid from the Treasury, American Airlines has notified employees of the possibility of furloughing 25,000 staff in the coming months and has threatened to cancel orders of Boeing’s 737 MAX jet.

Several other major US airlines are in a similar situation, with earnings reports revealing the extent of the economic pain. On July 20, United Airlines reported a $1.6 billion loss in Q2, with analysts warning against holding airline stocks. Delta Airlines, expected to perform strongest of the group, faced a 90% drop in revenues at its lowest point in Q2. JetBlue Airways also faced
losses, and the company expects revenue to drop 80% in the third quarter. American Airlines posted a 86% drop in revenues year over year. Analysts expect a slow recovery, with prolonged losses into late 2020, if not longer.

For some troubled European airlines, analysts predict similar challenges. Andrea Giuricin, a transport economist, expressed concerns that nationalisation will not provide the foundation that some airlines need to compete in an already depressed and competitive market. An example is Alitalia, which in comparison to competitors flies smaller planes that can hold fewer passengers, leaving the airline vulnerable to losses on routes profitable for larger airlines. The airline also comparatively has more ground personnel protected by strong unions, while falling behind in international flights to Italy. The Italian government hasn’t yet announced the final restructuring plan for renationalisation.

As the rate of air travel struggles to return to pre-crisis levels due to the continued persistence of the virus, many airlines fight to remain profitable. The industry continues to face high fixed costs and any ability to adjust current expenses does not directly align with drops in revenue creating cash flow challenges and making them especially vulnerable to economic shocks. The terrorist attacks of 9/11, after which passenger demand dropped dramatically once US airspace reopened, showed that the industry might require state aid to avoid bankruptcy and restore operations to pre-shock levels; in that circumstance such aid was provided.

Strategies used by several Asian governments demonstrate that there are other options for state aid that can address high fixed costs rather than directly mitigating the effects of lost income. The Singaporean government plans to spend S$15.1 billion ($10.6 billion) on a program paying 75% of all employee wages in the industry up to S$4,600 ($3,200) per month. In Korea, the government guaranteed aircraft lease deposits for airlines. The government also reduced occupancy taxes. The Hong Kong Airport Authority (HKAA) allocated HK$50 million ($6.5 million) to fund retraining for up to 25,000 airport staff on unpaid leave.

As airlines are critical industries that play key roles in transportation and supply chains for passengers and cargo, governments will likely adopt multiple strategies to keep local air carriers afloat. The persistence of the pandemic, which some commenters predict may last into mid-2021, may require multiple interventions in the air industry during the coming months.
USDA Announces $14 Billion in Aid to Farmers

By Sean Fulmer

Original post here.

The United States Department of Agriculture (USDA) announced on September 18 that a second tranche of approximately $14 billion in federal aid will be made available to agricultural producers struggling as a result of the ongoing COVID-19 pandemic. The Coronavirus Food Assistance Program (CFAP 2) provides direct support to farmers facing significant price declines.

The previous CFAP 1 distributed $9.9 billion to farmers affected by the COVID-19 pandemic, of a total $16 billion allocated to the program, before September 18. However, the program faced criticism from World Trade Organization member countries. Similar programs initiated in recent years have been the subject of watchdog and congressional investigations. The European Union, China, Brazil, and others have raised concerns that the CFAP violates the WTO Agriculture Agreement.

Agriculture Economic Situation

The USDA projects that farm cash receipts will decline 3.3% ($12.3 billion) in 2020 as a result of the COVID-19 demand shock. Prices have fallen for many crops as a result of supply surpluses and weak demand.

Corn prices have fallen 18% and have not recovered due to the drastic reduction in gasoline demand. As of April, ethanol production has dropped about 50% this year compared to last. Additionally, corn and wheat future prices have declined nearly 20% and 15%, respectively, as a result of continuing uncertainty regarding foodservice sales. Live cattle futures price and dairy product prices have fallen 10% and 12%, respectively.

Overview of the Program

Most of the funds for CFAP 2 will come from the Commodity Credit Corporation (CCC) Charter Act. However, tobacco products will be financed up to $100 million through the Coronavirus Aid, Relief, and Economic Security Act (CARES Act). Tobacco commodities were not eligible for funding in the original CFAP. The CCC is unable to provide funding for tobacco products, per regulation 15 U.S.C. 714c.

There are three categories of commodities that are eligible to receive CFAP 2 payments:

- Price Trigger Commodities,
- Flat-rate Crops, and
- Sales Commodities.
Price trigger commodities are those commodities that experienced at least a five percent decline in prices from January through July. Prices for these crops dropped an average of 14% from mid-January to late July. The eligible crops in this category are barley, corn, sorghum, soybeans, sunflowers, upland cotton, and all classes of wheat. The payments for these commodities are based on 80% of the price decline and eligible acreage, weighted by actual 2002 production. Also, if the payment calculated under this formula’s conditions are less than $15 per acre, then the payment will be raised to $15 per acre.

The second category is flat-rate crops, defined as crops whose prices did not fall by five percent from January through July. Payments related to these commodities will be calculated by multiplying eligible 2020 acres by $15 per acre. The USDA identified the following crops in this category: alfalfa, extra long staple (ELS) cotton, oats, peanuts, rice, hemp, millet, mustard, safflower, sesame, triticale, rapeseed, and several others.

Sales commodities, the third category, include a broad range of specialty crops, aquaculture, nursery crops and floriculture, and livestock. Payments under this category will be calculated on a sales-based approach with five payment gradations associated with 2019 sales.

It is important to note that none of the payments under CFAP 1 or 2 are based on actual losses to agricultural producers. Additionally, no specific provisions are granted for producers selling locally rather than at wholesale or at different price points, such as organic or grass-fed price points. Rather, they are estimated levels of previous yields or sales. These calculations may favor relatively large producers who sell into commodity and wholesale markets over smaller, family-owned farms. Critics such as the National Sustainable Agriculture Coalition (NSAC), which advocates for family farms, have focused on this aspect as reductive and lacking accurate targeting measures to provide proper payments based on losses.

Only commercially produced commodities are eligible for CFAP 2 and producers must be operating at the time they submit their applications. Crops intended for grazing or manure are not eligible for CFAP 2. Producers are only eligible for a CFAP payment if their average adjusted gross income (AGI) from the 2016, 2017, and 2018 is less than $900,000. However, the income cap does not apply if at least 75% of their average AGI comes from farming or foresting activities.

The NSAC also criticized this AGI provision for allowing large producers to claim the maximum payment possible. This might limit the funds available for small and medium-sized producers. Furthermore, the program operates on a “first-come, first-served” basis, which indirectly prioritizes larger producers with simple production mechanics since they can quickly file for CFAP payments, unlike smaller producers or those with more specialized production systems. Also, since CFAP payments are generated by commodity, diverse producers may face a more difficult time in gathering documentation.
The NSAC also criticized the CFAP 2 for not directly addressing difficulties of producers of color and others who have historically been underserved by USDA aid or have experienced difficulty obtaining service from FSA offices.

Producers cannot receive more than $250,000 under CFAP 2 for the combined commodities they grow; payments received from the original CFAP are not considered towards this limit. The payment ceiling can rise to as high as $750,000 if three different members of the legal entity applying each provide 400 hours of active personal labor.

In order to apply, producers must submit an application to the Farm Service Agency (FSA), as well as certifications of AGI and eligible crop acreages. The signup period will be open from September 21 through December 11.

The USDA estimates that $10.72 billion in CFAP 2 payments will go to price trigger commodities, after payment limitations are calculated; $0.32 will go to flat-rate commodities; and $2.17 billion will go to sales commodities.

CFAP 1

As of September 13, the original CFAP had approved 621,919 applications for funds, with over $9.9 billion in payments disbursed or in review for disbursement. About 77% of those funds went to cattle, milk and corn producers. Unlike complaints about the USDA’s 2019 Market Facilitation Program, the CFAP funds do not appear to have an overly concentrated geographic density in the South.

During the original CFAP, the USDA determined that payment limitations only affected 1% of applicants. The USDA did not provide detailed information on the concentration of payments to these producers. Payments were about 77% of the level that they would have been without payment limitations. According to the USDA cost-benefit analysis, this saved the federal government approximately $3 billion. The USDA maintains that these payment limitations are an effective way to ensure equity and fairness in its distribution of CFAP funds.

Some critiques of the CFAP have focused on the lack of a commitment to reducing inequalities in the farming industry. Specifically, CFAP does not reserve funding for historically underrepresented groups of farmers, such as members of the Black, Latinx, and immigrant communities. These farmers, as well as new and inexperienced producers, are more likely to be unaware of the CFAP, despite its potential to be the largest direct payment program to producers.

Commodity Credit Corporation

The CCC is a Depression-era program that allows the USDA to borrow as much as $30 billion from the Treasury Department. President Trump requested that an additional $21 billion be allocated to the CCC in the short-term spending resolution to avoid a government shutdown. The CARES Act allocated $14 billion to replenish the CCC, which is the source of funding for CFAP 2. This appropriation is not specifically limited to COVID-19 programs, but the
equivalent headline numbers imply that those funds allotted to the CCC in the CARES Act are the basis for CFAP 2.

However, the Farm Bureau, a lobbying organization representing the agriculture industry, still estimates that the CCC funds will be depleted by November, since the original CFAP used $6.5 billion in CCC funds. The CCC currently has about $2 billion in borrowing authority, with projected outlays of another $7 billion. This means that noncontroversial annual support aid and conservation payments could be delayed for several months, causing further uncertainty and instability. Congressional Democrats are hesitant to fund the CCC further. The top Democrat on the Senate Agriculture Committee said the administration of CFAP has “not been fair,” prioritizing large over small farmers and southern over midwestern districts.

Despite these disagreements, the Continuing Resolution (CR) that passed the House on September 22 states that the CCC will be reimbursed for entitlements and mandatory 2020 payments, ensuring that the CCC will be able to fund conservation programs and annual aid payments. The CR also restricts CCC and USDA funds from supporting oil refineries or importers, directly or indirectly. Prior to this limitation, reports indicated that the Trump Administration considered using $300 million in USDA funds, likely through the CCC, to provide cash aid to US oil refineries. However, this would no longer be possible if the CR becomes law.
Liquidity and Market Liquidity

Central banks support will normally provide large amounts of liquidity to encourage credit markets to operate in times where they tend to slow or completely freeze. Market and emergency liquidity relief comes in various forms, such as increased central bank repurchase agreement activity, large-scale direct purchases of obligations like government debt, corporate bonds, or commercial paper on primary and secondary markets, and expanding the scope of existing facilities and operations by increasing tenor and widening eligibility, to name a few.
Central Banks Introduce Programs to Improve Liquidity in Key Markets

**By June Rhee with Research Support from Aidan Lawson and Manuel Leon Hoyos**

*Original post here.*

As the coronavirus crisis continues to disrupt global markets, several countries have adopted new or revised programs to improve liquidity in specific credit markets that are critical to households and businesses. Similar market liquidity programs were introduced during the 2007-2009 Global Financial Crisis (GFC) to backstop wholesale funding markets. Although evaluations of these programs are limited due to the difficulty in isolating the independent effects of these programs, studies report that most of these programs, regardless of size, were helpful in reducing disruptions in these markets by assisting price discovery, restoring confidence and catalyzing market volume.

When designing a market liquidity program, policymakers need to make key design decisions about:

1. Legal authority - what is the legal authority of the central bank for intervening in these markets?
2. Stigma problem - how do you ensure wide enough participation in the programs?
3. Loans: recourse or non-recourse and term - if the central bank is providing a loan, what are specific features that the central bank should be mindful of?
4. Eligibility - which institutions are allowed to participate in the program?
5. Haircuts, interest rates, and fees - how will the central bank strike a balance between incentivizing the participants to reenter the market and minimizing the risk to the central bank?
6. Relief from regulatory requirements - what existing regulatory restrictions may restrict the usage and efficiency of the program?

Below is a summary of how policymakers have approached these questions in the past.

**Legal Authority**

The legal authority of a central bank can influence the method by which it intervenes in credit markets. During the GFC, central banks either purchased or made loans in market liquidity programs. The Bank of England, ECB, and Bank of Japan directly purchased securities. Their legal framework authorized them to make outright asset purchases and they had a history of direct participation.
In contrast, in the U.S., section 13(3) of the Federal Reserve Act allows the Fed to lend to nonbanks through its discount window only in “unusual or exigent” circumstances. Its power to purchase market instruments is limited. For that reason, in designing several programs during the GFC, the Fed lent funds to an intermediary, and the intermediary would then purchase eligible market instruments and post them to the Fed as collateral for the loan.

Because of the legal limitations, the Fed’s Term Asset-Backed Securities Loan Facility (TALF) provided term credit against newly issued ABS rather than making outright purchases. Similarly, the Fed’s Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) lent funds to an intermediary such as a depository institution or a broker-dealer so that entity could purchase asset-backed commercial paper (ABCP) from money market mutual funds. The Fed has reintroduced revised versions of the TALF and AMLF recently in response to the coronavirus crisis. Posts on the recent TALF can be found here and the recent AMLF can be found here.

One study observed that the legal restrictions were the only reason the Fed used an intermediary to purchase assets in the earlier GFC programs. The loan vs. purchase decision does not seem to have made a noticeable difference on the effectiveness of these programs. Non-recourse loans and purchasing are economically similar for central banks.

On the other hand, some countries’ central banks are able to use their regular or standing operations to lend to nonbanks. These programs naturally took the form of loans, as seen in Australia, Canada and Chile.

Limitation on legal authority also led the Fed to use special purpose vehicles (SPVs) as a third party intermediary in these programs. A caution for using an SPV is that they can be complex. Utilization of an SPV in the Fed’s GFC-era Money Market Investor Funding Facility (MMIFF) may have delayed the Fed’s efforts to reach illiquid markets. The program took more than one month to get off the ground. Certainly, response time is an element of effectiveness.

SPVs have advantages. South Korea has and is now using a fund jointly financed by the Bank of Korea and private institutional investors to conduct market liquidity programs. Some observers [p.42] argue that the existence of an intermediary vehicle separate from the central bank can make it easier to use private institutions as agents, asset managers, and custodians.

**Stigma Problem**

These programs can only work if financial institutions participate. During a crisis, financial institutions may be reluctant to draw on emergency lines of credit from the central bank if doing so could signal weakness to others. Moreover, the perception of weakness does not need to be based on reality to keep eligible institutions from participating in emergency lending programs (see here [p.25]).

One way the Fed addressed stigma during the GFC was through auctions, as in its Term Auction Facility. For that facility, auctions provided safety in numbers. Also, since the price was set by the
auction, it did not imply that borrowers were paying a penalty rate. Moreover, because auctions were held only at certain times, unlike a standing facility, using the facility did not imply a borrower had an immediate need for funding (see here).

Some programs were run as standing facilities and used other features to deal with stigma.

First, limited or lagging disclosure can prevent stigma: if the market doesn’t know a bank has received government liquidity, that bank won’t suffer from stigma. In the U.S., however, post-GFC disclosure requirements imposed on the Fed may raise stigma problems. The Fed now must report to the Congress for any use of emergency lending authority under section 13(3) of the Federal Reserve Act. Within seven days of establishment of any section 13(3) program, also, the Board must report detailed transaction-level information to the Congress on any lending activity it conducts under those programs.

Second, offering uniform access for all financial institutions, irrespective of their condition and systemic importance, can prevent stigma. For that reason, central banks sometimes encourage healthy institutions to participate.

The stigma problem is mainly relevant for government programs that financial institutions don’t use in normal times. The ECB during the GFC was able to lend billions of euros in the early days of the GFC in part because its facility was already available to hundreds of financial institutions and had been used regularly. Banks could avoid stigma because that borrowing was seen as unremarkable.

**Loans: Non-recourse and Term**

The advantage of recourse loans is that repayment is backed by the financial resources of the borrower. Earlier programs by the Fed heading into the GFC were recourse but later ones were non-recourse as the Fed was lending to new counterparties whose financial condition could not be readily assessed. In other cases, the Fed found it would be counterproductive to expose counterparties to the risk of a decline in the collateral’s value.

Non-recourse loans by the Fed generally accompanied a private loss-sharing arrangement to mitigate the risk it took in collateralized non-recourse loans. In TALF, this created an incentive for participants to establish sound collateral for the securities, since they took the first risk of loss. In view of the long term to maturity of the loans, and wide-variety of newly issued spreads and credit quality across the ABS market, it was desirable to have private investors’ scrutiny. This involvement also avoided undercutting market mechanisms for allocating credit to borrowers by relying on private structuring and pricing of new securitizations. Relying on private investors in newly issued ABS and CMBS also provided benchmark pricing to the market.

The terms of loans generally mirrored the terms of underlying collateral (AMLF and Commercial Paper Funding Facility (CPFF)). In TALF, the term was initially one year, which was shorter than that of underlying assets posted as collateral for the loan. This mismatch meant that the financing would expire before the underlying debt securities were paid back, leaving the
investors to assume the full risk for the rest of the term left in the investment. The Fed recognized that flaw and extended the term to three to five years, reflecting the maturity of underlying assets.

**Eligibility**

Many U.S. programs during the GFC were limited to institutions the government was already familiar with. In the case of the AMLF, to facilitate quick implementation of the program, the Fed relied on institutions with which it had existing relationships (depository institutions and broker-dealers) to act as intermediaries and to be the actual borrowers under the program.

**Haircuts, Interest Rates and Fees**

Setting haircuts, interest rates and fees are a balancing act. For a program to be effective and ensure widespread use, these should be high enough to minimize moral hazard but not too high as to deter participation.

The Bank of England’s GFC-era Commercial Paper Facility bought CP at spreads that were significantly below market rates at the time, but significantly above those expected to prevail in normal conditions. Initially this was to help drive market spreads down and provide a backstop. This was set up to be self-liquidating as normal market conditions returned.

Haircuts and interest rates also represented the risks the central bank was taking on with illiquid assets. In launching Outright Purchases of CP, Bank of Japan governor Masaaki Shirakawa stated that the bid rate would be “more favorable than the market interest rates when the market is malfunctioning;” since losses on any purchased CP come at a cost to the taxpayers, a penalty rate would ensure that taxpayers were compensated for taking on the credit risk. The CPFF used interest rate as a security feature where the accumulation of interest was expected to absorb losses and provide additional protection for central banks (see here[p.197]).

However, the AMLF did not impose any haircuts. Under the AMLF, borrowers purchased ABCP at amortized cost, not at depressed values. The Fed feared further market instability if another money market fund were to “break the buck,” that is, to announce that the market value of its assets had fallen below 99.5% of book value. The Fed, instead, to minimize the risk that it undertook, only took high-quality ABCP as collateral and tightened the requirements as the program progressed.

Fees should be sufficient to cover central banks’ costs of managing each program. A Bank of England report emphasizes that fees in GFC programs were not designed to manage the risks to the central bank or to the public – those risks should have been adequately covered by collateral and haircuts (see here).

The Fed sometimes relies on private institutions to ensure the accuracy and efficacy of these programs. In the TALF, agents were hired to handle administrative activities between the Fed and the borrowers. Bank of New York Mellon, the program custodian, was responsible for holding collateral, collecting and distributing payments and administrative fees, and validating
the pricing and ratings submitted for pledged securities. Collateral monitors, selected by the Federal Reserve Bank of New York, provided data and modeling services used in risk assessments and also validated collateral pricing and ratings.

**Relief from Regulatory Requirements**

To ensure the effectiveness of these programs to reach their intended markets, central banks have at times exempted or limited existing legal restrictions.

In the AMLF, because the Fed protected borrowing banks from credit or market risk in holding ABCP, the Fed assessed no regulatory capital charge on banks for those holdings. The Fed also exempted banks from the maximum limit that Fed rules imposed on a bank’s “covered transactions” with any single affiliate of the bank from 10% of the bank’s equity to 20%. This allowed the AMLF borrowing banks to purchase ABCP from their affiliated money market funds.

In the TALF, the government made it clear that the executive compensation restrictions that Congress had mandated for companies receiving taxpayer support under the Troubled Asset Relief Program (TARP) would not be applied to TALF sponsors, underwriters, and borrowers. This was to encourage participation in the program. In another program, the Fed didn’t make this clear, and some potential borrowers were unsure whether to participate.

**Effect on Lending to Households and Businesses**

Market participants and government officials have claimed that various market liquidity programs succeeded in channeling credit to frozen markets, although empirical evidence is limited. Post-GFC, some in the U.S. have attempted to compare programs to identify which have been the most effective in channeling credit to households and businesses. One paper by Fed economists argued that TALF had the most direct impact on consumers. They attribute TALF’s success to its three features: (i) a non-recourse loan structure, (ii) longer maturities than discount window and other lending programs, and (iii) availability to a wide set of market participants, beyond the Fed’s traditional counterparties.
Treasury Backstop for Fed Lending under CARES Act: Lessons from 2008 TALF

By June Rhee with research support from Aidan Lawson

Original post here.

Section 4003(b) of the CARES Act appropriates $454 billion for the Treasury to backstop Federal Reserve (Fed) lending programs aimed at supporting credit flows to businesses, states, or municipalities in the midst of the coronavirus pandemic.

The week before the CARES Act was signed into law, the Treasury had already used $50 billion in total from the Exchange Stabilization Fund (ESF) to backstop five Fed emergency lending programs, including the reintroduced Term Asset-Backed Securities Loan Facility (TALF). In 2008 during the Global Financial Crisis (GFC) the Treasury backstopped the first TALF using funds appropriated by Congress in the Emergency Economic Stabilization Act of 2008 (EESA).

The Fed has yet to determine the nature of any emergency lending programs (see here for discussion on the Fed’s section 13(3) power) it will launch under this authority, but Fed Chairman Jerome Powell said on March 26 that the Fed’s emergency lending powers are dependent on this Treasury backstop: “Effectively, $1 of loss-absorption is worth $10 worth of loans.” The Treasury backstop certainly extended the Fed’s lending power during GFC but what were the Treasury and Fed’s expectations in actually using this backstop? These expectations certainly influenced the design of 2008 TALF and a recent report to Congress includes the Fed’s expectation in the 2020 TALF.

Pre-CARES Act Treasury Backstop in 2020 TALF

On March 23, the Fed and the Treasury reintroduced TALF to support credit flows to households and businesses in the midst of economic distress caused by the coronavirus pandemic. Similar to the 2008 TALF, a special purpose vehicle (SPV) will make a total of $100 billion three-year nonrecourse loans to US companies that own eligible ABS. The SPV is funded by a recourse loan from the Federal Reserve Bank of New York (FRBNY) and an initial $10 billion equity investment by the Treasury. The Fed relies on Section 13(3) of the Federal Reserve Act (FRA) and the Treasury uses the Exchange Stabilization Fund to backstop the 2020 TALF.

On March 29, the Fed’s report to Congress pursuant to Section 13(3) revealed the Fed’s expectation in using the Treasury backstop. The Fed “does not expect at this time that the TALF will result in losses in excess of the Department of the Treasury’s equity investment”. Therefore, it seems the Fed is interpreting the Treasury’s backstop as available to use. Similar language is included in the report to Congress for the Primary Market Corporate Credit Facility, and the Secondary Market Corporate Credit Facility.
Treasury Backstop in 2008 TALF

The Emergency Economic Stabilization Act of 2008, which Congress passed in the midst of the GFC, established the Troubled Assets Relief Program (TARP) to help stabilize the US financial system and restore credit flows to households and businesses. It enabled the Treasury “to purchase and insure certain types of troubled assets for the purposes of providing stability to and preventing disruption in the economy and financial system.” Initially, Congress authorized $700 billion for TARP. It reduced TARP’s size to $475 billion in 2010 in the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Structure of Treasury Backstop in 2008 TALF

The 2008 TALF was a joint program between the Treasury and the Fed aimed at restarting the asset-backed securities (ABS) markets, which had come to a near complete halt in the fall of 2008 after the bankruptcy of the Lehman Brothers investment bank. The Fed, under Section 13(3) of the FRA, and the Treasury, using TARP funds, initially committed $200 billion. Later on February 10, 2009, this commitment was expanded up to a potential $1 trillion. The FRBNY made non-recourse loans to investors to purchase eligible ABS and the Treasury provided credit support for these loans.

Initially the staff at the Fed settled on two possible models for the Treasury backstop. The Board staff preferred market participants forming funds that would invest in ABS to which the Fed would provide leverage, the Treasury would provide mezzanine financing, and private investors would provide equity. A similar model without the leverage from the Fed was adopted by the Treasury as the Public-Private Investment Program (PPIP) during the GFC. The FRBNY staff favored a model under which the Fed would lend to private investors holding ABS, with the Treasury providing the Fed credit protection for those loans. This model became TALF. An important advantage of this model was that it would naturally sunset when credit risk spreads normalized and alternative financing became more attractive than TALF loans. (see here)

The FRBNY created a special purpose vehicle (SPV, TALF LLC) to manage assets posted as collateral for the loans. The SPV was initially funded by a $100 million drawing on the Treasury’s $20 billion commitment to purchase subordinated debt issued by the SPV. $16 million of this initial funding was set aside for administrative funding. If the SPV needed further funding beyond $20 billion committed by the Treasury, the FRBNY would lend up to $180 billion. The FRBNY’s loan to the SPV was senior to the Treasury’s subordinated debt, with recourse to the SPV, and secured by all the assets of the SPV.

Loan repayments and proceeds from asset sales were distributed in the following order under the credit agreement among the SPV, the FRBNY and the Treasury:

1. pay general TALF program administrative expenses,
2. repay the $16 million Treasury loan made to the SPV to cover administrative expenses,
3. repay outstanding principal on any FRBNY senior loans,
4. fund the cash collateral account,
5. repay outstanding principal on any Treasury loans,
6. repay FRBNY loan interest,
7. repay Treasury loan interest, and
8. repay any other obligations that may arise that have not been specified by the agencies.

Any residual returns were shared by the Treasury (90%) and the FRBNY (10%).

*Expectations on Actual Usage of Backstop and Features of 2008 TALF*

Unlike the 2020 TALF, testimonies by Treasury and Fed officials seem to suggest that neither the Treasury nor the Fed expected that the Fed would need to resort to the backstop. William R. Nelson, then Deputy Director of the Division of Monetary Affairs in the Board testified that “*although the Treasury provided credit protection for the Federal Reserve, the risk controls built into the TALF..., were designed to keep the risk for the US government as a whole very low*”.

*For further discussion on the risk controls built into 2008 TALF reflecting the Treasury and Fed’s expectation, see the YPFS case on the 2008 TALF.*
Barriers to Access Impede Utilization of Municipal Liquidity Facility

By Vaasavi Unnava

Original post here.

Many states are facing barriers to access the Federal Reserve’s $500 billion Municipal Liquidity Facility (MLF) due to constraints on general debt issuance in their constitutions.

Congress authorized the MLF in the CARES Act. The program authorizes the Fed to purchase up to $500 billion in debt issued by states and counties and cities of a certain size and is intended to help mitigate the economic impacts of the COVID-19 pandemic. The program represents a new area for the Fed, which has not traditionally lent to government subdivisions. The CARES Act separately also provided for $150 billion in grants to states to offset direct costs of the COVID-19 pandemic.

As originally implemented, the MLF provided limited opportunities for participation by cities and counties, instead allowing states to procure funding and distribute it amongst political subdivisions in their geographic area. However, as governors vocalized the extensive barriers to access, the Federal Reserve expanded eligibility from 10 cities and 16 counties to 87 cities and 140 counties. The Fed also extended the program’s end from September to December in response to states’ concerns.

Despite the changes, legal and practical hurdles still might limit utilization of the Fed’s program, which Congress intended to be a key tool to help states and municipalities manage the impacts of the virus. Many of these legal hurdles are written into constitutions to maintain fiscal responsibility in state spending. Moreover, some states can’t issue debt without voter approval, posing the challenge of conducting a ballot under extensive social distancing guidelines.

State Debt Issuance Caps

Many states have constitutionally-mandated caps on the amount of debt a government can issue within a fiscal year. These caps can vary dramatically.

Oregon, for example, only allows the issuance of $50,000 of aggregate debt, a sum small enough to render debt issuances unviable. Other states have much higher caps. For instance, South Carolina can issue debt up to 5% of its revenues from the previous fiscal year—an estimated $660 million for the state based on 2019 collections. Ohio utilizes a similar metric, requiring that debt obligations not exceed 5% of its general revenue fund plus net proceeds from lottery sales, making approximately $769 million its borrowing cap, based on 2019 revenues. Some states, such as Nevada, set caps based on the total assessed value of property in the state.

Debt servicing caps can operate as an informal form of debt issuance caps, limiting the size of debt issuances implicitly by limiting debt servicing costs. Debt servicing caps limit the size of principal and interest payments on existing debt to some percentage of a state’s budget or
revenue. For example, Florida provides that debt servicing cannot exceed 6% of revenues without legislative approval. Illinois has a relatively high debt issuance cap of 15% of general revenues, and aggregate debt servicing cannot exceed 7% of appropriations from the general revenues of the preceding year.

**Voter Approval**

In the context of COVID-19, the most pressing barrier to debt issuance is state requirements for voter approval. Twenty-one states in the U.S. require some form of voter approval before debt can be issued. Two types of voter approval are common: approval of the issuance or approval of the size of an issuance beyond a debt cap.

South Carolina, as mentioned earlier, may issue a sizable amount of debt, but the issuance must be preapproved by either two-thirds of the electorate or the legislature. Rhode Island may exceed its debt cap of $50,000 only if approved through a referendum. Texas requires the approval of a majority of voters, in addition to approval from the legislature.

Extensive social distancing guidelines have complicated voting procedures, leading many states to delay or cancel their primary elections to prevent the spread of the virus. Without opportunities to vote, some states cannot legally issue debt.

**Legislative Approval**

In addition to debt issuance caps, many states require that the legislature approve proposed debt issuances of any amount; sometimes this approval is coupled with voter approval requirements. Legislative approval requirements often need a supermajority to pass, which creates a high bar.

Delaware, which is permitted to issue up to 5% of the estimated net revenues of that year (approximately $210 million based on 2019 revenues) requires approval from three-fourths of the legislature. Illinois requires either approval from a majority of voters or from three-fifths of the legislature to allocate funding. Maine’s issuance cap of $2 million can be exceeded if passed by two-thirds of both houses of the state legislature and approved by voters in a referendum. Though Virginia only requires approval by a simple majority of both houses of the legislature, it also has a referendum requirement.

Social distancing guidelines have affected the daily operations of many state legislatures, temporarily suspending many sessions without means to operate remotely. Combined with the inability to conduct referendums, current health and safety requirements create barriers to states obtaining the necessary approvals for debt issuance.

**Coverage**

Practical difficulty in meeting requirements for legislative or voter approvals may prevent some states from participating in the MLF. Some counties and cities are eligible to participate in the MLF directly, although the scope of eligibility, even under the expanded criteria, has been contested. The cities and counties eligible—even with the latest expansion in eligibility—are
largely urban centers; many cities and municipalities in rural or suburban settings must therefore rely on state aid to receive funding for their local coronavirus response mechanisms, as seen in the chart below.

Eligible counties and cities may also face similar logistical barriers preventing debt issuances on a local level. City councils or governments must adhere to strict social distancing guidelines and are unable to hold referendums in their jurisdictions while maintaining public safety.

While some Federal Reserve officials acknowledged the limitations of the facility prior to the expansion, they have made no indication of additional expansions to the facility. As the first facility the Fed has created in this crisis to provide liquidity to municipalities, the MLF may expand or change as the COVID-19 crisis continues.

Smaller cities and counties ineligible for direct access to the MLF must rely on allocations from state governments for MLF aid. However, as noted above, several states face legislative and logistical barriers that impede access to the MLF. Presently, it’s unclear how smaller counties and cities within those states’ jurisdictions could receive aid if liquidity help cannot reach the states allocating funds. Congressional proposals for using federal government funds for municipal coronavirus expenses have received bipartisan support.
Summary

With direct state applications hampered through multiple barriers to debt issuances, it is unclear whether states will be able to fully participate in the program to cover the additional scores of counties and cities ineligible for the MLF. To issue debt, many states must pass legislation or receive approval by a supermajority of voters, both logistically challenging while adhering to social distancing guidelines. Other states, though able to issue debt, have low debt issuance caps, preventing them from issuing debt to the extent needed to address municipal funding needs.

It is also unclear whether the original $500 billion allocated will be enough to fund all the financial needs of states and municipalities as many states report large estimated deficits due to COVID-induced budgetary shortfalls. Inflexible barriers to access may exacerbate this issue, allocating aid to states that can more easily issue debt.

As social distancing guidelines relax, it is possible that state legislatures may be able to return to sessions and pass debt issuances. With the facility extending into December 2020, there are still opportunities to provide coverage to municipalities that need aid in fighting the COVID-19 pandemic.
In this post we consider the risk profiles of the programs that the Fed has implemented during the COVID-19 crisis as compared to those it adopted during the global financial crisis of 2007-09 (GFC) and the role of the Treasury's backstop in each instance.

In earlier posts, we considered how the Treasury’s use of $454 billion authorized by the United States CARES Act to backstop Federal Reserve (Fed) programs might leverage the funds into trillions of liquidity for the economy. Thus far, this strategy has seen the Fed launch nine programs potentially offering up to $1.950 trillion of loans backed by $215 billion of Treasury funds, or roughly 47% of the available amount. Consistent with the CARES ACT, these facilities were launched pursuant to Section 13(3) of the Federal Reserve Act, which requires, among other things, that the Fed be secured and that it seek to protect taxpayers. As of June 11, the Treasury has made investments into all SPVs for all programs except the TALF, and loans have been extended under the Municipal Liquidity Facility, the Corporate Credit Facility, and the Commercial Paper Funding Facility.

The Fed also launched two other Section 13(3) facilities without Treasury backing, the Primary Dealer Credit Facility, which provides recourse loans to primary dealers, and the Paycheck Protection Program Lending Facility, which finances Paycheck Protection Program loans guaranteed by the Small Business Administration. Loans have been extended under both these programs.

Fed Taking on more Credit Risk

Four of the Section 13(3) programs implemented by the Fed are variations of programs that it implemented during the GFC. However, as Chairman Powell has acknowledged, this time the Fed is taking on more risk. An April letter from the Congressional Budget Office (CBO) also concluded that, this time, the Fed is taking on “substantial additional credit risk for the government.”

Because of the wide impact of the government’s shutdown orders in response to the COVID pandemic, the programs that the Fed has implemented with Treasury support aim to distribute liquidity across wide swaths of the economy and reach borrowers to whom the Fed has not traditionally lent. These include corporations (Primary and Secondary Market Corporate Credit Facilities), political subdivisions (Municipal Liquidity Facility), and small and medium-sized businesses (Main Street Facilities).
Some of the programs are accepting riskier collateral than the Fed accepted under its GFC programs. The Fed’s GFC programs provided collateralized loans and required that such loans be “secured to the satisfaction of the lending reserve bank,” i.e., that there be a high degree of likelihood that the Fed would be repaid and not experience losses, as required by the Fed’s then interpretation of Section 13(3). See this YPFS blogpost for a discussion of Section 13(3).

Acceptable collateral under most GFC programs was limited to Treasuries, agency securities, and other investment-grade securities. Only after Lehman’s bankruptcy did the Fed expand the categories of eligible collateral under some programs to include riskier securities. For example, the collateral eligible to be pledged at the Primary Dealer Credit Facility (PDCF), which provided recourse loans, was originally limited to limited to investment-grade debt securities. It was then

<table>
<thead>
<tr>
<th>Fed Program</th>
<th>Date Authorized</th>
<th>Maximum Authorized</th>
<th>Total amount outstanding as of June 11 [USD mn]</th>
<th>Share of total amount invested in Treasury securities</th>
<th>Total Treasury Support [Equity investment unless stated otherwise]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary Dealer Credit Facility (PDCF)*</td>
<td>17-Mar</td>
<td>Not stated</td>
<td>$5,829</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Commercial Paper Funding Facility (CPFF)*</td>
<td>17-Mar</td>
<td>Not stated</td>
<td>$12,796</td>
<td>$8,500</td>
<td>$10 billion in SPV</td>
</tr>
<tr>
<td>Money Market Mutual Fund Liquidity Facility (MMMLF)*</td>
<td>18-Mar</td>
<td>Not stated</td>
<td>$26,977</td>
<td>N/A</td>
<td>$10 billion in credit protection</td>
</tr>
<tr>
<td>Term Asset-Backed Securities Loan Facility (TALF)*</td>
<td>23-Mar</td>
<td>$100 billion</td>
<td>N/A</td>
<td>N/A</td>
<td>$10 billion in SPV</td>
</tr>
<tr>
<td>Primary Market Corporate Credit Facility (PMCCF)</td>
<td>23-Mar</td>
<td>$750 billion shared evenly</td>
<td>$37,374</td>
<td>$31,875</td>
<td>$75 billion in SPV</td>
</tr>
<tr>
<td>Secondary Market Corporate Credit Facility (SMCCF)</td>
<td>23-Mar</td>
<td>$750 billion shared evenly</td>
<td>$37,374</td>
<td>$31,875</td>
<td>$75 billion in SPV</td>
</tr>
<tr>
<td>Municipal Liquidity Facility (MLF)</td>
<td>9-Apr</td>
<td>$500 billion</td>
<td>$16,077</td>
<td>$14,875</td>
<td>$35 billion in SPV</td>
</tr>
<tr>
<td>Paycheck Protection Program Lending Facility (PPLF)</td>
<td>9-Apr</td>
<td>Not stated</td>
<td>$56,983</td>
<td>N/A</td>
<td>N/A Extensions of credit under the PPLF are fully collateralized by downstream loans that are fully guaranteed by the SBA.</td>
</tr>
<tr>
<td>Main Street Expanded Loan Facility (MSELF)**</td>
<td>8-Apr</td>
<td>$600 billion shared evenly</td>
<td>$31,875</td>
<td>$31,875</td>
<td>$75 billion in SPV</td>
</tr>
<tr>
<td>Main Street New Loan Facility (MSNFLF)**</td>
<td>8-Apr</td>
<td>$600 billion shared evenly</td>
<td>$31,875</td>
<td>$31,875</td>
<td>$75 billion in SPV</td>
</tr>
<tr>
<td>Main Street Priority Loan Facility (MSPLF)**</td>
<td>8-Apr</td>
<td>$600 billion shared evenly</td>
<td>$31,875</td>
<td>$31,875</td>
<td>$75 billion in SPV</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>($1.95 trillion)</td>
<td>$187,911</td>
<td>87,125</td>
<td>$215 billion</td>
<td></td>
</tr>
</tbody>
</table>

* A similar program was implemented during the GFC.
**We refer to these programs on a combined basis as the “Main Street Lending Program,” a convention used by the Fed and Treasury.
expanded to closely match all types of collateral that could be pledged in the tri-party repo systems of the two major clearing banks. The collateral for the Term Securities Lending Facility (TSLF) was also expanded to include all investment-grade debt securities, whereas, previously it accepted only Treasury securities, agency securities, and AAA-rated mortgage-backed and asset-backed securities.

The most significant question of risk that arose under Section 13(3) during the GFC was with respect to the Commercial Paper Funding Facility (CPFF), under which the Federal Reserve Bank of New York provided loans to a special purpose vehicle to purchase newly issued commercial paper from issuers. The loans were non-recourse to the participating issuers and secured by the commercial paper. To resolve any issues of adequacy of security, the Fed required issuers to pay an insurance fee as extra security for the loan. Scott Alvarez, former Board General Counsel and his legal team penned a memo concluding that such a mechanism was sufficient to meet the requirements of Section 13(3).

The Fed was repaid all amounts of loans under its GFC programs, earned interest and fees on its loans, and experienced a net profit with respect to its programs. (CBO Ltr p. 20).

By comparison, the COVID-19 Section 13(3) programs have more risk built into them, as they are accepting a wide range of assets as collateral, including accepting lower quality collateral than the Fed has accepted in the past.

Several Fed programs will accept as collateral, “fallen angels,” bonds that were initially given an investment-grade rating, but which have since lost their investment grade rating due, in part, to the economic slowdown brought on by COVID-19. The following programs show the range of collateral that is being accepted:

- TALF can buy new AAA CLO tranches
- PMCCF can buy syndicated loans, and “fallen angels”
- SMCCF can buy HY ETFs and high-yield bonds, including “fallen angels”
- The Main Street facilities could help smaller leveraged loan issuers (<$150mn), the middle-market, that have depended on private equity lenders.

With the exception of the PDCF, the COVID-19 program loans are non-recourse to participants; in the event of default, the Fed would be able to take possession of the collateral to make itself whole. The Fed programs also seek to manage risk by varying the interest rates charged and the haircuts that are applied to different collateral. For example, under the 2020 TALF, there are three levels of interest rates. There are also three levels of haircuts ranging from 5% for ABS backed by prime credit card debt of less than a year duration, to 22% for 6-year leveraged loans.

By comparison, the 2008 TALF initially accepted only newly issued, highly rated ABS backed by new or recently extended auto loans, credit card loans, student loans, and small business loans. The program was later expanded twice to accept a wider range of collateral, but securities were
required to have triple-A ratings from two or more rating agencies and were subject to an additional risk assessment by the Federal Reserve. The collateral was also subject to a haircut that depended on its riskiness. The Fed considered accepting other types of securities, such as residential mortgage-backed securities and collateralized loan obligations, but ultimately decided they would present an unacceptable risk. At its highest, the 2008 TALF was authorized to purchase up to $1 trillion of ABS and was backstopped by $100 billion of Treasury funds from the TARP. See this YPFS blogpost for a discussion of the two TALF programs.

**A Treasury Backstop for COVID Facilities**

When one reviews the testimonies by Treasury and Fed officials regarding the 2008 TALF, they seem to suggest that neither the Treasury nor the Fed expected that the Fed would need to resort to the backstop. The recent CBO report noted that the Fed did not sustain losses on its GFC Section 13(3) program lending and that the interest and fees under such programs resulted in a profit to the Fed.

With respect to the COVID-19 lending, the CBO concluded that a broader range of lending was expected and that the Fed would likely take on greater risk under the new programs than it had during the GFC. Despite these factors, it concluded that in aggregate, the result would be similar to that of the GFC programs in that “income and costs will roughly offset each other [on average].”

However, the CBO also added important nuance to its analysis:

That additional lending will result in substantial additional credit risk for the government, however, which could have a wide range of budgetary effects. In CBO’s assessment, there is a high probability that the lending will result in a small net profit for the government, thus reducing the deficit, but there also is a small probability that the provisions could result in a very large loss—an outcome that would significantly increase the deficit. Finally, CBO expects that the performance of loans and assets will vary across facilities, with some realizing net losses and others net gains. (emphasis added.) (CBO Ltr 03/2020, p.20-21).

With the possibility of losses being discussed, the CBO also concluded that if losses were to occur, the Treasury’s equity investments would be “available to cover loan defaults or other losses” (CBO Ltr 03/2020, p.20).

Former Secretary Timothy Geithner has earlier posited that it would be acceptable for a central bank to accept losses when fighting a crisis: “Of course the central bank should be prepared to take losses. In fact, it is highly likely given all the risk and uncertainty in panics that the appropriate use of the lender of last resort authority might well result in some losses.”

During the current crisis, statements by Chairman Powell and the Fed have expressed the position that the Treasury’s investments in the Section 13(3) programs were available to act as loss backstops. Messages from Secretary Mnuchin were not so clear until May 18, when during
testimony to the Senate Banking Committee, he clarified that the Treasury was willing to absorb losses from the Section 13(3) programs. (See a [YPFS blog](https://ypfs.org) discussing this point.)

Prior to Secretary Mnuchin’s testimony, some legal and media commentators[1] had coalesced around a similar interpretation. Professor Kathryn Judge of Columbia Law School wrote in a blogpost that, “Although not statutorily required, [the Treasury backstops] signal the Treasury’s willingness to share in the losses given the credit risk that these programs may entail.” ([Blue Sky Blog Post](https://blueskyblog.org)). While not definitive, broad-based discussion regarding the possibility of losses may provide the Fed and Treasury some coverage against later scrutiny, at least with respect to those programs authorized by the CARES Act. In March, before the CARERS Act passed, Professor Judge urged Congress to endorse the Fed’s early actions: “An additional benefit of having Congress bless the Fed’s action and focus on ex post accountability is that it could stop any opportunistic denials of legal authority later in this crisis.” The CARES Act provisions do seem to provide some coverage by laying out guidelines.

The Treasury’s willingness to absorb losses will ultimately be judged by what occurs. As the key shareholder of the special purpose vehicles supporting many of the Fed’s programs, it has the ability to influence the Fed’s administration of programs to minimize credit risk. Any moves to tighten terms, however, may impact participants negatively and may create friction with the overall intent of the programs to shore up the economy. There have already been questions about whether some of the Fed’s [requirements are too strict](https://www.washingtonpost.com/business/2020/04/15/federal-reserve-municipal-liquidity-facility/) to achieve its broad goal. It has responded to such criticism with respect to the Municipal Liquidity Facility, for example, by expanding it twice, significantly expanding the number of eligible municipalities including some with less than 500,000 residents.

The COVID-19 programs are still very new and some of them have not yet become operational. There may be additional changes to the terms and risk profiles of these programs as they are brought on board and possibly expanded if the economic effects of the shutdown persist even as the country starts to reopen. Ultimately, these questions will be answered by future developments, including usage and how the economy responds.

[1] See for example the law firm [Skadden Arps](https://skadden.com) “A key purpose of Treasury’s investment in certain of these programs is to mitigate credit risk to the Federal Reserve in order to satisfy these legal conditions. Treasury’s equity investments in those programs protect the credit extended by the Federal Reserve by absorbing first losses.”), [WNBC](https://www.wnbc.com) (“The program is structured so the Treasury takes the first hit if there are any losses. Taking on those risks places it on top of the credit stack so that the Treasury, in essence, becomes the top shareholder of deals totaling $4 trillion.”), and [NY Times](https://www.nytimes.com) (“Treasury Secretary Steven Mnuchin has a favorite talking point. . . Because the Fed expects most borrowers to pay back, it does not need one-for-one support. As a result, a mere $10 billion from the Treasury can prop up $100 billion in Fed lending. And voilà – the $454 billion Congress dedicated to Fed programs in the aid bill can be multiplied many times.”).
Federal Reserve to Report Monthly on CARES Act Program

By Priya Sankar

Original post here.

On April 23, the Federal Reserve said it will include additional detailed information in its monthly reports that are released to the public on four lending and liquidity programs it is establishing with Treasury equity under the Coronavirus Aid, Relief, and Economic Security (CARES) Act.

A week earlier, Bharat Ramamurti, member of the COVID-19 Congressional Oversight Commission, had requested from Chairman Powell enhanced public disclosure for these and other Fed programs utilizing Treasury funds.

The policy will cover the $600 billion Main Street Lending Program, two corporate debt purchasing programs totalling $750 billion, and its $500 billion program to purchase state and municipal debt, according to press reports. The Treasury has made available a combined $185 billion for such programs.

Section 13(3) of the Federal Reserve Act, which governs the Fed’s emergency authority and the above programs, requires that it make an initial and then monthly reports to Congress upon the establishment of a new program. Although the identities of participants and details of loans are required to be included in such reports, the Chairman may request that they be kept confidential. For each of the four facilities receiving Treasury equity support, the Fed’s recent announcement states that it will publish the reports without redacting the names and details of participants; amounts borrowed and interest rate charged; and overall costs, revenues, and fees.

Many observers criticized the Fed for not revealing the identities of banks and other companies that it supported during the global financial crisis (GFC). In 2010, through the Dodd-Frank Act, Congress required the Fed to publish transaction data one year after closing an emergency facility.

There are concerns that the disclosure requirement may cause a stigma, leading borrowers to not use the facilities for fear of being perceived as troubled and potentially undermining the goal of the facilities to restore financial stability. Former Fed general counsel Scott Alvarez is concerned that stigma may be worse in the current crisis. He said, “It could be more discouraging to businesses if that information is disclosed” contemporaneously with the program, revealing financial details that could advantage competitors.

These enhanced public disclosures will not include information on recipients of Paycheck Protection Plan (PPP) loans, as they are administered by the Small Business Administration, although the Fed has also created a liquidity facility for banks making PPP loans (the Paycheck Protection Plan Liquidity Facility). The enhanced disclosure also does not cover other Fed lending programs directed towards financial markets. However, the Fed will release higher-level
aggregate data on all Section 13(3) programs monthly, and is legally obligated to disclose borrowers one year after the programs end.

“The Federal Reserve is committed to transparency and accountability by providing the public and Congress detailed information about our actions to support the economy during this difficult time,” Chair Jerome H. Powell said in the Fed’s press release.
How Available Is the ESF for New Fed Facilities?

By Steven Kelly

Original post here.

When Congress passed the Coronavirus Aid, Relief, and Economic Security (CARES) Act on March 27, 2020, it allocated $500 billion to the Exchange Stabilization Fund (ESF), $454 billion of which was for the Treasury Secretary to support Federal Reserve lending facilities. The Secretary committed $195 billion of these funds to provide credit support to some of the programs the Fed set up under its Section 13(3) emergency lending authority. The Consolidated Appropriations Act, 2021 signed into law on December 27 definitively closed these facilities and rescinded funds “not needed to meet the commitments, as of January 9, 2021, of the programs and facilities established.”

The 13(3) programs that received equity funding from the Treasury under the CARES Act purchased corporate bonds and loans, municipal bonds, and asset-backed securities (the Corporate Credit Facility (CCF), Main Street Lending Program (MSLP), Municipal Liquidity Facility (MLF), and Term Asset-backed Securities Loan Facility (TALF)). These programs ultimately made about $40 billion in loans and asset purchases, a fraction of the stated limit of almost $2 trillion.

Congress also forbade the Treasury Secretary from using the ESF for any future 13(3) program that is “the same as” any of the CARES Act facilities, except for the TALF. The Secretary is otherwise free to use the Fund “for any purpose” previously permitted. In other words, the Treasury may use the Fund to support any 13(3) facilities not precluded by the “same as” language.

The two parties may not agree exactly how broadly to interpret the scope of the “same as” language. Still, Congress did not amend the Section 13(3) language in the Federal Reserve Act. The unamended Section 13(3) and remaining discretion for the Secretary to invest in Fed facilities leave policymakers with a potentially potent tool for the rest of this crisis.

Given the still-uncertain economic outlook and the changing presidential administration, some are looking to new ESF-supported Fed facilities as a possible policy lever in 2021 under the next Treasury Secretary. This post describes how much ESF funding is available, or could be available, to the next Secretary.

The Exchange Stabilization Fund

Congress established the ESF as part of the Gold Reserve Act of 1934 and has given it only minor modifications since. Legislators designed the ESF as a tool to stabilize the exchange value of the dollar and, more broadly, to support “orderly exchange arrangements and a stable system of exchange rates.” When the International Monetary Fund (IMF) created Special Drawing
Rights (SDRs) in 1969, Congress provided that the Treasury would hold any SDRs in the ESF. The IMF uses SDRs as a reserve asset to supplement the global stock of currency reserves.

The Secretary has discretion over the use of the ESF, subject to the President’s approval. In pursuit of orderly exchange rates, the Secretary may use ESF funds to “deal in gold, foreign exchange, and other instruments of credit.” While originally used very narrowly, to intervene in foreign exchange markets and provide bridge loans to foreign countries, Treasury has interpreted that authority more broadly in recent decades.

After Congress rejected a proposal for a loan to Mexico during its economic crisis in the mid-1990s, the Clinton administration announced a rescue package that included up to $20 billion in loans from the ESF.

In September 2008, Treasury used the entirety of the approximately $50 billion in the Fund as an insurance reserve to provide a sweeping guarantee and stem the run on money market mutual funds (MMFs). Within weeks, Congress passed legislation banning use of the ESF for this express purpose in future crises. (Congress lifted this ban temporarily at the outset of the COVID-19 crisis, though Treasury did not ultimately exercise the authority.)

In the early days of the COVID-19 crisis in 2020, the Fed announced several 13(3) facilities to stem the pandemic-induced market volatility. Before the CARES Act was passed, the Treasury committed $50 billion of existing ESF funds to these facilities. These funds were to provide credit protection to the facilities to assist the Fed in meeting the legal requirement that its 13(3) facilities are “secured to the satisfaction” of the Fed. Later, the Treasury replaced $30 billion of that funding with CARES Act funds, while non-CARES ESF funds remained committed to the Commercial Paper Funding Facility (CPFF) and Money Market Mutual Fund Liquidity Facility (MMLF).

With the CARES Act, Congress allocated $500 billion in new funds to the ESF to support the response to the COVID-19 crisis. Congress assigned $454 billion to support Fed lending facilities; it also set aside $46 billion for loans to the aviation industry and firms critical to national security.

The Fed intended to leverage Treasury’s ESF investment with Fed lending at a ratio of approximately 10-to-1, depending on the riskiness of the underlying assets. In this way, these ESF investments could have backed Fed lending of as much as $4 trillion. However, as noted, in December 2020, Congress wrote new legal restraints that prevent the Treasury from using the ESF to support Fed facilities that are “the same as” the CCF, MSLP, or MLF.

**How Much Is Really Available in the ESF?**

Recent articles have offered competing depictions of how much unused funding remains in the ESF, with estimates ranging from $50 billion to almost $80 billion.

Following the rescission of the CARES Act funds, the ESF has approximately $85 billion in unencumbered assets, consisting of:
• $11.2 billion in U.S. Treasury securities
• $51.9 billion in SDRs
• $12.6 billion in liquid, euro-denominated assets
• $8.9 billion in liquid, yen-denominated assets

However, the ESF also has $8.5 billion in committed, but undisbursed, credit protection to the MMLF (in addition to the $1.5 billion already injected). Netting that amount, it appears that the ESF has about $76 billion available.

Can Foreign Exchange Support Dollar-Based Facilities?

It need not matter that most of these assets are not denominated in US dollars. The Treasury could simply request the Fed convert any SDRs into dollars. The Fed would be legally obligated to comply with this request.

There are also mechanisms by which the Treasury could use euro- and yen-denominated assets to support dollar-based 13(3) lending facilities.

First, the Fed has a limited authority to engage in foreign exchange “warehousing” for the Treasury. The Fed is authorized to swap dollars with the Treasury’s foreign exchange; this standing authority is for up to $5 billion, though the Fed voted to expand it temporarily to as high as $20 billion in 1995 to support the assistance to Mexico. Ultimately, the Treasury did not use the warehousing capability and hasn’t since 1992.

Second, the Treasury can simply sell the currency on the open market. The Treasury need not invoke the warehousing arrangement nor seek that the Fed expand it. The yen and euro are both reserve currencies with daily trading volumes that exceed $1 trillion. The Treasury may be able to sell the $22 billion of assets denominated in these currencies without disrupting the market or accepting material discounts.

Third, the Treasury can use the currencies as they are. When it used the ESF in 2008 to guarantee over $3.2 trillion of money market mutual fund (MMF) assets, almost half of the approximately $50 billion of ESF funds committed were denominated in foreign currencies. Yet, the commitment was largely effective in easing the run on those funds. Providing credit protection to the Federal Reserve could function largely the same way.

New Funds Absent Legislation?

Congress designed the ESF to be self-financing. While the CARES Act provided supplementary funds to the ESF that Congress later rescinded, the ESF is not subject to the normal budgetary appropriations processes. Even absent new congressional supplementation, however, the Fund’s available resources could be augmented in several ways.

Earnings
The Fund retains any earnings on its guarantees or investments. For instance, its credit protection agreement provided to the MMLF and its equity protection stake in the CPFF grant it 90% of any profits earned by those facilities. The MMF guarantee program of 2008 ultimately generated $1.2 billion in premium income. These retained earnings ultimately increase the resources of the Fund.

In 2013, for instance, despite the fact that the 2008-era TALF still had outstanding loans, the Fed returned the Treasury’s remaining subordinated investment (from TARP funds, not the ESF) early because they both agreed the TALF’s retained earnings provided sufficient credit protection. Given that when the ESF is used for guarantees or 13(3) facilities, such funds are typically leveraged many times over, even marginal earnings can substantively expand the Fund’s reach.

**IMF Allocations**

As noted, the ESF holds the U.S.’s SDRs. If members of the IMF can agree to a new SDR allocation in response to the pandemic, the IMF can create any amount less than $649 billion without the explicit approval of the U.S. Congress. Based on its IMF quota, the U.S. Treasury would receive 17% of any new SDRs created, or up to $113 billion if the IMF created the maximum.

However, there is no sign that the IMF’s member countries plan to create new SDRs in response to the COVID crisis. The October G20 Finance Meeting communiqué, as in July and April, said only that policymakers “discussed the possibility” of an SDR allocation and that “there was no consensus on the issue.”

When the IMF agreed to a $250 billion allocation in 2009 in response to the Global Financial Crisis, the ESF received $43 billion. Any new allocation in response to COVID-19 would similarly bolster the ESF’s resources.

**Equity Allocation**

Funds could flow back into the ESF from the relatively dormant liquidity facilities aimed at money markets that have funding from the ESF. The MMLF and CPFF each have $10 billion of equity (or equity-like) protection courtesy of non-CARES Act ESF funds. After peaking at over $50 billion of outstanding loans in April, the MMLF now has less than $3 billion of credit extended; the CPFF peaked at almost $13 billion in June and now has no credit extended.

Yet, these facilities may in some sense be a prerequisite to more novel credit facilities due to legal requirements from both the Fed and the Treasury. From the Fed’s side, it must vote that “unusual and exigent circumstances” are present before standing up Section 13(3) facilities. If the money markets are functioning smoothly—that is, to the point that Fed’s 13(3) facilities aimed at short-term funding markets can be retired—it may be the case that conditions simply don’t meet the exigent circumstances requirement from the perspective of the Fed.
From the Treasury’s side, there are some guardrails on the use of ESF funds. Notably, Treasury’s lawyers rejected on legal grounds the Federal Reserve Bank of New York President Tim Geithner’s suggestion to use the ESF in March 2008 to facilitate the rescue of Bear Stearns (p. 155). At the time of the Bear Stearns episode, the Fed had not yet opened any 13(3) facilities. Much like the Fed’s exigent circumstances hurdle, if money markets are functioning normally enough that policymakers let the MMLF and CPFF retire, the Treasury may determine that there is not enough risk to the dollar’s value to permit the ESF’s use in 13(3) credit facilities.

However, there is also potential middle ground here. Despite limited takeup of late, the Fed and Treasury have continued to extend the MMLF and CPFF, currently in place until March 31, 2021, due to unusual and exigent circumstances. Notably, the MMLF and CPFF as designed have no leverage limits. While they both received $10 billion in subordinated protection from the ESF, there is no fixed maximum on the ratio to which that protection can be leveraged, in contrast to the CARES Act facilities. The MMLF’s 2008-era predecessor, the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), did not utilize any subordinated funding. The CPFF and MMLF both peaked several quarters ago at fractions of their 2008 takeup. None of the 13(3) facilities set up during the GFC suffered losses.

These experiences could justify the Fed and Treasury operating these facilities with less equity. In a letter to the Congressional Oversight Commission in June, Fed Chair Jerome Powell and Treasury Secretary Steven Mnuchin said that “the agencies will rigorously assess the adequacy and appropriateness of the 13(3) facilities’ [equity] coverage and the corresponding allocations of CARES Act funds” and signaled a willingness to use the “full scope of authority provided by section 13(3)” if adjusting the level of credit protection was necessary.

A reassessment that determined the Fed could operate the MMLF and CPFF with less equity would allow the Fed and Treasury to return funds to the ESF for use in other facilities, even in a scenario in which these two facilities continued to operate.

To be clear, funding market disruption is not a requirement for invoking 13(3). The Fed can use Section 13(3) facilities in the absence of material banking or funding market distress, but must still at least obtain evidence that credit is not available on reasonable terms from other banking institutions.

Whether or not the Fed would invoke 13(3) in that case, however, remains an open question.
Federal Reserve Program Usage

Early Use of Federal Reserve Programs
By Pascal Ungersboeck and Greg Feldberg

Original post here.

After the COVID-19 crisis began, the Federal Reserve quickly announced a number of emergency lending facilities, largely based on programs it first introduced during the Global Financial Crisis of 2007-09 (GFC). These programs have varied in size and speed of implementation. Bank reserve balances at the Fed have reached a historic high in recent weeks, exceeding $3 trillion for the first time, suggesting banks could lend much more.

This post discusses the early use of the following Fed lending programs: (1) primary credit through the discount window, (2) central bank swap lines and FIMA repos, (3) the Money Market Mutual Fund Liquidity Facility (MMLF), (4) the Primary Dealer Credit Facility (PDCF), and (5) the Commercial Paper Funding Facility (CPFF).

In addition to these programs, the Fed announced two facilities to purchase corporate bonds on March 23. The Primary Market Corporate Credit Facility (PMCCF) and Secondary Market Corporate Credit Facility (SMCCF) are not yet operational, as of April 21. Similar programs announced by the European Central Bank (ECB) and Bank of England (BoE) are now operating.

The Discount Window

The discount window is a standing facility the Fed uses to provide collateralized loans to depository institutions. On March 15, the Fed lowered the primary credit rate, the interest rate it charges most banks, from 1.75% to 0.25%, lower than the lowest rate it charged during the GFC. It also said it would provide discount window credit for up to 90 days, rather than 30 days. Discount window lending surged during the following weeks from a negligible amount on March 11 to $28.2 billion on March 18 and $50.8 billion on March 25.

That’s faster than the take-up of discount window lending during the GFC. The Fed lowered the primary rate and extended the terms from overnight to 30 days in August 2007 without seeing significant usage (see the Fed’s data here). Usage still picked up slowly after the failure of Bear Stearns and the Fed’s extension of the terms to 90 days in March 2008. Volumes rose more rapidly amidst the volatile market conditions that followed the failure of Lehman Brothers in September, from under $20 billion to as high as $110 billion in October. It should be noted that during the GFC banks were reluctant to borrow from the discount window out of concern that their borrowing would signal financial weakness. To resolve the issue, the Fed established the Term Auction Facility (TAF) in December 2007. The facility provided term credit to depository institutions without the stigma associated with the discount window. The TAF was heavily used, with $493 billion outstanding at its peak in March 2009.
Central Bank Liquidity Swap Lines and FIMA repos

The swap lines are bilateral agreements between the Fed and foreign central banks. They allow foreign central banks to exchange domestic currency for US dollars in order to satisfy the dollar liquidity demand of local banks and businesses. The Fed operates the swap lines under Section 14 of the Federal Reserve Act. As of March 19, the Fed had established swap lines with 14 central banks. (See the YPFS blog). The Fed swap lines were operational immediately after their announcement and constitute the most used program in recent weeks, with $378.3 billion outstanding as of April 15.

On March 31, the Fed announced a new program to provide dollars to countries with whom it doesn’t have swap agreements. The FIMA Repo Facility allows foreign central banks and international monetary authorities to exchange US Treasuries for US dollars. The Fed did not enter into repos with other central banks during the GFC. (See the YPFS blog). There are no outstanding FIMA repos as of April 15.

As for the discount window, swap-line usage has grown much more rapidly this time, compared to the GFC. Then, usage rose to $24 billion in the months after the Fed set up the lines in December, 2007, and to $62 billion during the summer of 2008. But usage expanded rapidly during the month after the failure of Lehman Brothers and reached $583 billion in December.

Currently, the Bank of Japan (BoJ) is the biggest counterparty with 47 percent of the total outstanding amount, followed by the ECB (37%) and the BoE (6%). These same three banks were the biggest counterparties at peak usage during the GFC. The ECB (51%) drew a majority of the funds at the time, followed by the BoJ (22%) and the BoE (8%).

Money Market Mutual Fund Liquidity Facility (MMLF)

The Fed established the MMLF under section 13(3) of the Federal Reserve Act. It allows the Fed to purchase assets from money market mutual funds. The Fed announced the program on March 18 and it became operational on March 23. The current program is similar to the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) announced on September 19, 2008, and operational three days later. Under the MMLF, the Federal Reserve Bank of Boston makes direct loans to borrowers, allowing for rapid implementation. (See the YPFS blog).

The MMLF is the most used program that the Fed has established under section 13(3) during the current crisis so far, with $50.7 billion outstanding as of April 15. It has been less used in the first month than its GFC counterpart, the AMLF. That program peaked within two weeks of its announcement at $152 billion outstanding on October 2, 2008, indicating the dire conditions in money markets following Lehman’s failure.

Primary Dealer Credit Facility (PDCF)

The Primary Dealer Credit Facility allows the Fed to extend collateralized loans to primary dealers under section 13(3). The program was announced on March 17, and became operational
three days later. During the GFC, the PDCF was among the first programs the Fed announced. It was announced on March 16, 2008, and became operational the next day. (See the YPFS blog).

Currently, $33 billion is outstanding through the facility. Current use is very similar to the use of the program during its first four weeks of 2008. Under the PDCF, the Federal Reserve Bank of New York provides loans through a clearing bank. Collateral is assigned to a FRBNY account within the clearing bank. The use of the established financial infrastructure with primary dealers allowed for fast implementation.

**Commercial Paper Funding Facility (CPFF)**

The CPFF provides a liquidity backstop to issuers of commercial paper and was also established under section 13(3). The Fed announced the program on March 17 and the facility became operational on April 14. The CPFF took longer to implement because its operations require the Fed to engage in transactions that fall outside its traditional operating framework. To extend its reach, the Federal Reserve Bank of New York set up a special purpose vehicle, the Commercial Paper Funding Facility II LLC (CPFF II LLC), held in custody at State Street. Operations are conducted through the SPV while primary dealers serve as intermediaries for issuance requests. All issuers are required to register at least two days prior to their first issuance, registration began on April 7. The additional time required to build the facility’s infrastructure explains the operational delay. (See the YPFS blog). As of April 15, the facility had just $974 million outstanding. During the GFC, the Fed announced a similar CPFF program on October 7, 2008, and it became operational on October 27. The earlier CPFF was heavily used immediately, with $270 billion outstanding within 4 weeks of its launch.

Recently, Japan and the UK have implemented similar programs. The BoE’s commercial paper facility, Covid Corporate Financing Facility (CCFF), was announced on March 17 and opened for drawings within five days. (See the YPFS blog). The Bank of Japan announced more frequent auctions and increased amounts for outright commercial paper auctions on March 16, with a first auction two days later. (See the YPFS blog).

**Summary table**

<table>
<thead>
<tr>
<th>CB Swap</th>
<th>AMLF / MMLF</th>
<th>PDCF</th>
</tr>
</thead>
<tbody>
<tr>
<td>CB Swap</td>
<td>AMLF / MMLF</td>
<td>PDCF</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>CB Swap</th>
<th>AMLF / MMLF</th>
<th>PDCF</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>CB Swap</th>
<th>AMLF / MMLF</th>
<th>PDCF</th>
</tr>
</thead>
</table>
Data compiled by authors from https://www.federalreserve.gov/releases/h41/
Use of Federal Reserve Programs as of May 7
By Pascal Ungerboeck

Original post here.

The Federal Reserve recently announced a number of lending facilities, based on programs first implemented during the Global Financial Crisis of 2007-09. This post provides an update on the use of Fed lending programs since April 16. It also introduces the Fed’s newest lending facility, the Paycheck Protection Program Liquidity Facility (PPPLF); discusses international use of the Fed’s liquidity swap lines; and provides an overview of similar lending programs in Europe and the United Kingdom. Our previous post on the early use of Fed programs is available here.

Recent use of Fed programs

The total outstanding amount for the Fed’s main lending programs has changed little over the past two weeks, increasing from USD 120bn to 123bn, down slightly from a peak of USD 129bn on April 9. Usage of the discount window declined by USD 5bn since April 16.

The outstanding balances of the Money Market Mutual Fund Liquidity Facility (MMLF) and Primary Dealer Credit Facility (PDCF) decreased by USD 4bn and USD 8bn, respectively. The outstanding amount with the Commercial Paper Funding Facility (CPFF) increased from less than USD 1bn to USD 3.3bn and remains small relative to overall lending.

The declines in usage of the MMLF and PDCF were offset by the extension of loans through a new facility, the Paycheck Protection Program Liquidity Facility (PPPLF).

Usage of the Fed’s USD liquidity swap lines continued to increase over the last two weeks. Swap lines remain the largest program, with USD 438bn outstanding as of April 30. The use of the Foreign and International Monetary Authorities (FIMA) Repo facility, available to provide US dollar liquidity to central banks that don’t have access to an established swap line with the Fed, remains negligible at USD 2mn outstanding.

The Fed has yet to launch two corporate bond purchase programs that it announced on March 23.

The Paycheck Protection Program Liquidity Facility (PPPLF)

The Paycheck Protection Program Liquidity Facility (PPPLF) allows the Fed to provide financial institutions with liquidity backed by loans to small and medium businesses extended under the federal government’s Paycheck Protection Program. The PPPLF was announced on April 9 and became operational one week later. Immediate use was moderate with USD 8bn outstanding on April 23. It stands at USD 19bn as of April 30, showing a large increase as other asset-purchase programs saw their outstanding balance decline.
On April 30 the Fed announced an extension of the program, allowing it to include additional lenders and expand eligible collateral. Under the new framework, eligible lenders include all lenders approved by the Small Business Administration (SBA). Also, lenders can now pledge purchased PPP loans as collateral.

**Swap Line Use**

The network of 14 dollar liquidity swap lines remains the most used emergency program with USD 438bn outstanding as of April 30. On average, the outstanding amount has increased by USD 14bn every day since March 19. The European Central Bank (ECB), Bank of Japan (BoJ), Bank of England (BoE), and Swiss National Bank (SNB) drew funds on the first day of the program and were gradually joined by six other central banks. By April 3, 10 central banks had a positive outstanding balance.
As during the Global Financial Crisis of 2007-09 (GFC), the BoE, BoJ, and ECB constitute the three largest counterparties. They have drawn 88% of funds currently outstanding. The ECB was the largest single counterparty during the GFC with USD 313bn outstanding at its peak. The ECB also made heavy use of the line during the first days following the announcement of the facilities. It drew USD 112bn on March 19, the first day the facility was reactivated. The ECB has since slowly increased its use of the line to USD 143bn outstanding on April 30, on average by USD 1bn per trading day. The BoJ has increased its usage more gradually and has exceeded the ECB’s use since March 26. Since then, the BoJ has increased its drawings by USD 6bn every day on average, as of April 30 it has USD 220bn outstanding.

Ten out of 14 participating central banks have used their swap line. Nine banks used the swap lines during the GFC. Other than the three largest central banks, the central banks of Norway, Denmark, Australia, Switzerland, and Korea used the lines during both crises. The central bank of Sweden drew funds only during the GFC, while the central banks of Singapore and Mexico are currently drawing funds but did not use their line during the GFC.

**International Comparison**

The ECB announced its main asset-purchase program, the *Pandemic Emergency Purchase Program* (PEPP), on March 18. It expects to purchase up to EUR 750bn in private and public sector securities until “the COVID-19 crisis phase is over.” As of May 1, the facility had EUR 118bn outstanding, 0.7% of the Eurozone’s GDP. The marginal lending facility, the ECB’s equivalent of the discount window, has no balance outstanding as of May 1.

In the UK, the BoE implemented the *Covid Corporate Financing Facility* to purchase commercial paper from British issuers. As of April 29, the facility has an outstanding balance of GBP 15.91bn, or 0.7% of GDP. The USD 123bn in loans outstanding at the Fed as of April 30 constitute 0.6% of GDP.
### Summary Table

<table>
<thead>
<tr>
<th>Date</th>
<th>CB Swaps</th>
<th>AMFL / MMFL</th>
<th>PDCF</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/07</td>
<td>24,000</td>
<td>44</td>
<td>2/60</td>
</tr>
<tr>
<td>1/08</td>
<td>24,000</td>
<td>48</td>
<td>3/40</td>
</tr>
<tr>
<td>9/06</td>
<td>36,000</td>
<td>58</td>
<td>3/11</td>
</tr>
<tr>
<td>10/06</td>
<td>141,000</td>
<td>44</td>
<td>3/18</td>
</tr>
<tr>
<td>10/08</td>
<td>286,432</td>
<td>206,051</td>
<td>3/20</td>
</tr>
<tr>
<td>10/08</td>
<td>335,184</td>
<td>348,544</td>
<td>3/20</td>
</tr>
<tr>
<td>10/15</td>
<td>406,782</td>
<td>358,077</td>
<td>3/20</td>
</tr>
<tr>
<td>10/22</td>
<td>477,159</td>
<td>378,219</td>
<td>3/20</td>
</tr>
<tr>
<td>10/29</td>
<td>498,690</td>
<td>409,712</td>
<td>3/20</td>
</tr>
<tr>
<td>11/05</td>
<td>528,355</td>
<td>418,053</td>
<td>3/20</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date</th>
<th>PPPFL</th>
<th>CFRR</th>
</tr>
</thead>
<tbody>
<tr>
<td>8/27/08</td>
<td>18,901</td>
<td>306,035</td>
</tr>
<tr>
<td>9/3/08</td>
<td>19,000</td>
<td>3/40</td>
</tr>
<tr>
<td>9/10/08</td>
<td>23,455</td>
<td>3/11/08</td>
</tr>
<tr>
<td>9/17/08</td>
<td>33,401</td>
<td>3/18/08</td>
</tr>
<tr>
<td>9/24/08</td>
<td>33,401</td>
<td>30,785</td>
</tr>
<tr>
<td>10/1/08</td>
<td>49,234</td>
<td>43,744</td>
</tr>
<tr>
<td>10/8/08</td>
<td>98,107</td>
<td>43,449</td>
</tr>
<tr>
<td>10/15/08</td>
<td>101,853</td>
<td>36,284</td>
</tr>
<tr>
<td>10/22/08</td>
<td>107,547</td>
<td>33,742</td>
</tr>
<tr>
<td>10/29/08</td>
<td>110,177</td>
<td>31,799</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date</th>
<th>CB Swaps</th>
<th>AMFL / MMFL</th>
<th>PDCF</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/07</td>
<td>24,000</td>
<td>44</td>
<td>2/60</td>
</tr>
<tr>
<td>1/08</td>
<td>24,000</td>
<td>48</td>
<td>3/40</td>
</tr>
<tr>
<td>9/06</td>
<td>36,000</td>
<td>58</td>
<td>3/11</td>
</tr>
<tr>
<td>10/06</td>
<td>141,000</td>
<td>44</td>
<td>3/18</td>
</tr>
<tr>
<td>10/08</td>
<td>286,432</td>
<td>206,051</td>
<td>3/20</td>
</tr>
<tr>
<td>10/08</td>
<td>335,184</td>
<td>348,544</td>
<td>3/20</td>
</tr>
<tr>
<td>10/15</td>
<td>406,782</td>
<td>358,077</td>
<td>3/20</td>
</tr>
<tr>
<td>10/22</td>
<td>477,159</td>
<td>378,219</td>
<td>3/20</td>
</tr>
<tr>
<td>10/29</td>
<td>498,690</td>
<td>409,712</td>
<td>3/20</td>
</tr>
<tr>
<td>11/05</td>
<td>528,355</td>
<td>418,053</td>
<td>3/20</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date</th>
<th>PPPFL</th>
<th>CFRR</th>
</tr>
</thead>
<tbody>
<tr>
<td>8/27/08</td>
<td>18,901</td>
<td>306,035</td>
</tr>
<tr>
<td>9/3/08</td>
<td>19,000</td>
<td>3/40</td>
</tr>
<tr>
<td>9/10/08</td>
<td>23,455</td>
<td>3/11/08</td>
</tr>
<tr>
<td>9/17/08</td>
<td>33,401</td>
<td>3/18/08</td>
</tr>
<tr>
<td>9/24/08</td>
<td>33,401</td>
<td>30,785</td>
</tr>
<tr>
<td>10/1/08</td>
<td>49,234</td>
<td>43,744</td>
</tr>
<tr>
<td>10/8/08</td>
<td>98,107</td>
<td>43,449</td>
</tr>
<tr>
<td>10/15/08</td>
<td>101,853</td>
<td>36,284</td>
</tr>
<tr>
<td>10/22/08</td>
<td>107,547</td>
<td>33,742</td>
</tr>
<tr>
<td>10/29/08</td>
<td>110,177</td>
<td>31,799</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date</th>
<th>FIMA Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>8/27/08</td>
<td>2/60</td>
</tr>
<tr>
<td>9/3/08</td>
<td>3/40</td>
</tr>
<tr>
<td>9/10/08</td>
<td>3/11/08</td>
</tr>
<tr>
<td>9/17/08</td>
<td>3/18/08</td>
</tr>
<tr>
<td>9/24/08</td>
<td>3/35/08</td>
</tr>
<tr>
<td>10/1/08</td>
<td>4/1/08</td>
</tr>
<tr>
<td>10/8/08</td>
<td>4/8/08</td>
</tr>
<tr>
<td>10/15/08</td>
<td>4/15/08</td>
</tr>
<tr>
<td>10/22/08</td>
<td>4/22/08</td>
</tr>
<tr>
<td>10/29/08</td>
<td>4/29/08</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date</th>
<th>CDIO</th>
</tr>
</thead>
<tbody>
<tr>
<td>8/27/08</td>
<td>2/60</td>
</tr>
<tr>
<td>9/3/08</td>
<td>3/40</td>
</tr>
<tr>
<td>9/10/08</td>
<td>3/11/08</td>
</tr>
<tr>
<td>9/17/08</td>
<td>3/18/08</td>
</tr>
<tr>
<td>9/24/08</td>
<td>3/35/08</td>
</tr>
<tr>
<td>10/1/08</td>
<td>4/1/08</td>
</tr>
<tr>
<td>10/8/08</td>
<td>4/8/08</td>
</tr>
<tr>
<td>10/15/08</td>
<td>4/15/08</td>
</tr>
<tr>
<td>10/22/08</td>
<td>4/22/08</td>
</tr>
<tr>
<td>10/29/08</td>
<td>4/29/08</td>
</tr>
</tbody>
</table>
May 14
By Pascal Ungersboeck

Original post [here].

*Since last week, the Primary and Secondary Market Corporate Credit Facilities began operations.*
Liquidity Swap Lines

The USD swap lines are bilateral agreements between the Fed and foreign central banks. They allow foreign central banks to exchange domestic currency for US dollars. The Fed currently maintains swap line agreements with 14 central banks.

Money Market Mutual Fund Liquidity Facility

The MMLF allows the Fed to fund the purchase of money market mutual fund assets. The program is established under section 13(3) of the Federal Reserve Act.

Discount Window

The DW is a standing facility that allows the Fed to provide collateralized loans to depository institutions.

Primary Dealer Credit Facility

The PDCF allows the Fed to extend collateralized loans to primary dealers. The facility was established under section 13(3).

Paycheck Protection Program Liquidity Facility
The PPPLF allows the Fed to provide financial institutions with liquidity backed by loans to small and medium businesses extended under the federal government’s Paycheck Protection Program and guaranteed by the Small Business Administration. The Program is established under section 13(3).

Commercial Paper Funding Facility

The CPFF provides a liquidity backstop to issuers of commercial paper and was also established under section 13(3). It is operated by the FRBNY through a special purpose vehicle, the Commercial Paper Funding Facility II LLC.

Primary and Secondary Market Corporate Credit Facility

The PMCCF and SMCCF were set up under section 13(3) to support credit to employers through purchases of newly issued bonds and support market liquidity for outstanding corporate bonds. These facilities operate through a special purpose vehicle, the Corporate Credit Facility LLC (CCF LLC).
May 21
By Pascal Ungersboeck

Original post [here](#).
Liquidity Swap Lines

The USD swap lines are bilateral agreements between the Fed and foreign central banks. They allow foreign central banks to exchange domestic currency for US dollars. The Fed currently maintains swap line agreements with 14 central banks.

Money Market Mutual Fund Liquidity Facility

The MMLF allows the Fed to fund the purchase of money market mutual fund assets. The program is established under section 13(3) of the Federal Reserve Act. The Fed reported that the U.S. Treasury, to date, has provided credit protection of $1.5 billion to the Money Market Mutual Fund Liquidity Facility.

Discount Window

The DW is a standing facility that allows the Fed to provide collateralized loans to depository institutions.

Primary Dealer Credit Facility
The **PDCC** allows the Fed to extend collateralized loans to primary dealers. The facility was established under section 13(3).

**Paycheck Protection Program Liquidity Facility**

The **PPPLF** allows the Fed to provide financial institutions with liquidity backed by loans to small and medium businesses extended under the federal government’s Paycheck Protection Program and guaranteed by the Small Business Administration. The Program is established under section 13(3).

**Commercial Paper Funding Facility**

The **CPFF** provides a liquidity backstop to issuers of commercial paper and was also established under section 13(3). It is operated by the FRBNY through a special purpose vehicle, the Commercial Paper Funding Facility II LLC (CPFF LLC). The Treasury has made an equity investment of $10 billion in CPFF LLC.

**Primary and Secondary Market Corporate Credit Facility**

The **PMCCF** and **SMCCF** were set up under section 13(3) to support credit to employers through purchases of newly issued bonds and support market liquidity for outstanding corporate bonds. These facilities operate through a special purpose vehicle, the Corporate Credit Facility LLC (CCF LLC). The Treasury has made an equity investment of $37.5 billion in CCF LLC.
May 28
By Pascal Ungersboeck

Original post [here](#).

*Since last week the Municipal Lending Facility has started operations; however, no funds have been extended so far. Treasury has contributed $66.5 billion in CARES Act funds to four Fed lending facilities to date.*

Note on Treasury contributions to Fed facilities

The Treasury announced on April 9 that it intended to use funds available under the CARES Act to purchase equity in special purpose vehicles established under Fed lending programs. As of May 28, the Treasury invested a total of $66.5 billion in four facilities: equity investments of $10 billion into Commercial Paper Funding Facility LLC II, $37.5 billion into Corporate Credit Facilities LLC, and $17.5 billion into Municipal Liquidity Facility LLC; and $1.5 billion in credit protection for the Money Market Mutual Fund Liquidity Facility.

Per the facility agreements, 85% of the equity contributions to the CCF and CPFF have been invested in nonmarketable Treasury securities; $31.9 billion for the CCF and $8.5 billion for the CPFF. These investments are reflected in the balance of the CCF and CPFF. This week’s increases in the outstanding amounts for the CCF and CPFF thus largely reflect investments in Treasury securities, rather than in corporate bond or commercial paper holdings. The equity contributed to the MLF on May 26 has not been invested yet.
Liquidity Swap Lines

The USD swap lines are bilateral agreements between the Fed and foreign central banks. They allow foreign central banks to exchange domestic currency for US dollars. The Fed currently maintains swap line agreements with 14 central banks.

Money Market Mutual Fund Liquidity Facility

The MMLF allows the Fed to fund the purchase of money market mutual fund assets. The program is established under section 13(3) of the Federal Reserve Act. The Fed reported that the U.S. Treasury, to date, has provided credit protection of $1.5 billion to the Money Market Mutual Fund Liquidity Facility.

Discount Window

The DW is a standing facility that allows the Fed to provide collateralized loans to depository institutions.

Primary Dealer Credit Facility

The PDCE allows the Fed to extend collateralized loans to primary dealers. The facility was established under section 13(3).

Paycheck Protection Program Liquidity Facility

The PPPLF allows the Fed to provide financial institutions with liquidity backed by loans to small and medium businesses extended under the federal government’s Paycheck Protection
Program and guaranteed by the Small Business Administration. The Program was established under section 13(3).

### Table: Commercial Paper Funding Facility

<table>
<thead>
<tr>
<th>GFC</th>
<th>CB Swaps</th>
<th>MALF / MMFL</th>
<th>PFDF</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>9/17/20</td>
<td>3/11/20</td>
<td>58</td>
</tr>
<tr>
<td></td>
<td>9/24/20</td>
<td>3/18/20</td>
<td></td>
</tr>
<tr>
<td></td>
<td>10/01/20</td>
<td>135,063</td>
<td></td>
</tr>
<tr>
<td></td>
<td>10/08/20</td>
<td>298,421</td>
<td></td>
</tr>
<tr>
<td></td>
<td>10/15/20</td>
<td>496,882</td>
<td></td>
</tr>
<tr>
<td></td>
<td>10/22/20</td>
<td>477,125</td>
<td></td>
</tr>
<tr>
<td></td>
<td>10/29/20</td>
<td>498,880</td>
<td></td>
</tr>
<tr>
<td></td>
<td>11/03/20</td>
<td>328,355</td>
<td></td>
</tr>
<tr>
<td></td>
<td>11/10/20</td>
<td>360,716</td>
<td></td>
</tr>
<tr>
<td></td>
<td>11/17/20</td>
<td>392,090</td>
<td></td>
</tr>
<tr>
<td></td>
<td>11/30/20</td>
<td>365,835</td>
<td></td>
</tr>
<tr>
<td></td>
<td>12/07/20</td>
<td>396,819</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>GFC</th>
<th>COVID</th>
<th>MMLF</th>
<th>PFDF</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3/11/20</td>
<td>58</td>
<td></td>
</tr>
<tr>
<td></td>
<td>3/18/20</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>3/25/20</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>4/2/20</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>4/9/20</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>4/16/20</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>4/23/20</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>5/6/20</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>5/13/20</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>5/20/20</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>5/27/20</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Table: Other Funding Options

<table>
<thead>
<tr>
<th>GFC</th>
<th>COVID</th>
<th>MMLF</th>
<th>PFDF</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3/11/20</td>
<td>58</td>
<td></td>
</tr>
<tr>
<td></td>
<td>3/18/20</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>3/25/20</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>4/2/20</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>4/9/20</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>4/16/20</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>4/23/20</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>5/6/20</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>5/13/20</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>5/20/20</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>5/27/20</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Commercial Paper Funding Facility
The CPFF provides a liquidity backstop to issuers of commercial paper and was also established under section 13(3). It is operated by the FRBNY through a special purpose vehicle, the Commercial Paper Funding Facility II LLC (CPFF LLC). The Treasury has made an equity investment of $10 billion in CPFF LLC.
June 4
By Pascal Ungersboeck

Original post here.

Since last week the Main Street Lending Program has started operations; however, no funds have been extended so far. Treasury has contributed $104 billion in CARES Act funds to five Fed lending facilities to date.

Note on Treasury contributions to Fed facilities

The Treasury announced on April 9 that it intended to use funds available under the CARES Act to purchase equity in special purpose vehicles established under Fed lending programs. As of June 4, the Treasury invested a total of $104 billion in five facilities: equity investments of $10 billion into Commercial Paper Funding Facility LLC II, $37.5 billion into Corporate Credit Facilities LLC, $17.5 billion into Municipal Liquidity Facility LLC, and $37.5 billion into the Main Street Facilities LLC; and $1.5 billion in credit protection for the Money Market Mutual Fund Liquidity Facility.

Per the facility agreements, 85% of the equity contributions to the CCF, CPFF and MLF have been invested in nonmarketable Treasury securities; $31.9 billion for the CCF, $8.5 billion for the CPFF, and $14.9 billion for the MLF. These investments are reflected in the balance of the respective facilities. The equity contributed to the MSF on June 1 has not been invested yet.
Liquidity Swap Lines

The USD swap lines are bilateral agreements between the Fed and foreign central banks. They allow foreign central banks to exchange domestic currency for US dollars. The Fed currently maintains swap line agreements with 14 central banks.
Money Market Mutual Fund Liquidity Facility

The MMLF allows the Fed to fund the purchase of money market mutual fund assets. The program is established under section 13(3) of the Federal Reserve Act. The Fed reported that the U.S. Treasury, to date, has provided credit protection of $1.5 billion to the Money Market Mutual Fund Liquidity Facility.

Discount Window

The DW is a standing facility that allows the Fed to provide collateralized loans to depository institutions.

Primary Dealer Credit Facility

The PDCF allows the Fed to extend collateralized loans to primary dealers. The facility was established under section 13(3).

Paycheck Protection Program Liquidity Facility

The PPPLF allows the Fed to provide financial institutions with liquidity backed by loans to small and medium businesses extended under the federal government’s Paycheck Protection Program and guaranteed by the Small Business Administration. The Program was established under section 13(3).

Commercial Paper Funding Facility

The CPFF provides a liquidity backstop to issuers of commercial paper and was also established under section 13(3). It is operated by the FRBNY through a special purpose vehicle, the Commercial Paper Funding Facility II LLC (CPFF LLC). The Treasury has made an equity investment of $10 billion in CPFF LLC.

Primary and Secondary Market Corporate Credit Facilities

The PMCCF and SMCCF were set up under section 13(3) to support credit to employers through purchases of newly issued bonds and support market liquidity for outstanding corporate bonds. These facilities operate through a special purpose vehicle, the Corporate Credit Facilities LLC (CCF LLC). The Treasury has made an equity investment of $37.5 billion in CCF LLC.

Municipal Liquidity Facility

The MLF provides liquidity to states, counties and cities. The facility was set up to purchase up to $500 billion of short-term notes and was established under section 13(3). The Treasury has made an equity investment of $17.5 billion in MLF LLC.

Main Street Lending Programs

The MSF is established under section 13(3) to provide loans to SMEs. The program operates through three facilities: the Main Street New Loan Facility (MSNLF), the Main Street Priority Loan Facility (MSPLF), and the Main Street Expanded Loan Facility (MSELF). The loans are
extended through a special purpose vehicle, the Main Street Facilities LLC (MSF LLC), established by the Federal Reserve Bank of Boston.
Primary and Secondary Market Corporate Credit Facilities

The PMCCF and SMCCF were set up under section 13(3) to support credit to employers through purchases of newly issued bonds and support market liquidity for outstanding corporate bonds. These facilities operate through a special purpose vehicle, the Corporate Credit Facilities LLC (CCF LLC). The Treasury has made an equity investment of $37.5 billion in CCF LLC.

Municipal Liquidity Facility

The MLF provides liquidity to states, counties and cities. The facility was set up to purchase up to $500 billion of short-term notes and was established under section 13(3). The Treasury has made an equity investment of $17.5 billion in MLF LLC.
June 11
By Pascal Ungersboeck

Original post [here](#).

**Since last week, the ECB and BoE significantly decreased their use of the swap lines established with the Fed in March.**

Note on Federal Reserve Swap lines

Since last week, the European Central Bank (ECB) significantly decreased its use of the USD swap line established with the Fed in March. The decrease is due to the expiration of a $75 billion 84-day swap the ECB entered on March 18, shortly after the swap lines were established. As the contract reached maturity on June 11, the outstanding amount for the ECB decreased from $144 billion to $69 billion. The Bank of England’s position decreased from $20 billion to $13 billion, as a 84-day swap agreement entered on March 18 matured.

The Bank of Japan (BoJ) also entered a $30 billion swap that expired on June 11. However, its overall position did not decrease, as the BoJ entered a new 84-day contract for $15 billion on June 9. The BoJ has the highest outstanding amount at $213 billion.

Note on Treasury contributions to Fed facilities

The Treasury announced on April 9 that it intended to use funds available under the CARES Act to purchase equity in special purpose vehicles established under Fed lending programs. As of June 4, the Treasury invested a total of $104 billion in five facilities. Per the facility agreements, 85% of the equity contributions to the CCF, CPFF, MLF and MSF have been invested in nonmarketable Treasury securities; $31.9 billion for the CCF, $8.5 billion for the CPFF, $14.9 billion for the MLF and $31.9 billion for the MSF.

For the MSF and MLF, the current balance largely reflects the purchase of treasuries, rather than facility-specific assets. For the MLF treasuries purchased with equity constitute $14.9 billion out of $16 billion total. The facility began purchasing municipal notes on June 2. The current balance for the MSF is exclusively constituted by the 85 percent of equity invested in treasuries.
<table>
<thead>
<tr>
<th>GFC Swaps</th>
<th>AMF / MMF</th>
<th>PDCF</th>
</tr>
</thead>
<tbody>
<tr>
<td>9/17/08</td>
<td>62,000</td>
<td>3/11/20</td>
</tr>
<tr>
<td>9/24/08</td>
<td>145,900</td>
<td>3/18/20</td>
</tr>
<tr>
<td>10/1/08</td>
<td>286,432</td>
<td>3/25/20</td>
</tr>
<tr>
<td>10/8/08</td>
<td>335,184</td>
<td>4/1/20</td>
</tr>
<tr>
<td>10/15/08</td>
<td>406,862</td>
<td>4/8/20</td>
</tr>
<tr>
<td>10/30/08</td>
<td>477,163</td>
<td>4/15/20</td>
</tr>
<tr>
<td>10/29/08</td>
<td>488,860</td>
<td>4/22/20</td>
</tr>
<tr>
<td>11/5/08</td>
<td>528,855</td>
<td>4/29/20</td>
</tr>
<tr>
<td>11/12/08</td>
<td>549,716</td>
<td>5/6/20</td>
</tr>
<tr>
<td>11/19/08</td>
<td>562,090</td>
<td>5/13/20</td>
</tr>
<tr>
<td>11/26/08</td>
<td>575,438</td>
<td>5/20/20</td>
</tr>
<tr>
<td>12/3/08</td>
<td>596,819</td>
<td>5/27/20</td>
</tr>
<tr>
<td>12/10/08</td>
<td>582,575</td>
<td>6/3/20</td>
</tr>
<tr>
<td>12/17/08</td>
<td>583,135</td>
<td>6/10/20</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>DW</th>
<th>PPMLF</th>
<th>CFHF</th>
</tr>
</thead>
<tbody>
<tr>
<td>9/10/08</td>
<td>23,420</td>
<td>3/11/20</td>
</tr>
<tr>
<td>9/17/08</td>
<td>33,401</td>
<td>3/18/20</td>
</tr>
<tr>
<td>9/24/08</td>
<td>49,524</td>
<td>3/25/20</td>
</tr>
<tr>
<td>10/1/08</td>
<td>58,107</td>
<td>4/1/20</td>
</tr>
<tr>
<td>10/8/08</td>
<td>58,107</td>
<td>4/8/20</td>
</tr>
<tr>
<td>10/15/08</td>
<td>101,853</td>
<td>4/15/20</td>
</tr>
<tr>
<td>10/22/08</td>
<td>107,447</td>
<td>4/22/20</td>
</tr>
<tr>
<td>10/29/08</td>
<td>110,739</td>
<td>4/29/20</td>
</tr>
<tr>
<td>11/5/08</td>
<td>125,902</td>
<td>5/6/20</td>
</tr>
<tr>
<td>11/12/08</td>
<td>99,180</td>
<td>5/13/20</td>
</tr>
<tr>
<td>11/19/08</td>
<td>92,645</td>
<td>5/20/20</td>
</tr>
<tr>
<td>11/26/08</td>
<td>113,861</td>
<td>5/27/20</td>
</tr>
<tr>
<td>12/3/08</td>
<td>131,855</td>
<td>6/3/20</td>
</tr>
<tr>
<td>12/10/08</td>
<td>155,852</td>
<td>6/10/20</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>CCF</th>
<th>FIMA Repos</th>
<th>MLF</th>
</tr>
</thead>
<tbody>
<tr>
<td>3/18/20</td>
<td>-</td>
<td>3/18/20</td>
</tr>
<tr>
<td>3/25/20</td>
<td>-</td>
<td>3/25/20</td>
</tr>
<tr>
<td>4/1/20</td>
<td>-</td>
<td>4/1/20</td>
</tr>
<tr>
<td>4/8/20</td>
<td>-</td>
<td>4/8/20</td>
</tr>
<tr>
<td>4/15/20</td>
<td>-</td>
<td>4/15/20</td>
</tr>
<tr>
<td>4/22/20</td>
<td>-</td>
<td>4/22/20</td>
</tr>
<tr>
<td>4/29/20</td>
<td>-</td>
<td>4/29/20</td>
</tr>
<tr>
<td>5/6/20</td>
<td>-</td>
<td>5/6/20</td>
</tr>
<tr>
<td>5/13/20</td>
<td>305</td>
<td>5/13/20</td>
</tr>
<tr>
<td>5/20/20</td>
<td>1,004</td>
<td>5/20/20</td>
</tr>
<tr>
<td>5/27/20</td>
<td>2,506</td>
<td>5/27/20</td>
</tr>
<tr>
<td>6/3/20</td>
<td>-</td>
<td>6/3/20</td>
</tr>
<tr>
<td>6/10/20</td>
<td>37,374</td>
<td>6/10/20</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>MSF</th>
</tr>
</thead>
<tbody>
<tr>
<td>3/11/20</td>
</tr>
<tr>
<td>3/18/20</td>
</tr>
<tr>
<td>3/25/20</td>
</tr>
<tr>
<td>4/1/20</td>
</tr>
<tr>
<td>4/8/20</td>
</tr>
<tr>
<td>4/15/20</td>
</tr>
<tr>
<td>4/22/20</td>
</tr>
<tr>
<td>4/29/20</td>
</tr>
<tr>
<td>5/6/20</td>
</tr>
<tr>
<td>5/13/20</td>
</tr>
<tr>
<td>5/20/20</td>
</tr>
<tr>
<td>5/27/20</td>
</tr>
<tr>
<td>6/3/20</td>
</tr>
<tr>
<td>6/10/20</td>
</tr>
</tbody>
</table>

Liquidity Swap Lines
The USD swap lines are bilateral agreements between the Fed and foreign central banks. They allow foreign central banks to exchange domestic currency for US dollars. The Fed currently maintains swap line agreements with 14 central banks.

Money Market Mutual Fund Liquidity Facility

The MMLF allows the Fed to fund the purchase of money market mutual fund assets. The program is established under section 13(3) of the Federal Reserve Act. The Fed reported that the U.S. Treasury, to date, has provided credit protection of $1.5 billion to the Money Market Mutual Fund Liquidity Facility.

Discount Window

The DW is a standing facility that allows the Fed to provide collateralized loans to depository institutions.

Primary Dealer Credit Facility

The PDCF allows the Fed to extend collateralized loans to primary dealers. The facility was established under section 13(3).

Paycheck Protection Program Liquidity Facility

The PPPLF allows the Fed to provide financial institutions with liquidity backed by loans to small and medium businesses extended under the federal government’s Paycheck Protection Program and guaranteed by the Small Business Administration. The Program was established under section 13(3).

Commercial Paper Funding Facility

The CPFF provides a liquidity backstop to issuers of commercial paper and was also established under section 13(3). It is operated by the FRBNY through a special purpose vehicle, the Commercial Paper Funding Facility II LLC (CPFF LLC). The Treasury has made an equity investment of $10 billion in CPFF LLC.

Primary and Secondary Market Corporate Credit Facilities

The PMCCF and SMCCF were set up under section 13(3) to support credit to employers through purchases of newly issued bonds and support market liquidity for outstanding corporate bonds. These facilities operate through a special purpose vehicle, the Corporate Credit Facilities LLC (CCF LLC). The Treasury has made an equity investment of $37.5 billion in CCF LLC.

Municipal Liquidity Facility

The MLF provides liquidity to states, counties and cities. The facility was set up to purchase up to $500 billion of short-term notes and was established under section 13(3). The Treasury has made an equity investment of $17.5 billion in MLF LLC.

Main Street Lending Programs
The **MSF** is established under section 13(3) to provide loans to SMEs. The program operates through three facilities: the Main Street New Loan Facility (MSNLF), the Main Street Priority Loan Facility (MSPLF), and the Main Street Expanded Loan Facility (MSELF). The loans are extended through a special purpose vehicle, the Main Street Facilities LLC (MSF LLC), established by the Federal Reserve Bank of Boston.
Since last week, the Term Asset-Backed Securities Loan Facility has started operations; however, no funds have been extended so far. The ECB, BoE and BoJ further decreased their use of the swap lines established with the Fed in March.

Note on the Term Asset-Backed Securities Loan Facility and Treasury contributions

The Treasury announced on April 9 that it intended to use funds available under the CARES Act to purchase equity in special purpose vehicles established under Fed lending programs. On June 16, the Federal Reserve Bank of New York received the most recent contribution of $10 billion to TALF. In total, the Treasury has invested a total of $114 billion in six facilities. Per the facility agreements, 85% of the equity contributions to the CCF, CPFF, MLF and MSF have been invested in nonmarketable Treasury securities; $31.9 billion for the CCF, $8.5 billion for the CPFF, $14.9 billion for the MLF and $31.9 billion for the MSF. The funds contributed to TALF have not been invested yet.

For the MSF and MLF, the current balance largely reflects the purchase of Treasuries, rather than facility-specific assets. For the MLF, Treasuries purchased with equity constitute $14.9 billion out of $16 billion total. The facility began purchasing municipal notes on June 2. As of June 18, there are $195 billion outstanding across 10 facilities (Figure 1); $107 billion out of the total has been used to purchase targeted assets.

Note on Federal Reserve Swap lines

Over the last two weeks, the European Central Bank (ECB) significantly decreased its use of the USD swap line established with the Fed in March. The decrease is due to the expiration of two 84-day swaps the ECB entered on March 18 and March 25. As the contracts reached maturity on June 11, the ECB’s position decreased by over $100 billion. As of June 18 its total amount still outstanding is $45 billion. The position is expected to decrease further over the next week as another $16 billion swap matures. The Bank of England’s position decreased from $20 billion to $7.7 billion during the same time period as two of its large 84-day swaps expired.

The Bank of Japan (BoJ) also decreased its position in the last week. It currently stands at $171 billion, down from $212 billion last week after a $73 billion agreement matured on June 18. This was the second-largest swap agreement the Federal Reserve entered during the current crisis. The largest was a $75 billion swap with the ECB that expired on June 11.
<table>
<thead>
<tr>
<th>CB Swaps</th>
<th>AMF / MMF</th>
<th>PDCF</th>
</tr>
</thead>
<tbody>
<tr>
<td>GFC</td>
<td>COVID</td>
<td>GFC</td>
</tr>
<tr>
<td>8/17/20</td>
<td>20.00</td>
<td>8/11/20</td>
</tr>
<tr>
<td>9/4/20</td>
<td>14.900</td>
<td>9/8/20</td>
</tr>
<tr>
<td>9/11/20</td>
<td>286.422</td>
<td>9/15/20</td>
</tr>
<tr>
<td>9/18/20</td>
<td>351.198</td>
<td>9/22/20</td>
</tr>
<tr>
<td>9/25/20</td>
<td>406.882</td>
<td>9/29/20</td>
</tr>
<tr>
<td>10/8/20</td>
<td>477.129</td>
<td>10/12/20</td>
</tr>
<tr>
<td>10/15/20</td>
<td>493.860</td>
<td>10/19/20</td>
</tr>
<tr>
<td>11/6/20</td>
<td>529.345</td>
<td>11/13/20</td>
</tr>
<tr>
<td>11/14/20</td>
<td>660.716</td>
<td>11/20/20</td>
</tr>
<tr>
<td>11/21/20</td>
<td>662.050</td>
<td>11/27/20</td>
</tr>
<tr>
<td>11/26/20</td>
<td>475.436</td>
<td>12/3/20</td>
</tr>
<tr>
<td>12/7/20</td>
<td>505.533</td>
<td>12/13/20</td>
</tr>
<tr>
<td>12/14/20</td>
<td>532.718</td>
<td>12/18/20</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>DM</th>
<th>PPPFL</th>
<th>GFC</th>
<th>COVID</th>
</tr>
</thead>
<tbody>
<tr>
<td>3/12/20</td>
<td>23.455</td>
<td>3/13/20</td>
<td>15</td>
</tr>
<tr>
<td>3/17/20</td>
<td>33.461</td>
<td>3/18/20</td>
<td>23.224</td>
</tr>
<tr>
<td>3/24/20</td>
<td>39.337</td>
<td>3/25/20</td>
<td>50.793</td>
</tr>
<tr>
<td>3/31/20</td>
<td>49.924</td>
<td>4/1/20</td>
<td>43.741</td>
</tr>
<tr>
<td>4/7/20</td>
<td>98.167</td>
<td>4/8/20</td>
<td>12.193</td>
</tr>
<tr>
<td>4/14/20</td>
<td>131.814</td>
<td>4/15/20</td>
<td>-</td>
</tr>
<tr>
<td>4/21/20</td>
<td>197.547</td>
<td>4/22/20</td>
<td>-</td>
</tr>
<tr>
<td>4/28/20</td>
<td>127.737</td>
<td>4/29/20</td>
<td>-</td>
</tr>
<tr>
<td>5/5/20</td>
<td>183.007</td>
<td>5/6/20</td>
<td>-</td>
</tr>
<tr>
<td>5/11/20</td>
<td>93.670</td>
<td>5/12/20</td>
<td>-</td>
</tr>
<tr>
<td>5/18/20</td>
<td>92.944</td>
<td>5/19/20</td>
<td>-</td>
</tr>
<tr>
<td>5/24/20</td>
<td>91.725</td>
<td>5/25/20</td>
<td>-</td>
</tr>
<tr>
<td>5/31/20</td>
<td>87.813</td>
<td>6/1/20</td>
<td>-</td>
</tr>
<tr>
<td>6/7/20</td>
<td>80.932</td>
<td>6/8/20</td>
<td>-</td>
</tr>
<tr>
<td>6/14/20</td>
<td>92.237</td>
<td>6/15/20</td>
<td>-</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>CF</th>
<th>FINRA Regs</th>
<th>MLF</th>
</tr>
</thead>
<tbody>
<tr>
<td>GFC</td>
<td>COVID</td>
<td>GFC</td>
</tr>
<tr>
<td>8/1/20</td>
<td>-</td>
<td>8/15/20</td>
</tr>
<tr>
<td>8/8/20</td>
<td>-</td>
<td>8/22/20</td>
</tr>
<tr>
<td>8/15/20</td>
<td>-</td>
<td>8/29/20</td>
</tr>
<tr>
<td>8/22/20</td>
<td>-</td>
<td>9/5/20</td>
</tr>
<tr>
<td>8/29/20</td>
<td>-</td>
<td>9/12/20</td>
</tr>
<tr>
<td>9/5/20</td>
<td>-</td>
<td>9/19/20</td>
</tr>
<tr>
<td>9/12/20</td>
<td>-</td>
<td>9/26/20</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>MF</th>
<th>TALF</th>
</tr>
</thead>
<tbody>
<tr>
<td>GFC</td>
<td>COVID</td>
</tr>
<tr>
<td>3/1/20</td>
<td>-</td>
</tr>
<tr>
<td>3/8/20</td>
<td>-</td>
</tr>
<tr>
<td>3/15/20</td>
<td>-</td>
</tr>
<tr>
<td>3/22/20</td>
<td>-</td>
</tr>
<tr>
<td>3/29/20</td>
<td>-</td>
</tr>
<tr>
<td>4/6/20</td>
<td>-</td>
</tr>
<tr>
<td>4/13/20</td>
<td>-</td>
</tr>
<tr>
<td>4/20/20</td>
<td>-</td>
</tr>
<tr>
<td>4/27/20</td>
<td>-</td>
</tr>
<tr>
<td>5/1/20</td>
<td>-</td>
</tr>
<tr>
<td>5/8/20</td>
<td>-</td>
</tr>
<tr>
<td>5/15/20</td>
<td>-</td>
</tr>
<tr>
<td>5/22/20</td>
<td>-</td>
</tr>
<tr>
<td>6/1/20</td>
<td>-</td>
</tr>
<tr>
<td>6/8/20</td>
<td>-</td>
</tr>
<tr>
<td>6/15/20</td>
<td>-</td>
</tr>
</tbody>
</table>
Liquidity Swap Lines

The USD swap lines are bilateral agreements between the Fed and foreign central banks. They allow foreign central banks to exchange domestic currency for US dollars. The Fed currently maintains swap line agreements with 14 central banks.

Money Market Mutual Fund Liquidity Facility

The MMLF allows the Fed to fund the purchase of money market mutual fund assets. The program is established under section 13(3) of the Federal Reserve Act. The Fed reported that the U.S. Treasury, to date, has provided credit protection of $1.5 billion to the Money Market Mutual Fund Liquidity Facility.

Discount Window

The DW is a standing facility that allows the Fed to provide collateralized loans to depository institutions.

Primary Dealer Credit Facility

The PDCF allows the Fed to extend collateralized loans to primary dealers. The facility was established under section 13(3).

Paycheck Protection Program Liquidity Facility

The PPPLF allows the Fed to provide financial institutions with liquidity backed by loans to small and medium-sized businesses extended under the federal government's Paycheck Protection Program and guaranteed by the Small Business Administration. The Program was established under section 13(3).

Commercial Paper Funding Facility

The CPFF provides a liquidity backstop to issuers of commercial paper and was also established under section 13(3). It is operated by the FRBNY through a special purpose vehicle, the Commercial Paper Funding Facility II LLC (CPFF LLC). The Treasury has made an equity investment of $10 billion in CPFF LLC.

Primary and Secondary Market Corporate Credit Facilities

The PMCCF and SMCCF were set up under section 13(3) to support credit to employers through purchases of newly issued bonds and support market liquidity for outstanding corporate bonds. These facilities operate through a special purpose vehicle, the Corporate Credit Facilities LLC (CCF LLC). The Treasury has made an equity investment of $37.5 billion in CCF LLC.

Municipal Liquidity Facility

The MLF provides liquidity to states, counties and cities. The facility was set up to purchase up to $500 billion of short-term notes and was established under section 13(3). The Treasury has made an equity investment of $17.5 billion in MLF LLC.
Main Street Lending Programs

The MSF is established under section 13(3) to provide loans to SMEs. The program operates through three facilities: the Main Street New Loan Facility (MSNLF), the Main Street Priority Loan Facility (MSPLF), and the Main Street Expanded Loan Facility (MSELF). The loans are extended through a special purpose vehicle, the Main Street Facilities LLC (MSF LLC), established by the Federal Reserve Bank of Boston.

Term Asset-Backed Securities Loan Facility

The TALF is established under section 13(3) to provide liquidity guaranteed by asset-back securities (ABS). Under the facility the Federal Reserve lends to holders of certain AAA-rated ABS. The facility operates through a special purpose vehicle to extend its loans, the Term Asset-Backed Securities Loan Facility II LLC (TAF II LLC).
June 25
By Pascal Ungersboeck

Original post here.

Since last week, the Treasury’s equity contribution to the Term Asset-Backed Securities Loan Facility was invested in securities; however, no facility-specific assets have been purchased so far. The Bank of England significantly decreased its use of the swap lines established with the Fed in March. It is now the Fed’s smallest counterparty.

Note on the Term Asset-Backed Securities Loan Facility and Treasury contributions

The Treasury announced on April 9 that it intended to use funds available under the CARES Act to purchase equity in special purpose vehicles established under Fed lending programs. On June 16, the Federal Reserve Bank of New York received the most recent contribution of $10 billion to TALF. In total, the Treasury has invested a total of $114 billion in six facilities. Per the facility agreements, 85% of the equity contributions to the CCF, CPFF, MLF, MSF and TALF have been invested in nonmarketable Treasury securities; $31.9 billion for the CCF, $8.5 billion for the CPFF, $14.9 billion for the MLF, $31.9 billion for the MSF, and $8.5 billion for TALF.

For the MLF, MSF and TALF, the current balance largely reflects Treasury contributions, rather than facility-specific assets. For the MLF, Treasuries purchased with equity constitute $14.9 billion out of $16 billion total. The current balance for MSF and TALF exclusively reflect Treasury contributions. As of June 25, there are $210 billion outstanding across 10 facilities (Figure 1); $110 billion out of the total has been used to purchase targeted assets. Figure 1a below reports the outstanding amount of each facility, not including treasury contributions, from June 18 onwards.

Note on Federal Reserve Swap lines

Over the last two weeks, the Bank of Japan (BoJ), European Central Bank (ECB), and Bank of England (BoE) significantly reduced their use of the USD swap lines established with the Fed in March. The reduction is due to the expiration of a series of 84-day swaps those central banks entered in March and April. Auctions for these swaps were conducted weekly. As these contracts are reaching maturity, the total outstanding amount declined by over $220 billion since its peak on May 27. As of June 25, the total amount still outstanding is $228 billion. Over the course of the month, the BoE reduced its position from $23 billion to $695 million. The BoE was the Fed’s third largest counterparty since the lines had been extended; it is now the smallest among the ten central banks that used their lines. The ECB remains the second largest counterparty with $30 billion outstanding. At $155 billion outstanding, the BoJ’s share represents 68 percent of the total.
Figure 1: Use of Federal Reserve Lending Facilities

Figure 1a: Use of Federal Reserve Lending Facilities
not including uninvested Treasury contributions after 06/18
<table>
<thead>
<tr>
<th>Date</th>
<th>CB Swaps</th>
<th>CDVID</th>
<th>JANIS / MMIS</th>
<th>CDVID</th>
<th>GFC</th>
<th>CDVID</th>
<th>FDCS</th>
<th>CDVID</th>
</tr>
</thead>
<tbody>
<tr>
<td>9/1/2018</td>
<td>62,000</td>
<td>3/11/06</td>
<td>58</td>
<td>10/8/06</td>
<td>139,481</td>
<td>3/11/06</td>
<td>-</td>
<td>3/1/20</td>
</tr>
<tr>
<td>9/2/2018</td>
<td>54,000</td>
<td>3/12/00</td>
<td>44</td>
<td>10/15/06</td>
<td>122,763</td>
<td>3/18/00</td>
<td>-</td>
<td>1/12/06</td>
</tr>
<tr>
<td>9/3/2018</td>
<td>206,132</td>
<td>3/10/09</td>
<td>291,073</td>
<td>10/12/06</td>
<td>207,895</td>
<td>3/25/00</td>
<td>30,694</td>
<td>3/12/06</td>
</tr>
<tr>
<td>9/4/2018</td>
<td>355,184</td>
<td>3/15/01</td>
<td>391,294</td>
<td>10/19/06</td>
<td>96,030</td>
<td>4/21/00</td>
<td>32,661</td>
<td>4/21/00</td>
</tr>
<tr>
<td>9/5/2018</td>
<td>116,019</td>
<td>4/11/00</td>
<td>166,019</td>
<td>10/26/06</td>
<td>57,022</td>
<td>4/21/00</td>
<td>27,216</td>
<td>9/3/20</td>
</tr>
<tr>
<td>9/6/2018</td>
<td>22,189</td>
<td>4/13/00</td>
<td>31,189</td>
<td>10/27/06</td>
<td>58,597</td>
<td>4/21/00</td>
<td>32,661</td>
<td>9/3/20</td>
</tr>
<tr>
<td>9/7/2018</td>
<td>31,189</td>
<td>4/13/00</td>
<td>31,189</td>
<td>10/27/06</td>
<td>58,597</td>
<td>4/21/00</td>
<td>32,661</td>
<td>9/3/20</td>
</tr>
<tr>
<td>9/8/2018</td>
<td>31,189</td>
<td>4/13/00</td>
<td>31,189</td>
<td>10/27/06</td>
<td>58,597</td>
<td>4/21/00</td>
<td>32,661</td>
<td>9/3/20</td>
</tr>
<tr>
<td>9/9/2018</td>
<td>31,189</td>
<td>4/13/00</td>
<td>31,189</td>
<td>10/27/06</td>
<td>58,597</td>
<td>4/21/00</td>
<td>32,661</td>
<td>9/3/20</td>
</tr>
</tbody>
</table>

**Liquidity Swap Lines**
The USD swap lines are bilateral agreements between the Fed and foreign central banks. They allow foreign central banks to exchange domestic currency for US dollars. The Fed currently maintains swap line agreements with 14 central banks.

Money Market Mutual Fund Liquidity Facility

The MMLF allows the Fed to fund the purchase of money market mutual fund assets. The program is established under section 13(3) of the Federal Reserve Act. The Fed reported that the U.S. Treasury, to date, has provided credit protection of $1.5 billion to the Money Market Mutual Fund Liquidity Facility.

Discount Window

The DW is a standing facility that allows the Fed to provide collateralized loans to depository institutions.

Primary Dealer Credit Facility

The PDCF allows the Fed to extend collateralized loans to primary dealers. The facility was established under section 13(3).

Paycheck Protection Program Liquidity Facility

The PPPLF allows the Fed to provide financial institutions with liquidity backed by loans to small and medium-sized businesses extended under the federal government’s Paycheck Protection Program and guaranteed by the Small Business Administration. The Program was established under section 13(3).

Commercial Paper Funding Facility

The CPFF provides a liquidity backstop to issuers of commercial paper and was also established under section 13(3). It is operated by the FRBNY through a special purpose vehicle, the Commercial Paper Funding Facility II LLC (CPFF LLC). The Treasury has made an equity investment of $10 billion in CPFF LLC.

Primary and Secondary Market Corporate Credit Facilities

The PMCCF and SMCCF were set up under section 13(3) to support credit to employers through purchases of newly issued bonds and support market liquidity for outstanding corporate bonds. These facilities operate through a special purpose vehicle, the Corporate Credit Facilities LLC (CCF LLC). The Treasury has made an equity investment of $37.5 billion in CCF LLC.

Municipal Liquidity Facility

The MLF provides liquidity to states, counties and cities. The facility was set up to purchase up to $500 billion of short-term notes and was established under section 13(3). The Treasury has made an equity investment of $17.5 billion in MLF LLC.

Main Street Lending Programs
The **MSF** is established under section 13(3) to provide loans to SMEs. The program operates through three facilities: the Main Street New Loan Facility (MSNLF), the Main Street Priority Loan Facility (MSPLF), and the Main Street Expanded Loan Facility (MSELF). The loans are extended through a special purpose vehicle, the Main Street Facilities LLC (MSF LLC), established by the Federal Reserve Bank of Boston.

**Term Asset-Backed Securities Loan Facility**

The **TALF** is established under section 13(3) to provide liquidity guaranteed by asset-back securities (ABS). Under the facility the Federal Reserve lends to holders of certain AAA-rated ABS. The facility operates through a special purpose vehicle to extend its loans, the Term Asset-Backed Securities Loan Facility II LLC (TALF II LLC).
July 2
By Pascal Ungersboeck

Original post here.

Since last week, central banks have continued to reduce their use of the swap agreements with the Federal Reserve. The outstanding amount of the Fed’s purchase and lending programs has not increased significantly.

Note on Treasury contributions to Federal Reserve Programs

The Treasury announced on April 9 that it intended to use funds available under the CARES Act to purchase equity in special purpose vehicles established under Fed lending programs. On June 16, the Federal Reserve Bank of New York received the most recent contribution of $10 billion to TALF. In total, the Treasury has invested a total of $114 billion in six facilities. Per the facility agreements, 85% of the equity contributions to the CCF, CPFF, MLF, MSF and TALF have been invested in nonmarketable Treasury securities; $31.9 billion for the CCF, $8.5 billion for the CPFF, $14.9 billion for the MLF, $31.9 billion for the MSF, and $8.5 billion for TALF.

As of July 2, there is $215 billion outstanding across 10 facilities (Figure 1); $114 billion out of the total has been used to purchase targeted assets. Figure 1a below reports the outstanding amount of each facility, not including Treasury contributions that are invested in securities, from June 18 onwards.

Note on Federal Reserve Swap lines

Over the last two weeks, central banks significantly reduced their use of the USD swap lines established with the Fed in March. The reduction is due to the expiration of a series of 84-day swaps those central banks entered in March and April. Auctions for these swaps were conducted weekly. As these contracts are reaching maturity, the total outstanding amount declined by over $260 billion since its peak on May 27. As of July 2, the total amount still outstanding is $182 billion, down from $228 billion last week. With $395 million outstanding, the BoE is now among the three smallest counterparties. The ECB remains the second largest counterparty with $19 billion outstanding. At $132 billion outstanding, the BoJ’s share now represents 72 percent of the total.
<table>
<thead>
<tr>
<th>Date</th>
<th>CB Reps</th>
<th>AMREF / MAFREF</th>
<th>PDCF</th>
</tr>
</thead>
<tbody>
<tr>
<td>6/17/08</td>
<td>62,000</td>
<td>3/11/10</td>
<td>58</td>
</tr>
<tr>
<td>5/24/09</td>
<td>141,500</td>
<td>5/18/10</td>
<td>44</td>
</tr>
<tr>
<td>5/17/09</td>
<td>209,432</td>
<td>3/25/10</td>
<td>208,652</td>
</tr>
<tr>
<td>5/19/09</td>
<td>334,780</td>
<td>4/17/10</td>
<td>336,572</td>
</tr>
<tr>
<td>10/14/09</td>
<td>406,828</td>
<td>4/22/09</td>
<td>368,679</td>
</tr>
<tr>
<td>4/22/09</td>
<td>356,129</td>
<td>11/25/09</td>
<td>352,386</td>
</tr>
<tr>
<td>11/12/09</td>
<td>598,716</td>
<td>6/20/09</td>
<td>544,835</td>
</tr>
<tr>
<td>11/10/09</td>
<td>652,650</td>
<td>3/10/10</td>
<td>646,534</td>
</tr>
<tr>
<td>11/26/09</td>
<td>475,435</td>
<td>4/16/10</td>
<td>476,170</td>
</tr>
<tr>
<td>12/13/09</td>
<td>506,815</td>
<td>5/10/10</td>
<td>505,946</td>
</tr>
<tr>
<td>12/10/09</td>
<td>582,575</td>
<td>6/9/10</td>
<td>596,605</td>
</tr>
<tr>
<td>12/17/09</td>
<td>593,035</td>
<td>6/11/10</td>
<td>589,787</td>
</tr>
<tr>
<td>12/24/09</td>
<td>592,728</td>
<td>6/18/10</td>
<td>586,102</td>
</tr>
<tr>
<td>12/31/09</td>
<td>592,728</td>
<td>6/22/10</td>
<td>592,728</td>
</tr>
<tr>
<td>2/7/10</td>
<td>538,162</td>
<td>7/2/10</td>
<td>538,162</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date</th>
<th>DAV</th>
<th>CPFH</th>
</tr>
</thead>
<tbody>
<tr>
<td>9/12/08</td>
<td>29,493</td>
<td>12</td>
</tr>
<tr>
<td>9/17/08</td>
<td>67,000</td>
<td>23</td>
</tr>
<tr>
<td>9/24/08</td>
<td>38,327</td>
<td>28</td>
</tr>
<tr>
<td>10/1/08</td>
<td>63,574</td>
<td>39</td>
</tr>
<tr>
<td>10/8/08</td>
<td>98,107</td>
<td>41</td>
</tr>
<tr>
<td>10/15/08</td>
<td>170,855</td>
<td>40</td>
</tr>
<tr>
<td>10/22/08</td>
<td>137,547</td>
<td>37</td>
</tr>
<tr>
<td>10/29/08</td>
<td>118,737</td>
<td>37</td>
</tr>
<tr>
<td>11/5/08</td>
<td>208,567</td>
<td>36</td>
</tr>
<tr>
<td>11/12/08</td>
<td>296,180</td>
<td>35</td>
</tr>
<tr>
<td>11/19/08</td>
<td>246,840</td>
<td>35</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date</th>
<th>CNF</th>
<th>CNF Repo</th>
</tr>
</thead>
<tbody>
<tr>
<td>3/11/10</td>
<td>87,383</td>
<td>11,011</td>
</tr>
<tr>
<td>5/17/10</td>
<td>115,532</td>
<td>15,924</td>
</tr>
<tr>
<td>6/13/10</td>
<td>115,406</td>
<td>20,373</td>
</tr>
<tr>
<td>6/20/10</td>
<td>114,605</td>
<td>24,775</td>
</tr>
<tr>
<td>7/1/10</td>
<td>113,188</td>
<td>29,364</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date</th>
<th>PRSF</th>
<th>TALF</th>
</tr>
</thead>
<tbody>
<tr>
<td>3/12/10</td>
<td>12/12/10</td>
<td>12/12/10</td>
</tr>
<tr>
<td>5/24/09</td>
<td>5/24/09</td>
<td>5/24/09</td>
</tr>
<tr>
<td>5/17/09</td>
<td>5/17/09</td>
<td>5/17/09</td>
</tr>
<tr>
<td>5/19/09</td>
<td>5/19/09</td>
<td>5/19/09</td>
</tr>
<tr>
<td>5/22/09</td>
<td>5/22/09</td>
<td>5/22/09</td>
</tr>
<tr>
<td>5/25/09</td>
<td>5/25/09</td>
<td>5/25/09</td>
</tr>
<tr>
<td>5/27/09</td>
<td>5/27/09</td>
<td>5/27/09</td>
</tr>
<tr>
<td>5/30/09</td>
<td>5/30/09</td>
<td>5/30/09</td>
</tr>
<tr>
<td>6/10/09</td>
<td>6/10/09</td>
<td>6/10/09</td>
</tr>
<tr>
<td>6/13/09</td>
<td>6/13/09</td>
<td>6/13/09</td>
</tr>
<tr>
<td>6/16/09</td>
<td>6/16/09</td>
<td>6/16/09</td>
</tr>
<tr>
<td>6/19/09</td>
<td>6/19/09</td>
<td>6/19/09</td>
</tr>
<tr>
<td>6/22/09</td>
<td>6/22/09</td>
<td>6/22/09</td>
</tr>
<tr>
<td>7/3/10</td>
<td>7/3/10</td>
<td>7/3/10</td>
</tr>
</tbody>
</table>

Yale Program on Financial Stability | 117
Liquidity Swap Lines

The USD swap lines are bilateral agreements between the Fed and foreign central banks. They allow foreign central banks to exchange domestic currency for US dollars. The Fed currently maintains swap line agreements with 14 central banks.

Money Market Mutual Fund Liquidity Facility

The MMLF allows the Fed to fund the purchase of money market mutual fund assets. The program is established under section 13(3) of the Federal Reserve Act. The Fed reported that the U.S. Treasury, to date, has provided credit protection of $1.5 billion to the Money Market Mutual Fund Liquidity Facility.

Discount Window

The DW is a standing facility that allows the Fed to provide collateralized loans to depository institutions.

Primary Dealer Credit Facility

The PDCF allows the Fed to extend collateralized loans to primary dealers. The facility was established under section 13(3).

Paycheck Protection Program Liquidity Facility

The PPPLF allows the Fed to provide financial institutions with liquidity backed by loans to small and medium-sized businesses extended under the federal government’s Paycheck Protection Program and guaranteed by the Small Business Administration. The Program was established under section 13(3).

Commercial Paper Funding Facility

The CPFF provides a liquidity backstop to issuers of commercial paper and was also established under section 13(3). It is operated by the FRBNY through a special purpose vehicle, the Commercial Paper Funding Facility II LLC (CPFF LLC). The Treasury has made an equity investment of $10 billion in CPFF LLC.

Primary and Secondary Market Corporate Credit Facilities

The PMCCF and SMCCF were set up under section 13(3) to support credit to employers through purchases of newly issued bonds and support market liquidity for outstanding corporate bonds. These facilities operate through a special purpose vehicle, the Corporate Credit Facilities LLC (CCF LLC). The Treasury has made an equity investment of $37.5 billion in CCF LLC.

Municipal Liquidity Facility

The MLF provides liquidity to states, counties and cities. The facility was set up to purchase up to $500 billion of short-term notes and was established under section 13(3). The Treasury has made an equity investment of $17.5 billion in MLF LLC.
Main Street Lending Programs

The MSF is established under section 13(3) to provide loans to SMEs. The program operates through three facilities: the Main Street New Loan Facility (MSNLF), the Main Street Priority Loan Facility (MSPLF), and the Main Street Expanded Loan Facility (MSELF). The loans are extended through a special purpose vehicle, the Main Street Facilities LLC (MSF LLC), established by the Federal Reserve Bank of Boston.

Term Asset-Backed Securities Loan Facility

The TALF is established under section 13(3) to provide liquidity guaranteed by asset-back securities (ABS). Under the facility the Federal Reserve lends to holders of certain AAA-rated ABS. The facility operates through a special purpose vehicle to extend its loans, the Term Asset-Backed Securities Loan Facility II LLC (TALF II LLC).
July 9

By Pascal Ungersboeck

Original post here.

Since last week, the Term Asset-Backed Securities Loan Facility has started operations; however, no funds have been extended so far. The ECB, BoE and BoJ further decreased their use of the swap lines established with the Fed in March.

Note on Treasury contributions to Federal Reserve Programs

The Treasury announced on April 9 that it intended to use funds available under the CARES Act to purchase equity in special purpose vehicles established under Fed lending programs. On June 16, the Federal Reserve Bank of New York received the most recent contribution of $10 billion to TALF. In total, the Treasury has invested a total of $114 billion in six facilities. Per the facility agreements, 85% of the equity contributions to the CCF, CPFF, MLF, MSF and TALF have been invested in nonmarketable Treasury securities; $31.9 billion for the CCF, $8.5 billion for the CPFF, $14.9 billion for the MLF, $31.9 billion for the MSF, and $8.5 billion for TALF.

As of July 2, there is $211 billion outstanding across 10 facilities (Figure 1); $109 billion out of the total has been used to purchase targeted assets. The total amount outstanding is slightly down from last week, when it stood at $215 billion - $114 billion excluding Treasury contributions. It is the first time the total has declined since the launch of the first programs in March. Figure 1a below reports the outstanding amount of each facility, not including Treasury contributions that are invested in securities, from June 18 onwards.

Note on Federal Reserve Swap lines

Over the last month, central banks significantly reduced their use of the USD swap lines established with the Fed in March. The reduction is due to the expiration of 84-day swaps entered during the early weeks of the crisis. Auctions for these swaps were conducted weekly. As these contracts are reaching maturity, the total outstanding amount declined by almost $300 billion since its peak on May 27. As of July 9, the total amount still outstanding is $153 billion, down from $183 billion last week. The BoJ and ECB are now the only counterparties with an outstanding amount above $10 billion. At $112 billion outstanding, the BoJ’s share represents 73 percent of the total. The ECB stands at $17 billion; together the two largest counterparties hold 84 percent.
| GFC | COVID | 0-3/3/20 | 3/4/20 | 4/1/20 | 4/2/20 | 4/3/20 | 4/4/20 | 4/5/20 | 4/6/20 | 4/7/20 | 4/8/20 | 4/9/20 | 4/10/20 | 4/11/20 | 4/12/20 | 4/13/20 | 4/14/20 | 4/15/20 | 4/16/20 | 4/17/20 | 4/18/20 | 4/19/20 | 4/20/20 | 4/21/20 | 4/22/20 | 4/23/20 | 4/24/20 | 4/25/20 | 4/26/20 | 4/27/20 | 4/28/20 | 4/29/20 | 4/30/20 | 05/01/20 | 05/02/20 | 05/03/20 | 05/04/20 | 05/05/20 | 05/06/20 | 05/07/20 | 05/08/20 | 05/09/20 | 05/10/20 | 05/11/20 | 05/12/20 | 05/13/20 | 05/14/20 | 05/15/20 | 05/16/20 | 05/17/20 | 05/18/20 | 05/19/20 | 05/20/20 | 05/21/20 | 05/22/20 | 05/23/20 | 05/24/20 | 05/25/20 | 05/26/20 | 05/27/20 | 05/28/20 | 05/29/20 | 05/30/20 | 05/31/20 |
|-----|-------|----------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
Liquidity Swap Lines

The USD swap lines are bilateral agreements between the Fed and foreign central banks. They allow foreign central banks to exchange domestic currency for US dollars. The Fed currently maintains swap line agreements with 14 central banks.

Money Market Mutual Fund Liquidity Facility

The MMLF allows the Fed to fund the purchase of money market mutual fund assets. The program is established under section 13(3) of the Federal Reserve Act.

Discount Window

The DW is a standing facility that allows the Fed to provide collateralized loans to depository institutions.

Primary Dealer Credit Facility

The PDCF allows the Fed to extend collateralized loans to primary dealers. The facility was established under section 13(3).

Paycheck Protection Program Liquidity Facility

The PPPLF allows the Fed to provide financial institutions with liquidity backed by loans to small and medium businesses extended under the federal government’s Paycheck Protection Program and guaranteed by the Small Business Administration. The Program is established under section 13(3).

Commercial Paper Funding Facility

The CPFF provides a liquidity backstop to issuers of commercial paper and was also established under section 13(3). It is operated by the FRBNY through a special purpose vehicle, the Commercial Paper Funding Facility II LLC.

Primary and Secondary Market Corporate Credit Facility

The PMCCF and SMCCF were set up under section 13(3) to support credit to employers through purchases of newly issued bonds and support market liquidity for outstanding corporate bonds. These facilities operate through a special purpose vehicle, the Corporate Credit Facility LLC (CCF LLC).
Original post here.

Since last week, the Main Street Lending Program has started operations. As of Wednesday, the program holds $12 million in purchased assets. The BoJ and ECB further decreased their use of the swap lines.

Note on Treasury Contributions to Federal Reserve Programs

The Treasury announced on April 9 that it intended to use funds available under the CARES Act to purchase equity in special purpose vehicles established under Fed lending programs. On June 16, the Federal Reserve Bank of New York received the most recent contribution of $10 billion to TALF. In total, the Treasury has invested $114 billion in six facilities. Per the facility agreements, 85% of the equity contributions to the CCF, CPFF, MLF, MSF and TALF have been invested in nonmarketable Treasury securities: $31.9 billion for the CCF, $8.5 billion for the CPFF, $14.9 billion for the MLF, $37.5 billion for the MSF, and $8.5 billion for TALF.

As of July 15, there is $210.5 billion outstanding across 10 facilities (Figure 1); $109.1 billion out of the total has been used to purchase targeted assets. The total amount outstanding is slightly down from last week, when it stood at $211.1 billion - $109.7 billion excluding Treasury contributions. Figure 1a below reports the outstanding amount of each facility, not including Treasury contributions that are invested in securities, from June 18 onwards.

Note on Federal Reserve Swap Lines

Over the last month, central banks reduced their use of the USD swap lines. The reduction is partially due to the expiration of 84-day swaps entered during the early weeks of the crisis. Auctions for these swaps were conducted weekly. As these contracts are reaching maturity, the total outstanding amount declined to 29 percent of its peak on May 27. As of July 15, the total amount still outstanding is $128 billion, down from $153 billion last week. The BoJ reduced its outstanding amount by $24 billion. At $90 billion outstanding, the BoJ’s share represents 70 percent of the total. The ECB stands at $16 billion; together the two largest counterparties hold 83 percent.

Note on Main Street Lending Programs

On July 15, 2020, the Main Street Lending Program began purchasing loans. The facility holds $12 million in purchased assets.
Figure 2: Use of USD Liquidity Swap Line
<table>
<thead>
<tr>
<th>EN</th>
<th>PFF</th>
<th>YFF</th>
<th>FTT</th>
</tr>
</thead>
<tbody>
<tr>
<td>9/15/08</td>
<td>23,495</td>
<td>3/12/08</td>
<td>N/A</td>
</tr>
</tbody>
</table>

| 9/15/08 | 23,495 | 3/12/08 | N/A | 10/15/08 | N/A | 11/15/08 | N/A | 12/15/08 | N/A | 1/15/09 | N/A | 2/15/09 | N/A | 3/15/09 | N/A | 4/15/09 | N/A | 5/15/09 | N/A | 6/15/09 | N/A | 7/15/09 | N/A | 8/15/09 | N/A | 9/15/09 | N/A | 10/15/09 | N/A | 11/15/09 | N/A | 12/15/09 | N/A |

| 9/15/08 | 23,495 | 3/12/08 | N/A | 10/15/08 | N/A | 11/15/08 | N/A | 12/15/08 | N/A | 1/15/09 | N/A | 2/15/09 | N/A | 3/15/09 | N/A | 4/15/09 | N/A | 5/15/09 | N/A | 6/15/09 | N/A | 7/15/09 | N/A | 8/15/09 | N/A | 9/15/09 | N/A | 10/15/09 | N/A | 11/15/09 | N/A | 12/15/09 | N/A |

| 9/15/08 | 23,495 | 3/12/08 | N/A | 10/15/08 | N/A | 11/15/08 | N/A | 12/15/08 | N/A | 1/15/09 | N/A | 2/15/09 | N/A | 3/15/09 | N/A | 4/15/09 | N/A | 5/15/09 | N/A | 6/15/09 | N/A | 7/15/09 | N/A | 8/15/09 | N/A | 9/15/09 | N/A | 10/15/09 | N/A | 11/15/09 | N/A | 12/15/09 | N/A |
Liquidity Swap Lines
The USD swap lines are bilateral agreements between the Fed and foreign central banks. They allow foreign central banks to exchange domestic currency for US dollars. The Fed currently maintains swap line agreements with 14 central banks.

Money Market Mutual Fund Liquidity Facility
The MMLF allows the Fed to fund the purchase of money market mutual fund assets. The program is established under section 13(3) of the Federal Reserve Act. The Fed reported that the U.S. Treasury, to date, has provided credit protection of $1.5 billion to the Money Market Mutual Fund Liquidity Facility.

Discount Window
The DW is a standing facility that allows the Fed to provide collateralized loans to depository institutions.

Primary Dealer Credit Facility
The PDCF allows the Fed to extend collateralized loans to primary dealers. The facility was established under section 13(3).

Paycheck Protection Program Liquidity Facility
The PPPLF allows the Fed to provide financial institutions with liquidity backed by loans to small and medium-sized businesses extended under the federal government’s Paycheck Protection Program and guaranteed by the Small Business Administration. The Program was established under section 13(3).

Commercial Paper Funding Facility
The CPFF provides a liquidity backstop to issuers of commercial paper and was also established under section 13(3). It is operated by the FRBNY through a special purpose vehicle, the Commercial Paper Funding Facility II LLC (CPFF LLC). The Treasury has made an equity investment of $10 billion in CPFF LLC.

Primary and Secondary Market Corporate Credit Facilities
The PMCCF and SMCCF were set up under section 13(3) to support credit to employers through purchases of newly issued bonds and support market liquidity for outstanding corporate bonds. These facilities operate through a special purpose vehicle, the Corporate Credit Facilities LLC (CCF LLC). The Treasury has made an equity investment of $37.5 billion in CCF LLC.

Municipal Liquidity Facility
The MLF provides liquidity to states, counties and cities. The facility was set up to purchase up to $500 billion of short-term notes and was established under section 13(3). The Treasury has made an equity investment of $17.5 billion in MLF LLC.
Main Street Lending Programs

The **MSF** is established under section 13(3) to provide loans to SMEs. The program operates through three facilities: the Main Street New Loan Facility (MSNLF), the Main Street Priority Loan Facility (MSPLF), and the Main Street Expanded Loan Facility (MSELF). The loans are extended through a special purpose vehicle, the Main Street Facilities LLC (MSF LLC), established by the Federal Reserve Bank of Boston. The Treasury has made an equity investment of $37.5 billion in MSF LLC.

Term Asset-Backed Securities Loan Facility

The **TALF** is established under section 13(3) to provide liquidity guaranteed by asset-backed securities (ABS). Under the facility, the Federal Reserve lends to holders of certain AAA-rated ABS. The facility operates through a special purpose vehicle to extend its loans, the Term Asset-Backed Securities Loan Facility II LLC (TALF II LLC). The Treasury has made an equity investment of $10 billion in TALF II LLC.
Since last week, the BOE has ceased its use of the swap lines. The use of PDCF and MMLF has declined, and the PPPLF now represents 63 percent of the total amount outstanding.

As of July 22, the Fed’s liquidity programs had $108.3 billion in outstanding loans, slightly down from $109.1 billion last week.

Figure 1 below shows the outstanding amount of each facility, not including Treasury contributions that are invested in securities rather than loans to market participants. Earlier versions of this report (link) included Treasury contributions that the Fed had not yet invested.

Fed officials have noted the relatively low usage of Fed programs compared to similar programs during the Global Financial Crisis of 2007-09. Recent Fed research shows that simply announcing the facilities helped restore market confidence this time. Establishing the lending facilities “boost[ed] confidence to the point where borrowers are able to access credit from the private market at affordable rates,” said John C. Williams, President of the Federal Reserve Bank of New York.

On July 23, the New York Fed announced that it is looking to expand its counterparties and agents for the CPFF, SMCCF, and TALF. It said it expects the larger cohort of counterparties and agents will increase the Bank’s operational capacity and the accessibility of these facilities.

Note on Treasury Contributions to Federal Reserve Programs

The Treasury announced on April 9 that it intended to use funds available under the CARES Act to purchase equity in special purpose vehicles established under Fed lending programs.

In total, the Treasury has invested $114 billion in six facilities, as of July 22. Per the facility agreements, 85% of the equity contributions to the CCF, CPFF, MLF, MSF, and TALF have been invested in nonmarketable Treasury securities: $31.9 billion for the CCF, $8.5 billion for the CPFF, $14.9 billion for the MLF, $14.9 billion for the MSF, and $8.5 billion for TALF.

Note on Federal Reserve Swap Lines

Over the past month, central banks continued to reduce their use of the Fed’s USD swap lines. The reduction is partially due to the expiration of 84-day swaps entered during the early weeks of the crisis. Auctions for these swaps were conducted weekly. As these contracts are reaching maturity, the total outstanding amount declined to 26 percent of its peak on May 27. As of July 15, the total amount still outstanding is $118 billion, down from $128 billion last week.
The BOE reduced its outstanding amount by $395 million and it no longer has outstanding USD swaps with the Fed. At $90 billion outstanding, the BoJ’s share now represents 76 percent of the total. The ECB stands at $14 billion; together the two hold 88 percent.

The following figures show the usage of Fed programs during the COVID-19 crisis. They also show data for similar programs during the Global Financial Crisis of 2007-09 (GFC), where applicable. The new graphs also indicate how soon each program was launched relative to the
start date of recessions (February 1, 2020, for COVID, December 1, 2007 for GFC). The actual take-up of these facilities has been relatively low compared to the take-up of similar facilities during the GFC.

Liquidity Swap Lines

The USD swap lines are bilateral agreements between the Fed and foreign central banks. They allow foreign central banks to exchange domestic currency for US dollars. The Fed currently maintains swap line agreements with 14 central banks.

Money Market Mutual Fund Liquidity Facility

The MMLF allows the Fed to fund the purchase of money market mutual fund assets. The program is established under section 13(3) of the Federal Reserve Act. The Fed reported that the U.S. Treasury, to date, has provided credit protection of $1.5 billion to the Money Market Mutual Fund Liquidity Facility. The facility had $17.5 billion in outstanding loans on July 22.
Discount Window

The Discount Window (DW) is a standing facility that allows the Fed to provide collateralized loans to depository institutions. It had $4.6 billion in outstanding loans on July 22.

Note: (a) The start date for the graph “MMLF in COVID-19 crisis” is February 1, 2020 and the start date for the graph “AMLF in GFC” is December 1, 2007. (b) The green dotted line in the graph “MMLF in COVID-19 crisis” indicates March 23, 2020, the launch date of the program. (c) The green dotted line in the graph “AMLF in GFC” indicates September 19, 2008, the announcement date of the program. (d) Includes author’s estimate for MMLF data prior to June 18, 2020.

Sources: FRBNY, Federal Reserve Board
Primary Dealer Credit Facility

The Primary Dealer Credit Facility (PDCF) allows the Fed to extend collateralized loans to primary dealers. The facility was established under section 13(3). The facility had $1.9 billion in outstanding loans on July 22.
Paycheck Protection Program Liquidity Facility

The PPPLF allows the Fed to provide financial institutions with liquidity backed by loans to small and medium-sized businesses extended under the federal government’s Paycheck Protection Program and guaranteed by the Small Business Administration. The Program was established under section 13(3). The facility had $68.5 billion in outstanding loans on July 22.

![PPPLF in COVID-19 crisis](image)

Note: (a) The start date for the graph is February 1, 2020. (b) The green dotted line in the graph indicates April 16, 2020, the launch date of the program.
Sources: FRBNY, Federal Reserve Board

Commercial Paper Funding Facility

The CPFF provides a liquidity backstop to issuers of commercial paper and was also established under section 13(3). It is operated by the FRBNY through a special purpose vehicle, the Commercial Paper Funding Facility II LLC (CPFF LLC). The Treasury has made an equity investment of $10 billion in CPFF LLC. The facility had $1.5 billion in outstanding loans on July 22.

![CPFF in COVID-19 crisis](image)

Note: (a) The start date for the graph “CPFF in COVID-19 crisis” is February 1, 2020 and the start date for the graph “CPFF in GFC” is December 1, 2007. (b) The green dotted line in the graph “CPFF in COVID-19 crisis” indicates April 14, 2020, the launch date of the program. (c) The green dotted line in the graph “CPFF in GFC” indicates October 27, 2008, the date commercial paper purchases began. (d) “CPFF in COVID-19 crisis” includes author’s estimate for data prior to June 18, 2020.
Sources: FRBNY, Federal Reserve Board
Primary and Secondary Market Corporate Credit Facilities

The PMCCF and SMCCF were set up under section 13(3) to support credit to employers through purchases of newly issued bonds and support market liquidity for outstanding corporate bonds. These facilities operate through a special purpose vehicle, the Corporate Credit Facilities LLC (CCF LLC). The Treasury has made an equity investment of $37.5 billion in CCF LLC. The facilities had $12.1 billion in outstanding loans on July 22.

Municipal Liquidity Facility

The MLF provides liquidity to states, counties and cities. The facility was set up to purchase up to $500 billion of short-term notes and was established under section 13(3). The Treasury has made an equity investment of $17.5 billion in MLF LLC. The facility had $1.2 billion in outstanding loans on July 22.

Main Street Lending Programs

The MSF is established under section 13(3) to provide loans to SMEs. The program operates through three facilities: the Main Street New Loan Facility (MSNLF), the Main Street Priority Loan Facility (MSPLF), and the Main Street Expanded Loan Facility (MSELF). The loans are extended through a special purpose vehicle, the Main Street Facilities LLC (MSF LLC),
established by the Federal Reserve Bank of Boston. The Treasury has made an equity investment of $37.5 billion in MSF LLC. The facility had $14 million in outstanding loans on July 22.

**Term Asset-Backed Securities Loan Facility**

The TALF is established under section 13(3) to provide liquidity guaranteed by asset-backed securities (ABS). Under the facility, the Federal Reserve lends to holders of certain AAA-rated ABS. The facility operates through a special purpose vehicle to extend its loans, the Term Asset-Backed Securities Loan Facility II LLC (TALF II LLC). The Treasury has made an equity investment of $10 billion in TALF II LLC. The facility had $937 million in outstanding loans on July 22.
Original post [here](#).

Since last week, the Reserve Bank of Australia and Bank of Korea have ceased their use of the Fed’s swap lines. The use of lending facilities has declined to $98.4 billion.

As of August 26, the Fed’s liquidity programs had $98.5 billion in outstanding loans. The outstanding has decreased by approximately 6.5% compared to the end of July (see the post [here](#)).

Figure 1 below shows the outstanding amount of each facility, not including Treasury contributions that are invested in securities rather than loans to market participants.

On July 29, the Federal Reserve announced the extensions of its temporary U.S. dollar liquidity swap lines and the temporary repurchase agreement facility for foreign and international monetary authorities (FIMA repo facility). Now, these facilities are set to expire on March 31, 2021 (see our blog post [here](#)). These deadline extensions follow the extensions of other lending programs to December 31, as announced on July 28. The Fed had previously extended the termination date for the Municipal Lending Facility in April.

**Note on Treasury Contributions to Federal Reserve Programs**

The Treasury announced on April 9 that it intended to use funds available under the CARES Act to purchase equity in special purpose vehicles established under Fed lending programs.

In total, the Treasury has invested $114 billion in six facilities, as of August 26, unchanged from July 22. Per the facility agreements, 85% of the equity contributions to the CCF, CPFF, MLF, MSF, and TALF have been invested in nonmarketable Treasury securities: $31.9 billion for the CCF, $8.5 billion for the CPFF, $14.9 billion for the MLF, $14.9 billion for the MSF, and $8.5 billion for TALF.

**Note on the Municipal Lending Facility**

According to Bloomberg, the Fed purchased $451 million of notes sold by New York’s Metropolitan Transportation Authority (MTA), charging an interest rate of 1.92%. This purchase increased the outstanding MLF loans from $1.20 billion to $1.65 billion. MTA was second to tap the MLF after the state of Illinois. This was also the first purchase after the Fed’s announcement (see our related blogpost [here](#)) to lower pricing for the MLF.

**Note on Federal Reserve Swap Lines**

Over the past month, central banks continued to reduce their use of the Fed’s USD swap lines. The reduction is partially due to the expiration of 84-day swaps entered during the early weeks of the crisis. Auctions for these swaps were conducted weekly. As these contracts are reaching
maturity, the total outstanding amount declined. As of August 26, the total amount still outstanding is $89 billion, down by 24.7 percent since the end of July.

Over the past month, the Reserve bank of Australia and Bank of Korea reduced their outstanding amount, and these two central banks no longer has outstanding USD swaps with the Fed. At $89 billion outstanding, the BoJ’s share now represents 81.7% of the total.

BOE, BOJ, ECB, and the Swiss National Bank, in consultation with the Federal Reserve, have jointly decided to further reduce the frequency of their 7-day operations from three times per week to once per week (BOE’s press release here). This reflects the low demand for recent 7-day maturity US dollar liquidity providing operations.

On August 19, ECB published at blog post analyzing the use of swap lines, explaining how swap lines improved market sentiment and contributed to reduce the cost of dollar funding.
The following figures show the usage of Fed programs during the COVID-19 crisis. They also show data for similar programs during the Global Financial Crisis of 2007-09 (GFC), where applicable. The new graphs also indicate how soon each program was launched relative to the start date of recessions (February 1, 2020, for COVID, and December 1, 2007 for GFC). The actual take-up of these facilities has been relatively low compared to the take-up of similar facilities during the GFC.
For a more detailed comparison of Fed programs during the GFC and the COVID-19, see our Key Program Summaries.

Liquidity Swap Lines

The USD swap lines are bilateral agreements between the Fed and foreign central banks. They allow foreign central banks to exchange domestic currency for US dollars. The Fed currently maintains swap line agreements with 14 central banks.

Money Market Mutual Fund Liquidity Facility

The MMLF allows the Fed to fund the purchase of money market mutual fund assets. The program is established under section 13(3) of the Federal Reserve Act. The Fed reported that the U.S. Treasury, to date, has provided credit protection of $1.5 billion to the Money Market Mutual Fund Liquidity Facility. The facility had $10.0 billion in outstanding loans on August 26. It is similar to the Asset-Backed Commercial Paper Liquidity Money Market Mutual Fund Liquidity Facility (AMLF) that the Fed launched during the GFC. The AMLF funded the purchase of ABCP from MMFs. In comparison, the MMLF is authorized to purchase a broader range of collateral.

Note: (a) The start date for the graph “Swapline in COVID-19” is February 1, 2020 and the start date for the graph “Swapline in GFC” is December 1, 2007. (b) The green dotted line in the graph “Swapline in GFC” indicates December 12, 2007, the date when the FOMC authorized temporary dollar liquidity swap arrangements with foreign central banks.
Sources: H.4.1, weekly release, FRBNY, Federal Reserve Board
Discount Window

The **Discount Window (DW)** is a standing facility that allows the Fed to provide collateralized loans to depository institutions. It had $2.7 billion in outstanding loans on August 26.
Primary Dealer Credit Facility

The Primary Dealer Credit Facility (PDCF) allows the Fed to extend collateralized loans to primary dealers. The facility was established under section 13(3). The facility had $243 million in outstanding loans on August 26.
Paycheck Protection Program Liquidity Facility

The PPPLF allows the Fed to provide financial institutions with liquidity backed by loans to small and medium-sized businesses extended under the federal government’s Paycheck Protection Program and guaranteed by the Small Business Administration. The Program was established under section 13(3). The facility had $68.2 billion in outstanding loans on August 26.

Commercial Paper Funding Facility

The CPFF provides a liquidity backstop to issuers of commercial paper and was also established under section 13(3). It is operated by the FRBNY through a special purpose vehicle, the Commercial Paper Funding Facility II LLC (CPFF LLC). The Treasury has made an equity
investment of $10 billion in CPFF LLC. The facility had $30 million in outstanding loans on August 26.

Primary and Secondary Market Corporate Credit Facilities

The **PMCCF** and **SMCCF** were set up under section 13(3) to support credit to employers through purchases of newly issued bonds and support market liquidity for outstanding corporate bonds. These facilities operate through a special purpose vehicle, the Corporate Credit Facilities LLC (CCF LLC). The Treasury has made an equity investment of $37.5 billion in CCF LLC. The facilities had $12.6 billion in outstanding loans on August 26.

Municipal Liquidity Facility
The MLF provides liquidity to states, counties and cities. The facility was set up to purchase up to $500 billion of short-term notes and was established under section 13(3). The Treasury has made an equity investment of $17.5 billion in MLF LLC. The facility had $1.7 billion in outstanding loans on August 26.

Main Street Lending Programs

The MSF is established under section 13(3) to provide loans to SMEs. The program operates through three facilities: the Main Street New Loan Facility (MSNLF), the Main Street Priority Loan Facility (MSPLF), and the Main Street Expanded Loan Facility (MSELF). The loans are extended through a special purpose vehicle, the Main Street Facilities LLC (MSF LLC), established by the Federal Reserve Bank of Boston. The Treasury has made an equity investment of $37.5 billion in MSF LLC. The facility had $855 million in outstanding loans on August 26.

Term Asset-Backed Securities Loan Facility

The TALF is established under section 13(3) to provide liquidity guaranteed by asset-backed securities (ABS). Under the facility, the Federal Reserve lends to holders of certain AAA-rated ABS. The facility operates through a special purpose vehicle to extend its loans, the Term Asset-Backed Securities Loan Facility II LLC (TALF II LLC). The Treasury has made an equity
investment of $10 billion in TALF II LLC. The facility had $2.3 billion in outstanding loans on August 26.

Summary Table from our **Key Program Summaries**

<table>
<thead>
<tr>
<th></th>
<th>GFC</th>
<th>COVID-19</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Who</strong></td>
<td><strong>GFC</strong></td>
<td><strong>COVID-19</strong></td>
</tr>
<tr>
<td>Financial Institute</td>
<td>Discount Window (DWF) *Not 10(3)</td>
<td>Discount Window (DWF) *Not 10(3)</td>
</tr>
<tr>
<td></td>
<td>Primary Dealer Credit Facility (PDCF)</td>
<td>Primary Dealer Credit Facility (PDCF)</td>
</tr>
<tr>
<td></td>
<td>Term Auction Facility (TAF) *Not 10(3)</td>
<td>Term Auction Facility (TAF) *Not 10(3)</td>
</tr>
<tr>
<td></td>
<td>Term Securities Lending Facility (TSLF)</td>
<td>Term Securities Lending Facility (TSLF)</td>
</tr>
<tr>
<td></td>
<td>Bridge-to-Term Repo Agreement (BTTA)</td>
<td>Bridge-to-Term Repo Agreement (BTTA)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$2,007</td>
<td>No stated limit</td>
</tr>
<tr>
<td>Businesses</td>
<td>Commercial Paper Funding Facility (CPF)</td>
<td>Commercial Paper Funding Facility (CPF)</td>
</tr>
<tr>
<td></td>
<td>Term Asset-Backed Securities Loan Facility (TALF)</td>
<td>Term Asset-Backed Securities Loan Facility (TALF)</td>
</tr>
<tr>
<td></td>
<td>Money Market Mutual Fund Liquidity Facility (MMFLF)</td>
<td>Money Market Mutual Fund Liquidity Facility (MMFLF)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$1,300</td>
<td>No stated limit</td>
</tr>
<tr>
<td>Money Markets</td>
<td>Asset-Backed Commercial Paper Funding Facility (CPFP)</td>
<td>Asset-Backed Commercial Paper Funding Facility (CPFP)</td>
</tr>
<tr>
<td></td>
<td>Money Market Investor Funding Facility (MMIF)</td>
<td>Money Market Investor Funding Facility (MMIF)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$1,302</td>
<td>No stated limit</td>
</tr>
<tr>
<td>States and Municipalities</td>
<td>Municipal Liquidity Facility (MLF)</td>
<td>Municipal Liquidity Facility (MLF)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$0</td>
<td>No stated limit</td>
</tr>
<tr>
<td>Small Businesses</td>
<td>Paycheck Protection Program (PPP)</td>
<td>Paycheck Protection Program (PPP)</td>
</tr>
<tr>
<td></td>
<td>Paycheck Protection Program (PPP)</td>
<td>Paycheck Protection Program (PPP)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$0</td>
<td>No stated limit</td>
</tr>
<tr>
<td>Medium Businesses</td>
<td>Main Street Lending Program (MSLP)</td>
<td>Main Street Lending Program (MSLP)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$0</td>
<td>No stated limit</td>
</tr>
<tr>
<td>Foreign Countries</td>
<td>Central Bank Liquidity Swap (CBSL) *Not 10(3)</td>
<td>Central Bank Liquidity Swap (CBSL) *Not 10(3)</td>
</tr>
<tr>
<td></td>
<td>Temporary Repo Facility Agreement with Foreign and International Monetary Authorities (FMIA) *Not 10(3)</td>
<td>Temporary Repo Facility Agreement with Foreign and International Monetary Authorities (FMIA) *Not 10(3)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$0</td>
<td>No stated limit</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$3,382</td>
<td>$2,069</td>
</tr>
</tbody>
</table>

*Note: Excludes programs with no stated limit.
The use of lending facilities has declined to $97.4 billion. The use of swaps also continued to decline, and is now at 7% of the peak amount.

As of September 23, the Fed’s liquidity programs had $97.4 billion in outstanding loans. The total outstanding has not changed much compared to $98.4 billion, the outstanding amount at the end of August, the last time we reported the usage (see the post here).

Figure 1 below shows the outstanding amount of each facility, not including Treasury contributions that are invested in securities rather than loans to market participants.

Note on Treasury Contributions to Federal Reserve Programs

The Treasury announced on April 9 that it intended to use funds available under the CARES Act to purchase equity in special purpose vehicles established under Fed lending programs.

In total, the Treasury has invested $114 billion in six facilities as of September 23, which is unchanged since the August report. Per the facility agreements, 85% of the equity contributions to the CCF, CPFF, MLF, MSF, and TALF have been invested in nonmarketable Treasury securities: $31.9 billion for the CCF, $8.5 billion for the CPFF, $14.9 billion for the MLF, $14.9 billion for the MSF, and $8.5 billion for TALF.

At the congressional hearing, Treasury Secretary Steven Mnuchin and Jerome H. Powell, Chair of the Federal Reserve, reconfirmed their commitment to provide support to households and businesses. Meanwhile, Mnuchin noted there were limits to what could be done with the existing lending facilities and said that he would like to see legislation that would “reallocate that money to better use.”

Note on the Commercial Paper Funding Facility (CPFF) and Secondary Market Corporate Credit Facility (SMCCF)

On September 9, the Federal Reserve Bank of New York (NY Fed) announced the first wave of additional counterparties for CPFF and SMCCF. This follows the statement in July, which announced an initiative to expand the set of counterparties for CPFF, SMCCF, and the TALF.

According to the NY Fed’s press release, by widening the eligibility criteria for counterparties, it intends to further “its commitment to support diversity, inclusion, and opportunity as we increase these facilities’ operational capacity and reach.” On September 10, Daleep Singh, executive vice president of the NY Fed, emphasized the NY Fed’s effort in expanding the vendors and the counterparties for the lending facilities.

Note on Federal Reserve Swap Lines
Over the past month, central banks continued to reduce their use of the Fed’s USD swap lines. The reduction is partially due to the expiration of 84-day swaps entered during the early weeks of the crisis. Auctions for these swaps were conducted weekly. As these contracts are reaching maturity, the total outstanding amount declined. As of September 23, the total amount still outstanding is $31 billion. Compared to the peak on May 27, this is a 93% drop, reflecting the low demand of the swap lines these days.

Figure 1: Use of Federal Reserve Lending Facilities
not including uninvested Treasury contributions

Figure 2: Use of USD Liquidity Swap Line

Note: Includes author’s estimate for data prior to June 18, 2020.
Source: H.4.1. weekly release, FRBNY, Federal Reserve Board

Note: Data available after March 2, 2020.
Source: H.4.1. weekly release, FRBNY, Federal Reserve Board
The following figures show the usage of Fed programs during the COVID-19 crisis. They also show data for similar programs during the Global Financial Crisis of 2007-09 (GFC), where applicable. The new graphs also indicate how soon each program was launched relative to the start date of recessions (February 1, 2020, for COVID, and December 1, 2007 for GFC). The actual take-up of these facilities has been relatively low compared to the take-up of similar facilities during the GFC.

For a more detailed comparison of Fed programs during the GFC and the COVID-19, see our Key Program Summaries.

**Liquidity Swap Lines**

The USD swap lines are bilateral agreements between the Fed and foreign central banks. They allow foreign central banks to exchange domestic currency for US dollars. The Fed currently maintains swap line agreements with 14 central banks.

**Money Market Mutual Fund Liquidity Facility**

The MMLF allows the Fed to fund the purchase of money market mutual fund assets. The program is established under section 13(3) of the Federal Reserve Act. The Fed reported that the U.S. Treasury, to date, has provided credit protection of $1.5 billion to the Money Market Mutual Fund Liquidity Facility. The facility had $7,377 million in outstanding loans on September 23. It is similar to the Asset-Backed Commercial Paper Liquidity Money Market Mutual Fund Liquidity Facility (AMLF) that the Fed launched during the GFC. The AMLF
funded the purchase of ABCP from MMFs. In comparison, the MMLF is authorized to purchase a broader range of collateral.

Discount Window

The DW is a standing facility that allows the Fed to provide collateralized loans to depository institutions. It had $3,359 million in outstanding loans on September 23.
**Primary Dealer Credit Facility**

The [PDCF](#) allows the Fed to extend collateralized loans to primary dealers. The facility was established under section 13(3). The facility had $233 million in outstanding loans on September 23.
Paycheck Protection Program Liquidity Facility

The PPPLF allows the Fed to provide financial institutions with liquidity backed by loans to small and medium-sized businesses extended under the federal government’s Paycheck Protection Program and guaranteed by the Small Business Administration. The Program was established under section 13(3). The facility had $67.1 billion in outstanding loans on September 23.

Commercial Paper Funding Facility

The CPFF provides a liquidity backstop to issuers of commercial paper and was also established under section 13(3). It is operated by the FRBNY through a special purpose vehicle, the Commercial Paper Funding Facility II LLC (CPFF LLC). The Treasury has made an equity investment of $10 billion in CPFF LLC. The facility had $30 million in outstanding loans on September 23.
Primary and Secondary Market Corporate Credit Facilities

The PMCCF and SMCCF were set up under section 13(3) to support credit to employers through purchases of newly issued bonds and support market liquidity for outstanding corporate bonds. These facilities operate through a special purpose vehicle, the Corporate Credit Facilities LLC (CCF LLC). The Treasury has made an equity investment of $37.5 billion in CCF LLC. The SMCCF had $12.9 billion in outstanding loans on September 23. The PMCCF has not extended any loans to date.

Municipal Liquidity Facility
The MLF provides liquidity to states, counties and cities. The facility was set up to purchase up to $500 billion of short-term notes and was established under section 13(3). The Treasury has made an equity investment of $17.5 billion in MLF LLC. The facility had $1,651 million in outstanding loans on September 23.

Main Street Lending Programs

The MSF is established under section 13(3) to provide loans to SMEs. The program operates through three facilities: the Main Street New Loan Facility (MSNLF), the Main Street Priority Loan Facility (MSPLF), and the Main Street Expanded Loan Facility (MSELF). The loans are extended through a special purpose vehicle, the Main Street Facilities LLC (MSF LLC), established by the Federal Reserve Bank of Boston. The Treasury has made an equity investment of $37.5 billion in MSF LLC. The facility had $1,837 million in outstanding loans on September 23.

Term Asset-Backed Securities Loan Facility

The TALF is established under section 13(3) to provide liquidity guaranteed by asset-backed securities (ABS). Under the facility, the Federal Reserve lends to holders of certain AAA-rated ABS. The facility operates through a special purpose vehicle to extend its loans, the Term Asset-Backed Securities Loan Facility II LLC (TALF II LLC). The Treasury has made an equity
investment of $10 billion in TALF II LLC. The facility had $2,896 million in outstanding loans on September 23.

Note: (a) The start date for the graph “TALF in COVID-19 crisis” is February 1, 2020 and the start date for the graph “TALF in GFC” is December 1, 2007. (b) The green dotted line in the graph “TALF in COVID-19 crisis” indicates June 17, 2020, the launch date of the program. (c) The green dotted line in the graph “TALF in GFC” indicates March 1, 2008, the date lending operation began. (d) “TALF in COVID-19 crisis” includes author’s estimate for data prior to June 18, 2020.

Sources: FRBNY, Federal Reserve Board
### Summary Table from our Key Program Summaries

<table>
<thead>
<tr>
<th>Who</th>
<th>Program</th>
<th>GFC</th>
<th>Peak Size (billions)</th>
<th>Program</th>
<th>COVID-19</th>
<th>Peak Size (billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financial Institutions</strong></td>
<td>Discount Window (DW)</td>
<td>No limit</td>
<td>$111</td>
<td>Discount Window (DW)</td>
<td>No limit</td>
<td>$51</td>
</tr>
<tr>
<td></td>
<td>* Not (5)</td>
<td></td>
<td></td>
<td>* Not (5)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Primary Dealer Credit Facility (PDCF)</td>
<td>No limit</td>
<td>$147</td>
<td>Primary Dealer Credit Facility (PDCF)</td>
<td>No limit</td>
<td>$53</td>
</tr>
<tr>
<td></td>
<td>* Not (5)</td>
<td></td>
<td></td>
<td>* Not (5)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Term Auction Facility (TAF)</td>
<td>$40</td>
<td>$453</td>
<td>Term Asset-Backed Securities Loan Facility (TALF)</td>
<td>$100</td>
<td>n/a</td>
</tr>
<tr>
<td></td>
<td>* Size for only first two auctions announced</td>
<td></td>
<td></td>
<td>* Size later increased</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Term Securities Lending Facility (TSLF)</td>
<td>$200</td>
<td>$316</td>
<td>Term Asset-Backed Securities Loan Facility (TALF)</td>
<td>$100</td>
<td>n/a</td>
</tr>
<tr>
<td></td>
<td>Single-Family Term Repo Agreement (STTR)</td>
<td>$100</td>
<td>$500</td>
<td>Primary Market Corporate Credit Facility (PMCCF)</td>
<td>$500</td>
<td>n/a</td>
</tr>
<tr>
<td></td>
<td>* Two facilities with no stated limit, one facility with unaccepted future auction</td>
<td></td>
<td></td>
<td>Secondary Market Corporate Credit Facility (SMCCF)</td>
<td>$250</td>
<td>n/a</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$240</td>
<td>$3,168</td>
<td>* One facility with no stated limit</td>
<td></td>
<td>$64</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>* One facility with no stated limit</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Businesses</strong></td>
<td>Commercial Paper Funding Facility (CPFF)</td>
<td>No limit</td>
<td>$343</td>
<td>Commercial Paper Funding Facility (CPFF)</td>
<td>No limit</td>
<td>$4</td>
</tr>
<tr>
<td></td>
<td>* Market size $1.6 trillion at announcement</td>
<td></td>
<td></td>
<td>* Market size $1 trillion at announcement</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Term Asset-Backed Securities Loan Facility (TALF)</td>
<td>$200</td>
<td>$465</td>
<td>Term Asset-Backed Securities Loan Facility (TALF)</td>
<td>$100</td>
<td>n/a</td>
</tr>
<tr>
<td></td>
<td>* Size later increased</td>
<td></td>
<td></td>
<td>Secondary Market Corporate Credit Facility (SMCCF)</td>
<td>$250</td>
<td>n/a</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$200</td>
<td>$385</td>
<td>* One facility with no stated limit</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>* One facility with no stated limit</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Money Markets</strong></td>
<td>Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF)</td>
<td>No limit</td>
<td>$152</td>
<td>Money Market Mutual Fund Liquidity Facility (MMF)</td>
<td>No limit</td>
<td>$53</td>
</tr>
<tr>
<td></td>
<td>* Market size $42.4 trillion at announcement</td>
<td></td>
<td></td>
<td>* Market size $5.8 trillion at announcement</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Money Market Investor Funding Facility (MMIF)</td>
<td>No limit</td>
<td>$0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>$152</td>
<td>$53</td>
<td>* Total markups $3.4 billion at announcement</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>States and Municipalities</strong></td>
<td>Municipal Liquidity Facility (MLF)</td>
<td>No limit</td>
<td>$50</td>
<td></td>
<td></td>
<td>$0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>$152</td>
<td>$53</td>
<td></td>
<td></td>
<td>$0</td>
</tr>
<tr>
<td><strong>Small Businesses</strong></td>
<td>Paycheck Protection Program Liquidity Facility (PPLF)</td>
<td>No limit</td>
<td>$61</td>
<td>* Amount authorized under Congressional allocations</td>
<td></td>
<td>$41</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>$61</td>
<td>$41</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Medium Businesses</strong></td>
<td>Bank Support Program (MLP)</td>
<td>$25</td>
<td>$25</td>
<td></td>
<td></td>
<td>$41</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>$25</td>
<td>$41</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Foreign Countries</strong></td>
<td>Central Bank Liquidity Swap Lines (CDSL)</td>
<td>$24</td>
<td>$589</td>
<td>Central Bank Liquidity Swap Lines (CDSL)</td>
<td>$24</td>
<td>$41</td>
</tr>
<tr>
<td></td>
<td>* Only for only ECB and GFS announced</td>
<td></td>
<td></td>
<td>* Temporary Haircuts on Foreign and International Monetary Authorities (FIMA)</td>
<td>$1</td>
<td>$1</td>
</tr>
<tr>
<td></td>
<td>initially $3.4 billion at announcement</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>$24</td>
<td>$589</td>
<td></td>
<td></td>
<td>$41</td>
</tr>
<tr>
<td><strong>Support to a Specific Company</strong></td>
<td>Bear Stearns/Morgan (Makenzie)</td>
<td>$25</td>
<td>$25</td>
<td></td>
<td></td>
<td>$0</td>
</tr>
<tr>
<td></td>
<td>AIG (Revolving Credit Facility)</td>
<td>$32</td>
<td>$32</td>
<td></td>
<td></td>
<td>$0</td>
</tr>
<tr>
<td></td>
<td>AIG (Master Line 1)</td>
<td>$20</td>
<td>$20</td>
<td></td>
<td></td>
<td>$0</td>
</tr>
<tr>
<td></td>
<td>AIG Securities Borrowing Facility</td>
<td>$36</td>
<td>$36</td>
<td></td>
<td></td>
<td>$0</td>
</tr>
<tr>
<td></td>
<td>AIG (Master Line II)</td>
<td>$24</td>
<td>$24</td>
<td></td>
<td></td>
<td>$0</td>
</tr>
<tr>
<td></td>
<td>AIG IL&amp;I Aurora</td>
<td>$25</td>
<td>$25</td>
<td></td>
<td></td>
<td>$0</td>
</tr>
<tr>
<td></td>
<td>CitiGroup</td>
<td>$24</td>
<td>$24</td>
<td></td>
<td></td>
<td>$0</td>
</tr>
<tr>
<td></td>
<td>Bank of America</td>
<td>$30</td>
<td>$30</td>
<td></td>
<td></td>
<td>$0</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$151</td>
<td>$151</td>
<td></td>
<td></td>
<td>$0</td>
</tr>
<tr>
<td><strong>Grand Total</strong></td>
<td></td>
<td>$2,352</td>
<td>$2,352</td>
<td></td>
<td></td>
<td>$629</td>
</tr>
<tr>
<td></td>
<td>* Total excludes programs with no stated limit</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
October 22
By Junko Oguri

Original post here.

The use of lending facilities has declined to $97.4 billion. The use of swaps also continued to decline, and is now at 7% of the peak amount.

As of October 22, the Fed’s liquidity programs had $94.7 billion in outstanding loans. The total outstanding has not changed much compared to $97.4 billion, the outstanding amount at September, the last time we reported the usage (see the post here).

Figure 1 below shows the outstanding amount of each facility, not including Treasury contributions that are invested in securities rather than loans to market participants.

Note on Treasury Contributions to Federal Reserve Programs

The Treasury announced on April 9 that it intended to use funds available under the CARES Act to purchase equity in special purpose vehicles established under Fed lending programs.

In total, the Treasury has invested $114 billion in six facilities, as of September 23, which is unchanged since the August report. Per the facility agreements, 85% of the equity contributions to the CCF, CPFF, MLF, MSF, and TALF have been invested in nonmarketable Treasury securities: $31.9 billion for the CCF, $8.5 billion for the CPFF, $14.9 billion for the MLF, $14.9 billion for the MSF, and $8.5 billion for TALF.

Note on the Commercial Paper Funding Facility (CPFF) and Secondary Market Corporate Credit Facility (SMCCF)

On October 19 and 23, the Federal Reserve Bank of New York (NY Fed) announced additional counterparties for CPFF and SMCCF, in addition to the agency commercial mortgage-backed securities (agency CMBS) purchases. This follows the statement in July, which announced an initiative to expand the set of counterparties for CPFF, SMCCF, and the TALF. The NY Fed explained that the newly added firms represent a diverse range of market participants, including Minority, Women, and Veteran Business Enterprises (MWVBES).

The additional commercial paper dealers for the CPFF are:

- Academy Securities, Inc. (announced on October 19)
- CastleOak Securities, L.P. (announced on October 19)
- MUFG Securities Americas Inc. (announced on October 23)

The additional eligible sellers for the SMCCF are:

- FHN Financial Securities Corp.
• Flow Traders U.S. Institutional Trading LLC
• Guzman & Company
• Imperial Capital, LLC
• Mischler Financial Group, Inc.
• MUFG Securities Americas Inc.
• Samuel A. Ramirez & Co., Inc.
  (all firms announced on October 23)

*Note on Federal Reserve Swap Lines*

Over the past month, central banks continued to reduce their use of the Fed’s USD swap lines. The reduction is partially due to the expiration of 84-day swaps entered during the early weeks of the crisis. Auctions for these swaps were conducted weekly. As these contracts are reaching maturity, the total outstanding amount declined. As of October 21, the total amount still outstanding is $6,799 million. Compared to the peak on May 27, this is a 98% drop, reflecting the low demand of the swap lines these days.
For further details on the use of Federal Reserve Programs, please refer to the Fed’s monthly report to Congress.

The following figures show the usage of Fed programs during the COVID-19 crisis. They also show data for similar programs during the Global Financial Crisis of 2007–09 (GFC), where applicable. The graphs also indicate how soon each program was launched relative to the start date of recessions (February 1, 2020, for COVID, and December 1, 2007 for GFC). The actual take-up of these facilities has been relatively low compared to the take-up of similar facilities during the GFC.
For a more detailed comparison of Fed programs during the GFC and the COVID-19, see our Key Program Summaries.

**Liquidity Swap Lines**

The USD swap lines are bilateral agreements between the Fed and foreign central banks. They allow foreign central banks to exchange domestic currency for US dollars. The Fed currently maintains swap line agreements with 14 central banks.

Money Market Mutual Fund Liquidity Facility

The MMLF allows the Fed to fund the purchase of money market mutual fund assets. The program is established under section 13(3) of the Federal Reserve Act. The Fed reported that the U.S. Treasury, to date, has provided credit protection of $1.5 billion to the Money Market Mutual Fund Liquidity Facility. The facility had $5,740 million in outstanding loans on October 21. It is similar to the Asset-Backed Commercial Paper Liquidity Money Market Mutual Fund Liquidity Facility (AMLF) that the Fed launched during the GFC. The AMLF funded the purchase of ABCP from MMFs. In comparison, the MMLF is authorized to purchase a broader range of collateral.
Discount Window

The **DW** is a standing facility that allows the Fed to provide collateralized loans to depository institutions. It had $3,146 million in outstanding loans on October 21.

Primary Dealer Credit Facility

---

**Note:** (a) The start date for the graph “MMLF in COVID-19 crisis” is February 1, 2020 and the start date for the graph “AMLF in GFC” is December 1, 2007. (b) The green dotted line in the graph “MMLF in COVID-19 crisis” indicates March 23, 2020, the launch date of the program. (c) The green dotted line in the graph “AMLF in GFC” indicates September 19, 2008, the announcement date of the program. (d) Includes author’s estimate for MMLF data prior to June 18, 2020.

Sources: FRBNY, Federal Reserve Board
The **PDCF** allows the Fed to extend collateralized loans to primary dealers. The facility was established under section 13(3). The facility had $193 million in outstanding loans on October 21.

![PDCF in COVID-19 crisis](image1)

**Paycheck Protection Program Liquidity Facility**

The **PPPLF** allows the Fed to provide financial institutions with liquidity backed by loans to small and medium-sized businesses extended under the federal government’s Paycheck Protection Program and guaranteed by the Small Business Administration. The Program was established under section 13(3). The facility had $64.1 billion in outstanding loans on October 21.

![PPPLF in COVID-19 crisis](image2)

**Commercial Paper Funding Facility**
The **CPFF** provides a liquidity backstop to issuers of commercial paper and was also established under section 13(3). It is operated by the FRBNY through a special purpose vehicle, the Commercial Paper Funding Facility II LLC (CPFF LLC). The Treasury has made an equity investment of $10 billion in CPFF LLC. The facility had no outstanding loans on October 21.

---

**Primary and Secondary Market Corporate Credit Facilities**

The **PMCCF** and **SMCCF** were set up under section 13(3) to support credit to employers through purchases of newly issued bonds and support market liquidity for outstanding corporate bonds. These facilities operate through a special purpose vehicle, the Corporate Credit Facilities LLC (CCF LLC). The Treasury has made an equity investment of $37.5 billion in CCF LLC. The SMCCF had $13.3 billion in outstanding loans on October 21. The PMCCF has not extended any loans to date.
Municipal Liquidity Facility

The **MLF** provides liquidity to states, counties and cities. The facility was set up to purchase up to $500 billion of short-term notes and was established under section 13(3). The Treasury has made an equity investment of $17.5 billion in MLF LLC. The facility had $1,651 million in outstanding loans on October 21.

Main Street Lending Programs

The **MSF** is established under section 13(3) to provide loans to SMEs. The program operates through three facilities: the Main Street New Loan Facility (MSNLF), the Main Street Priority Loan Facility (MSPLF), and the Main Street Expanded Loan Facility (MSELF). The loans are extended through a special purpose vehicle, the Main Street Facilities LLC (MSF LLC), established by the Federal Reserve Bank of Boston. The Treasury has made an equity investment of $37.5 billion in MSF LLC. The facility had $3,358 million in outstanding loans on October 21.
Term Asset-Backed Securities Loan Facility

The **TALF** is established under section 13(3) to provide liquidity guaranteed by asset-backed securities (ABS). Under the facility, the Federal Reserve lends to holders of certain AAA-rated ABS. The facility operates through a special purpose vehicle to extend its loans, the Term Asset-Backed Securities Loan Facility II LLC (TALF II LLC). The Treasury has made an equity investment of $10 billion in TALF II LLC. The facility had $3,159 million in outstanding loans on October 21.
<table>
<thead>
<tr>
<th>Program</th>
<th>Initial Announcement Size (billions)</th>
<th>Peak Size (billions)</th>
<th>Program</th>
<th>Initial Announcement Size (billions)</th>
<th>Peak Size (billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discount Window (DW)</td>
<td>No limit</td>
<td>$111</td>
<td>Discount Window (DW)</td>
<td>No limit</td>
<td>$51</td>
</tr>
<tr>
<td>Term Auction Facility (TAF)</td>
<td>No limit</td>
<td>$147</td>
<td>Primary Dealer Credit Facility (PDCF)</td>
<td>No limit</td>
<td>$53</td>
</tr>
<tr>
<td>Term Securities Lending Facility (TSUF)</td>
<td>$200</td>
<td>$345</td>
<td>Term Securities Lending Facility (TSLF)</td>
<td>$200</td>
<td>$345</td>
</tr>
<tr>
<td>Term Auction Facility (TAF)</td>
<td>Size for only two auctions announced</td>
<td>$147</td>
<td>Term Auction Facility (TAF)</td>
<td>Size for only two auctions announced</td>
<td>$147</td>
</tr>
<tr>
<td>Term Securities Lending Facility (TSUF)</td>
<td>$200</td>
<td>$345</td>
<td>Term Securities Lending Facility (TSLF)</td>
<td>$200</td>
<td>$345</td>
</tr>
<tr>
<td>Total</td>
<td>$240</td>
<td>$1,087</td>
<td>No stated limit</td>
<td>$54</td>
<td></td>
</tr>
<tr>
<td>Commercial Paper Funding Facility (CPFF)</td>
<td>No limit</td>
<td>$348</td>
<td>Commercial Paper Funding Facility (CPFF)</td>
<td>No limit</td>
<td>$4</td>
</tr>
<tr>
<td>Term Asset-Backed Securities Loan Facility (TALF)</td>
<td>Size later increased</td>
<td>$348</td>
<td>Term Asset-Backed Securities Loan Facility (TALF)</td>
<td>Size later increased</td>
<td>$348</td>
</tr>
<tr>
<td>Total</td>
<td>$200</td>
<td>$1,087</td>
<td>No stated limit</td>
<td>$54</td>
<td></td>
</tr>
<tr>
<td>Money Market Mutual Fund Liquidity Facility (MMIF)</td>
<td>No limit</td>
<td>$152</td>
<td>Money Market Mutual Fund Liquidity Facility (MMIF)</td>
<td>No limit</td>
<td>$53</td>
</tr>
<tr>
<td>Money Market Inventory Funding Facility (MMIF)</td>
<td>No limit</td>
<td>$0</td>
<td>Money Market Inventory Funding Facility (MMIF)</td>
<td>No limit</td>
<td>$0</td>
</tr>
<tr>
<td>Total</td>
<td>$0</td>
<td>$152</td>
<td>No stated limit</td>
<td>$53</td>
<td></td>
</tr>
<tr>
<td>States and Municipalities</td>
<td>Municipal Liquidity Facility (MLF)</td>
<td>$600</td>
<td>Paycheck Protection Program</td>
<td>$500</td>
<td>$0</td>
</tr>
<tr>
<td>Total</td>
<td>$0</td>
<td>$600</td>
<td>Paycheck Protection Program</td>
<td>$500</td>
<td>$0</td>
</tr>
<tr>
<td>Foreign Countries</td>
<td>Central Bank Liquidity Swap Lines (CBL, SL)</td>
<td>$24</td>
<td>Central Bank Liquidity Swap Lines (CBL, SL)</td>
<td>No limit</td>
<td>$44</td>
</tr>
<tr>
<td>Support to a Specific Company</td>
<td>Bear Stearns/JP Morgan (Wiederholt, Lora)</td>
<td>$29</td>
<td>Bear Stearns/JP Morgan (Wiederholt, Lora)</td>
<td>$29</td>
<td>$29</td>
</tr>
<tr>
<td>Total</td>
<td>$24</td>
<td>$985</td>
<td>No stated limit</td>
<td>$44</td>
<td></td>
</tr>
<tr>
<td>Grand Total</td>
<td>$2,392</td>
<td>$1,087</td>
<td>No stated limit</td>
<td>$54</td>
<td></td>
</tr>
</tbody>
</table>
Original post here.

The use of lending facilities has declined to $87.1 billion. The use of swaps is now at 2% of the peak amount while a few central banks have slightly increased their use in the past few weeks.

As of December 2, the Fed’s liquidity programs had $87.1 billion in outstanding loans. The total outstanding has fallen from $94.7 billion in October, the last time we reported the usage (see the post here).

Figure 1 below shows the outstanding amount of each facility, not including Treasury contributions that are invested in Treasury securities rather than loans to market participants.

Note on the counterparties of the Commercial Paper Funding Facility (CPFF), Secondary Market Corporate Credit Facility (SMCCF), Term Asset-Backed Securities Loan Facility (TALF), and the agency commercial mortgage-backed securities purchases

On November 6 and 20, the Federal Reserve Bank of New York (NY Fed) announced additional counterparties for the CPFF, SMCCF, TALF, and the agency commercial mortgage-backed securities (agency CMBS) purchases. This follows the statement in July, which announced an initiative to expand the set of counterparties for these programs. The NY Fed explained that the newly added firms represent a diverse range of market participants, including Minority-, Women-, and Veteran-owned Business Enterprises (MWVBEs). The following dealers and sellers will be eligible in addition to those already announced on October 19 and 23.

The additional commercial paper dealer for the CPFF announced on November 6 is:

- BNY Mellon Capital Markets, LLC

The additional eligible sellers for the SMCCF announced on November 6 are:

- CastleOak Securities, L.P.
- Great Pacific Securities
- SMBC Nikko Securities America, Inc.
- U.S. Bancorp Investments, Inc.

The additional agency CMBS approved counterparties announced on November 20 are:

- Brean Capital LLC
- PNC Capital Markets LLC

The additional agent for TALF announced on November 20 is:
• Loop Capital Markets LLC

Note on Treasury Contributions to Federal Reserve Programs

On April 9, the Treasury announced that it intended to use funds available under the Coronavirus Aid, Relief, and Economic Security (CARES) Act to purchase equity in special purpose vehicles established under Fed lending programs.

In total, the Treasury has invested $114 billion—including CARES and non-CARES funds—in six facilities, as of December 2. Per the facility agreements, 85% of the equity contributions to the CCF, CPFF, MLF, MSF, and TALF have been invested in nonmarketable Treasury securities: $31.9 billion for the CCF, $8.5 billion for the CPFF, $14.9 billion for the MLF, $31.9 billion for the MSF, and $8.5 billion for TALF.

On November 19, the Treasury published a letter from Secretary Steven T. Mnuchin to Jerome Powell, Chairman of the Federal Reserve Board of Governors. The letter indicated the Treasury would not extend the programs established under the CARES Act after December 31.

The Fed’s lending facilities established under Section 13(3) can be categorized into three buckets: the PDCF and PPPLF do not have Treasury capitalization; second, the CPFF and MMLF have equity protection from the Treasury’s pre-existing ESF funds; and, third, the facilities for corporate bonds and loans, municipal bonds, and asset-backed securities (the SMCCF, PMCCF, MSLP, MLF, and TALF) have equity funding that the Treasury provided under the CARES Act. The letter’s request applies to the latter bucket.

The Fed responded on November 19 with a statement that, “the Federal Reserve would prefer that the full suite of emergency facilities established during the coronavirus pandemic continue to serve their important role as a backstop for our still-strained and vulnerable economy.” On November 20, Chair Powell confirmed the Fed would arrange to return the unused portions of the funds allocated to the CARES Act facilities with a December 31 termination.

For a discussion of these developments and the future of the Fed emergency lending facilities supported by CARES Act funds, see this YPFS blog post.

Note on the extension of Commercial Paper Funding Facility (CPFF), the Money Market Mutual Fund Liquidity Facility (MMLF), the Primary Dealer Credit Facility (PDCF), and the Paycheck Protection Program Liquidity Facility (PPPLF)

On November 30, the Fed announced that it would extend the following facilities originally scheduled to expire on (or around) December 31 this year, through March 31, 2021: the CPFF, MMLF, PDCF, and PPPLF. These four facilities do not have equity funding that the Treasury provided under the CARES Act.

Note on Federal Reserve Swap Lines
Over the past month, central banks reduced their use of the Fed’s U.S. dollar swap lines. As of December 3, the total amount outstanding is $9,128 million. Compared to the peak on May 27, this is a 98% drop, reflecting the low demand of the swap lines in the current environment.

While the overall demand has been low, a few central banks have resumed the use of the swap line over the past weeks. For instance, on November 19, the Bank of England (BOE) reported the use of $115 million. This was the first time since July 22 that the BOE reported use larger than $100 million. The Swiss National Bank has been increasing its use of the swap line. As of December 3, the Swiss National Bank reported $5,866 million outstanding, now representing 64 percent of the total outstanding amount (Figure 2).
For further details on the use of Federal Reserve Programs, please refer to the Fed’s monthly report to Congress.

The following figures show the usage of Fed programs during the COVID-19 crisis. They also show data for similar programs during the Global Financial Crisis of 2007-09 (GFC), where applicable. The graphs also indicate how soon each program was launched relative to the start date of recessions (February 1, 2020, for COVID, and December 1, 2007 for GFC). The actual take-up of these facilities has been relatively low compared to the take-up of similar facilities during the GFC.

For a more detailed comparison of Fed programs during the GFC and the COVID-19, see our Key Program Summaries.

**Liquidity Swap Lines**

The USD swap lines are bilateral agreements between the Fed and foreign central banks. They allow foreign central banks to exchange domestic currency for US dollars. The Fed currently maintains swap line agreements with 14 central banks.
Money Market Mutual Fund Liquidity Facility

The MMLF allows the Fed to fund the purchase of money market mutual fund (MMF) assets. The program is established under Section 13(3) of the Federal Reserve Act. The Fed reported that the U.S. Treasury, to date, has provided an equity cushion of $1.5 billion to the Money Market Mutual Fund Liquidity Facility — as part of $10 billion total in credit protection. The facility had $4,915 million in outstanding loans on December 2. It is similar to the Asset-Backed Commercial Paper Liquidity Money Market Mutual Fund Liquidity Facility (AMLF) that the Fed launched during the GFC. The AMLF funded the purchase of ABCP from MMFs. In comparison, the MMLF is authorized to lend against a broader range of collateral.
Discount Window

The **Discount Window (DW)** is a standing facility that allows the Fed to provide collateralized loans to depository institutions. It had $1,992 million in outstanding loans on December 2.
Primary Dealer Credit Facility

The PDCF allows the Fed to extend collateralized loans to primary dealers. The facility was established under Section 13(3). The facility had $250 million in outstanding loans on December 2.

Paycheck Protection Program Liquidity Facility

The PPPLF allows the Fed to provide financial institutions with liquidity backed by loans to small businesses extended under the federal government’s Paycheck Protection Program and guaranteed by the Small Business Administration. The PPPLF was established under Section 13(3). The facility had $55 billion in outstanding loans on December 2.
Commercial Paper Funding Facility

The CPFF provides a liquidity backstop to issuers of commercial paper and was also established under Section 13(3). It is operated by the NY Fed through a special purpose vehicle, the Commercial Paper Funding Facility II LLC (CPFF II LLC). The Treasury has made an equity investment of $10 billion in CPFF II LLC. The facility had no outstanding loans on December 2.

Primary and Secondary Market Corporate Credit Facilities
The PMCCF and SMCCF were set up under Section 13(3) to support credit to employers through purchases of newly issued bonds and support market liquidity for outstanding corporate bonds. These facilities operate through a special purpose vehicle, the Corporate Credit Facilities LLC (CCF LLC). The Treasury has made an equity investment of $37.5 billion in CCF LLC. The SMCCF had $13.9 billion in outstanding assets on December 2. The PMCCF has not extended any credit to date.

The SMCCF had $13.9 billion in outstanding assets on December 2. The PMCCF has not extended any credit to date.

Municipal Liquidity Facility

The MLF provides liquidity to states, counties, and cities. The facility was set up to purchase up to $500 billion of short-term notes and was established under Section 13(3). The Treasury has made an equity investment of $17.5 billion in MLF LLC. The facility had $1,454 million in outstanding loans on December 2.

Main Street Lending Programs

The MSF is established under Section 13(3) to provide loans to small and medium-sized businesses. The program operates through five facilities: the Main Street New Loan Facility (MSNLF), the Main Street Priority Loan Facility (MSPLF), the Main Street Expanded Loan Facility (MSELF), the Nonprofit Organization New Loan Facility (NONLF), and the Nonprofit
Organization Expanded Loan Facility (NOELF). The loans for all five facilities are extended through a special purpose vehicle, the Main Street Facilities LLC (MSF LLC), established by the Federal Reserve Bank of Boston. The Treasury has made an equity investment of $37.5 billion in MSF LLC. The facility had $6,212 million in outstanding loans on December 2.

Term Asset-Backed Securities Loan Facility

The TALF is established under Section 13(3) to provide liquidity collateralized by asset-backed securities (ABS). Under the facility, the Federal Reserve lends to holders of certain AAA-rated ABS. The facility operates through a special purpose vehicle to extend its loans, the Term Asset-Backed Securities Loan Facility II LLC (TALF II LLC). The Treasury has made an equity investment of $10 billion in TALF II LLC. The facility had $3,548 million in outstanding loans on December 2.
Summary Table from our Key Program Summaries

Note: (a) The start date for the graph “TALF in COVID-19 crisis” is February 1, 2020 and the start date for the graph “TALF in GFC” is December 1, 2007. (b) The green dotted line in the graph “TALF in COVID-19 crisis” indicates June 17, 2020, the launch date of the program. (c) The green dotted line in the graph “TALF in GFC” indicates March 1, 2008, the date lending operation began. (d) “TALF in COVID-19 crisis” includes author’s estimate for data prior to June 18, 2020.

Sources: FRBNY, Federal Reserve Board
<table>
<thead>
<tr>
<th>Date</th>
<th>Initial Assumptions</th>
<th>Peak Size (Millions)</th>
<th>Program</th>
<th>Initial Assumptions</th>
<th>Peak Size (Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Institutions</td>
<td></td>
<td>$111</td>
<td>Program 1</td>
<td></td>
<td>$111</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$141</td>
<td>Program 2</td>
<td></td>
<td>$141</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$161</td>
<td>Program 3</td>
<td></td>
<td>$161</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$373</td>
<td></td>
<td></td>
<td>$373</td>
</tr>
<tr>
<td>Businesses</td>
<td></td>
<td>$112</td>
<td>Program 1</td>
<td></td>
<td>$112</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$142</td>
<td>Program 2</td>
<td></td>
<td>$142</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$162</td>
<td>Program 3</td>
<td></td>
<td>$162</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$376</td>
<td></td>
<td></td>
<td>$376</td>
</tr>
<tr>
<td>Nonprofitities</td>
<td></td>
<td>$113</td>
<td>Program 1</td>
<td></td>
<td>$113</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$143</td>
<td>Program 2</td>
<td></td>
<td>$143</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$163</td>
<td>Program 3</td>
<td></td>
<td>$163</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$379</td>
<td></td>
<td></td>
<td>$379</td>
</tr>
<tr>
<td>Sales and Marketing</td>
<td></td>
<td>$114</td>
<td>Program 1</td>
<td></td>
<td>$114</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$144</td>
<td>Program 2</td>
<td></td>
<td>$144</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$164</td>
<td>Program 3</td>
<td></td>
<td>$164</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$378</td>
<td></td>
<td></td>
<td>$378</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$376</td>
<td></td>
<td></td>
<td>$376</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$376</td>
<td></td>
<td></td>
<td>$376</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$376</td>
<td></td>
<td></td>
<td>$376</td>
</tr>
</tbody>
</table>
Since our last report, the use of lending facilities has increased to $92.6 billion due to increased use of the PDCF, CCF, MLF, and MSF. The outstanding amount of the Fed’s U.S. dollar swap lines has also increased.

As of December 16, the Fed’s liquidity programs had $92.6 billion in outstanding loans. The total outstanding has risen from $87.1 billion on December 2, the last time we reported the usage (see the post here).

Figure 1-1 and 1-2 show the outstanding amount of each facility, not including Treasury contributions that are invested in Treasury securities rather than loans to market participants. Figure 1-1 shows the use of the lending facilities from early 2020 and Figure 1-2 shows the use in a shorter time period, from November to December.

Note: Includes author’s estimate for data prior to June 18, 2020. Source: H.4.1 weekly release, FRBNY, Federal Reserve Board.
The use in four facilities (PDCF, CCF, MLF, and MSF) has increased since the last time we reported the usage on December 2. On December 16, the use of MSF, CCF, and MLF saw record volume since the outbreak of COVID-19.

Note on the Municipal Liquidity Facility (MLF)

The use of MLF has increased by $4.9 billion. According to Bloomberg and Bond Buyer, the increase is attributed to the incremental use by New York’s Metropolitan Transportation Authority (MTA) of $2.9 billion and the state of Illinois of $2.0 billion.

MTA, according to Bloomberg, may need to reduce subway and bus service by 40% and slash rail service by 50% if it does not receive the MLF from the Fed.

The state of Illinois has a budget hole of approximately $4 billion and the $2 billion Fed loan should cover part of it. The state of Illinois had already borrowed $1.2 billion from the Fed to deal with a $2.7 billion fiscal 2020 pandemic hole and is expected to repay the first borrowing by June 30, 2021.

Note on the counterparties of the Commercial Paper Funding Facility (CPFF)

On December 9, the Federal Reserve Bank of New York (NY Fed) announced the launch of a prequalification process for cash investment management services for the CPFF. This follows the statement on October 5 announcing a new initiative to secure competitive procurement in the vendor for the sake of equal opportunities (for the further details, see here). The due date for prequalification is December 23.
**Note on Treasury Contributions to Federal Reserve Programs**

On April 9, the Treasury announced that it intended to use funds available under the *Coronavirus Aid, Relief, and Economic Security (CARES) Act* to purchase equity in special purpose vehicles established under Fed lending programs.

In total, the Treasury has invested $114 billion—including CARES and non-CARES funds—in six facilities, as of December 2. Per the facility agreements, 85% of the equity contributions to the CCF, CPFF, MLF, MSF, and TALF have been invested in nonmarketable Treasury securities: $31.9 billion for the CCF, $8.5 billion for the CPFF, $14.9 billion for the MLF, $31.9 billion for the MSF, and $8.5 billion for TALF.

On November 19, the Treasury published a letter from Secretary Steven T. Mnuchin to Jerome Powell, Chairman of the Federal Reserve Board of Governors. The letter indicated the Treasury would not extend the programs established under the CARES Act after December 31. These include the facilities for corporate bonds and loans, municipal bonds, and asset-backed securities (the SMCCF, PMCCF, MSLP, MLF, and TALF), which have equity funding that the Treasury provided under the CARES Act. (For a discussion of these developments and the future of the Fed emergency lending facilities supported by CARES Act funds, see this YPFS blog post.)

**Note on Federal Reserve Swap Lines**

Figure 2-1 and 2-2 show the outstanding amount of the Fed’s U.S. dollar swap lines. Figure 2-1 shows the use from early 2020 and Figure 2-2 shows the use in a shorter time period, from November to December.

![Figure 2-1: Use of USD Liquidity Swap Line](image)
Central banks increased their use of the Fed’s U.S. dollar swap lines. As of December 17, the total amount outstanding is $16.1 billion. Compared to the peak on May 27, this is still a 96% drop; however, the amount has significantly increased from $9.1 billion, on December 3, the last time we reported the usage (see the post here).

The recent increase in the use of the U.S. dollar swap lines can be explained by several central banks: Swiss National Bank, European Central Bank (ECB), Monetary Authority of Singapore (MAS), and Danmarks Nationalbank (Denmark). Meanwhile, the Bank of Japan (BOJ), which once used to represent the highest share of usage, no longer has any outstanding U.S. swaps with the Fed (Figure 2-3).
For further details on the use of Federal Reserve Programs, please refer to the Fed’s monthly report to Congress.

The following figures show the usage of Fed programs during the COVID-19 crisis. They also show data for similar programs during the Global Financial Crisis of 2007-09 (GFC), where applicable. The graphs also indicate how soon each program was launched relative to the start date of recessions (February 1, 2020, for COVID, and December 1, 2007 for GFC). The actual take-up of these facilities has been relatively low compared to the take-up of similar facilities during the GFC.

For a more detailed comparison of Fed programs during the GFC and the COVID-19, see our Key Program Summaries.

**Money Market Mutual Fund Liquidity Facility**

The MMLF allows the Fed to fund the purchase of money market mutual fund (MMF) assets. The program is established under Section 13(3) of the Federal Reserve Act. The Fed reported that the U.S. Treasury, to date, has provided an equity cushion of $1.5 billion to the Money Market Mutual Fund Liquidity Facility — as part of $10 billion total in credit protection. The facility had $4,449 million in outstanding loans on December 16. It is similar to the Asset-Backed Commercial Paper Liquidity Money Market Mutual Fund Liquidity Facility (AMLF) that
the Fed launched during the GFC. The AMLF funded the purchase of ABCP from MMFs. In comparison, the MMLF is authorized to lend against a broader range of collateral.

Discount Window

The **DW** is a standing facility that allows the Fed to provide collateralized loans to depository institutions. It had $1,871 million in outstanding loans on December 16.
Primary Dealer Credit Facility

The PDCF allows the Fed to extend collateralized loans to primary dealers. The facility was established under Section 13(3). The facility had $350 million in outstanding loans on December 16.
Paycheck Protection Program Liquidity Facility

The PPPLF allows the Fed to provide financial institutions with liquidity backed by loans to small businesses extended under the federal government’s Paycheck Protection Program and guaranteed by the Small Business Administration. The PPPLF was established under Section 13(3). The facility had $52.1 billion in outstanding loans on December 16.

Commercial Paper Funding Facility

The CPFF provides a liquidity backstop to issuers of commercial paper and was also established under Section 13(3). It is operated by the NY Fed through a special purpose vehicle, the Commercial Paper Funding Facility II LLC (CPFF II LLC). The Treasury has made an equity investment of $10 billion in CPFF II LLC. The facility had no outstanding loans on December 16.
Primary and Secondary Market Corporate Credit Facilities

The PMCCF and SMCCF were set up under Section 13(3) to support credit to employers through purchases of newly issued bonds and support market liquidity for outstanding corporate bonds. These facilities operate through a special purpose vehicle, the Corporate Credit Facilities LLC (CCF LLC). The Treasury has made an equity investment of $37.5 billion in CCF LLC. The SMCCF had $14.1 billion in outstanding assets on December 16. The PMCCF has not extended any credit to date. Additional transaction-specific disclosures regarding the SMCCF as of end November can be found here.
Municipal Liquidity Facility

The MLF provides liquidity to states, counties, and cities. The facility was set up to purchase up to $500 billion of short-term notes and was established under Section 13(3). The Treasury has made an equity investment of $17.5 billion in MLF LLC. The facility had $6,361 million in outstanding loans on December 16.

Main Street Lending Programs

The MSF is established under Section 13(3) to provide loans to small and medium-sized businesses. The program operates through five facilities: the Main Street New Loan Facility (MSNLF), the Main Street Priority Loan Facility (MSPLF), the Main Street Expanded Loan Facility (MSELF), the Nonprofit Organization New Loan Facility (NONLF), and the Nonprofit Organization Expanded Loan Facility (NOELF). The loans for all five facilities are extended through a special purpose vehicle, the Main Street Facilities LLC (MSF LLC), established by the Federal Reserve Bank of Boston. The Treasury has made an equity investment of $37.5 billion in MSF LLC. The facility had $9,911 million in outstanding loans on December 16.

Term Asset-Backed Securities Loan Facility
The TALF is established under Section 13(3) to provide liquidity collateralized by asset-backed securities (ABS). Under the facility, the Federal Reserve lends to holders of certain AAA-rated ABS. The facility operates through a special purpose vehicle to extend its loans, the Term Asset-Backed Securities Loan Facility II LLC (TALF II LLC). The Treasury has made an equity investment of $10 billion in TALF II LLC. The facility had $3,458 million in outstanding loans on December 16.

Note: (a) The start date for the graph “TALF in COVID-19 crisis” is February 1, 2020 and the start date for the graph “TALF in GFC” is December 1, 2007. (b) The green dotted line in the graph “TALF in COVID-19 crisis” indicates June 17, 2020, the launch date of the program. (c) The green dotted line in the graph “TALF in GFC” indicates March 1, 2008, the date lending operation began. (d) “TALF in COVID-19 crisis” includes author’s estimate for data prior to June 18, 2020.

Sources: FRBNY, Federal Reserve Board

Also, see the summary Table from our Key Program Summaries.
Original post [here](#).

*Since our last report, the use of lending facilities has increased to $94.8 billion. The use of the Main Street Lending Facility (MSF) surged before it, along with the other CARES ACT facilities, ceased new lending at the end of the year. The outstanding amount of the Fed’s U.S. dollar swap lines expanded to the end of the year, then dropped.*

As of January 6 2021, the Fed’s liquidity programs had $94.8 billion in outstanding loans. The total outstanding has slightly increased from $92.6 billion on December 16, the last time we reported the usage (see the post [here](#)).

Figure 1-1 and 1-2 below show the outstanding amount of each facility, not including Treasury contributions that are invested in Treasury securities rather than loans to market participants. Figure 1-1 shows the use of the lending facilities from early 2020 and Figure 1-2 shows the use in a shorter time period, from November 2020 to January 2021.

Figure 1-1 and 1-2 below show the outstanding amount of each facility, not including Treasury contributions that are invested in Treasury securities rather than loans to market participants. Figure 1-1 shows the use of the lending facilities from early 2020 and Figure 1-2 shows the use in a shorter time period, from November 2020 to January 2021.

---

**Figure 1-1: Use of Federal Reserve Lending Facilities**

Not including uninvested Treasury contributions

- MMLF / AMLF
- PDCF
- DW
- PPPLF
- CPFF
- CCF
- MLF
- MSF
- TALF

Note: includes author’s estimate for data prior to June 15, 2020.

Source: H.4.1 weekly release, FRBNY, Federal Reserve Board
The use in four facilities (PDCF, CCF, TALF, and MSF) have increased since the last time we reported the usage on December 16.

**Note on the CARES Act facilities (the PMCCF, SMCCCF, MSLP, MLF, and TALF)**

The Fed’s lending facilities established under Section 13(3) can be categorized into three buckets: the PDCF and PPPLF do not have Treasury capitalization; second, the CPFF and MMLF have equity protection from pre-existing funds in the Treasury’s Exchange Stabilization Fund (ESF); and, third, the facilities for corporate bonds and loans, municipal bonds, and asset-backed securities (the PMCCF, SMCCF, MSLP, MLF, and TALF) have equity funding that the Treasury provided under the CARES Act.

As we have reported in details in our previous blog posts, (December 8 “The Uncertain Future of the Fed’s CARES Act Facilities” and December 22 “Redux: Outlook for 13(3) and Fed Crisis Response”), Treasury Secretary Steven Mnuchin announced that the Treasury would not extend the programs established under the CARES Act after December 31, and further requested the Fed to return the Treasury’s unused funds for those facilities. The “unused funds” are those that are not needed to meet the commitments, as of January 9, 2021, of the programs and facilities established under section 13(3).

This means that approximately $62 billion of unused fund are expected to return to the Treasury. On January 5, 2021, the Federal Reserve returned a portion of Treasury’s equity investment in the CCF, MLF, and TALF.

As of January 7, the amount returned, remaining capital contribution by the Treasury, and the current equity investments for CCFs, MLF, and TALS are shown in Table 1.
Table 1: Treasury contributions to CCFs (PMCCF and SMCCF), MLF, and TALF

<table>
<thead>
<tr>
<th></th>
<th>CCFs</th>
<th>MLF</th>
<th>TALF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Returned on January 5, 2021</td>
<td>$23.6 billion</td>
<td>$11.2 billion</td>
<td>$6.5 billion</td>
</tr>
<tr>
<td>Remaining capital contribution by the Treasury</td>
<td>$37.5 billion</td>
<td>$17.5 billion</td>
<td>$10 billion</td>
</tr>
<tr>
<td>Current Equity investments in nonmarketable Treasury securities*</td>
<td>$11.8 billion</td>
<td>$5.4 billion</td>
<td>$3 billion</td>
</tr>
</tbody>
</table>

* 85% of the equity contributions.

On Dec 29, the Fed announced that it would extend termination date of the MSLP to January 8, 2021, so it can process and fund loans that were submitted before December 14, 2020. The surge in the number in mid-December suggests that eligible borrowers “rushed” to the program before it closed on December 31, 2020.

CPFF and MMLF, which are designed separately from the framework of the CARES Act, have equity protection from the Treasury’s pre-existing ESF funds; CPFF holds $10 billion of equity investment and MMLF holds $1.5 billion credit protection.

Note on Federal Reserve Swap Lines

Figure 2-1 and 2-2 below show the outstanding amount of the Fed’s U.S. dollar swap lines. Figure 2-1 shows the use from early 2020 and Figure 2-2 shows the use in a shorter time period, from November 2020 to January 2021.
Central banks increased their use of the Fed’s U.S. dollar swap lines. As of January 7, the total amount outstanding is $11.2 billion. Compared to the peak on May 27, this is a 97% drop. As Figure 2-2 shows, from January 6 to January 7, the European Central Bank (ECB) and Swiss National Bank dropped their use of the swaps by $3 billion each. The Monetary Authority of Singapore (MAS) has also reduced its outstanding U.S. swaps. In terms of the share, Swiss National Bank was the largest user on January 7, accounting for 65% of the total swap use (Figure 2-3).
For further details on the use of Federal Reserve Programs, please refer to the Fed’s monthly report to Congress.

The following figures show the usage of Fed programs during the COVID-19 crisis. They also show data for similar programs during the Global Financial Crisis of 2007-09 (GFC), where applicable. The graphs also indicate how soon each program was launched relative to the start date of recessions (February 1, 2020, for COVID, and December 1, 2007 for GFC). The actual take-up of these facilities has been relatively low compared to the take-up of similar facilities during the GFC.

For a more detailed comparison of Fed programs during the GFC and the COVID-19, see our Key Program Summaries.

**Liquidity Swap Lines**

The USD swap lines are bilateral agreements between the Fed and foreign central banks. They allow foreign central banks to exchange domestic currency for US dollars. The Fed currently maintains swap line agreements with 14 central banks.
Money Market Mutual Fund Liquidity Facility

The MMLF allows the Fed to fund the purchase of money market mutual fund (MMF) assets. The program is established under Section 13(3) of the Federal Reserve Act. The facility had $2,496 million in outstanding loans on January 6. It is similar to the Asset-Backed Commercial Paper Liquidity Money Market Mutual Fund Liquidity Facility (AMLF) that the Fed launched during the GFC. The AMLF funded the purchase of ABCP from MMFs. In comparison, the MMLF is authorized to lend against a broader range of collateral.
The **Discount Window** (DW) is a standing facility that allows the Fed to provide collateralized loans to depository institutions. It had $1,485 million in outstanding loans on January 6.
Primary Dealer Credit Facility

The **PDCF** allows the Fed to extend collateralized loans to primary dealers. The facility was established under Section 13(3). The facility had $485 million in outstanding loans on January 6.

![PDCF in COVID-19 crisis graph](chart1.png)

Paycheck Protection Program Liquidity Facility

The **PPPLF** allows the Fed to provide financial institutions with liquidity backed by loans to small businesses extended under the federal government’s Paycheck Protection Program and guaranteed by the Small Business Administration. The PPPLF was established under Section 13(3). The facility had $49.8 billion in outstanding loans on January 6.

![PPPLF in COVID-19 crisis graph](chart2.png)

Commercial Paper Funding Facility
The **CPFF** provides a liquidity backstop to issuers of commercial paper and was also established under Section 13(3). It is operated by the Federal Reserve Bank of New York through a special purpose vehicle, the Commercial Paper Funding Facility II LLC (CPFF II LLC). The Treasury has made an equity investment of $10 billion in CPFF II LLC. The facility had no outstanding loans on January 6.

**Primary and Secondary Market Corporate Credit Facilities**

The **PMCCF** and **SMCCF** were set up under Section 13(3) to support credit to employers through purchases of newly issued bonds and support market liquidity for outstanding corporate bonds. These facilities operate through a special purpose vehicle, the Corporate Credit Facilities LLC (CCF LLC). The SMCCF had $14.2 billion in outstanding assets on January 6. The PMCCF has not extended any credit to date.
Municipal Liquidity Facility

The MLF provides liquidity to states, counties, and cities. The facility was set up to purchase up to $500 billion of short-term notes and was established under Section 13(3). The facility had $6,283 million in outstanding loans on January 6.

Main Street Lending Programs

The MSF is established under Section 13(3) to provide loans to small and medium-sized businesses. The program operates through five facilities: the Main Street New Loan Facility (MSNLF), the Main Street Priority Loan Facility (MSPLF), the Main Street Expanded Loan Facility (MSELF), the Nonprofit Organization New Loan Facility (NONLF), and the Nonprofit Organization Expanded Loan Facility (NOELF). The loans for all five facilities are extended through a special purpose vehicle, the Main Street Facilities LLC (MSF LLC), established by the Federal Reserve Bank of Boston. The facility had $16,465 million in outstanding loans on January 6, the record volume.

Term Asset-Backed Securities Loan Facility

The TALF is established under Section 13(3) to provide liquidity collateralized by asset-backed securities (ABS). Under the facility, the Federal Reserve lends to holders of certain AAA-rated ABS. The facility operates through a special purpose vehicle to extend its loans, the Term Asset-
Backed Securities Loan Facility II LLC (TALF II LLC). The facility had $3,458 million in outstanding loans on January 6.

Also, see the summary Table from our Key Program Summaries.
Fed Introduces Modified Primary Dealer Credit Facility

By June Rhee

Original post here.

On March 17, the Federal Reserve authorized the Primary Dealer Credit Facility (PDCF) “to support the credit needs of American households and businesses” by enabling primary dealers to support normal market functioning.

The Fed used its authority under section 13(3) of the Federal Reserve Act to implement the new program (see here). Section 13(3) allows the Fed to lend to nonfinancial organizations when the Federal Reserve Board determines there are “unusual and exigent circumstances.”

The Fed last employed a PDCF in March 2008 during the Global Financial Crisis to improve the ability of primary dealers to provide financing to participants in securitization markets and promote the orderly functioning of financial markets.

The terms of the current PDCF (see here) closely follow the terms of the 2008 PDCF (see here). As in 2008, the Federal Reserve Bank of New York will offer loans to primary dealers. The loans will be made available for terms of up to 90 days at a primary credit rate or discount rate. Loans can be secured by collateral eligible for pledge in the Fed’s open-market operations. Also eligible are investment-grade corporate debt securities, international agency securities, investment grade commercial paper, municipal securities, mortgage-backed securities, asset-backed securities, and equity securities. The Fed will accept commercial mortgage-backed securities (CMBS), collateralized loan obligations (CLOs), and collateralized debt obligations (CDOs) that are AAA-rated.

The Fed plans to make the PDCF available for at least six months and may extend the facility if conditions warrant. The primary dealers will be able to access the facility starting on March 20, 2020.

Click here to read a YPFS case study that discusses the 2008 PDCF in detail and provides access to the key documents utilized with that facility.
Fed Reintroduces Commercial Paper Funding Facility

By Rosalind Z. Wiggins

Original post here.

On March 17, the Federal Reserve announced that it would implement a Commercial Paper Funding Facility (CPFF) to support the flow of credit to businesses and households during the coronavirus pandemic.

The Fed used its authority under section 13(3) of the Federal Reserve Act to implement the new program (see here). Section 13(3) allows the Fed to lend to nonfinancial organizations when the Federal Reserve Board determines there are “unusual and exigent circumstances.” This is the Fed’s first use of that authority since the Global Financial Crisis of 2007-09.

The Fed last employed a CPFF in October 2008, when in the midst of the Global Financial Crisis outstanding CP had dropped by roughly $300 billion. At that time, the market experienced severe shortening of maturities and increased rates making it difficult for issuers to place new paper.

The language in the terms of the new CPFF closely follows the language in the earlier CPFF. As in 2008, the Federal Reserve Bank of New York (FRBNY) will make loans to a special purpose vehicle that will purchase highly-rated US dollar-denominated, three-month unsecured and asset-backed commercial paper from eligible US issuers. As before, eligible issuers are U.S. issuers of commercial paper, including U.S. issuers with a foreign parent company. The program will purchase commercial paper until March 17, 2021. The Fed could extend the facility past that date. The 2020 CPFF Terms and Conditions can be found here and the 2008 CPFF Terms and Conditions and FAQs can be found here and here, respectively.

The new program is supported by $10 billion in credit protection provided by the U.S. Treasury Department, using the Exchange Stabilization Fund (ESF). The earlier CPFF was also supported by $50 billion from the Treasury.

The 2008 CPFF’s role in helping to revive the term-lending market has been debated. However, in its first weeks it was highly utilized and purchased the overwhelming majority of new term CP. At its highest level in January 2009, the CPFF held $350 billion of CP, 20% of all outstanding CP. Evidence suggests that the 2008 CPFF provided market participants a rollover option for maturing paper and helped restore lending by CPFF participants to their non-financial corporate borrowers.

Click here to read a YPFS case study that discusses the 2008 CPFF in detail and provides access to the key documents utilized with that facility.
Fed Provides Liquidity Options to Cities and States
By Rosalind Z. Wiggins

Original post here.

Over the past couple of weeks in response to the stresses of the COVID-19 pandemic the bond markets that states and cities traditionally access to raise funds have recently stalled; the “primary market that has all but shut down” as rates have followed Treasuries downward and many investors sell to await a rebound. (Funk 03/23/2020) (Oh 2020). In addition, many of the financial institutions that usually buy these bonds and make markets in them have been reluctant to do so because they are holding large quantities. (Oh 2020). Further, the commercial paper market has been experiencing runs. (Tumulty 03/23/2020)

Hoping to provide a safety net for states and cities which are facing increased costs from fighting the health crisis while having to continue to fund payroll, pensions and debt service, the Federal Reserve (the “Fed”) has in the past three days provided three facilities aimed at assisting these entities with accessing liquidity.

- On March 20th, the Fed expanded the recently announced Money Market Mutual Fund Liquidity Facility (MMLF) to permit financial institutions to also borrow from the Federal Reserve Bank of Boston (FRBB) to purchase highly rated US municipal short-term debt with maturities of 12 months or less (“municipal debt”) from eligible single-state or other tax exempt money market funds (“state and city funds”). The FRBB will make nonrecourse loans to eligible financial institutions (including depository institutions, bank holding companies and US branches of foreign banks) anywhere in the country to facilitate the purchases. The MMLF would continue to provide loans to financial institutions to purchase designated high-quality assets from money market mutual funds (“money funds”).

- In another move, the Fed announced today that it would expand the MMLF further to permit the purchase of (i) negotiable certificates of deposits issued by states, municipalities, or banks, and (ii) highly rated municipal variable rate demand notes (VRDNs) with maturities of 12 months or less. The MMLF will begin accepting certificates of deposits and VRDNs as of March 25. However, such items purchased on March 23 and 24 may be accepted if pledged on March 25th.

- MMLF loans secured by municipal debt or VRDNs would be made at a rate equal to the primary rate plus 25 bps. Loans secured by Treasuries or agency securities would be at a rate equal to the primary rate, and loans secured by other collateral would be at a rate equal to the primary rate plus 100 bps.

- Also, as of today the Fed has expanded the Commercial Paper Funding Facility (CPFF) (reintroduced on March 17th) to include as eligible securities high-quality, tax-
exempt commercial paper providing purchasers for municipal issuers. Under the CPFF, the Federal Reserve Bank of New York provides loans to a special purpose vehicle that purchases high-quality commercial paper from eligible issuers.

- For additional details see the updated MMLF Term Sheet.
- For additional details see the updated CPFF Term Sheet.

The Fed is employing all its tools to maintain the flow of funds to states and municipalities that may be experiencing liquidity constraints and or having difficulty placing new debt. During the Global Financial Crisis (GFC), many cities experienced severe economic stress as they suffered reduced tax revenues, losses on portfolios and higher unemployment. Several major cities, with Detroit, MI and Stockton, CA being the largest, filed for bankruptcy protection.

The Fed’s efforts provide some avenues for states and cities needing liquidity but the Fed’s arsenal in this area is not the broadest. Pursuant to Section 14 of the Federal Reserve Act, the Fed can purchase municipal debt with maturities up to six months through its Open Markets Operations. This has led some commentators to state that what is also needed is action from the Congress to provide such broader authority to the Fed. Senator Bob Menendez, (D-NJ) has proposed “The Municipal Bonds Emergency Relief Act” that would amend the Federal Reserve Act to allow the Fed to buy municipal bonds of any maturity under “unusual and exigent circumstances.” The bill would also include coverage for hospitals and colleges that issue tax-exempt bonds. The bill has received support from the Securities Industry and Financial Markets Association and the National League of Cities, but was not included in the bill proposed by the Senate and was cited as one of its weaknesses by the Democrats. (Tumulty 03/23/2020)

The MMLF and the CPFF were both established under Section 13(3) of the Federal Reserve Act, with approval of the Treasury Secretary (see here). Section 13(3) allows the Fed to lend to any “individual, partnership or corporation” when the Federal Reserve Board determines there are “unusual and exigent circumstances”. Using the Exchange Stabilization Fund, the Treasury has provided credit protection to the Fed for both programs.

Both the MMLF and CPFF are similar to programs that the Fed utilized during the GFC, however, then, municipal debt, certificates of deposits, VRDNs, and tax-exempt commercial paper were not included in the programs. These recent amendments demonstrate that the plans have some flexibility and can be easily expanded if the Fed determines circumstances warrant.
Fed Reintroduces Term Asset-backed Securities Loan Facility

By Aidan Lawson

On March 23, the Federal Reserve reintroduced the Term Asset-Backed Securities Loan Facility (TALF), one of its many programs used in the Global Financial Crisis (GFC), to further support households, businesses, and the U.S. economy overall.

The Fed used its authority under Section 13(3) of the Federal Reserve Act to implement the new program (see here). Section 13(3) allows the Fed to lend to any “individual, partnership or corporation” when the Federal Reserve Board determines there are “unusual and exigent circumstances” with the Treasury Secretary’s approval. The Treasury used the Exchange Stabilization Fund (ESF) to make a $10 billion equity investment to the new TALF.

Under the new TALF, the Fed, "to help meet the credit needs of consumers and small businesses” will use a special purpose vehicle (SPV) to make a total of $100 billion in three-year nonrecourse loans to U.S. companies that own eligible asset-backed securities (ABS). The SPV will be funded by a recourse loan from the Reserve Bank of New York and the Treasury’s equity investment. The new TALF is to be open through September 30, 2020, unless the Fed extends it.

The terms and conditions of the new TALF mostly follow the language of the $200 billion TALF that was announced in November 2008 and in operation in March 2009 during the GFC. However, while the 2008 TALF progressed to include newly issued and legacy commercial mortgage-backed securities, the 2020 TALF only includes non-mortgage asset-backed securities, such as those backed by student loans, small business loans guaranteed by the Small Business Administration (SBA), and automobile loans, among others.

The Fed also continues to purchase Treasury securities and agency mortgage-backed securities as part of its open market operations. On March 23, the Fed expanded these operations to include the purchase of agency commercial mortgage-backed securities and increased their purchases from a total of $700 billion to an amount “needed to support smooth market functioning and effective transmission of monetary policy to broader financial conditions and the economy” (see here). Loans will be priced based on the collateral pledged with the appropriate LIBOR swap rate, and haircuts will be applied based on sector, weighted average life, and historical volatility of the ABS (see here).
Bank of England activates the Contingent Term Repo Facility

By Manuel Leon Hoyos

Original post [here](#).

On March 24, 2020, the Bank of England activated a liquidity “insurance” facility that it created after the 2007-09 Global Financial Crisis to be available in a crisis such as the current one.

The Contingent Term Repo Facility (CTRF) aims to “help alleviate frictions observed in money markets in recent weeks, both globally and domestically, as a result of the economic shock caused by the outbreak of Covid-19.” Financial institutions will be able borrow cash from the central bank reserves for a 3-month term in exchange for less liquid assets. CTRF operations will run for the next two weeks and the Bank of England will announce further operations as needed.

The CTRF was established in 2014 and replaced the then existing facility that aimed to mitigate risks to financial stability arising from a market-wide shortage of short-term sterling liquidity. The CTRF forms part of the Sterling Monetary Framework and serves as a temporary enhancement for firms that need “cheap, plentiful cash at term.” The Sterling Monetary Framework provided a “liquidity upgrade” in that it allows firms to swap less liquid collateral for the most liquid assets in the economy.

The contingent nature of the CTRF allows the Bank of England to provide liquidity against the full range of eligible collateral at any time, term and price it chooses, in response to actual or prospective exceptional market-wide stress. Institutions eligible for the Bank’s Discount Window Facility (DWF) are eligible to participate in the CTRF.

Under the terms and conditions, the program size is unlimited. The minimum bid is £5 million and allocations have a fixed price (Bank Rate plus 15bps) with full allotment. Eligible collateral consists of the full range of SMF collateral – Levels A, B and C. Level A collateral comprises assets expected to remain liquid, such as high-quality sovereign debt. Level B consists of assets that would normally be liquid, such as sovereign debt, supranational and private sector debt and the highest-quality asset-backed securities. Level C consists of typically less liquid assets, such as securitizations, securities delivered by the same entity that originated the underlying assets, and portfolios of loans, including mortgages.

Federal Reserve Supports Corporate Bond Markets

By Manuel Leon Hoyos

Original post here.

On March 23, the Federal Reserve introduced two new facilities to support credit to large US companies. One will purchase newly issued bonds and loans on the primary market and the other will purchase outstanding corporate bonds and exchange-traded funds (ETFs) on the secondary market. The Fed used its emergency authority under section 13(3) of the Federal Reserve Act to create these programs.

Under both facilities, the Federal Reserve Bank of New York will lend to a special purpose vehicle (SPV) on a recourse basis. These loans will be secured by all assets of the SPV. The US Treasury, using the Exchange Stabilization Fund (ESF), will provide $20 billion in equity—$10 billion for each SPV.

Under the Primary Market Corporate Credit Facility, the SPV will transact directly with US-based companies with material operations in the US. The SPV will purchase investment-grade (BBB-/Baa3 or higher) corporate bonds with maximum maturities of four years. It will also grant loans at interest rates informed by market conditions. The Fed designed the facility to help companies “maintain business operations and capacity” during the coronavirus disruption.

The Fed set limits on each issuer’s total borrowing while it participates in the program, including its borrowing from the SPV. The limits are based on the issuer’s credit rating. An AAA/Aaa1-rated issuer’s total outstanding bonds and loans may not exceed 140% of its maximum outstanding bonds and loans on any day during the 12-month period ending March 22, 2020. For BBB-/Baa3-rated companies, the limit is 110%.

Borrowing companies may defer interest and principal payments for the first six months of their loans, which may be extendable at the Fed’s discretion. The commitment fee will be set at 100 bps. Bonds and loans will be callable at any time at par. (See the term sheet).

Under the Secondary Market Corporate Credit Facility, a separate SPV will purchase investment grade (BBB- or higher) corporate bonds with maximum maturities of five years. As with the primary market facility, issuers must be US-based and have material operations in the US. Companies that receive direct financial assistance under the new federal CARES Act will not be eligible.

The SPV can also purchase US-listed exchange-traded funds (ETFs) whose investment objective is to provide broad exposure to the market for US investment-grade corporate bonds. The SPV will purchase corporate bonds at “fair market value” and up to a maximum of 10% of the issuer’s maximum bonds outstanding. It will purchase ETFs up to a maximum of 20% of an ETF’s assets. Amidst price dislocation in the ETF market, rather than purchase at fair market value, the Fed says in its term sheet: “The Facility will avoid purchasing shares of eligible ETFs when they
trade at prices that materially exceed the estimated net asset value of the underlying portfolio.” (See the term sheet).
ECB Unveils Pandemic Emergency Purchase Programme

By Aidan Lawson

Original post here.

On March 18, the ECB unveiled a temporary program to purchase up to €750 billion in public and private-sector securities until the “crisis phase” of the COVID-19 crisis is over, but at least until the end of 2020.

The Pandemic Emergency Purchase Programme (PEPP) is an expansion of the ECB’s Asset Purchase Programme (APP), a package of asset-purchase measures that the ECB initiated in 2014 to support monetary policy. The PEPP, like the earlier APP, includes programs to buy sovereign debt, covered bonds, asset-backed securities, corporate bonds, and commercial paper. As with the APP, the ECB will make available for lending any securities that it purchases under the PEPP.

Purchasing conventions are based on the type of asset purchased. They generally follow the guidelines for the relevant ECB APP. For instance, purchases of sovereign debt under the PEPP would generally follow the same rules as purchases made under the APP’s sovereign debt program, unless otherwise specified in the PEPP framework.

The table below shows eligible securities for the PEPP, as announced on March 18. However, the ECB may waive some requirements to allow for wider participation. For example, the ECB waived the eligibility requirements for Greek debt because Greek financial markets have been severely destabilized, and previous commitments by the Greek government to achieve structural reform would be more difficult if it could not access the PEPP.

<table>
<thead>
<tr>
<th>Security</th>
<th>Minimum Credit Rating</th>
<th>Maturity</th>
<th>Purchase Limits</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sovereign debt</strong></td>
<td>Credit Quality Step 3</td>
<td>70 days – 30 yr + 364 days</td>
<td>33% of total debt if issued by sovereign&lt;br&gt;50% of total debt if issued by international institution</td>
</tr>
<tr>
<td><strong>Corporate bonds</strong></td>
<td>Credit Quality Step 3</td>
<td>6 mo. – 30 yr + 364 days</td>
<td>70% per ISIN[1]</td>
</tr>
<tr>
<td><strong>Covered bonds</strong></td>
<td>Credit Quality Step 3</td>
<td>Unspecified</td>
<td>70% per ISIN&lt;br&gt;30% per ISIN for Greece + Cyprus</td>
</tr>
</tbody>
</table>
The ECB published details of the new program in the Journal of the European Union on March 26. It had changed some details. Most significantly, it removed the limit to buy no more than 33% of any country’s bonds, which was in the initial announcement (see here, point number (6), and here, Article 5). This has given the ECB the authority to essentially purchase unlimited amounts of sovereign debt, up to the €750 billion limit.

In the updated publication, the ECB said that it would “not tolerate any risks to the smooth transmission of its monetary policy in all jurisdictions of the Euro area.” While a wide range of securities are eligible for purchase under PEPP, the vast majority of securities purchased under the APP have been government debt (see here).

Generally, the allocation of purchases will be proportionate to the amount of ECB capital subscribed to by euro-area national central banks. Therefore, it is likely that Germany, France, and Italy will obtain a sizable share of the ECB funding (see here).

Still, the language allows the ECB some discretion. The ECB can make purchases “in a flexible manner allowing for fluctuations in the distribution of purchase flows over time, across asset classes and among jurisdictions.”

The decision to remove the purchase limit on government debt suggested that the ECB prefers to use the PEPP instead of the Outright Monetary Transactions (OMT). The ECB has confirmed this. OMT, which would allow the ECB to buy essentially unlimited quantities of an individual nation’s sovereign debt, has not been used since the ECB introduced it in 2012. Countries are required to apply for aid, leading to concerns about stigmatization of OMT aid, and assistance comes with “strict conditionality,” sometimes taking the form of a macroeconomic adjustment program or even the involvement of the IMF (see here).

The ECB earlier created two covered-bond purchase programs—in 2009 during the Global Financial Crisis and in 2011 during the sovereign debt crisis. The ECB purchased €60 billion and €16.4 billion in bonds in the two programs, respectively. The purpose of the two programs was to restore liquidity to the market, tighten credit spreads, ease bank funding costs, and promote lending. Observers view the first program as a modest success, while the impact of the second is less clear. See the YPFS case for more.

[11] An International Securities Identification Number (ISIN) is a 12-digit code used to unify different ticker symbols and identifications that can vary across exchanges, currencies, and countries. As such, a 70 percent purchase limit on an ISIN indicates that the ECB can purchase up to 70% of the outstanding issue of that particular security or debt instrument (see here).
Federal Reserve Expands Support to Corporate Bond Markets

By Manuel Leon Hoyos

Original post here.

On April 9, the Federal Reserve (Fed) updated and expanded the corporate bond-buying programs originally announced on March 23 to support credit to riskier corporations.

The Fed used its authority under Section 13(3) of the Federal Reserve Act to implement the Primary Market Corporate Credit Facility (PMCCF) and the Secondary Market Corporate Credit Facility (SMCCF) (see here). For both facilities, the Federal Reserve Bank of New York lends to a special purpose vehicle (SPV) on a recourse basis. These loans are secured by all assets of the SPV. The Treasury, using the Exchange Stabilization Fund (ESF), increased the amount of equity it will provide from $20 billion to $75 billion—$50 billion for the PMCCF’s SPV and $25 billion for the SMCCF’s SPV. The combined size of both facilities can now be up to $750 billion; the Fed has not provided any allocation between the two programs. Further discussion on the Treasury backstop can be found here.

Under both facilities, companies that receive direct financial assistance under the new CARES Act or other subsequent federal legislation are not eligible. Eligible institutions must satisfy the conflict-of-interest requirements of section 4019 of the CARES Act. Both facilities are to be open through September 30 unless the Fed and Treasury extend it.

Under the PMCCF, the SPV transacts directly with US-based companies with material operations in the US. The SPV purchases investment-grade corporate bonds with maximum maturities of four years. The latest revision includes purchases of portions of syndicated loans or bonds at issuance.

The Fed set limits on each issuer’s total borrowing under the PMCCF. The limits are based on the issuer’s credit rating. Initially, for an AAA/Aaa1-rated issuer, the total outstanding bonds and loans were not to exceed 140% of its maximum outstanding bonds and loans on any day during the 12-month period ending March 22, 2020. The latest revision, however, reduces this limit to 130%. Additionally, the maximum amount of instruments that both the PMCCF and the SMCCF combined can purchase from an eligible issuer is limited to 1.5% of the combined potential size of both facilities.

Under the SMCCF, the SPV has purchased investment grade corporate bonds with maximum maturities of five years at a fair market value up to 10% of the issuer’s bonds outstanding. As with the PMCCF, issuers must be US-based and have material operations in the US. The SPV also has purchased US-listed exchange-traded funds (ETFs) whose investment objective is to provide broad exposure to the market for US investment-grade corporate bonds. The latest revision adds ETFs whose primary investment objective is exposure to US high-yield corporate bonds. Purchases of ETFs are limited to 20% of an ETF’s assets. Amidst price dislocation in the
ETF market, rather than purchase at fair market value, the Fed says in its term sheet: “The Facility will avoid purchasing shares of eligible ETFs when they trade at prices that materially exceed the estimated net asset value of the underlying portfolio.”
Federal Reserve Broadens Range of Eligible Collateral for TALF

By June Rhee

Original post here.

On April 9, the Federal Reserve (Fed) broadened the range of eligible collateral for the Term Asset-Backed Securities Loan Facility (TALF) to include riskier assets such as legacy commercial mortgage backed securities (CMBS) and collateralized loan obligations (CLOs).

The Fed reintroduced TALF on March 23. It was one of the many programs the Fed used in the 2007-09 Global Financial Crisis to support households, businesses, and the economy. Under the original TALF, the Federal Reserve lent on a non-recourse basis to holders of highly rated asset-backed securities (ABS) backed by newly and recently originated consumer and small business loans.

The 2020 TALF initially only included newly issued non-mortgage asset-backed securities, such as those backed by student loans, small business loans guaranteed by the Small Business Administration, and automobile loans as eligible collateral. However, the expanded 2020 TALF now accepts the triple-A rated tranches of both legacy CMBS and newly issued static CLO as eligible collateral. Single-asset single-borrower CMBS and commercial real estate CLOs are excluded. The other terms and conditions of the new TALF mostly follow the language of the $200 billion TALF that the Fed announced in November 2008 and implemented in March 2009 during the GFC.

Under the 2020 TALF, the Fed, "to help meet the credit needs of consumers and small businesses," will use a special purpose vehicle to make a total of $100 billion in three-year nonrecourse loans to US companies that own eligible collateral. The SPV will be funded by a recourse loan from the Reserve Bank of New York and the Treasury’s equity investment. The new TALF is to be open through September 30, unless the Fed and Treasury extend it, and participating borrowers and issuers will be subject to conflict-of-interest requirements under section 4019 of the CARES Act.

The Fed used its authority under Section 13(3) of the Federal Reserve Act to implement the 2020 TALF (see here). Section 13(3) allows the Fed to lend to any “individual, partnership or corporation” when the Federal Reserve Board determines there are “unusual and exigent circumstances,” with the Treasury Secretary’s approval. The Treasury used the Exchange Stabilization Fund to make a $10 billion equity investment in the 2020 TALF. Further discussion on the Treasury backstop and the 2008 TALF can be found here.

The Fed will haircut collateral based on the riskiness of underlying assets, as in the 2008 TALF. The haircuts range from 5% for short-term Small Business Administration loans to 22% for longer-term leveraged loans.
The Fed also continues to purchase Treasury securities and agency mortgage-backed securities as part of its open market operations. On March 23, the Fed expanded these operations to include the purchase of agency commercial mortgage-backed securities and increased their purchases from a total of $700 billion to an amount “needed to support smooth market functioning and effective transmission of monetary policy to broader financial conditions and the economy” (see here). Loans will be priced based on the collateral pledged with the appropriate LIBOR swap rate, and haircuts will be applied based on sector, weighted average life, and historical volatility of the ABS (see here).

Click here to read a survey post on market liquidity programs including the TALF and here to read a YPFS case study that discusses the 2008 TALF in detail and provides access to the key documents utilized with that facility.
Federal Reserve Announces New Municipal Liquidity Facility
By Vaasavi Unnava and Rosalind Z. Wiggins

On April 9, the Federal Reserve announced the Municipal Liquidity Facility (MLF) as part of a new series of facilities providing up to $2.3 trillion in loans to support the economy. The facility aims to ease cash flow pressures on state and local governments as they adjust to a decline in municipal and state revenues and face greater than expected public health costs due to the COVID-19 pandemic.

The Federal Reserve established the MLF pursuant to its Section 13(3) authority under the Federal Reserve Act (FRA); it was approved by the Treasury Secretary.

The Federal Reserve will operate the facility by recourse lending to a newly-established special purpose vehicle (SPV). The SPV will then purchase eligible notes directly from eligible issuers. The SPV may purchase up to $500 billion of eligible notes. The Treasury Department will fund the facility with an initial equity investment of $35 billion from funds appropriated to its Exchange Stabilization Fund under the CARES Act. This structure is similar to that of the Commercial Paper Funding Facility, which the Fed first used during the Global Financial Crisis in 2008-09 (GFC) and which it has recently reintroduced.

Eligible issuers under the MLF include all the states and the District of Columbia, cities with greater than one million residents, and counties with greater than two million residents. Only 10 cities and 16 counties meet the above criteria, according to the latest Census data. To provide aid to municipalities ineligible to participate in the MLF, participating states may utilize the proceeds generated through the issuance of eligible bonds to purchase similar notes from municipalities within their jurisdictions. An eligible state, city, or county may participate through a related entity that normally issues notes on its behalf, but only one issuer per state, city, or county is eligible.

In addition to utilizing proceeds to purchase similar notes from political subdivisions, localities may use proceeds from the sales of eligible notes to the MLF for mitigation of reduced cash flows from income tax deferrals due to extensions to the tax filing deadlines. They may also be used to address reductions in revenues due to COVID-19 or for payments of principal and interest on other obligations.

Notes that are eligible for purchase under the MLF include tax anticipation notes (TANs), tax and revenue anticipation notes (TRANs), bond anticipation notes (BANs), or other short-term debt that matures no later than 24 months after issuance. The price of notes purchased will be based on the issuer’s rating at the time of issuance. Issuers are required to pay an origination fee equal to 10 basis points (0.1%) of the principal amount of the notes being purchased by the SPV. The fee will be deducted from the proceeds of the issuance.
The SPV may purchase multiple note issuances from an eligible issuer but the total amount purchased from any one issuer cannot exceed 20% of the issuer’s 2017 revenues from their government’s own sources and utilities revenues. However, a state may request that the SPV purchase more than the 20% limit to assist municipalities ineligible to participate in the MLF. The purchased notes are callable by the issuer at any time before maturity at par value.

The Federal Reserve plans to stop purchases under the MLF on September 30, although the facility may be extended if needed. The Fed plans to continue funding the SPV until all underlying assets mature or are sold.

Establishment of the MLF follows previous Federal Reserve efforts to provide liquidity to municipalities. On March 23, the Federal Reserve began accepting highly-rated municipal bonds, commercial paper, and other securities as collateral under the Commercial Paper Funding Facility (CPFF) and the Money Market Liquidity Facility (MMLF). The CPFF and MMLF are similar to programs that the Fed utilized during the GFC, however then municipal debt, tax-exempt municipal commercial paper and municipal securities were not included in the programs. Notably the Fed chose to implement the MLF under its FRA Section 13(3) emergency authority rather than utilize its authority under FRA Section 14, which provides that the Fed can purchase municipal debt with maturities up to six months through its Open Markets Operations. Commenters had called for broader authority than that, a gap that the CARES Act seems to have filled.

During the current pandemic, other countries have also made adjustments to aid municipalities with cash flow needs. Canada has provided a similar expansion allowing the purchase of municipalities’ commercial paper by its Commercial Paper Purchase Program. Other countries have pursued fiscal responses to liquidity squeezes in municipalities, such as Finland’s €100 million allocation to municipalities to support business owners affected by COVID-19.
Bank of Canada Establishes Series of Programs to Promote Market Liquidity

By Aidan Lawson

Original post here.

Since the beginning of April, the Bank of Canada (BoC) has launched three market-liquidity programs. Two are new asset purchase programs, under which it will buy commercial paper and government bonds. The third is an activation of a standing repurchase agreement (repo) facility to get cash to market participants.

COMMERCIAL PAPER PURCHASE PROGRAM (CPPP)

The BoC announced its intent to directly purchase commercial paper under a new Commercial Paper Purchase Program (CPPP) on March 27, with purchases commencing on April 2. The BoC buys commercial paper (including asset-backed commercial paper) with up to a 3-month maturity on both the primary and secondary markets.

To be eligible, the commercial paper must be issued by Canadian businesses, municipalities, and provincial agencies through already-existing commercial paper programs. Issuers must have a minimum short-term credit rating of R-1 High/Mid/Low from DBRS Morningstar as of April 2, though the BoC can approve issuers that are downgraded after that date or are not rated by DBRS, so long as they have ratings from Fitch, Moody’s, or S&P. The BoC limits individual purchases to 1.25 times the largest amount of Canadian dollar-denominated commercial paper that an issuer had outstanding on any day in the last year. The CPPP is expected to last for 12 months.

Purchases are made daily and priced at a fixed rate based on the 3-month Canadian overnight index swap (OIS) rate, which is the Canadian Overnight Repo Rate Average (see here, pp. 17). Pricing varies based on the credit risk of the issuer (see here). Aggregate results are published weekly by the BoC, but individual transaction data are not. As of April 8, the facility has purchased CAD$1.9 billion of commercial paper (see here).

The BoC has enlisted the help of Blackrock Financial Markets Advisory, TD Asset Management, and CIBC Mellon to act as advisor, asset manager and custodian, respectively.

SECONDARY MARKET BOND PURCHASE FACILITY

On April 1, the BoC launched a program to purchase at least CAD$5 billion in government bonds on the secondary market. These purchases are via reverse auction and conducted across the yield curve.

The BoC announced the program on March 27. So far, the BoC has conducted six auctions for a total of CAD$7.15 billion. It is planning on purchasing another CAD$500 million in 30-year government debt today (see here). The BoC releases details about the date and maturity of bonds...
it will purchase every two weeks. It announces more specific operational details closer to the date of each auction (see [here](#)).

**CONTINGENT TERM REPO FACILITY (CTRF)**

On April 3, the BoC activated the Contingent Term Repo Facility (CTRF). The CTRF is an unlimited emergency repo facility designed to counter severe liquidity stresses. It engages in one-month repurchase (repo) agreements with market participants that “demonstrate significant activity” in Canadian dollar money markets or fixed income markets. The BoC has considerably increased its presence in repo markets since the beginning of April, nearly doubling its repo activity from CAD$64.8 billion to CAD$110.7 billion as of April 8 (see [here](#)). This is the most the BoC has participated in the repo market, including at the height of the Global Financial Crisis.

All government and government-guaranteed bonds are eligible, as well as Canada Mortgage Bonds and National Housing Act (NHA) MBS, which are two types of mortgage bonds insured and guaranteed by the Canada Mortgage and Housing Corporation (see [here](#), pp. 57). The CTRF began operation on April 6 and is open for a year. The CTRF is similar to the Bank of England’s facility **of the same name**.
Federal Reserve Expands Eligibility for Municipal Liquidity Facility

By Vaasavi Unnava

Original post here.

On April 27, the Federal Reserve announced an expansion in scope and duration of the Municipal Liquidity Facility (MLF), a new facility established on April 9 to alleviate the funding needs of cities, counties, and states as municipalities fight the ongoing threat of COVID-19 across the United States and bond markets stall.

The new terms of the MLF allow the 50 states, counties of 500,000 residents or more, and cities of 250,000 residents or more to sell their debt issuances directly to a special purpose vehicle created and funded by the Federal Reserve. The new rule is significantly more inclusive than the previous standard, as seen in the table below.

<table>
<thead>
<tr>
<th></th>
<th>Number of Cities</th>
<th>Population Covered (City)</th>
<th>Number of Counties</th>
<th>Population Covered (County)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original MLF</td>
<td>10</td>
<td>~26,000,000</td>
<td>16</td>
<td>~54,000,000</td>
</tr>
<tr>
<td>Revised MLF</td>
<td>87</td>
<td>~62,000,000</td>
<td>140</td>
<td>~162,000,000</td>
</tr>
</tbody>
</table>

Source: Census City and County Population Estimates

In addition to the changes in participation, the Federal Reserve revised standards for eligible notes. Eligible notes may now have maturities of up to 36 months after issuance, twelve months longer than the original 24 month maturity.

New guidelines regarding ratings also affect eligibility of issuances. Eligible issuers must have “investment grade” ratings--ratings of at least a BBB-/Baa3--as of April 8, by two or more nationally recognized statistical ratings organizations (NRSRO), such as Standard and Poor’s or Fitch. If an NRSRO subsequently downgrades an issuer after April 8, the issuer must raise their ratings to at least BB-/Ba3 by the time the MLF makes a purchase.

The Federal Reserve has also expanded participation in the facility to multi-state entities, such as the Port Authority of New York and New Jersey. The MLF will hold multi-state entities to higher standards. Multi-state entities must have ratings of A-/A3 as of April 8 by two or more NRSROs. Should NRSROs downgrade the entity, it must raise its ratings to BBB-/Baa3 by the time of purchase.
Multi-state entities may issue, in one or more issuances, up to 20% of the entity’s gross revenue in 2019; however, unlike states, multi-state entities may not issue in excess of the applicable limit and transfer the funding to political subdivisions within their jurisdictions.

Finally, the Federal Reserve has changed the facility’s termination date from September to December 2020.

Elected officials widely criticized the original terms of the MLF as too restrictive, making the funds unavailable to many cities and counties that needed aid. The previous iteration of the facility only allowed 10 cities and 16 counties to participate directly in the funding mechanism. Some senators complained that their states would qualify for aid, but their states’ towns or counties were exempt. The previous iteration of the facility appeared to attend to this issue by allowing states to issue bonds and distribute the funding directly to municipalities within their jurisdictions. However, it appears this mechanism may not be direct enough, as some states struggle to issue debt based on state constitution barriers.

The Federal Reserve also said that it is considering allowing some governmental entities that issue revenue bonds to directly participate in the MLF as eligible issuers. However, it’s unclear whether the Federal Reserve will approve this.
India Extends Special Liquidity Facility to Mutual Funds
By Priya Sankar

Original post here.

On April 27, the Reserve Bank of India (RBI) announced a ₹500 billion ($6.6 billion) special liquidity facility for mutual funds (SLF-MF), in response to increased volatility in capital markets due to the COVID-19 pandemic. The SLF-MF operated for two weeks and closed on May 11.

The RBI reports that the program had ₹24.3 billion outstanding as of May 11, of which ₹20 billion was allotted on April 27 and ₹4.3 billion was allotted on April 30. The Indian mutual fund industry has about $300 billion in total assets under management, according to an industry association website. More than half of those assets are in debt funds.

In the midst of increased client redemptions and drained liquidity in the debt market due to the COVID-19 crisis, concerns around the potential contagion effects were accelerated after Franklin Templeton’s Indian arm halted withdrawals and shut six high-risk debt funds, trapping over $3 billion of investor money.

To address this concern, the RBI established the SLF-MF. In a statement, the RBI said that market stress was “confined to the high-risk debt [mutual fund] segment at this stage; the larger industry remains liquid.” The SLF-MF is a 90-day repo operation at the fixed repo rate of 4.4%.

The SLF-MF was open from April 27 to May 11 to liquidity adjustment facility eligible banks. Borrowing banks must use these funds to meet liquidity needs of mutual funds by (i) extending loans, or (ii) undertaking outright purchase of and/or repos against the collateral of investment grade corporate bonds, commercial papers (CPs), debentures and certificates of deposit (CDs) held by mutual funds.

Liquidity support provided by the funds obtained through the SLF-MF is eligible to be classified as held to maturity (HTM) in excess of 25% of the total investment permitted to be included in the HTM portfolio. It is also exempt from banks’ capital market exposure limits.

Responding to the requests from banks, these regulatory benefits also became available to all banks providing liquidity support to mutual funds regardless of whether they used funds from the SLF-MF or from their own resources as of April 30. A bank claiming the regulatory benefits was required to submit a weekly statement containing consolidated information on its support as long as the SLF-MF was open.

Some commentators view the SLF-MF as a step in the right direction, easing liquidity concerns and providing a psychological signal to mitigate investor panic. However, the measure is small relative to the asset management sector as a whole. According to the RBI’s most recent Financial Stability Report (p.51), mutual funds are “the largest net providers of funds to the financial system.”
India faces a substantial crisis of confidence, as its economy has been at a standstill since the nationwide lockdown implemented in early March. Even before COVID-19 concerns, rising corporate defaults, the collapse of lenders, and questionable lending practices in the mutual fund industry raised questions about the resilience of the financial system in India. On May 12, India’s Prime Minister Narendra Modi announced a $260 billion economic rescue package, an amount equal to 10% of India’s GDP, but currently short on details.
Bank of Japan Increases Liquidity Measures

By Manuel Leon Hoyos

Original post here.

On May 22, the Bank of Japan (BOJ) extended and expanded its “Special Program to Support Financing in Response to the Novel Coronavirus (COVID-19)” to 75 trillion yen (about $700 billion). This includes three programs: (1) $186 billion in Outright Purchases of Commercial Paper and Corporate Bonds, (2) $233 billion for the Special Funds-Supplying Operations, and (3) $279 billion for the recently launched New Fund-Provisioning Measure to support small and medium-sized enterprises. The duration of the measures was extended by six months from September 30, 2020 to March 31, 2021. On March 16, the BoJ had announced emergency measures to facilitate corporate financing that included the first two measures (For details on the third measure, see this YPFS blog post).

On April 27, the BOJ increased its upper-limit on Outright Purchases of Commercial Paper and Corporate Bonds to $186 billion. This is a standing facility the BoJ has used for many years to conduct its monetary policy. Eligible counterparties must have a current account at the BoJ and be deemed sufficiently creditworthy. The mechanism requires counterparties to bid in competitive auctions the yield at which they desire to sell commercial paper or corporate bonds. The updated terms and conditions can be found here.

On April 27, the Special Funds-Supplying Operations was expanded from $72 billion to $233 billion. It also increased the number of eligible counterparties to include member financial institutions of central organizations of financial cooperatives (rules published on May 1) and expanded the range of eligible collateral to private debt in general, including household debt. The BoJ now applies a positive interest rate of 0.1% to the outstanding balances of current accounts held at the BoJ. The program lends against corporate debt at a 0% interest rate, with maturities up to one year. The original terms and conditions can be found here.

Additionally, the BoJ has further incorporated active purchases of Japanese government bonds (JGBs) and Treasury discount bills (T-Bills) to maintain stability in the bond market and stabilizing the yield curve at a low level.

During the 2007-09 global financial crises, the BoJ introduced both the Special Funds-Supplying Operations and Outright Purchases of Commercial Paper. Both of these programs had intended to facilitate corporate financing and were thought to have contributed to lowering interest rates in the commercial paper market. 

Click here to read a YPFS case study on the BoJ Outright Purchase of Commercial Paper and here for the Special Funds-Supplying Operations during the GFC. These cases provide details of the program and access to key documents.
The Bank of Mexico Plans to Inject $30 billion to Provide Liquidity

By Manuel Leon Hoyos

Original post here.

On April 21, the Bank of Mexico (Banxico) unveiled a series of liquidity measures totaling $30 billion to “foster an orderly functioning of financial markets, strengthen the credit channels and provide liquidity for the sound development of the financial system.”

The market liquidity measures total 3.3% of last year’s GDP. So far, only the government securities swaps have been in operation; rules for additional facilities were published last week. In addition to these measures, Banxico cut interest rates by 50 basis points, and again on May 14 to 5.5% — its lowest level since December 2016. So far, Banxico has cut 175 basis points this year.

Mexico, the second largest Latin American economy, has been hit hard by the COVID-19 crisis. Since February, the Mexican peso has depreciated by over 20%. The country has experienced shortages in foreign exchange liquidity and a sharp fall in commodity prices — particularly crude oil prices. According to Banxico, the crisis has brought “the greatest contraction ever recorded of holdings of emerging economies’ assets, especially of fixed-income instruments.” Additionally, Mexico’s sovereign credit rating and Mexico’s national oil company Pemex have been downgraded. Mexico’s central bank expects the Mexican economy to contract by 5% in the first half of 2020 — a forecast that might be revised in the next quarterly report at the end of May. The IMF currently expects a 6.6% contraction in 2020.

The $30 billion in liquidity includes programs financing SMEs and individuals, the corporate debt market, the government debt market, and other domestic debt markets. In addition, existing facilities have been expanded to provide greater liquidity and foreign exchange hedges. Banxico published rules for financial institutions on these measures in Mexico’s Official Journal Circular 15/2020 on May 13 and Circulars 16/2020, 17/2020, and 18/2020 on May 19.

For SMEs funding:

- A $10 billion financing facility directed to support micro, small-, and medium-sized enterprises, and individuals will operate through commercial and development banks. Resources will come from Banxico’s Monetary Regulation Deposits (DRM) or, if necessary, the Banxico will provide financing at terms of 18-24 months, at the overnight interbank interest target rate. The DRMs are mandatory long-term deposits from national credit institutions in the Banxico and have an indefinite maturity date and generate yields equivalent to the interbank funding rate. They differ from the reserve requirement used by other central banks in that the DRM is not continually adjusted according to fluctuations in the benchmark liabilities of the banks. The DRM may be
used as collateral in Banxico’s transactions with banking institutions such as in liquidity-providing auction. (see here on DRM). Securities eligible for the Ordinary Additional Liquidity Facility (FLAO) will be eligible for this facility. The FLAO has been available since 2008 and offers liquidity to commercial banks through collateralized credits or repos, at a reduced cost of 1.1 times the Bank of Mexico’s target overnight interbank interest rate.

- A $4 billion temporary collateralized financing facility is directed for commercial banks holding corporate loans of micro, small- and medium-size enterprises. The facility will provide financing at a term of 18-24 months, at the target overnight interbank interest rate. The financing will be guaranteed by the SME corporate loans held by the commercial banks, with credit ratings of at least “A” at local scale, by at least two rating agencies.

For the corporate debt market:

- A $4 billion Corporate Securities Repurchase Facility (FRTC) aims to support the corporate debt market by providing liquidity for short-term corporate securities and long-term corporate debt. Eligible securities include those issued by nonfinancial private companies that reside in Mexico and comply with FLAO criteria. The cost of the repos will be 1.1 times the average of the overnight interbank interest rate.

For the government debt market:

- A $4 billion facility to repurchase government securities at longer terms than in regular open market operations aims to facilitate intermediation of government securities. Financial institutions holding government debt will obtain liquidity without the need to dispose of their securities in stressed financial markets. The cost of repurchase agreements will be set at 1.02 times the average of the overnight interbank interest rate.

- A $4 billion facility for auctions of government securities swaps will trade long-term securities of at least 10 years in exchange for shorter maturities of up to 3 years to promote proper functioning of the government debt market. The terms for each swap will be determined in each auction. The first auctions occurred on April 29.

For the general domestic debt market:

- A $4 billion temporary debt securities swap facility is to promote an orderly behavior of Mexico’s debt market. The facility aims to provide liquidity for securities that have become illiquid in the secondary market. Eligible institutions can exchange debt securities exchange for government securities. FLAO criteria apply for Peso-denominated securities eligible for the facility.

Other extensions of existing facilities:
• The Bank of Mexico widened the eligibility of debt securities in FLAO repos and of collateral for foreign exchange hedges settled by differences in US dollar credit auctions. Securities eligible in Mexican pesos must have credit ratings of at least “A” in the local scale or “BB+” in the global scale (for securities denominated in foreign currency), from at least two agencies.

• In order to foster a sound functioning of the money market, Baxico has preserved excess liquidity during trading hours. To foster the orderly operating conditions in the MXN/USD exchange market, particularly when markets in Asia and Europe operate, by instruction of the Mexican Foreign Exchange Commission, the Bank of Mexico will conduct hedge transactions settled by differences in US dollars at hours when Mexican markets are closed.

• Banxico reduced the DRM by $2 billion. The resources will improve the liquidity of these institutions and their capacity to grant credit.
Federal Reserve Expands Support to Corporate Bond Markets Again

By Manuel Leon Hoyos

Original post [here](#).

On June 15, the Federal Reserve (Fed) updated and expanded the Secondary Market Corporate Credit Facility (SMCCF), one of the Fed’s corporate bond-buying programs, to support market liquidity and the availability of credit for large employers. The recent change allows the facility to buy U.S. corporate bond portfolios that track a broad market index.

Bonds eligible for the [Broad Market Index](#) must:

- have remaining maturity of up to 5 years
- be issued in the U.S. or under the laws of the U.S
- meet the same rating requirements for eligible individual corporate bonds under the SMCCF
- not be issued by an insured depository institution, depository institution holding company, or subsidiary of a depository institution holding company, as defined in the Dodd-Frank Act.

Ratings are subject to review by the Fed. This expansion will complement the Fed’s purchases of exchange-traded funds. As of May 19, the Fed’s total outstanding amount of loans under the SMCCF was $1.29 billion. For more information about the SMCCF and the Primary Market Corporate Credit Facility, see the previous [YPFS blog post](#).
Japan Begins Capital Injections for Financial Institutions in Response to COVID-19

By June Rhee with research assistance from Vaasavi Unnava

Original post here.

***The author would like to thank Junko Oguri for exceptional research support and comments.

On June 13, the Japanese Diet passed an amendment to the Act on Special Measures for Strengthening Financial Functions (ASFF) extending the period of government capital injection to financial institutions from March 31, 2022 to March 31, 2026 and expanding the available public funds for the injection from ¥12 trillion to ¥15 trillion.

The ASFF, first introduced in 2004, has injected ¥674.84 billion into 30 institutions over the past 16 years. A YPFS case on the previous ASFF can be accessed here. ¥474.34 billion remains outstanding as of September 2019. (see here) The first amendment was during the 2007-09 global financial crisis (GFC) introducing a focus for SME-support. Under this amendment, the government had injected ¥309 billion to various financial institutions.

In proposing the new amendment this month, the Japan Financial Services Agency (JFSA) emphasized that the domestic financial system is currently sound and this is a preemptive measure ensuring the long-run soundness of the financial system so that it can continue to support small and medium-sized enterprises (SMEs) impacted by the COVID-19 crisis and revitalize the economy.

All financial institutions are eligible for capital injections, however, as the amended ASFF specifically focuses on SME lending, the main recipients of the capital injection are expected to be regional banks. Institutions must first submit an application to the JFSA. The application will include: (i) numerical targets for an institution’s profitability and efficiency, and means to achieve those targets, (ii) related commitments by the management, and (iii) measures the institution will take to facilitate credit to SMEs and revitalize the local economy. (see here)

The Financial Functions Enhancement Examination Committee, currently composed of five members from the private sector, then will review each application. It will evaluate: (i) the feasibility of the targets, (ii) whether the institution will be able to repay within 15 years, and (iii) current asset value. (see here) The review meeting minutes and participants’ list will be posted here.

However, the amended ASFF allows financial institutions “affected by coronavirus” to apply for an injection without meeting the first two hurdles. Such institutions must meet only the third hurdle, to describe measures they will take to facilitate credit to SMEs. “Affected” institutions are those whose “financial statements have gotten considerably worse due to the coronavirus or measures to prevent coronavirus, or if the financial institution needs to lend to companies that are affected by coronavirus or measures to prevent coronavirus.”
Moreover, the review process for these “affected” institutions will neither consider the feasibility nor the 15-year deadline but only consider the best possible asset value of the institution based on available information. (see here) However, a news report notes that the JFSA had expressed intentions to set repayment dates for each bank receiving capital injection.

Once the application is approved, the Deposit Insurance Corporation of Japan (DICJ) will purchase preferred shares, as consistent with injections under the previous ASFF. However, the amended ASFF further allows the DICJ to purchase common stocks and subordinated debt from the “affected” institutions. It is not clear whether the common stocks will be voting or non-voting.

The JFSA notes that a wider variety of capital will meet the needs of different financial institutions. The JFSA also announced lower dividend rates than normal for shares purchased from affected financial institutions. (see here) The DIJC has existing guidelines on exercising voting rights and disposing of preferred shares but these have yet to be updated. The capital injection for affected financial institutions does not require recipient companies to limit dividend payments to existing shareholders.

A commentator questions the amended ASFF as it no longer sets a repayment deadline. Regional banks have already been struggling with the decline in population and in the number of borrowers. Some market observers are skeptical about whether banks receiving ASFF capital will be able to repay.

The same commentator notes that Mr. Toshihide Endo, the Commissioner of the JFSA, had denied that the amended ASFF would lead to nationalization. Although the JFSA has promised a rigorous review process for the application and its best efforts to improve profitability and management of the assisted institutions, the commentator remains pessimistic about the future of regional banks.

Takahide Kiuchi, a former Bank of Japan Policy Board Member, acknowledges that this amended ASFF may carry a risk of moral hazard in the long run but emphasizes that it is justified under the current unusual economic environment. Kiuchi also commends the government for implementing this difficult policy early on.

Ogawa and Tanaka examine the nature of the shocks that hit the SMEs during the GFC and how they responded to these shocks. They find that the capital injection under the ASFF may have acted to strengthen the role of financial institutions as a buffer for SMEs against these shocks.
ECB Announces New Eurosystem Repo Facility to Provide Euro Liquidity

By Aidan Lawson

Original post here.

On June 25 the European Central Bank (ECB) announced a new facility to provide euro liquidity to non-eurozone central banks. The announcement does not specify the total size of this new facility.

The Eurosystem repo facility for central banks (EUREP) is designed as a “precautionary backstop to address pandemic-related euro liquidity needs outside [the] euro area” (see here). It is intended to reduce both the impacts and risks of sudden sell-offs of euro-denominated assets and any potential confidence-related spill-over effects into the euro area. The EUREP complements the ECB’s standing swap lines with 11 countries (see here) and one bilateral repo agreement (see here), addressing the limited access to euros that central banks have.

Any non-Eurosystem central bank can request a EUREP line, even those that already have existing bilateral swap lines or repo arrangements. The ECB’s Governing Council, which consists of 25 total members - 6 from the Executive Board and the governors of the 19 national central banks - makes the final decision. Central banks that are accepted will be able to borrow euros in exchange for euro-denominated debt issued either by euro-area governments or supranational institutions.

While a term sheet has not yet been released, the ECB has specified that the facility will be "slightly" more expensive than its existing bilateral swap and repo lines. The range of collateral will be narrower (see here). These terms, and the involvement of the Governing Council, reflect the ECB’s desire for the facility to be used exclusively as a backstop, rather than a facility that non-euro central banks turn to immediately.

EUREP may also be seen as a complement to its U.S-based counterpart: the Federal Reserve’s temporary repurchase agreement facility for foreign and international monetary authorities, or “FIMA repo facility.” The FIMA repo facility, created on March 31, mirrors the EUREP’s function as a liquidity backstop. However, unlike EUREP, it is only available to central banks and other foreign monetary authorities with existing accounts with the central bank. For more information on the FIMA repo facility, see the following YPFS blog. The usage of FIMA repo facility has been low, with $1.4 billion in dollar repos outstanding as of the week of May 13, and limited activity since then.

However, the Fed’s existing swap lines with 14 central banks have been used extensively, peaking at over $440 billion at the beginning of May (see here). The ECB has not published usage data for their swap lines or bilateral repo agreements. Swap lines were an effective tool in meeting demand for widely used currencies, especially during the Global Financial Crisis (GFC). The Fed’s swap lines were used extensively by the ECB, the Bank of Japan, and other major
central banks during the GFC (see here). For more information on usage of swap lines currently and during the GFC, see the following YPFS blog.

EUREP will be active through June 2021, and the exact pricing, collateral eligibility and tenor of the repos are still unknown. We will publish updates as details become available.
Brazil’s central bank injects liquidity in financial markets

By Aidan Lawson

Original post here.

In March, Brazil’s central bank (BCB) unveiled a series of liquidity measures totaling $243 billion (1.2 trillion Brazilian reals) to ensure that “financial institutions have funding to meet the market’s liquidity needs.” The measures represent about 16.7% of last year’s GDP. In addition, the BCB can now temporarily purchase government bonds directly in the primary market and purchase corporate bonds in the secondary market due to recent constitutional amendments.

Brazil, the largest Latin American economy, has been hit hard by COVID-19. It recently became the second country after the U.S. to surpass 50,000 deaths. Since March, Brazil has experienced shortages in foreign exchange liquidity; the Brazilian real has depreciated by over 25%; and Brazil’s national debt hit a record 79.7% of GDP in April. The IMF currently expects a 9.1% contraction in 2020. (For the Bank of Mexico’s liquidity measures, see this YPFS blog post.)

The BCB stated that it “will not hesitate to use its entire arsenal to ensure financial stability and smooth operation of the money and foreign exchange markets — supporting, therefore, the normal functioning of the Brazilian economy.”

On May 7, Brazil amended its constitution to temporarily allow the BCB to directly purchase government debt during the COVID-19 crisis. Previously, the BCB could only buy government debt on secondary markets. BCB’s President Roberto Campos Neto said that the newly granted powers are intended for “market stabilisation and not an alternative form of monetary policy.”

Additionally, the BCB can now purchase corporate bonds in the secondary market. In regards to these non-financial sector assets, the constitutional amendment sets limitations. Securities must have a BB- rating or higher provided by an international credit rating agency, and the reference price published by a financial market entity needs to be approved by the BCB (BCB Circular 4028).

The $243 billion in liquidity measures include fostering credit for SMEs, increase in the amount reserve requirements are taken into account in the Liquidity Coverage Ratio, reduction of the Capital Conservation Buffer, restrictions on dividends distribution and top managerial compensation, and other temporary relaxation of rules. Among those measures, this post focuses on measures aiming to support certain financial markets.

For the credit market by providing liquidity to financial institutions:

- Through the Special Temporary Liquidity Facility (LTEL-LFG), the BCB lends up to $134 billion to financial institutions backed by Guaranteed Financial Letters (LFG) collateralized by loan pools or securities. Financial letters’ primary issuance must be
registered with a central depository, and the financial assets or securities pledged as collaterals must be fiduciarily assigned to the BCB (CMN Resolution 4795).

- Through the Special Temporary Liquidity Line (LTEL), the BCB lends up to $18.2 billion in domestic-currency to financial institutions backed by debentures. These operations are guaranteed by reserves that financial institutions hold at BCB (CMN Resolution 4786).

- The New Term Deposit with Special Guarantees (NDPGE) offers an alternative fundraising instrument to financial institutions members of the Credit Guarantee Fund (FGC). The FGC is one of the two private nonprofit entities in Brazil that provides deposit insurance and protects clients of financial institutions in the event of resolution. It is regulated by the National Monetary Council and the BCB. The NDPGE increases the guarantee amount for its member institutions in an amount corresponding exactly to their net worth, limited to $400 million (CMN Resolution 4785). The NDPGE was used in 2009 during the 2007-09 global financial crisis and is now expected to expand credit provision by $40 billion. FGC’s guarantees do not involve public funds since they are funded by premiums paid by member institutions.

**For the government bond market:**

- The BCB will conduct up to $10 billion in repurchase operations (repos), with up to one-year terms, collateralized by Brazilian sovereign bonds denominated in US dollars. The repos are expected to reduce volatility in the market. A 10% haircut will apply and there is a transfer of margin during the repurchase maturity period, whenever the exposure of any counterparty is equal to or greater than $500,000 (BCB Circular 3990).

**For the foreign exchange (FX) market:**

The BCB has been intervening in foreign exchange markets, supported by a cushion of foreign exchange reserves. That support was as high as 20% of Brazil’s GDP in March. BCB interventions may be conducted through currency swaps, operations in the spot market, and repo lines of credit.

- In March, the BCB and the U.S. Federal Reserve established a $60 billion liquidity swap line for at least six months. The swap line potentially expands U.S. dollar availability in the domestic market, and does not entail economic policy conditionalities. BCB’s President Campos Neto said that “for Brazil, the swap line reassures external investors and commercial partners. But it works much more as a signal than as an effective source of U.S. dollars for the Brazilian economy, since we do not foresee the need to use the facility.”

- Tax effects arising from the FX hedge operations of banks will not be deducted from their equity (CMN Resolution 4784). Banks hedge their investments on equity held abroad, in order to obtain protection against exchange-rate fluctuations. The estimated capital
relief is $9.2 billion, which could allow for an additional $104 billion in credit operations.

- A legislative change eliminated the tax asymmetry between the financial impacts of exchange-rate fluctuations on banks’ investments overseas and the impact of the associated foreign-exchange rate hedge of this investment (Provisional Measure 930). This asymmetry is an incentive for banks to contract excess protection—the so-called overhedge. In times of higher FX volatility, the effect of the FX variations on the overhedge increases demand for dollar liquidity by banks, reinforcing FX volatility and entailing negative effects on FX market functionality.
**Table 1**: Brazil’s Central Bank Liquidity Measures Usage (as of June 29, 2020)

<table>
<thead>
<tr>
<th>Liquidity Measures</th>
<th>Potential</th>
<th>Implemented</th>
</tr>
</thead>
<tbody>
<tr>
<td>Special Temporary Liquidity Line (LTEL-LFG): loans</td>
<td>$134 billion</td>
<td>$5.2 billion</td>
</tr>
<tr>
<td>backed by Guaranteed Financial Letters (LFG)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Special Temporary Liquidity Line (LTEL): loans backed</td>
<td>$18.2 billion</td>
<td>$0.6 billion</td>
</tr>
<tr>
<td>by debentures</td>
<td></td>
<td></td>
</tr>
<tr>
<td>New Term Deposits with Special Guarantees (NDPGE)</td>
<td>$40 billion</td>
<td>$1.2 billion</td>
</tr>
<tr>
<td>One-year term repos backed by federal government bonds</td>
<td>$10 billion</td>
<td>$4.6 billion</td>
</tr>
<tr>
<td>Swap Lines with the Federal Reserve</td>
<td>$60 billion</td>
<td>Not used</td>
</tr>
<tr>
<td>Overhedge: capital relief</td>
<td>$104 billion</td>
<td>$104 billion</td>
</tr>
</tbody>
</table>

Source: Brazil’s Central Bank, Presentations by Governor Roberto Campos Neto. [June 29](#) and [June 26](#).
RBI to provide liquidity to non-bank financial firms

By Junko Oguri

Original post here.

On July 1, the Reserve Bank of India (RBI) announced guidelines for a $4 billion ($300 billion) special liquidity scheme (SLS) to purchase short-term debt from eligible non-banking financial firms (NBFCs) and housing finance companies (HFCs). The RBI said its purpose is to “avoid any potential systemic risk to the financial sector.”

This liquidity scheme is consistent with what the Finance Minister announced as part of a COVID-19 relief package on May 13. The Indian government’s broader “Self-Reliant India Movement” (Aatmanirbhar Bharat Abhiyaan), a special economic and comprehensive package, is equivalent to 10% of India’s GDP.

SBI Capital Markets (SBICAP), a subsidiary of a state-owned commercial lender, set up the SLS Trust, a special purpose vehicle (SPV). RBI will provide funds by subscribing to special securities issued by the Trust. These securities will be granted unconditional and irrevocable guarantees by the Indian government. RBI will provide liquidity to the SLS Trust based on its realized purchases of short-term paper from eligible companies. The total outstanding short-term paper purchased by the Trust may not exceed $4 billion ($300 billion).

In order to participate in the SLS, NBFCs and HFCs must fulfill the following eligibility criteria:

- NBFCs, including Microfinance Institutions, that are registered with the RBI under the RBI Act, 1934, excluding those registered as Core Investment Companies;
- HFCs that are registered under the National Housing Bank Act of 1987;
- The eligible institution’s capital adequacy ratio should not be below the regulatory minimum (i.e., 15% for NBFCs and 12% for HFCs);
- The institution’s net non-performing assets should not be more than 6% (as of March 31, 2019);
- The institution should have made a net profit in at least one of the last two preceding financial years;
- The institution’s borrowing should not have been reported as “special mention account” (whose repayments are overdue for between 31 to 90 days) by any bank during the one year prior to August 1, 2018; and
- The institution should be rated investment grade by an Securities and Exchange Board of India (SEBI) [FG1] registered rating agency.
The SLS Trust will purchase commercial paper (CP) and negotiable certificate of deposits (NCDs) of eligible NBFCs and HFCs on an application basis. The Trust can invest in securities either on the primary or secondary market.
The CP and NCDs of eligible institutions must meet the following requirements:

- The CP and NCDs must be rated investment-grade by credit rating agencies registered with SEBI.
- The CP and NCDs must be issued before September 30, when the SPV will cease purchases.
- The CP and NCDs must have residual maturity of up to 90 days.
- The CP and NCDs should be in the NBFCs and HFCs’ standard books as on date of sale and should not have defaulted on that date.

The SLS Trust has launched an investment committee, consisting of representatives from the SBICAP and its parent company, the State Bank of India. The unanimous decision by the committee will ultimately determine further details of the purchase, including the followings:

- Any additional evaluation criteria
- Optional collateral requirement
- The maximum amount of liquidity that the Trust will provide to a single NBFC/HFC
- Interest rate (yield)
- Purchasing market (primary/secondary)

The NBFCs and HFCs must use the acquired liquidity solely to repay pre-existing liabilities and shall not be used to expand assets.

The SLS is similar to a liquidity scheme that RBI set up during the Global Financial Crisis. In February 2009, RBI announced a liquidity scheme of ₹200 billion ($2.6 billion) for NBCFs in order to “meet the temporary liquidity mismatches.” An SPV was set up to purchase short-term paper, and RBI extended the scheme twice. Anand Sinha, former Deputy Governor of the RBI, recalls that “the actual condition of NBFCs was not so alarming” and only one NBCF used the scheme.

Some commenters argue that the SLS will successfully support small and medium-sized non-banks that are unable to raise funds from CP and bond markets. One commentary suggests that NBFCs could be facing CP repayments of close to $8.7 billion (₹650 billion) in the coming three months.

At the same time, some are doubtful that the SLS will be sufficient to buttress financial stability. For instance, Abizer Diwanji, leader for financial services at EY, notes that the SLS could be too small given that NBFCs account for $3.6 trillion (₹27 trillion) in term of lending, of which $2.5 trillion (₹19 trillion) is financed via the capital markets.
Non-banks in India had been facing difficulties before the COVID-19 crisis, particularly since the default of Infrastructure Leasing & Financial Services (IL&FS) in September 2018. On July 1, Fitch Ratings reported that India’s non-bank financial institutions will “continue to face elevated near-term risks, even as economic activity picks up with the easing of the country’s nationwide lockdown.” The same commentary also noted that the moratorium will “erode payment discipline and its extension will result in lagged asset-quality problems” for non-banks, “particularly when combined with the economic damage from the pandemic and lockdown.”

As of July 7, India has reported more than 719,600 total cases. The country has overtaken Russia as the third country in terms of positive cases, behind the US and Brazil.
Implications of the German Constitutional Court’s Objection to the ECB's Public Sector Purchase Program

By Aidan Lawson

Original post here.

The Bundesbank, the German central bank, will continue to participate in the European Central Bank’s Public Sector Purchase Program (PSPP) after the German finance minister and parliament declared that the Bundesbank’s participation was allowable under EU guidelines.

This is the latest episode in a legal battle that has seen Germany’s Federal Constitutional Court (the “Court”) pitted against the European Central Bank (ECB). The Court fulfils a judicial review function similar to the U.S. Supreme Court.

The Court initially issued several preliminary inquiries for review to the Court of Justice of the European Union (CJEU) in 2017. The German Court argued that the PSPP purchases constituted monetary financing of ECB member state budgets, overstepped the monetary policy mandate of the ECB, and created “a potential encroachment upon the Member States’ competences and sovereignty in budget matters.” The CJEU ruled in December 2018 that the program did not overstep the ECB’s monetary policy mandate.

But the German Court returned to the issue in May 2020. It delivered a landmark ruling that disregarded the CJEU’s previous judgment, arguing that the ECB’s actions qualified as ultra vires, or done beyond one’s legal power or authority. The Court also argued the CJEU’s decision violated the principle of proportionality, which states that any action by EU institutions (including the ECB) “shall not exceed what is necessary to achieve the objectives of the Treaties” among sovereign European nations (see here, pp. 18).

It should be noted that the Court explicitly stated that its ruling in May 2020 did not concern any COVID-19-related financial assistance measures.

In the May ruling, the Court cited a number of economic effects of the PSPP that it said the European Central Bank and court had failed to consider. These were:

1. The bond-buying allowed member states to obtain cheaper financing than they otherwise would be able to.
2. The size and duration of the program created proportionality concerns, even if the initial terms may have been proportionate.
3. The purchase of “high-risk” government bonds by the ECB improved the financial condition of the banks selling these and improved their credit rating.
4. As the PSPP lowered interest rates, it could have allowed companies that were not viable to continue operating, raising moral hazard concerns.
The Court did not express a view on whether the PSPP constituted monetary financing, which is prohibited by Article 123 of the TFEU (see here, pp. 99).

While the Court, as a German judicial body, has no authority over the ECB or other member states, the May ruling meant that the Bundesbank would not be allowed to participate in the PSPP. The PSPP is by far the largest of the ECB’s asset purchase programs and the Bundesbank is the largest participant, per the capital subscription guidelines for the ECB. Purchases consist of bonds issued by governments, euro-area international organizations, and multilateral development banks.

To address these concerns, the Court requested that the ECB conduct a “proportionality assessment.” The ECB had three months to conduct this assessment, and the Court threatened to block the Bundesbank from participating in the program if it was not done within three months.

In response, the ECB released several unpublished documents and meeting minutes to the German government that highlighted the debate amongst ECB members of the economic effects of the asset purchases (see here). In late June, the German finance minister and parliament declared that the assessment delivered by the ECB met the requirements outlined in the Court’s ruling, which allows the Bundesbank to continue purchasing bonds.

Figure 1. Total ECB Expanded Asset Purchase Programme (EAPP) holdings (EUR Billions)
Bundesbank President Jans Weidmann tacitly sided with the German Court. Over the past nine years, he has consistently spoken against the ECB’s unconventional policies (see here). It is currently unclear if the Bundesbank will issue a formal statement on this decision or just let the deadline on August 5 pass, since the Bundesbank has not generally supported the ECB’s unconventional programs in the past. Regardless, individuals close to the matter have stated that the central bank would “take its lead” from the German government and finance minister (see here).

In response to the COVID-19 crisis, the ECB has dramatically increased the scale of its asset purchases, primarily through the PSPP, as well as through the new temporary pandemic emergency purchase programme (PEPP). For more information on PEPP, see this YPFS blog post. From February 2020 to March 2020 the amount of securities purchased under the PSPP increased from €14.1 billion to €37.3 billion. See Figures 1 and 2 below for a breakdown of the ECB’s standing asset purchase facilities.

**Figure 2.** Monthly net PSPP asset purchases (EUR billions)

The May ruling received some backlash, with a former ECB vice president calling it “nonsensical.” The far-right Alternative for Germany (AfD) party has already unveiled pending
legal action against the PEPP. Some members of the European parliament have expressed concern that the challenge could be the first of many by national governments that seek to question the independence and credibility of the CJEU and ECB.
The Federal Reserve expands eligible counterparties and agents in three emergency facilities

By Manuel Leon Hoyos

Original post here.

On July 23, the Federal Reserve expanded eligible counterparties and agents in three emergency lending facilities: the Term Asset-Backed Securities Loan Facility (TALF), the Commercial Paper Funding Facility (CPFF), and the Secondary Market Corporate Credit Facility (SMCCF). This move is aimed at increasing the Fed’s operational capacity and reach into the targeted markets.

The Federal Reserve Bank of New York (FRB-NY) has relied on existing primary dealers as counterparties and agents. However, it now seeks to expand counterparties to include non-primary dealers. The FRB-NY has requested expressions of interest in order to identify additional commercial paper dealers for the CPFF, agents for the TALF, and broker-dealers for the SMCCF.

Any new counterparty or agent should be a broker-dealer registered with the Securities and Exchange Commission (SEC) and regulated as a member of the Financial Industry Regulatory Authority (FINRA) with an established track record operating in the targeted market, a net regulatory capital of at least $1 million, and shareholders’ equity of at least $1 million.

Potential counterparties and agents will be prioritized based on their ability to add operational capacity or expand the access and reach of the facility (see the latest terms and conditions for the TALF, CPFF and SMCCF).

The three emergency lending facilities were created under section 13(3) of the Federal Reserve Act, under “unusual and exigent circumstances,” with the U.S. Treasury Secretary’s approval and an equity investment. The facilities are part of a $2.3 trillion Fed lending package aimed at supporting the flow of credit to households, businesses, and the broader economy.
Federal Reserve Extends Lending Programs to December 31
By Mallory Dreyer and Kaleb Nygaard

Original post here.

On July 28, the Federal Reserve announced that seven of its COVID-19 emergency lending facilities that were set to expire on or around September 30 have been extended to December 31.

These deadline extensions come after multiple comments from Fed officials regarding the importance of the public health response and the uncertainty regarding how long the crisis will last. Federal Reserve officials are meeting on July 28 and 29 but are not expected to announce new stimulus measures.

The table below lists expiration dates for all nine active emergency Fed lending facilities.

<table>
<thead>
<tr>
<th>Lending Facility</th>
<th>Original Expiration</th>
<th>New Expiration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary Dealer Credit Facility (PDCF)</td>
<td>September 20, 2020</td>
<td>December 31, 2020</td>
</tr>
<tr>
<td>Money Market Mutual Fund Liquidity Facility (MMLF)</td>
<td>September 30, 2020</td>
<td>December 31, 2020</td>
</tr>
<tr>
<td>Primary Market Corporate Credit Facility (PMCCF)</td>
<td>September 30, 2020</td>
<td>December 31, 2020</td>
</tr>
<tr>
<td>Secondary Market Corporate Credit Facility (SMCCF)</td>
<td>September 30, 2020</td>
<td>December 31, 2020</td>
</tr>
<tr>
<td>Term Asset-Backed Securities Loan Facility (TALF)</td>
<td>September 30, 2020</td>
<td>December 31, 2020</td>
</tr>
<tr>
<td>Paycheck Protection Program Liquidity Facility (PPPLF)</td>
<td>September 30, 2020</td>
<td>December 31, 2020</td>
</tr>
<tr>
<td>Main Street Lending Program (MSLP)</td>
<td>September 30, 2020</td>
<td>December 31, 2020</td>
</tr>
<tr>
<td>Municipal Liquidity Facility (MLF)</td>
<td>September 30, 2020</td>
<td>December 31, 2020</td>
</tr>
<tr>
<td>*extended on April 27</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commercial Paper Funding Facility (CPFF)</td>
<td>March 17, 2021</td>
<td>n/a</td>
</tr>
</tbody>
</table>

For usage information about the Fed facilities, see YPFS’s July 24 update. YPFS has also created detailed timelines for the Paycheck Protection Program Liquidity Facility and the Main Street Lending Program.
Bank of England Rapidly Expands Asset Purchase Facility

By Adam Kulam

Original post here.

In response to the COVID-19 crisis, the Bank of England (BoE) has expanded its existing Asset Purchase Facility (APF) from GBP 445 billion to GBP 745 billion (USD 950 billion).

BoE created the APF in January 2009 to ease corporate credit conditions during the 2007-2009 Global Financial Crisis. One month later, BoE expanded the APF remit to achieve monetary policy objectives through quantitative easing (QE), and purchased GBP 200 billion of UK government bonds. Last March, BoE relied on QE to restore order to gilt markets and guide price levels towards its 2% inflation target. As global financial conditions tightened due to COVID-19, the BoE’s Monetary Policy Committee (MPC) noted that “conditions in the UK gilt market had deteriorated substantially as investors sought shorter-dated instruments that were closer substitutes for highly liquid central bank reserves.”

Worldwide, financial market participants moved money away from risky assets and government bonds, and shifted to cash, especially US dollars. Within the UK, fixed-income strategists expected the British government to launch ambitious fiscal stimulus measures to counter the effects COVID-19 on businesses and consumers. Her Majesty’s Treasury’s (HMT) Budget 2020, announced on March 11, described just GBP 30 billion of coronavirus relief, and the government’s five-year macroeconomic forecasts limited the incorporation of additional COVID-19 spending into its projections of fiscal expenditure. On March 17, Chancellor Rishi Sunak announced additional emergency support for both new and existing programs, and the additions were not captured by the Budget 2020’s GBP 30 billion figure.

The UK government’s successive announcements of COVID-19 interventions stirred concerns about whether investors would have sufficient demand for the gilts that the government would have to issue to pay for the stimulus. By March 19, UK financial markets exhibited heightened volatility: the GBP/USD exchange rate hit a 35-year low, risky asset prices fell, both investment-grade and high-yield bond spreads soared, and gilt yields spiked. After the Debt Management Office (DMO), which is a part of the HMT responsible for government wholesale sterling debt issuance, successfully completed the morning’s auction, gilt markets entered into a standstill.

On the same day, the MPC obtained permission from HMT to purchase GBP 190 billion of gilts and GBP 10 billion of non-financial, investment-grade corporate debt from the secondary market to address the deteriorating conditions of gilt markets. “Had the Bank not stepped in, things would have gotten very difficult,” said Sir Robert Stheeman, chief executive of the DMO. Gilt purchases commenced on March 25, and corporate bond purchases on April 7.

By June 17, the APF had grown to GBP 613 billion while the MPC maintained the Bank Rate steady at 0.10%. After completing nearly 80% of its emergency asset purchases, the MPC
decided to raise the APF target by an additional GBP 100 billion of government debt, bringing the total stock to GBP 745 billion. Though the MPC acknowledged that recent setbacks to output and demand growth were not as bad as previously expected, 12-month CPI inflation remained low at 1.5% in March, 0.8% in April, and 0.5% in May. Some MPC members expressed a concern that inflation would fall even further due to prolonged unemployment. While the MPC’s March vote on QE was unanimous at 9-0, the June vote was 8-1: Andy Haldane later explained his belief that the upside news about demand outweighed the negative outlook on British labor markets, so further monetary easing was unnecessary.

The MPC omitted corporate debt purchases in its second round of expansion. The June 17 minutes offer details on high corporate credit demand, stabilization of credit conditions for firms, the UK government’s other corporate financing facilities, and already-indebted firms’ desires to seek other methods for raising capital. At the same meeting, the MPC decided to slow the weekly volume of asset purchases by about two-thirds because liquidity conditions improved, and asserted that it would be willing and able to raise the volume of weekly purchases if conditions worsened again.

The BoE purchases assets through the Asset Purchase Facility Fund Limited (APF), which is a wholly-owned subsidiary of the BoE, to raise prices and lower the yields on assets held by non-banks. As shown in Figure 1, BoE provides loans to the APF so that it can purchase assets. Depending on the MPC’s policy stance, the APF may repay loan principal or reinvest proceeds from gilt redemptions.

HMT sets the APF’s risk and control frameworks. HMT also fully indemnifies the APF’s net financial gains and losses. In a 2013 Quarterly Bulletin, the BoE acknowledged that APF involves large and variable cash transfers between the BoE and HMT, but stressed that the APF’s annual losses and gains are not appropriate metrics of success. Rather, the BoE argued, the success of the APF should be determined by its effects on credit conditions, nominal spending, and their effects on the medium-term inflation target.

Within the HMT, DMO has the remit to minimize the government’s long-term financing costs. DMO issues gilts to primary market buyers, who trade gilts on secondary markets. After the APF buys gilts from the secondary market, APF may lend a proportion of its gilts to DMO through the Debt Management Account for DMO’s short-term repo activities. In exchange for APF gilts, the DMO posts government securities of equal value and longer maturity as collateral, so there is no net change in the value of the APF’s gilt portfolio. The purpose of on-lending is to resolve market frictions stemming from the APF’s asset purchases.

Since 2016, the APF’s asset purchases have mostly maintained the same operating procedures. However, for the expanded APF in response to the COVID-19 crisis, it now includes the following changes:
• The MPC changed the definition of residual maturities from 7-15 years to 7-20 years (“medium”) and from 15+ years to 20+ years (“long”) to “free up additional headroom to purchase gilts” equally across the maturity sectors.

• On April 22, BoE doubled the gilt lending limit to insulate DMO repo facilities, which use gilts as collateral, from the Bank’s extensive gilt purchases, and minimize frictions between the APF and DMO.

• On June 4, BoE expanded the list of eligible corporate debt to include bonds with 3 months-to-maturity par call features.

BoE pledged to coordinate any reduction in the APF with the DMO. BoE Governor Andrew Bailey suggested that an exit strategy could involve gradual asset maturation or sales.

BoE emphasized that the combination of the APF and HMT’s programs on workers’ support, business assistance, tax deferrals, and other fiscal relief improved confidence in sterling markets; the sterling appreciated slightly, gilt yields fell, and the yield curve flattened. BoE also acknowledged that while the gilt market calmed, repo and money markets remained unstable and LIBOR-OIS spreads were still high. In a June 2020 interview with Sky News, Governor Andrew Bailey said that the BoE’s recent APF interventions worked because they restored order to markets. He said that the BoE decided to inject liquidity into the gilt market in order to reach the more illiquid nonbanking markets. At a Financial Times digital event, Governor Bailey acknowledged that the rapid expansion of quantitative easing both calmed the financial markets and smoothed the “profile of government borrowing.”

Some commentators have voiced concerns about threats to BoE’s independence due to the expansion of the APF. On June 25, 2020 BoE’s former deputy governor Paul Tucker claimed that the APF purchased more than what was necessary for market liquidity, and that this was not a “classic market maker of last resort operation” in a virtual Royal Economic Society event. On the other hand, Governor Bailey emphasized that it was a mere by-product of the current economic situation that the government was the largest borrower and the largest beneficiary of BoE’s asset purchases.

Though at least one other major central bank has attempted to partially unwind large-scale asset purchases within the last decade, the BoE has not officially planned to decrease the APF’s outstanding holdings since beginning quantitative easing (QE1) in January 2009. Over the next decade, BoE conducted successive asset purchases of GBP 175 billion (QE2), GBP 60 billion (QE3), and GPB 10 billion (Corporate Bond Purchase Scheme). The Yale Program on Financial Stability has published cases that cover these programs in greater detail.

Studies suggested that the BoE’s asset purchases from 2009 through 2016 had positive effects on price levels, output, and stock prices, and a negative effect on 10-year gilt yields. Some researchers argued that QE also decreased liquidity risk and lowered interbank credit spreads. There is also evidence that BoE’s asset-purchase shocks worked better during times of high financial market stress (2008-2010) rather than low market stress (after 2010). Though
scholars generally agree that the UK’s QE worked, they cannot pinpoint the policy channel through which the purchases were transmitted from the financial system to the real economy.

In addition to the expansion of APF, BoE cut rates by 15 basis points in response to the COVID-19 crisis to a level of 0.10%, the lowest Bank Rate in the Bank’s 325 years of operation. It also put forth the Term Funding Scheme with additional incentives for SMEs (TFSME), the COVID Corporate Financing Facility (CCFF), and supervisory and prudential easing.
UK Introduces Covid Corporate Financing Facility

By Aidan Lawson

Original post here.

On March 17, the UK government announced the creation of the Covid Corporate Financing Facility (CCFF) to purchase commercial paper from issuers that “make a material contribution to the UK economy.” Eligible issuers will broadly include all UK-incorporated companies, including those with foreign parents. The program will not purchase commercial paper issued by banks or their affiliates, or by leveraged investment vehicles.

The facility will purchase commercial paper between 10:00 and 11:00 each morning in both primary and secondary markets. In primary market purchases, the facility will purchase commercial paper through just one dealer each day. Issuers wishing to sell their commercial paper will have to coordinate to ensure that only one dealer sells to the facility each day. The Bank of England will publish aggregate data weekly but will not identify issuers or securities.

The facility will purchase investment-grade commercial paper with maturities ranging from one week to 12 months. Securities must have a face value of at least £1 million and cannot include features such as subordination or extendibility.

While the facility will be open for a minimum of 12 months, the Bank of England and HM Treasury said that it would be operational “for as long as needed to relieve cash flow.” The Bank of England pledged to provide six months’ notice before closing the facility. Current details can be found here. The Bank of England will release more details, including terms and conditions and a pricing schedule, on March 23.


The Secured Commercial Paper Facility (SCPF) began operating later in 2009. It was similar to the CPF. However, it purchased asset-backed commercial paper, and its eligibility criteria were much narrower. The SCPF only purchased CP from one institution while it was active. Monthly issuance peaked at about £30 million, and the facility was terminated in August 2016.

Despite the modest usage of both programs, market observers argued that the presence of these facilities showed that there would be a backstop should the market require one, restoring confidence.
Fed introduces Money Market Mutual Fund Liquidity Facility

By Rosalind Z. Wiggins

Original post here.

Money market mutual funds (“money funds”) are common investments for families, businesses, pension funds, municipalities and others. On March 18th, the Federal Reserve announced that it would implement a Money Market Mutual Fund Liquidity Facility (MMLF) to enable money funds to meet redemption requests and support the overall flow of credit to businesses and households. Money funds are significant investors in commercial paper, which many businesses rely on as a source of funding.

Under the MMLF, the Federal Reserve Bank of Boston will make nonrecourse loans to eligible financial institutions (including depository institutions, bank holding companies and US branches of foreign banks) anywhere in the country to facilitate the purchase of high-quality assets from eligible prime money funds. Loans will be for no more than 12 months or the term of the assets purchased, if less, and secured by the purchased assets. Assets eligible for purchase include: US Treasuries, agency securities, and highly rated unsecured and asset-backed commercial paper (ABCP) issued by US issuers. For additional details see the MMLF Term Sheet.

Participating financial institutions will not bear any credit or market risk from the purchased assets. For this reason, under a proposed rule modification, federal bank regulators will not require them to hold regulatory capital against these assets.

The Fed established the MMLF under Section 13(3) of the Federal Reserve Act, with approval of the Treasury Secretary (see here). Section 13(3) allows the Fed to lend to any “individual, partnership or corporation” when the Federal Reserve Board determines there are “unusual and exigent circumstances”. Although the MMLF loans will be made to depository institutions, they are for the benefit of money funds. Using the Exchange Fund, the Treasury has provided $10 billion as credit protection to the Fed.

The MMLF is similar to the Asset-backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) operated by the Fed from late 2008 through 2009. That facility funded $217 billion in purchases of commercial paper from mutual funds at a time when funds were experiencing significant withdrawals and when the commercial paper market was also under distress. It enabled money funds to access liquidity without having to sell assets into illiquid markets and helped fostered liquidity in the ABCP market and money markets more generally.

The MMLF will fund a broader set of asset purchases than the AMLF did but is similarly structured. Although it operated alongside other programs aimed at the same stresses (such as the Commercial Paper Funding Facility, a version of which the Fed reintroduced on March
17th), market observers believe the AMLF helped stabilize outflows from money funds and provided reassurance to investors and issuers that they would be able to rollover their commercial paper at maturity. See the Fed’s description of the AMLF here.
Federal Reserve Announces $2.3 trillion Lending Package

By Aidan Lawson and Greg Feldberg

Original post here.

The Federal Reserve announced on April 9 a series of programs totaling $2.3 trillion with significant equity participation from the Treasury, including unprecedented direct financing to businesses. The programs include new facilities and expansions of existing programs. By including both riskier securities and issuers, they signal the Fed's willingness to take risks it did not take during the Global Financial Crisis.

The Fed’s announcement lays out its plans for using some of the $454 billion Emergency Fund that Congress allocated to the Treasury in the CARES Act. For all of these programs, the Fed will use its authority under Section 13(3) of the Federal Reserve Act to lend to nonbank institutions, with equity support from the Treasury. Section 4003(C)(3)(B) of the CARES Act specifies that, in order for the Fed to use the Treasury’s equity support, it must meet all Section 13(3) requirements “relating to loan collateralization, taxpayer protection, and borrower solvency.”

The programs include:

- Up to $600 billion from the Fed, matched by $75 billion from the Treasury, for the **Main Street Lending Program**.
- Up to $500 billion from the Fed, matched by $35 billion from the Treasury, for the **Municipal Liquidity Facility**.
- Creation of the **Paycheck Protection Program Lending Facility** to support banks issuing Small Business Administration-guaranteed loans under another CARES Act program.

The Fed also announced expansions to existing programs.

- The **Term Asset-Backed Securities Loan Facility (TALF)** will now accept commercial mortgage-backed securities (CMBS) and collateralized loan obligations (CLOs) as collateral.
- The size of the Treasury equity investment in the **Primary Market Corporate Credit Facility (PMCCF)** has been increased from $10 billion to $50 billion, and portions of newly issued syndicated loans and bonds are now eligible for purchase.
- The size of the Treasury equity investment in the **Secondary Market Corporate Credit Facility (SMCCF)** has been increased from $10 billion to $25 billion and exchange-traded funds (ETFs) exposed to high-yield bonds are now eligible for purchase.

The Main Street Lending Program was originally announced on March 23 as part of a separate relief package. Until now, the Fed has created programs that provide liquidity to key funding markets, such as those for treasuries, commercial paper, and corporate bonds. In contrast, the
Main Street Lending Program provides funding to small and medium-sized businesses that have up to 10,000 employees or yearly revenue of up to $2.5 billion.

The program will use a special purpose vehicle (SPV) financed through recourse Fed loans and the Treasury’s equity investment to purchase 95% interests in loans made by eligible lenders, which include banks, bank holding companies, and savings and loans companies. Those lenders will retain 5%. These loans can be newly issued or already existing.

Loans purchased by the SPV will be priced at a floating rate above the Secured Overnight Financing Rate. They must have a four-year term, with a one-year deferral of principal and interest payments. For more information on the Main Street Lending Program see the following YPFS blog.

The Fed also unveiled a Municipal Liquidity Facility (MLF), which will directly purchase up to $500 billion in short-term (less than 2 year) municipal debt. As in the Main Street Lending Program, the Fed will lend on a recourse basis to an SPV, with Treasury providing a $35 billion equity investment. The SPV is limited to purchasing notes totaling 20% of the aggregate amount of general revenue (as of 2017) of the state, city, or county issuing them. Pricing will vary based on the credit rating of the issuer, and all debt issued to the SPV is callable, which means that it can be repurchased at any time by the issuer.

The Fed has provided relief to municipalities in a number of other ways, such as making them eligible for the Commercial Paper Funding Facility (CPFF) and using municipal debt as collateral for loans under the Money Market Mutual Fund Liquidity Facility (MMLF). Both of these programs were present in the Fed’s crisis fighting efforts during the GFC, but did not include municipal debt. For more information on the MLF see the following YPFS blog.

To support the Small Business Administration’s (SBA) Paycheck Protection Program under the CARES Act, which provides SBA-guaranteed loans to businesses through partnered financial institutions, the Fed established the Paycheck Protection Program Lending Facility (PPPLF). Financial institutions originating PPP loans are eligible to obtain non-recourse loans from the Facility, which uses the PPP loans as collateral and charges a modest rate of 35 basis points. For more information on the PPPLF see the following YPFS blog.

In addition to these new programs, the Fed dramatically expanded the scope of several existing facilities. The TALF, which was reactivated on March 23 to facilitate the issuance of asset-backed securities (ABS), uses an SPV to provide three-year secured loans to issuers of ABS. Under the April 9 guidance, the TALF now allows highly rated tranches of outstanding commercial mortgage-backed securities (CMBS), as well as newly issued collateralized loan obligations (CLOs), to be used as collateral. The size of the program remains at $100 billion. For more information on the TALF see the following YPFS blog.

The Fed substantially expanded the size and scope of the PMCCF and SMCCF, which were first announced on March 23. The facilities each use Treasury and Fed-funded SPVs to purchase both newly issued (for the PMCCF) and outstanding (for the SMCCF) corporate-debt securities.
The PMCCF received an increase in its Treasury equity investment from $10 billion to $50 billion, had its issuance limits changed from risk-based to flat, and is now able to purchase portions of newly issued syndicated loans and bonds.

The SMCCF received an increase in its Treasury equity investment from $10 billion to $25 billion and is now able to purchase ETFs that are primarily exposed to high-yield U.S. corporate bonds, though the majority of ETF holdings still must be of those that are exposed to investment grade corporations.

Both facilities now allow issuers that were recently downgraded from the minimally allowed BBB-/Baa3 rating to BB-/Ba3 to participate if the downgrade occurred after March 22.

Any businesses that participate in the Main Street Lending Program are not eligible for either of these facilities. For more information on the PMCCF and SMCCF see the following YPFS blog.

These new programs and changes are just the latest in the Fed's efforts to provide support to a struggling economy. In addition to those mentioned above, the Fed has already announced unlimited purchases of both Treasuries and agency mortgage-backed securities, rolled out programs aimed at supporting commercial paper markets, primary dealers, and money market mutual funds, and provided dollar liquidity globally via the increased use of swap lines and a central bank-only repo facility. Chairman Powell has reiterated that the Fed will continue to use its lending powers “forcefully, proactively, and aggressively until we are confident that we are on the road to recovery.”
Federal Reserve further expands access to Municipal Liquidity Facility

By Corey Runkel

Original post here.

On June 3, the Federal Reserve Board of Governors unanimously approved a second expansion of eligibility under its Municipal Liquidity Facility (MLF).

Authorized by the CARES Act, the MLF can purchase up to $500 billion of newly-issued bonds from qualifying municipalities, using funds from the Fed and Treasury. Until this latest action, the MLF had restricted the eligibility of cities and counties based only on their population. The newest terms guarantee the eligibility of at least two political subdivisions and two revenue-bond issuers from each state.

The expansion comes after the Fed once again weathered criticism from state governors and representatives that the MLF’s eligibility criteria were too narrow. The original MLF criteria designated states, the District of Columbia, cities larger than one million residents, counties larger than two million residents, and one revenue-bond issuer (such as a utility or transit authority) per state as the only eligible recipients.

In effect, the original term sheet ceded borrowing privileges to just 10 cities and 16 counties. The Federal Reserve at the time said states could funnel the proceeds from bond sales to smaller cities and counties whose budgets had been strained by the effects of the novel coronavirus.

But this approach, while preserving the Fed’s historical distance from small borrowers, ran into several issues. For instance, some states lack the organizational infrastructure to lend to cities and counties. More importantly, several states face legal impediments to borrowing. Twenty-one states require referenda to issue debt at levels demanded by COVID-19 disruptions, while a previous YPFS blogpost noted that several more states require legislative supermajorities to push through bond issuances. The current situation presents unique challenges to meeting such requirements, given that social distancing demands have closed many governing bodies and forestalled the possibilities of voting. In many cases, safe alternatives have not yet been designed.

Members of Congress criticized the Fed’s narrow interpretation of the CARES Act, which did not specify eligibility criteria for the MLF. The Fed’s first expansion on April 27 extended the program from September 30 to December 31, and lowered the eligibility thresholds from 1 million residents per city and 2 million residents per county to 500,000 and 1 million, respectively. As a result, the total number of eligible cities and counties increased from 26 to 227. However, even under the amended criteria, several states still lacked a single municipality that met the population threshold.

The June 3 terms lowered the thresholds again to 250,000 residents per city and 500,000 residents per county. Should a state lack one or two municipalities that meet these thresholds, governors may designate one or two of the largest ineligible cities or counties. Governors may
also designate two non-governing entities that currently issue bonds secured by government revenue. Additionally, multi-state revenue-bond issuers, such as the Port Authority of New York and New Jersey and the Washington Metropolitan Area Transit Authority, are now also eligible issuers, provided that minimum credit rating thresholds are met.

The Fed has not changed the original terms regarding the MLF’s size, and eligible uses of funds. The facility is authorized to purchase up to $500 billion in eligible bonds (allocated among the states as proportions of FY2017 general revenue), and is backstopped by an equity investment of $35 billion from the Treasury’s Exchange Stabilization Fund, as authorized by the CARES Act. The facility takes the form of a special purpose vehicle (SPV) established by the Fed under Section 13(3) of the Federal Reserve Act. The facility may purchase “tax anticipation notes (TANs), tax and revenue anticipation notes (TRANs), bond anticipation notes (BANs), revenue anticipation notes (RANs),” and similar bonds with maturities no longer than 36 months, funding up to 20% of a state, county, city, or revenue-bond issuer’s revenue.

Small cities are particularly sensitive to economic shocks due to their dependence on sales tax. Brookings reported that cities in the Midwest, generally smaller than those in the dense East and heavily urbanized West, rely more on sales taxes. Whereas property values are assessed not more than once a year, and income taxes are filed annually, sales tax receipts enter municipal finances at frequencies varying between once a month and once a year. These higher-frequency collections mean that shocks affect sales tax revenues much more quickly than other types of taxes.

Compounding pressure on the MLF to purchase small-city debt are high-population thresholds and use restrictions on CARES Act grants. Under the Coronavirus Relief Fund, only municipalities with 500,000 residents or more are eligible and funds may only be used for necessary and unexpected expenditures demanded by COVID-19. Thus, monies cannot be used to compensate for reduced sales tax receipts, a use that is permissible for proceeds from MLF bond purchases.

The MLF marks the first time the Federal Reserve has waded into direct purchases of municipal bonds. In 2011, in the wake of the Global Financial Crisis, Republicans in both chambers balked at suggestions from Democrats that the federal government bail out municipalities. The then-Chair of the Federal Reserve, Ben Bernanke, said that the Fed had “no expectation or intention to get involved in state and local finance.” The Fed’s legal authority to buy municipal bonds extended to only 2% of the market, and Bernanke noted that there might be other legal restrictions under the Dodd-Frank Act.

But, in spite of the Fed’s historic distance from municipal debt, the efficacy of the MLF may lead to deeper involvement in municipal finances. The initial announcement of the MLF in April immediately stabilized a $4 trillion market that saw AAA yields jump from just under 1% to just under 3% in a matter of days.

Politico pointed to House Ways & Means Chair Richard Neal as a catalyst for more intervention in munis. Even before the novel coronavirus, the former mayor of Springfield, Massachusetts,
had established himself as a supporter of municipal bonds. However, aid may instead come from traditional fiscal policy routes should the Fed hold firm on its new eligibility thresholds. Neal represents Springfield and its enclosing county Hampden, each of which just miss these newest MLF population thresholds.

Thus far, Illinois is the only state to announce its participation in the MLF, issuing $1.2 billion in 12-month maturities at 3.82%. The MLF became operational on May 26.
Federal Reserve Lowers Pricing for Municipal Liquidity Facility

By Natalie Leonard

Original post here.

The Federal Reserve Board announced August 10 that it would revise pricing for the Municipal Liquidity Facility (MLF). Specifically, the updated term sheet includes a reduction in the interest rate on MLF loans of 50 basis points across all credit rating categories. The Fed also revised the relationship between interest rates for tax-exempt notes and for taxable notes.

The Fed created the Municipal Liquidity Facility under the authority of Section 13(3) of the Federal Reserve Act. The Treasury, under the authority of the Coronavirus Aid, Relief, and Economic Security (CARES) Act, has made a $35 billion equity investment in the facility. Read more about the MLF here.

The Fed announced in April that the MLF could lend up to $500 billion to eligible states, counties, and cities. As of yet, though, it has only extended a single one-year loan of $1.25 billion, priced at 3.82%, to the state of Illinois. New Jersey reportedly is also considering requesting a loan through the facility.

Soon after the Fed launched the facility, a progressive advocacy group criticized the MLF for unfavorable pricing. According to the group’s analysis, before the reduction in pricing, 97% of eligible cities, counties, and states could find better funding on the market. A letter signed by 53 progressive members of congress similarly criticized the facility for being “functionally unusable.” In the Third Report of the Congressional Oversight Committee, the Chair of the Fed Jay Powell and Treasury Secretary Steven Mnuchin responded to such criticism by emphasizing that they had intended the MLF to be only a backstop for municipalities that had trouble getting funded on the municipal market. They also cited a Federal Reserve study showing that the market for municipal securities has recovered since March.

The new pricing for tax-exempt notes is summarized in the table below. Interest rates are calculated by adding the comparable maturity overnight indexed swap (OIS) rate to the spread in the table below, based on the debt issuer’s credit rating. For most high-rated eligible issuers, the new pricing remains uncompetitive with market rates, so utilization of the facility will likely remain low. New York’s Metropolitan Transportation Authority said it may tap the Fed for half a billion in three-year notes, if pricing beats Wall Street.

Table 1. MLF Spread Table

<table>
<thead>
<tr>
<th>Credit rating</th>
<th>Spread (bps):</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA/Aaa</td>
<td>100</td>
</tr>
<tr>
<td>AA+/Aa1</td>
<td>120</td>
</tr>
</tbody>
</table>
The other change the Fed announced is a minor revision to the rates for taxable eligible notes. Previously, if notes were subject to federal income tax, pricing would be calculated by adding the comparable maturity OIS rate to the spread and dividing by 0.65; now the sum will be divided by 0.7. This improves the interest rate for taxable eligible notes.

This announcement comes as direct aid to state and local governments is unlikely to pass Congress until September. Negotiations over the next round of fiscal spending have frozen in the Senate, while the White House has stepped in with four executive orders aimed at continuing expanded unemployment benefits and decreasing payroll taxes. The executive orders did not include funding for state and local governments, who a think tank estimates will face budget shortfalls of $555 billion over the next two years.

The Fed says that the pricing will “provide an effective backstop to assist U.S. states and local governments as they weather the pandemic.”
RBI announces further liquidity measures in response to COVID-19

By Lily Engbith

Original post here.

The Reserve Bank of India (RBI) announced on August 31 a series of measures intended to “restore macroeconomic and financial stability,” including:

- Special open market operations (OMOs);
- Repurchase (repo) operations; and
- Temporary relaxation of certain liquidity requirements for banks (see here).

These latest interventions follow a month-long fiscal and regulatory campaign to bolster support for markets and businesses most impacted by the pandemic. For more information on previous actions taken by the RBI in response to COVID-19, please see here and here.

Background

In a monetary policy statement dated August 6, the RBI acknowledged the need to manage both systemic liquidity and medium-term Consumer Price Index inflation (see here). This assessment led to, among other targeted operations, the introduction of special financing facilities to support the National Housing Bank and the National Bank for Agricultural and Rural Development (NABARD) and a macroprudential rule change enabling lenders to implement resolution plans (with respect to eligible corporate exposures) without changes in ownership (see here).

Despite the RBI’s efforts to calm markets, traders were expecting the central bank to announce that it would buy government bonds to alleviate some of its debt burden (see here). Their anxieties played out on August 14 as primary dealers who had underwritten a government bond issue were forced to “rescue” the sale, exacerbating the central bank’s attempts to maintain the premium that the bonds had previously commanded over the yield curve (see here). An unexpected ₹46.5 million (USD 632,400) of 10-year bonds remained unsold, despite the fact that banks have been sitting on excess liquidity (see here). Furthermore, the July spike in retail inflation to 7% complicated policymakers’ promises to hold course against inflationary pressures (see here).

On August 25, the RBI announced that it would conduct special OMOs that would involve the simultaneous purchase and sale of government securities for an aggregate amount of ₹200 million (USD 2.72 million) in two tranches of ₹100 million (USD 1.36 million) each (see here). The auctions, held on August 27 and September 3, were again under-sold. Primary dealers were forced to buy bonds worth ₹180 million (USD 2.44 million), more than half the amount issued (see here). The RBI decided to devolve the auction amidst concerns about the tepid response, leading economists to predict that only the RBI, by buying government bonds through OMOs, would be able to cool down yields and entice banks sitting on excess liquidity to
participate in future sales (see here). In an additional attempt to control inflation, the RBI announced on August 28 that nine State Governments had offered to sell securities by way of auction (see here).

**Special liquidity measures announced August 31**

Also on August 31, the RBI said that it would conduct additional special OMOs for the simultaneous purchase and sale of government securities (see here). Similar to before, the RBI would hold auctions on September 10 and September 17 in an aggregate amount of ₹200 million (USD 2.72 million), again divided into two equal tranches.

The RBI also stated its intention to conduct repo operations in an aggregate amount of ₹1 billion (USD 13.60 million) at floating rates in mid-September. The purpose would be to “assuage pressures on the market on account of advance tax outflows” (see here). In an effort to reduce the cost of funding, banks that have drawn down funds under long-term repo operations (LTROs) will be able to reverse these transactions before maturity, reducing their interest liability by returning funds taken at the repo rate of 5.15% and accessing funds at the current repo rate of 4.00%.

Finally, the RBI decided to allow banks to hold fresh acquisitions of statutory liquidity ratio (SLR) securities acquired after September 1, 2020, under the held to maturity (HTM) category - up to an overall limit of 22% of net demand and time liabilities (NDTL) - until March 31, 2021. Normally, banks would have to sell off their securities, as well as government and state development loans, in order to comply with HTM regulatory limits. It is expected that raising the ratio of securities that banks can hold to maturity within their SLR (mandatory holding requirement) will help to limit losses in the currently volatile market (see here).

In addition to the actions described above, the central bank suggested that it is comfortable with the appreciation of the rupee, which it hopes will drive down import-related inflation (see here). The deployment of special OMOs also indicates that the RBI is willing to combat rising prices using tools other than interest rate adjustments (see here). This unconventional use of currency management in place of monetary policy suggests that the RBI is committed to “maintaining congenial financial conditions, [mitigating] the impact of COVID-19 and [restoring] the economy to a path of sustainable growth while preserving macroeconomic and financial stability” (see here).
RBI reinforce liquidity measures while keeping the interest rate constant

By Junko Oguri

Original post [here](#).

At its most recent monetary policy meeting, the Reserve Bank of India reinforced a number of measures to fight against shocks caused by COVID-19. The measures to ease liquidity issues include (i) establishment of On Tap Targeted Long-Term Repo Operations (TLTRO), (ii) extension of Statutory Liquidity Ratio (SLR) Holdings in the Held To Maturity (HTM) category, and (iii) adjustments in Open Market Operations (OMOs) to purchase State Development Loans and increase the overall purchase amount.

*See the blog posts below for our past analysis on India during the COVID-19 crisis:

- [India Extends Special Liquidity Facility to Mutual Funds](#) (May 14, 2020)
- [RBI to provide liquidity to non-bank financial firms](#) (July 9, 2020)
- [RBI expands its regulatory reach: Reforms to watch](#) (September 10, 2020)
- [RBI announces further liquidity measures in response to COVID-19](#) (September 10, 2020)

The Background

The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) met from October 7 to 9. The meeting, which had been originally scheduled from September 28 to October 1, was postponed once, and it was finally held after three external members were replaced on October 5.

The MPC held the policy interest rates constant, retaining the repo rate (key lending rate) at 4.0 percent and the reverse repo rate (key borrowing rate) at 3.5 percent. The result aligned with market expectations after RBI had reduced the repo rate by 115 basis points (bps) since late March.

However, the Monetary Policy Statement also noted the worsening projection of the economy due to the shock and uncertainty brought by the COVID-19 crisis. The real GDP (gross domestic product) for the full year is expected to decline by 9.5 percent, “with risks tilted to the downside” (Figure 1).

**Figure 1: Quarterly Projection of CPI Inflation and Real GDP Growth**
Therefore, RBI also announced a series of accommodative measures to “provide impetus towards reviving the economy.” Nine measures across the following four areas were announced on October 9: (i) enhance liquidity support for financial markets; (ii) offer regulatory support to improve the flow of credit to specific sectors within the ambit of the norms for credit discipline; (iii) provide a boost to exports; and (iv) deepen financial inclusion and facilitate ease of doing business by upgrading payment system services.

This post will focus on (i) the enhanced liquidity support for financial markets.

**Liquidity Measures Announced on October 9**

Three measures announced are:

1. The establishment of On Tap Targeted Long-Term Repo Operations (TLTRO);
2. Extension of statutory liquidity ratio (SLR) Holdings in the Held to Maturity (HTM) category; and
3. Changes in Open Market Operations (OMOs) to purchase State Developments Loans (SDLs) and increase the overall purchase amount

These three measures were either a modification or reintroduction of the measures that had been implemented earlier during the COVID-19 crisis (Figure 2).

**Figure 2: Development of selected liquidity measures announced by RBI during the COVID-19 crisis**

<table>
<thead>
<tr>
<th>Date</th>
<th>Measure</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mar 27:</td>
<td>TLTRO</td>
<td>₹1 trillion</td>
</tr>
<tr>
<td>Mar 18:</td>
<td>OMOs</td>
<td>₹100 billion</td>
</tr>
<tr>
<td>Mar 20:</td>
<td></td>
<td>₹150 billion</td>
</tr>
<tr>
<td>Mar 23:</td>
<td></td>
<td>₹150 billion</td>
</tr>
</tbody>
</table>

Sources: RBI

2020 1. TLTRO

27: Announced TLTROs to purchase investment grade corporate bonds, CPs, and non-convertible debentures [NCDs] up to three years for a total amount of ₹1 trillion in primary market and secondary market, including from mutual funds and NBFCs.

2. SLR Holding Related

18: Announced to conduct OMOs of ₹100 billion to purchase Government securities (GS)

3. OMOs

20: ₹150 billion GS

23: ₹150 billion GS
17: Announced TLTROs 2.0 to purchase investment grade bonds, CPs, and Non-Convertible Debentures (NCDs) of Non-Banking Financial Company (NBFCs), with at least 50 percent of the total amount availed going to small and mid-sized NBFCs and Microfinance institutions (MFIs) up to three years for a total amount of ₹500 billion

420: Simultaneous purchase and sale of ₹100 billion GS each

23: Simultaneous purchase and sale of ₹100 billion GS each

29: Simultaneous purchase and sale of ₹100 billion GS each

31: Announced to increase the statutory liquidity ratio (SLR) holdings in Held-To-Maturity (HTM) category from 19.5 percent to 22 percent, valid until March 2021 (see our blog post here)

25: Simultaneous purchase and sale of GS for an aggregate amount of ₹200 billion in two tranches of ₹100 billion each

31: Simultaneous purchase and sale of ₹100 billion GS each (see our blog post here)

07: Simultaneous purchase and sale of ₹100 billion GS each

14: Simultaneous purchase and sale of ₹100 billion GS each

17: ₹100 billion GS

24: Simultaneous purchase and sale of ₹100 billion GS each

29: Simultaneous purchase and sale of ₹100 billion GS each

25: Simultaneous purchase and sale of GS for an aggregate amount of ₹200 billion in two tranches of ₹100 billion each

07: Simultaneous purchase and sale of ₹100 billion GS each

14: Simultaneous purchase and sale of ₹100 billion GS each

17: ₹100 billion GS

24: Simultaneous purchase and sale of ₹100 billion GS each

29: Simultaneous purchase and sale of ₹100 billion GS each

25: Simultaneous purchase and sale of GS for an aggregate amount of ₹200 billion in two tranches of ₹100 billion each

07: Simultaneous purchase and sale of ₹100 billion GS each

14: Simultaneous purchase and sale of ₹100 billion GS each

17: ₹100 billion GS

24: Simultaneous purchase and sale of ₹100 billion GS each

29: Simultaneous purchase and sale of ₹100 billion GS each

25: Simultaneous purchase and sale of GS for an aggregate amount of ₹200 billion in two tranches of ₹100 billion each

07: Simultaneous purchase and sale of ₹100 billion GS each

14: Simultaneous purchase and sale of ₹100 billion GS each

17: ₹100 billion GS

24: Simultaneous purchase and sale of ₹100 billion GS each

29: Simultaneous purchase and sale of ₹100 billion GS each

25: Simultaneous purchase and sale of GS for an aggregate amount of ₹200 billion in two tranches of ₹100 billion each

07: Simultaneous purchase and sale of ₹100 billion GS each

14: Simultaneous purchase and sale of ₹100 billion GS each

17: ₹100 billion GS

24: Simultaneous purchase and sale of ₹100 billion GS each

29: Simultaneous purchase and sale of ₹100 billion GS each

25: Simultaneous purchase and sale of GS for an aggregate amount of ₹200 billion in two tranches of ₹100 billion each

07: Simultaneous purchase and sale of ₹100 billion GS each

14: Simultaneous purchase and sale of ₹100 billion GS each

17: ₹100 billion GS

24: Simultaneous purchase and sale of ₹100 billion GS each

29: Simultaneous purchase and sale of ₹100 billion GS each

25: Simultaneous purchase and sale of GS for an aggregate amount of ₹200 billion in two tranches of ₹100 billion each

07: Simultaneous purchase and sale of ₹100 billion GS each

14: Simultaneous purchase and sale of ₹100 billion GS each

17: ₹100 billion GS

24: Simultaneous purchase and sale of ₹100 billion GS each

29: Simultaneous purchase and sale of ₹100 billion GS each

25: Simultaneous purchase and sale of GS for an aggregate amount of ₹200 billion in two tranches of ₹100 billion each

07: Simultaneous purchase and sale of ₹100 billion GS each

14: Simultaneous purchase and sale of ₹100 billion GS each

17: ₹100 billion GS

24: Simultaneous purchase and sale of ₹100 billion GS each

29: Simultaneous purchase and sale of ₹100 billion GS each

25: Simultaneous purchase and sale of GS for an aggregate amount of ₹200 billion in two tranches of ₹100 billion each

07: Simultaneous purchase and sale of ₹100 billion GS each

14: Simultaneous purchase and sale of ₹100 billion GS each

17: ₹100 billion GS

24: Simultaneous purchase and sale of ₹100 billion GS each

29: Simultaneous purchase and sale of ₹100 billion GS each

25: Simultaneous purchase and sale of GS for an aggregate amount of ₹200 billion in two tranches of ₹100 billion each

07: Simultaneous purchase and sale of ₹100 billion GS each

14: Simultaneous purchase and sale of ₹100 billion GS each

17: ₹100 billion GS

24: Simultaneous purchase and sale of ₹100 billion GS each

29: Simultaneous purchase and sale of ₹100 billion GS each

25: Simultaneous purchase and sale of GS for an aggregate amount of ₹200 billion in two tranches of ₹100 billion each

07: Simultaneous purchase and sale of ₹100 billion GS each

14: Simultaneous purchase and sale of ₹100 billion GS each

17: ₹100 billion GS

24: Simultaneous purchase and sale of ₹100 billion GS each
The scheme will be available up to March 31, 2021. 2022, an extension from the August announcement size, responding to the market participants’ expectation)

\textbf{09:} Announced to conduct OMOs in State Development Loans (SDLs) as a special case during the 2020 financial year. The OMOs would be conducted for a basket of SDLs comprising securities issued by states.

\textbf{Sources:} RBI press releases and reports

\textbf{1. On Tap TLTRO}

RBI announced an “On tap TLTRO” scheme, aiming to ensure abundant liquidity in the financial system.

The long-term repo operation (LTRO) is an RBI scheme which enables banks to borrow funds from RBI at the repo rate (currently 4 percent) by providing government securities as collateral. It is aimed to ensure adequate liquidity at the longer end of the yield curve (see here for the LTROs’ operational guidance, which also applies to TLTROs). LTRO is a scheme similar to the “long-term refinancing operations” used by the European Central Bank (ECB) during the sovereign debt crisis (see here for our recently published Journal of Financial Crisis case study for “The European Central Bank’s Three-Year Long-Term Refinancing Operations”).

Targeted long-term repo operations, TLTRO, are a kind of LTRO with certain restrictions for the use of funds borrowed from RBI. Under the TLTRO, banks are required to use the borrowed funds to invest in specific securities, aimed to ease the liquidity stress in the targeted market. RBI has released the ₹ 1 trillion (approximately $1,360 million) “TLTROs” in March and ₹ 500 billion “TLTROs 2.0” in April (Figure 3).

Banks participating in the TLTROs schemes are expected to purchase specific kinds of securities designated by RBI. For instance, under the TLTROs announced on March 27, banks were required to purchase investment grade corporate bonds, commercial paper, and non-convertible debentures. The TLTROs 2.0 released on April 14 required banks to purchase bonds from Non-Banking Financial Companies (NBFCs) to support the liquidity in small and middle-sized firms. While the TLTROs scheme enables banks to borrow at low rates, it also incorporates a penalty mechanism. If banks fail to purchase the targeted securities under specified window period (30 days for TLTROs, 45 days for TLTROs 2.0), banks would be charged interest at the repo rate plus 2 percent for the number of days the funds were not deployed. Furthermore, the
incremental interest liability will have to be paid along with regular interest at the time of maturity.

The exposures under the TLTROs will be exempted from several regulations. For instance, the investments made by banks will be classified as Held-To-Maturity (HTM) even in excess of the 25 percent of total investments permitted to be included in the HTM portfolio. Furthermore, all exposures under the TLTROs will be exempted from the large exposure framework.

According to a media report, after the launch of TLTROs and TLTROs 2.0, banks’ investment in CPs, bonds, debentures and shares of public and private corporations (so-called “non-SLR investments”) have increased, boosting the liquidity to the private sectors in need.

The overall design of the newly released “On tap TLTRO” is largely consistent with its predecessors, requiring banks to purchase corporate bonds, commercial paper, and non-convertible debentures issued by specific sectors. Meanwhile, banks can also use the liquidity available under the “On Tap TLTRO” scheme to extend bank loans to these designated sectors. This reflects the changes in the purpose of the TLTROs. Whereas the former TLTROs schemes were established to ease the liquidity constraints in financial markets, the “On Tap TLTRO” is expected to achieve the “revival of activity in specific sectors that have both backward and forward linkages, and multiplier effects on growth” in India, and to “enable banks to conduct their lending operations smoothly and seamlessly without being hindered by illiquidity frictions, ensuring that liquidity in the system remains comfortable”.

While further details are yet to be announced, RBI announced that it would conduct the On tap TLTROs with tenors of up to three years for a total amount of up to ₹1 trillion at a floating rate linked to the policy repo rate. The newly established scheme will be available up to March 31, 2021. RBI also noted that the total amount and the duration of the scheme are subject to change upon “a review of the response to the scheme”. Banks that had accessed the earlier targeted long-term repo operations (TLTROs and TLTROs 2.0) may be given the option to reverse these transactions before maturity and instead participate in the On Tap TLTRO. The FAQ for TLTROs is expected to be revised accordingly. Figure 3 below summarizes the developments of TLTRO set forth by the RBI in response to the COVID-19 crisis.

**Figure 3: Development of TLTROs framework by RBI**

<table>
<thead>
<tr>
<th>Date Announced</th>
<th>TLTROs</th>
<th>TLTROs 2.0</th>
<th>On Tap TLTRO</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 27, 2020</td>
<td>April 1, 2020</td>
<td>October 9, 2020</td>
<td></td>
</tr>
<tr>
<td>Background</td>
<td>Large sell-offs in financial markets due to COVID-19,</td>
<td>Specific sectors and entities experiencing</td>
<td>The Indian economy entering into a decisive</td>
</tr>
</tbody>
</table>

redemption pressures, the surge of liquidity premia on instruments such as corporate bonds, the thinning of trading activities

liquidity constraints and/or hindrances to market access

phase in the fight against the pandemic, shifting RBI’s focus from containment to revival

To mitigate the adverse effects on economic activity leading to pressures on cash flows

To channel liquidity to small and mid-sized corporates, including NBFCs and MFIs, that have been impacted by COVID-19 disruptions

To revive economic activities in specific sectors that have both backward and forward linkages, and multiplier effects on growth

To enable banks to conduct their lending operations smoothly and seamlessly without being hindered by illiquidity frictions, ensuring that liquidity in the system remains comfortable

Required to acquire investment grade (BBB or higher) corporate bonds, commercial paper, and non-convertible debentures over and above the outstanding level of their investments in

Required to acquire corporate bonds, commercial paper, and non-convertible debentures issued by entities in specific sectors over and above the outstanding level of their investments in such instruments as on September 30, 2020.

Aim

Requirement (“target”)

Required to acquire investment grade bonds, commercial paper, and non-convertible debentures of NBFCs.

Required to acquire at least 50 per cent of the total amount
these bonds as on March 27, 2020.

- Required to acquire up to 50 per cent from primary market issuances and the remaining 50 per cent from the secondary market, including from mutual funds and NBFCs.

- Investments made by banks will be classified as HTM even in excess of the 25 per cent of total investments normally permitted to be included in the HTM portfolio.

- Exposures under this facility will also be exempt under the large exposure framework.

- On April 15, RBI noted that the maximum amount for a particular bank to invest in securities should not exceed 10 percent of the allotment.

- Investments made by banks will be classified as HTM even in excess of the 25 per cent of total investments normally permitted to be included in the HTM portfolio.

- Exposures under this facility will also be exempt under the large exposure framework.

- No maximum 10 percent allocation for individual company rule.

- The liquidity available under the On Tap TLTRO scheme can also be used to extend bank loans to these sectors.
2. SLR Holdings in Held to Maturity (HTM) category

As we have reported in our former blog post, on August 31, RBI decided to allow banks to hold fresh acquisitions of statutory liquidity ratio (SLR) securities acquired after September 1, 2020, under the HTM category - up to an overall limit of 22 percent of net demand and time liabilities (NDTL) - until March 31, 2021. The limit was originally set at 19.5 percent. If banks were to exceed this limit, banks would need to sell off their liquid assets so that the exposure would be contained under the SLR. The aim of raising the limit in August was to “engender orderly market conditions and ensure congenial financing costs”, aiming to help to limit losses in the currently volatile market.

On October 9, in order to “give more certainty to the markets about the status of these investments in SLR securities after March 31, 2021”, RBI announced an extension of the SLR holdings in HTM to March 2022. Moreover, HTM limits would be restored from 22 percent to 19.5 percent in a phased manner starting from the quarter ending June 30, 2022. RBI underscored that banks shall plan their investments in SLR securities in an “optimal manner with a clear glide path for restoration of HTM limits.”

3. Open Market operations (OMOs) in State Developments Loans (SDLs)

The MPC also made two announcements related to the OMOs. First, RBI decided to conduct open market operations (OMOs) in State Developments Loans (SDLs) as a special case during the current financial year (April 1, 2020 to March 31, 2021). RBI explains that the objective of the SDLs OMOs is to improve liquidity and facilitate efficient pricing, and the OMOs would be conducted for a basket of SDLs comprising securities issued by states. Notably, the SDLs have been treated as eligible collateral for the Liquidity Adjustment Facility (LAF) along with T-bills, dated government securities and oil bonds. LAF is a liquidity scheme in which banks can borrow from and lend to RBI through repo and reverse repo arrangements. On October 16, RBI...
announced it would purchase SDLs under OMOs for an aggregate amount of ₹100 billion on October 22, 2020, through a multi-security auction using the multiple price method.

Additionally, “Financial Market Guidance” in the Governor’s statement, doubles the size of OMOs auctions from ₹100 billion to ₹200 billion, consistent with market participants’ expectations.

**Ways Forward: Challenges for India**

The three measures above are not the only liquidity measures so far implemented by RBI. For instance, RBI has established a ₹500 billion ($6.6 billion) special liquidity facility for mutual funds (SLF-MF) on April 24 and a ₹300 billion ($4 billion) special liquidity scheme (SLS) on July 1.

These measures, along with other policy interventions, are expected to ease the liquidity problems in Indian financial markets while balancing the interest rate. However, a number of challenges remain in India. The piled up non-performing assets have been casting a dark shadow in the Indian financial system for a long time. As Viral V. Acharya argues in his recent book “Quest for Restoring Financial Stability in India”, India had been in the state of fiscal dominance (a situation in which government debts have become so large that monetary policy is subordinated, with rates having to stay low to stop the government’s finances collapsing) prior to the outbreak of COVID-19, piling up twin deficits (current account deficits and fiscal deficits). As a consequence, COVID-19 has not only been challenging the country’s public health but also the economy and the financial system.

However, some remain positive. On October 9, Governor Shaktikanta Das confirmed in his speech that the country has entered the recovery stage in his view. He said that “the deep contractions of Q1:2020-21 are behind us; silver linings are visible in the flattening of the active caseload curve across the country.” Governor Das also underscored that the optimism by citing the falling trend in household expectation inflation and other positive outlook indicators. “If […] the current momentum of upturn gains ground, a faster and stronger rebound is eminently feasible,” he emphasized. Following RBI’s actions, the Government announced a ₹730 billion (approximately $10 billion) stimulus package on October 12. According to the announcement, the package is meant to stimulate consumer spending during India’s festival season, which climaxes in October and November.

“The upturn momentum” dubbed by Governor Das will be difficult to maintain if the country fails to contain the spread of COVID-19. As of October 15, according to the John Hopkins Coronavirus Resource Center, India faces over 7 million confirmed cases and more than 110,000 deaths. The cumulative confirmed case number is the highest among the world after the US, while some suggest that the contracted number may be higher than the officially reported numbers. Controlling this pandemic will be critical for the lives of over 1.3 billion people and for the economy.
Macroprudential Policy

Central banks do not just support the economy using their ability to set interest rates and provide lender-of-last-resort financing. They, and their financial supervisory colleagues, also have a set of tools to keep financial markets and institutions from running too hot or too cold. These are known as macroprudential policies. With these policies, governments might allow financial institutions to do things like use their capital buffers, allow payment standstills on loans, or use their liquidity buffers. Authorities typically use macroprudential policies to complement fiscal policy and monetary policy.
Analysis

Countries Implement Broad Forbearance Programs for Small Businesses, Sometimes with Taxpayer Support

By Greg Feldberg and Alexander Nye with research support from Kaleb Nygaard

Original post here.

The government-mandated lockdowns in many countries responding to the coronavirus pandemic have threatened the financial health of small businesses, who typically have sufficient cash on hand to cover just one month of fixed cash-flow needs. Banks, utilities, landlords, and other creditors responded early with temporary payment holidays and other forbearance efforts, often at the urging of regulators. Creditors can grant limited forbearance to assist debtors in normal times. As the lockdown continues, however, private-sector creditors won’t be able to afford forbearance alone. To avoid widespread nonpayment from sparking a systemic financial crisis, governments are turning to taxpayers to help small businesses meet their fixed-cost obligations.

When designing a loan forbearance program for small and medium-sized enterprises (SMEs), policymakers consider:

1. Eligible institutions/obligations – Which creditors should offer forbearance, for which types of obligations?
2. Borrower eligibility – What borrowers will be eligible to participate?
3. Implementation – How will the program be implemented?
4. Duration – How long will the program last?
5. Support – Will the taxpayers foot the bill, and if so, how?

Eligible institutions/obligations

In a few cases, government programs have covered all types of fixed-cost obligations that distressed companies face. Denmark plans to directly pay 25% to 100% of the reported fixed costs for SMEs whose revenues fall by more than 25% during the coronavirus pandemic. More commonly, programs have targeted specific types of obligations to specific types of creditors. SMEs can have fixed-payment obligations to entities in the public sector, financial private sector, and nonfinancial sector.

Public-sector payment obligations can include government-owned utilities and other services, government-sponsored entities, and, of course, taxes. It may be relatively easy for a government to waive such payments for a short period. On March 18, for example, Dubai and Abu
Dhabi reduced 15 different customs fees, taxes, and other costs for businesses, including an across-the-board 10% reduction in water and electricity bills owed to the government-run utility.

Banks typically have procedures for working with borrowers who are experiencing temporary financial stress. In this crisis, some of the largest banks voluntarily created forbearance programs. A broad, government-initiated moratorium on loan payments to banks and other financial institutions could effectively protect small businesses during a crisis. Several governments encouraged bank forbearance on loan principal or interest payments. But U.S. banks, though well-capitalized compared to the beginning of the last global financial crisis, may not be able to bear the cost of an unprecedented number of nonperforming loans for very long. And nonbank financial institutions are typically less prepared than banks for a surge in nonpayment by SME debtors.

SMEs also may have obligations to creditors in the nonfinancial private sector, such as landlords, employees, and suppliers. Government programs to help SMEs with these costs are rare, to date. Denmark’s direct financial support program pays a proportion of eligible SMEs’ bills regardless of the type of creditor. France’s current program allows SMEs to apply to defer rent and utility payments. Programs that target employees, by using government funds to prop up SME payrolls, can become difficult to distinguish from unemployment insurance. In the context of COVID-19, they have become more common. Three examples are the UK’s Coronavirus Job Retention Scheme, the Republic of Ireland’s COVID-19 Wage Subsidy Scheme, and Germany’s Emergency Aid Grants.

**Borrower eligibility**

While past forbearance programs typically responded to natural disasters just in affected regions, most programs this year have been national, reflecting the nature of the current crisis. Eligibility can be extended very broadly or limited to borrowers meeting specific criteria.

On March 19, Korea’s Financial Services Commission (FSC) announced a fixed-cost forbearance program that appears to offer blanket eligibility. Under the program, SMEs can access a six-month minimum extension on existing loans and guarantees from both banks and nonbanks. Blanket eligibility may be most efficient in a pervasive crisis such as the current one, in which the sheer number of affected SMEs is so large as to challenge systematic efforts to distinguish the truly needy. However, blanket eligibility, as seen in some of India’s farm loan waiver programs, can also be susceptible to abuse due to the moral hazard.

Recent small-business programs in Europe have tended to limit eligibility to borrowers that meet certain criteria. Greece’s loan principal-repayment holiday restricts participation to businesses in sectors directly impacted by the pandemic that were current on their obligations when the program was announced. France and Denmark link eligibility to lost revenues. Denmark’s program determines how much support to offer a given business by looking at that business’s expected decline in revenues. France conditions eligibility for its rent forbearance program on a
company having less than €1 million in turnover and having either been ordered closed by the government or losing over 70% of turnover in March 2020 compared to March 2019.

**Parts of Denmark’s program are only available** to companies with 10 or fewer employees. But strictly using a business’s number of employees to determine eligibility may encourage some SMEs to lay off employees before joining the program. Perhaps for this reason, Denmark’s program disqualifies businesses that fire workers before joining the scheme.

Implementing restrictive eligibility requirements can impose a significant administrative burden on government resources, which can limit the speed and effectiveness of a program. European governments can track sales that are subject to the value-added tax, which can help businesses illustrate their need, as in the case of Denmark’s program. A sufficiently detailed quarterly income tax system could provide similar information.

**How does a government implement such a program?**

Creditors sometimes voluntarily decide to grant forbearance, even in normal times. This happens when the creditor believes a borrower is viable as a going concern, but can’t meet payments due to temporary difficulties. In response to the COVID-19 pandemic, many individual creditors and creditor associations like the Thai Bankers’ Association have announced forbearance programs for SMEs unilaterally.

Government supervisory authorities (like the ECB) can incentivize forbearance. As noted, several authorities have advised banks not to be too quick to mark a loan as nonperforming when the borrower has been affected by the COVID-19 crisis. This can free bank capital for lending in the short run. In the long run, though, it can drain bank capital. Supervisors are faced with a [dilemma](https): “On one hand, protecting the financial system by forcing banks to correct weaknesses in how they assess and manage their loans[;]...on the other hand, causing a credit crunch for the real economy by being too strict with banks.” Credit crunches can be especially dangerous for forbearance programs that do not protect the credit ratings of participating borrowers. Participants in those programs will already have a more difficult time accessing credit with a poor credit rating, and a credit crunch would make this problem worse.

Authorities can outright require forbearance. In some cases, governments pass laws that require creditors to restructure SMEs loans. The Japanese government passed [such a law](https) during the GFC. The law stipulated: “When debtors asked financial institutions to ease repayment conditions (e.g., extend repayment periods or bring down interest rates), the institution would have an obligation to meet such needs as best as possible.” Finance ministries are often responsible for implementing these programs. This was the case with Italy’s year-long debt moratorium during the GFC and Germany’s current program. Moratoria are sometimes accompanied by subsidies to the financial institutions for the cost of deferring payments (Saudi Arabia) or providing some of the funds directly to SMEs (Denmark).

A government can order related organizations, like state-owned development banks or agencies, to offer forbearance on their loans to businesses. After the natural disasters in 2006 and 2011
the SME Development Bank of Thailand provided six-month debt moratoria to SMEs in the affected regions.

Governments can also negotiate forbearance programs with creditor associations for institutions like banks and non-banks, then bind them to the program. The Central Bank of Ireland announced one such agreement in response to the COVID-19 pandemic. France and Belgium have government credit mediation programs that individual creditors can use, put in place in 2008 during the Global Financial Crisis. The credit mediator helps distressed businesses negotiate with banks, credit insurers, supplier credit companies, and other financial institutions.

**Duration**

 Typically, payment forbearance programs operate for a short and specified time period tied to the nature of the crisis. In cases of natural disasters, like destructive floods in Thailand, these programs can last for just a few months, as affected regions return to normalcy. These programs rarely extend beyond six months.

Financial crises are different. Governments that introduce programs as only temporary can end up extending them under political pressure or simply because the economic stress has continued longer than expected. During the GFC, the Italian government, in collaboration with a creditor association, imposed a loan forbearance program for SMEs in August 2009. The program accepted 200,000 applications and rolled over €13 billion in SME debt by December 2010. But as the economic situation did not improve, Italy continued to extend and modify the program through at least 2014. Japan extended its 2009 SME Financing Facilitation Act for several years. Some critics say the government’s ongoing forbearance helped perpetuate Japan’s problem of “zombie” SMEs.

**Taxpayer Support**

Some programs directly subsidize the costs of SMEs. A government can seek to limit these costs by only covering losses the SME may suffer due to COVID-19. Denmark’s programs do this. But predicting these impacts is extremely difficult. Governments might make a program less generous if they find an SME’s actual performance is better than expected.

Northern Ireland offered some amount of taxpayer support as well, although it narrowed eligibility to three sectors especially affected by COVID-19: hospitality, tourism and retail. Germany and the US have tried a more blanket approach to providing taxpayers support. In Germany’s program, employers with up to five employees receive a grant of €9,000 and employers with up to fifteen employees receive a grant of €15,000. The CARES Act, as passed by the US Senate on March 25, provides $10 billion for Small Business Administration (SBA) emergency grants of up to $10,000 to provide immediate relief for small business operating costs and appropriates $17 billion to cover six months of payments for current SBA borrowers.

Other programs, like Saudi Arabia’s recent program and India’s farm loan waiver system, provide support to SMEs indirectly. They subsidize banks and other creditors for the losses they
bear in supporting SMEs. Programs that put losses on banks and other creditors can be costly to financial stability in the long run. Taxpayers may end up footing the bill if the financial and economic distress caused by the coronavirus response is protracted and affects confidence in bank solvency.
Authorities Restrict Short Sales during COVID-19 Crisis

By Greg Feldberg and Adam Kulam

The COVID-19 pandemic has created extraordinary uncertainty; it is too early to predict how bad it will get or how it will impact the world economy. This uncertainty has substantially elevated the volatility in bond and equity markets. In response, several countries have placed restrictions on short sales. In short sales, an investor sells a security she doesn’t own, hoping to profit when its price falls. Economists generally find that the benefits of short selling to market efficiency and liquidity outweigh the potential costs, most of the time. But authorities argue that short sales amidst extreme uncertainty can excessively deflate market prices and lead to further market contagion in a crisis. We discuss: (i) short-sale restrictions during the COVID-19 crisis, (ii) similar actions in earlier crises, and (iii) key design decisions that authorities face in restricting short sales.

Note that, while we focus here on short-sales bans, they are not the only tools authorities have used to address market volatility in the current crisis. Authorities have expanded the mandatory disclosure of net-short positions (Europe), introduced new circuit breakers to halt trading as prices fell (Thailand), and even briefly banned all trading for a few days (Philippines).

2020 Actions

In the COVID-19 crisis, several European countries, such as Spain and Italy; South Korea; and three Gulf States have banned short-selling. The Stock Exchange of Thailand (SET) and Securities and Exchange Commission of Pakistan (SECP) imposed uptick rules, which only allow short sales to occur just after a stock price has risen. Turkey’s Capital Markets Board and Indonesian authorities adjusted domestic circuit-breaker rules, which temporarily halt trading on an exchange if a specified index significantly declines in price. The Johannesburg Stock Exchange (JSE) Settlement Authority raised settlement obligations, and pledged to force short-sellers to borrow securities in the open market if it appeared that their short-sales would fail.

Actions in Earlier Crises

For as long as stocks have traded, authorities have blamed short-sellers for market stress and periodically banned their activities (McGavin (2010), p. 207). Bans can be instituted either by a financial regulator or a self-regulating organization (SRO) such as a stock exchange.

During the Global Financial Crisis, the United States’ Securities and Exchange Commission (SEC), in concert with the United Kingdom’s Financial Services Authority (FSA), banned short-selling of nearly 1,000 financial stocks in 2008. At the same time, the SEC introduced a temporary requirement that all money managers publicly report any short sales. Amidst the Eurozone debt crisis, several countries banned short selling for three weeks in August 2011. When China’s stock market suffered from turbulence in 2015, the Securities Regulatory...
Commission imposed a new rule requiring short sellers to wait one day before covering their short positions and paying back loans used to buy shares.

Studies of historical uses of short-sales bans haven’t found them to be very successful (Battalio et al. (2012), p. 4). Scholars argue that short-sales bans decrease market efficiency, impede price discovery, and bring unintended negative effects, such as price inflation (Hendershott et al. (2013), p. 6). One study found that the US ban in 2008 did succeed at significantly reducing shorting activity. But the ban worsened market quality, as measured by quoted and effective spreads, price impacts, and realized spreads (Boehmer et al. (2013), p. 1398, 1399).

Key Design Decisions

Regulators face the following key design decisions in restricting short sales:

- Communicated Purpose – How will the authorities explain the ban?
- Nature of the Ban – Will the ban cover all shorts, or just uncovered or “naked” shorts? Will the authority use other tools, like an “uptick” rule?
- Scope – Will the ban cover shorts on all stocks, or selected companies or sectors?
- Exemptions – Will some market participants, particularly market-makers, be exempt from the ban?
- Timeframe – Will the ban be for a short term, longer term, or indefinite?
- Coordination of Measures – Will the ban apply to other types of bearish activity, and will other countries cooperate?

Communicated Purpose

 Authorities’ documents and press releases suggest an attempt to curb price decline, control volatility, or bolster market confidence. Authorities typically express the concern that excessive short-selling might misrepresent a company’s true value and eventually damage the fundamentals of the underlying company – especially for companies whose counterparties treat the stock price as a proxy for long-term financial health. So they use short-sales bans to avoid a “crisis of confidence,” as the SEC said in 2008.

Short-sales bans in 2008 focused on shares of financial institutions “whose health may have an impact on financial stability” (IOSCO, 2008). Regulators in that crisis were concerned about financial contagion, as counterparties took falling share prices to indicate weakness in these companies. “In the context of a credit crisis, where some entities face liquidity challenges but are otherwise solvent, a decrease in their share price induced by short-selling may lead to further credit tightening for these entities, possibly resulting in bankruptcy” (IOSCO, 2008).

The SEC’s September 18, 2008 prohibition of short sales was the first of several around the world. South Korea’s Financial Supervisory Service (FSS) banned short sales of all South Korean stocks on September 30, 2008, citing “malignant rumors” in its financial markets (Bohl et al.
Germany, France, Australia, and the United Kingdom followed similar policy agendas soon after.

**Nature of the Ban**

In some cases, authorities have banned all short sales. In other cases, they have banned only “naked” or uncovered short sales. In a “naked” short sale, the short seller neither borrows nor arranges to borrow the underlying security by the settlement date. This introduces a settlement risk that the seller will fail to deliver the security when it is due. If a trade fails, the short seller will not receive any cash, and the buyer will not receive any security. These “failures to deliver” (FTDs) are a key measure of naked short-selling, and scholars suggest that naked short sales result in higher levels of volatility than covered short sales (McGavin (2010), pp. 204-6).

Authorities also have to make judgments about how a short sale can be covered (Howell (2016), pp. 15-6). During the “close-out” portion of the short sale, the short seller “covers” their position by re-obtaining the security and returning it to the original lender by the date of settlement. Regulators can set the degree of ownership that satisfies minimum “coverage” thresholds. Authorities may require a short seller to wholly possess the security, to obtain a legal contract entitling the short seller absolute ownership of the security, or use a “locate” requirement, which is more or less a promise from the short seller that they reasonably expect to obtain the security from a third party before the settlement date. There is some evidence that stringent covering requirements can increase the ratio of informed to uninformed short-sellers.

Another way to regulate short-selling is through uptick rules, which permit traders to short-sell securities only at prices above the current market price. Simply put, short-sales can’t go through until the security’s price rises. Authorities aim to limit the contribution of short-selling to market abuse or bear raids, which may result in steep and sudden price declines (McGavin (2010), p. 214). Authorities also rely on uptick rules to communicate that there are active buyers in the market (Howell (2016), p. 34).

Uptick regimes have re-entered both the public discussion and the active macroprudential toolkit in the current crisis. The Stock Exchange of Thailand (SET) employed a temporary, three-month uptick rule “to cope with high uncertainties” and volatility related to the COVID-19 outbreak. The Securities and Exchange Commission of Pakistan (SECP) imposed an uptick rule on 36 shares listed on its futures market “in the wake of COVID-19 and its unprecedented effect on global stock markets.”

Also, rather than restrict short sales, authorities have on some occasions sought to limit the possible negative impacts by requiring more disclosure. The UK FSA argued that disclosure-induced transparency would prevent market manipulation and ward off speculation and market overreaction (McGavin (2010), p. 237).
**Scope**

A short-selling ban can span groups of securities, indexes, or country-wide stock markets and exchanges. In 2008, the SEC first banned short sales on the stocks of the two mortgage government-sponsored enterprises in July. It later extended the ban to 799 financial companies’ stocks. In announcing the expanded list, the US SEC noted that it had focused on financial institutions because of “the essential link between their stock price and confidence in the institution.”

Of course, short sales are not the only way for investors to take bearish positions on equities. Some authorities have more broadly prohibited all net-short positions, thereby extending the ban to derivative securities and other “bearish operations” that profit from the problematic securities' price-decline. Several European countries such as Spain and Italy recently banned net-short positions, but exempted credit default swaps, corporate debt instruments, and balanced hedging activity.

One study of the 2008 short-sales bans in the US noted that options markets continued to function. The authors were able to show that banning short-selling slowed the flow of negative information into stock prices, relative to the options markets that weren’t covered.

**Participant Exemptions**

Rather than ban all short-selling, authorities may prohibit or exempt specific market participants. One academic paper classified short-sellers as algorithmic traders, market-makers, or long-term profiteers (Battalio et al. (2012), p. 2). Market makers are participants that facilitate the purchase and sale of stocks “on a regular and continuous basis at a publicly quoted price.” Expansive prohibitions have made it difficult for specialists such as market makers to provide liquidity by short-selling (Jones (2012), p. 27). When the NYSE banned all market participants from short-selling in 1931, it included market makers and “provoked something akin to a short squeeze” and accidentally permitted short-term buyers to ratchet up prices (Boehmer et al. (2013), p. 1367). In 2008, the SEC included algorithmic traders in its ban; some saw this as a mistake, because those traders could not act as informal market makers while the ban was in force. With less competition, the exempted formal market makers collected greater rents from those demanding liquidity. In most recent cases, authorities have exempted market makers.

**Timeframe**

Temporary short-selling and net-short bans might function as extreme macroprudential tools if they could limit panic selling. During the Global Financial Crisis, “Temporary short selling restrictions were imposed as a means to try and restore financial stability: the constraints could be swiftly introduced; they were easy to sell to the public; and they demonstrated the regulators were taking action to try and control the situation” (Howell (2016), p. 10). Still, temporary bans can cause uncertainty because market participants do not know what is included in the ban (Howell (2016), p. 28-9). Recently, international regulators have clarified the length and scope
of their short-selling restrictions by publishing answers to frequently asked questions (FAQs) on their websites.

**Coordination of Measures**

In some instances, authorities have coordinated short-sales restrictions across jurisdictions. On September 18, 2008, the Securities and Exchange Commission (SEC) and the Financial Services Authority (FSA) consulted one another before prohibiting the short-sale of domestic financial stocks (Boehmer et al. (2013), p. 1366-7). After the GFC, the European Securities and Markets Authority (ESMA) was established to promote supervisory convergence across the European Union. Recently, the ESMA ensured that the short-sales bans of foreign securities were consistent across markets in multiple nations (France, Belgium, Greece, and Italy). Regulators coordinate to make their policies transparent and harmonize them with the policies of other regulators. In another recent example, ESMA strengthened the EU’s short-sale disclosure requirements, and the UK’s Financial Conduct Authority (FCA) imposed a reciprocal rule to avoid the migration of share-specific short-selling from one market to another. Coordination can be essential to prevent regulatory arbitrage or exploitation by short-sellers (McGavin (2010), p. 238).
Easing Liquidity Regulations to Counter COVID-19

By Priya Sankar, Alexander Nye, and Greg Feldberg

Original post [here](#).

Many countries are easing liquidity regulations to help banks get cash to their customers and to prevent liquidity shortages from spreading across financial markets. Countries are addressing liquidity shortages using two main tools: the liquidity coverage ratio (LCR), which most developed countries implemented in recent years as part of the Basel III agreements, and the more traditional reserve requirement ratio.

LCR rules require banks to hold high-quality liquid assets (HQLA) sufficient to meet their needs through a 30-day liquidity stress scenario. Most countries that have an LCR rule have now eased its enforcement, encouraged by the Basel Committee itself in March. Other countries have lowered their reserve requirements, the amount of cash relative to liabilities that banks must hold on reserve with their central bank. A few countries have taken other measures, such as easing rules on foreign exchange liquidity. All of these tools are countercyclical and macroprudential, in that regulators are now using them to spur broad-based lending during a difficult crisis.

This blog discusses options for easing liquidity regulations:

1. Which tool to use?
2. How long will the change last?
3. Will the government provide a backstop?
4. Are there targets or conditions for use?

**Which tool to use?**

Reserve requirements

Central banks have used reserve requirements to pursue monetary, macroprudential, and other policy goals for a very long time. Since central banks generally pay less than other cash-like instruments, reserves are costly for banks to hold. By raising the reserve ratio, a central bank can impose a tax on banks, tightening credit; by lowering it, the central bank can reduce that tax, incentivizing banks to lend. From the 1930s until the 1990s, the U.S. Federal Reserve used the reserve ratio frequently as a countercyclical tool, typically in conjunction with its monetary policy.

But reserve requirements lost favor in the U.S. and other developed countries amidst the deregulatory trend in the 1990s and 2000s. In recent years, it is primarily emerging economies that have used reserve requirements as a countercyclical policy tool. Since 2004, no advanced economy has actively managed its reserve ratio countercyclically; 90% of developing
countries with reserve requirements have done so, including during the 2007-09 global financial crisis.

This trend has held in the current crisis. According to the YPFS Financial-Intervention Tracker, 22 countries, mostly developing countries, have lowered their reserve ratios or otherwise eased their reserve policies this year. The Democratic Republic of the Congo and Iceland have cut their ratios to zero, from 2% and 1%, respectively. Others have made larger cuts. The United Arab Emirates (UAE) cut its reserve ratio from 14% to 7%; Croatia cut its reserve ratio from 12% to 9%.

Some countries made multiple cuts. Brazil cut its reserve ratio from 31% to 25% and later to 17%. The Philippines reduced reserve requirements from 14% to 12% and signaled up to another 2% of cuts. China cut its reserve ratios three times since the beginning of 2020.

Liquidity Coverage Ratio (LCR)

Global regulators developed the LCR after witnessing extraordinary, systemic wholesale funding runs in the global financial crisis. Its purpose is both microprudential and macroprudential, although some viewed it more as a microprudential tool before the current crisis. By requiring every bank to hold sufficient liquidity to make it through 30 days of stress, the LCR reduces the potential for asset fire sales and wholesale funding runs to spread across banks.

While the decision to ease the LCR is up to the discretion of supervisors or financial stability committees, the wording in the 2013 Basel agreement on the LCR strongly suggests supervisors should do so in a systemic crisis. The concern is that the actions banks may take to maintain their LCRs above 100% could lead to the very financial contagion supervisors seek to avoid. “[I]n a situation of sufficiently severe system-wide stress, effects on the entire financial system should be considered.”

The members of the European Union and more than a dozen other countries have eased their LCR policies in response to the COVID-19 crisis. In explaining its policy easing on April 3, the European Central Bank (ECB) noted: “It is key that banks make use of the buffer under stress, even if that means falling substantially below the minimum 100% level, in order to ensure liquidity in the system and avoid contagion effects and chain reactions that might trigger liquidity problems in other institutions.”

The UAE, South Africa, and Korea have set new targets of 70%, 80%, and 85%, respectively. The U.S., ECB, and most others that eased their LCRs did not specify a new target below 100%. Some experts have argued that this lack of specificity will limit the usefulness of easing the LCR in these countries.

A few countries with LCRs, including Australia and China, have not eased them during the COVID-19 crisis. China has aggressively eased its reserve requirements. Australia is unusual in that it allows banks to use a committed liquidity facility from the central bank to stand in for a substantial portion of high quality liquid assets in calculating their LCRs.
Net Stable Funding Ratio (NSFR)

Global regulators also included the net stable funding ratio (NSFR) in Basel III. The NSFR requires banks to maintain sufficient stable funding to meet maturing liabilities and other needs for one year. This helps to prevent banks relying on wholesale funding during booms and encourages them to better assess liquidity risk on and off their balance sheets.

A handful of countries have adjusted their NSFRs or related policies during the COVID-19 crisis. Singapore has lowered its NSFR for loans to households and businesses maturing in the next six months from 50% to 25% until September 2021. India has delayed implementation from April to October. Malaysia is sticking to its July implementation date, but will require an NSFR of 80% rather than 100%. Australia has allowed banks to include their initial allowance under the central bank’s Term Funding Facility in their calculation of the NSFR.

Foreign Exchange Measures

There is no lender of last resort to help borrowers whose debts are denominated in foreign currencies. During a crisis like the current one, liquidity shortages can propagate across borders, as happened in the Asian financial crisis of 1997-98. Since then, several emerging-market countries have foreign currency reserve requirements or liquidity coverage ratios to address currency mismatches. A few countries raised those requirements prior to the global financial crisis and later eased them. This year, some countries have eased these rules. South Korea lowered its foreign exchange LCR from 80% to 70% for banks until May. Indonesia expanded the range of transactions foreign investors could use to hedge their holdings of rupiah.

Measures changing the assets that can be counted for reserve ratios, LCRs, or NSFRs

A few countries changed their definitions of HQLA for the LCR calculation or of assets acceptable as reserves for determining reserve requirements. For example, Brazil’s central bank increased the amount of central bank reserves that financial institutions can count in calculating their LCRs. This had a similar effect as lowering the LCR. Similarly, Iceland’s 1% reserve ratio reduction effectively boosted the HQLAs, and thus the LCRs, for some banks.

The Dominican Republic revised the rules around its reserve ratio so that financial institutions could count central bank and finance ministry securities for up to 2% of their reserve ratios. This had a similar effect as a reduction in banks’ reserve requirements.

In cases where an asset class has become or might become less liquid, governments might allow those previously liquid assets to count as HQLA for a longer period of time. Canada activated its hardship exemption for the LCR. This allows institutions to permit early outflows from retail and small business term deposits without imposing a penalty since they are not required to write down these withdrawals as LCR outflow.

How long will the change last?
Policymakers have to think about how long a liquidity easing tool will be in place, but how they choose to communicate the length of a program can be just as important. In 2012, the Bank for International Settlements (BIS) suggested that easing is more likely to be effective if authorities make a credible commitment to maintain loose policies for a “pre-specified period of time, or conditionally until the threat [...] has passed.”

Some countries have been very specific about the duration of their reserve requirement changes. Chile said its change allowing banks to fulfill the foreign exchange reserve requirement using Chilean pesos, euros, and Japanese yen would end September 8. India lowered its cash reserve requirement for one year. The Philippines framed its easing as conditional on “the impact of COVID-19 on domestic liquidity.” Others, like Turkey, Sri Lanka, and the UAE, did not say anything about how long they would maintain relaxed reserve requirements.

Most countries easing their LCRs were though not specific about the duration of the measure. The ECB only specified that it would “allow banks to operate temporarily below” the LCR. South Africa said its LCR cut would last “for the duration of the crisis.” An exception was South Korea, which lowered its foreign exchange LCR only through May.

The 2013 Basel agreement said that supervisors should have a range of tools for dealing with a bank whose LCR drops below the target, depending on factors such as the severity and duration of the decline and whether the problem is idiosyncratic or systemic. At a minimum, a bank should report to the supervisors with an assessment of its liquidity position. “Potential measures to restore liquidity levels should be discussed, and should be executed over a period of time considered appropriate to prevent additional stress on the bank and on the financial system as a whole.”

The U.S. took such a flexible approach. The central bank said that a bank that falls below the LCR “must submit a plan to its supervisor. But there is no requirement to rebuild high-quality liquid assets within a specific time period.” The Bank of England made a similar statement.

**Will the government provide a backstop?**

The BIS said authorities should coordinate the easing of liquidity buffers with central bank liquidity support. The availability of central bank support can help reassure markets and make financial institutions more likely to actually use the liquidity buffers they have built above the required amounts. In describing first-quarter results to analysts, the CEO of JPMorganChase said the company’s “liquidity position remains strong” even as it prepares to use internal buffers, reflecting that JPMC has “significant liquidity resources beyond HQLA including the discount window if need be.”

Governments frequently coordinate reserve requirements changes with other liquidity-easing tools. Kenya cut its cash reserve ratio (CRR) from 5.25% to 4.25% in the same announcement in which it lowered its central bank rate from 8.25% to 7.25%. India coordinated a cut in its CRR with a targeted long term repo operations, an expanded marginal standing facility, and several regulatory changes. Governments might structure programs so that they support one-
another. Australia allowed financial institutions to count some of their assistance from the central bank’s Term Funding Facility toward their LCR.

Policymakers modifying their LCR or NSFR in response to COVID-19 have nearly always chosen to announce the measures at the same time as other policy initiatives. Singapore announced its NSFR changes and its policy relaxing capital buffers at the same time. The UK said banks could use their countercyclical capital buffers and liquidity buffers in the same announcement, which also included monetary policy easing and a funding scheme for small businesses.

**Are there targets or conditions for use?**

Several countries have sought to tie liquidity easing with lending goals during the COVID-19 crisis. The U.S. said it encouraged banks “to use their capital and liquidity buffers to lend and undertake other supportive actions in a safe and sound manner.” Other countries made similar statements.

Reserve requirements are easier to use for such targeted policies. Authorities can set higher or lower requirements on various types of liability for policy reasons. They can also guide banks to a particular type of lending by lowering the reserve “tax” if banks meet lending targets.

China is a good example. On March 13 (following up with more information on March 17), China said it would cut its required reserve ratios by 50-100 basis points for large and medium-sized banks that met government criteria for financing small companies. It cut the separate reserve ratio for larger joint-stock banks by 100 basis points, noting: “The funds released are required to be used to issue inclusive finance loans, and the interest rates of these loans would drop significantly, thereby increasing credit support for the inclusive financial areas, such as MSEs and private enterprises.” On April 3, the central bank cut the reserve ratio for the country’s 4,000 small and medium-sized banks from 7% to 6%. It also reduced the interest it paid on excess reserves from 72 to 35 bps to further incentivize lending.

Indonesia aimed to help its export-import sector by cutting rupiah reserve requirements (local currency reserve requirements) by 0.50% “for banks financing export-import activity in coordination with the Government.”
COVID-19 Liquidity Measures

Reserve Requirements (RR)

Lowered: Algeria (10% to 8%), Aruba (12% to 11%), Brazil (31% to 25% to 17%), China (1.0% cut and then a 0.5% cut) Croatia (12% to 9%), Democratic Republic of the Congo (2% to 0%), Iceland (average RR lowered from 1% to 0%), India (4% to 3%), Kenya (5.25% to 4.25%), Malaysia (3% to 2%), Moldova (41% to 38.5% for Moldovan lei and other nonconvertible currencies), Philippines (14% to 12% and authorized to lower to 10%), Peru (5% to 4%), Poland (3.5% to 0.5%) Sri Lanka (5% to 4%), United Arab Emirates (14% to 7%), United States (eliminated reserve requirements)

Lowered but with no new target specified: Belize

Change to Policy: Argentina (lowered for bank-loans to households and SMEs), Chile (FX reserve requirements can now be fulfilled by euros, Japanese yen, and Chilean pesos, in addition to US dollars) Indonesia (lowered RR 50bp for firms financing import-export) Hungary (exempted credit institutions subject to reserve requirements from their domestic counterparties), Moldova (increased 20% to 21% for freely convertible currencies), Dominican Republic (Central Bank and Finance Ministry securities can count for up to 2% of the reserve ratio; a portion of this figure must be used to finance MSMEs and households in strategic sectors)

Foreign Exchange: Indonesia (8% to 4%), Peru (50% to 9% for instruments with terms of two years or less; additional FX reserve requirements suspended), Turkey (lowered by 500bp)

Liquidity Coverage Ratio (LCR)

Lowered: Korea (100% to 85%), South Africa (100% to 80%), United Arab Emirates (100% to 70%)

Allowed banks to fall below LCR, but with no new target specified: Basel Committee, Canada, Croatia, Denmark, European Union, Finland, Germany, Italy, Japan, Lithuania, Malaysia, Malta, Netherlands, Norway, Poland, Portugal, Romania, Russia, Spain, Sweden, United Kingdom, United States

Changes to Policy: Australia (portion of aid from the Term Funding Facility in the calculation of the LCR), Brazil (a larger portion of reserves now count as HQLA when calculating the LCR), Canada (withdrawals by depositors related to a new hardship exemption will not change the treatment of deposits when calculating the LCR), Chile (decided not to modify the regulatory limit applicable to the LCR), Denmark (institutions can count the ability to roll-over short term borrowing from the Danish Central Bank in the LCR), Mexico (any asset that counted as liquid asset for the LCR as of February 28, can be counted toward the LCR for a period of six months and may be extended for a maximum period up to six additional months), Russia (eased requirements for one method used to calculate an alternative to the LCR, the irrevocable credit line)

Foreign Exchange: Republic of Korea (80% to 70%)

Other Liquidity Ratios

Lowered: Aruba (18% to 15%)

Net Stable Funding Ratio (NSFR)

Lowered: Singapore (for loans to individuals and businesses 50% to 25%)

Policy Change: Australia (included the benefit of the Initial Allowance from the Term Funding Facility in the calculation of the Net Stable Funding Ratio)
Countries Ease Bank Capital Buffers

By Priya Sankar and Greg Feldberg

Original post here.

Countries around the world are easing bank capital requirements to help banks absorb losses and to allow them to maintain the flow of credit during the COVID-19 crisis.

Most of these measures involve the Basel III capital standards that global regulators agreed to implement after the 2007-09 financial crisis. Thanks to Basel III and like measures, banks across the world have substantially more capital than they had heading into that crisis. However, the current crisis threatens to quickly eat into those capital cushions. Banks are already reporting substantial credit losses and growing balance sheets, as they meet existing commitments and extend new loans. Easing capital standards today is a form of macroprudential policy, because regulators’ focus is on maintaining the health of the financial system as a whole.

This blog discusses options for easing capital standards:

1. Which buffer to adjust?
2. Constraints on capital distribution – Do countries enforce them when reducing their capital buffers?
3. How long will the change last?
4. Conditions for use of capital – Does the capital need to be used for a particular purpose?
5. Quality of Capital - Any change in the capital usually required to meet a buffer?
6. Changing risk weights - What kind of assets get their risk weights changed?

Which buffer to adjust?

Under Basel III, all banks must hold high-quality capital equal to 4.5% of their risk-weighted assets, plus a 2.5% capital conservation buffer (CCB). The purpose of the CCB is to encourage banks to conserve capital. When the buffer is breached, banks must limit bonuses to managers and distributions to shareholders. Before the current crisis, about a dozen countries had also imposed a countercyclical capital buffer on their banks (CCyB). The CCyB is a buffer under Basel III that countries can build during boom times and draw down during busts to absorb losses and mitigate the increase in risk-weighted assets; they may set it as high as 2.5%. In addition to the CCB and CCyB, many countries also impose additional buffers on systemically important banks.

During the current crisis, most countries that had earlier activated their CCyB have now cut it. But countries without a CCyB have found other ways to ease capital requirements. Several have told banks they can use their CCBs, resulting in automatic consequences for bonuses and...
dividends. Others have reduced the surcharge they had imposed on domestic systemically important banks (D-SIBs), their broader systemic risk buffers (SRBs), or other company-specific buffers.

**Countercyclical capital buffer (CCyB)**

To combat the COVID-19 crisis, close to 20 governments have released, reduced, or delayed planned increases in their countercyclical capital buffers. As regulators had designed it as a countercyclical tool, it is the easiest to deploy in a crisis.

Ten countries have released their entire CCyB, according to Yale's Financial-Intervention Tracker. The size of the decrease determines its impact. Sweden reduced its buffer the most, from 2.5% to 0%, freeing SEK45 billion (US$4.5 billion) in capital; that much capital could make roughly $60 billion available for lending, or more than 10% of Sweden’s GDP. Denmark and France had planned to raise their buffers, but instead cut them to zero.

Bulgaria and the Czech Republic left their buffers at zero, canceling planned increases. In the United States, the Federal Reserve Board is responsible for setting the CCyB, and has maintained it at zero since 2016. Most countries, including 18 in Europe, have also kept their CCyBs at zero since 2016.

**Capital Conservation Buffer (CCB)**

For countries that had not raised their countercyclical capital buffers before the crisis, the capital conservation buffer (CCB) is a common alternative.

Nine authorities, including the European Central Bank, have allowed banks to use their CCB in the current crisis, according to our tracker. Of these, four replaced it with a new, lower target, and five have encouraged banks to use their buffers without specifying a new target. The United Arab Emirates lowered it the most—from 2.5% to 1%. Brazil and Oman cut their buffers in half, from 2.5% to 1.25%. Sri Lanka lowered it more for large banks (to 1.5%) than for others (to 2%).

By international agreement, the CCB is 2.5% of risk-weighted assets, but countries typically allow their banks a few years to build capital to that level. India and Ukraine had been on the way to building their banks’ buffers to 2.5%. With COVID-19, they have delayed further implementation. India has said it will hold its CCB at 1.88%, and Ukraine will hold its CCB at 0.63%.

**Domestic Systemically Important Bank (D-SIB) Surcharges and Systemic Risk Buffers (SRBs)**

Basel III also introduced capital surcharges for systemically important banks. The purpose of these surcharges is to force banks to internalize the costs of their potential failure on the broader financial system. The Financial Stability Board, which is made up of leading national central banks and finance ministries, determines the “global systemically important banks” (G-SIBs). G-
SIBs are subject to a G-SIB capital surcharge, based on international agreement. Regulators have not revised G-SIB surcharges so far in the crisis.

However, prior to this crisis, many countries had introduced capital surcharges for domestic systemically important banks—banks in their jurisdiction that didn’t make the global list, but which they considered important to their own economies. During the COVID crisis, at least a half-dozen countries have lowered those surcharges. For example, Canada lowered its surcharge on D-SIBs from 2.25% to 1%.

Some countries reduced D-SIB buffers that applied to individual banks. This is the case in the Netherlands, which reduced the systemic buffer of 3% for three of its five systemically important banks to 2.5% for ING, 2% for Rabobank, and 1.5% for ABN Amro. This will free up EUR 8 billion in capital to back more lending. Hungary’s D-SIB buffers ranged from 0.5% to 2.0% for its largest banks before the crisis; it has cut all of those to zero.

Under Pillar 2 of the Basel capital accords, supervisors also may set company-specific capital requirements on top of those that apply to all banks. The ECB, among others, has advised banks it directly supervises that they may operate temporarily below the level of capital defined by their Pillar 2 guidance.

Some countries also have a systemic risk buffer (SRB) to cover systemic risks that other aspects of the capital requirements don’t cover. Poland—whose systemic risk buffer applies to all domestic banks—appears to have eased its SRB the most, from 3% to 0%. Finland reduced its systemic risk buffer to zero; it had previously set the systemic risk buffer at 1%-3%, depending on the bank. Finland also lowered its D-SIB buffer for one out of three D-SIBs.

Similarly, Australia’s regulator, in 2017, had set benchmark capital targets above minimum regulatory requirements to enable banks to be regarded internationally as “unquestionably strong.” During this crisis, it said it “would not be concerned if they were not meeting the additional benchmarks announced in 2017 during the period of disruption caused by COVID-19.”

In mid-March, the US Federal Reserve and Japan’s Financial Service Agency said they were encouraging banks to use their buffers, without specifying which buffers or to what extent.

**Constraints on Capital Distribution**

Basel standards dictate that banks that do not maintain their CCB standard will face automatic constraints on capital distributions, that is, dividends and share buybacks. These policies are enforced when a bank’s capital dips below its “expanded” CCB, which includes the CCyB and systemic risk buffers.

Many countries that eased capital buffers—including Australia, Canada, Denmark, Estonia, Finland, Iceland, Norway, Sweden, and the U.K.—set an expectation that banks should halt or not increase their dividends. The ECB has suggested that banks use their additional capital to support the economy and not for capital distributions.
Russia demanded that credit institutions “comply with the set limits for the share of profits to be distributed in accordance with the buffers’ size, including dividend payouts and compensations (incentives) to be paid to management.” The Czech Republic has explicitly required that banks refrain from making dividend payments or anything else that may compromise their resilience.

US regulators have not imposed a freeze on dividends or other shareholder distributions. The eight US-based G-SIBs voluntarily suspended stock buybacks in the second quarter of 2020. Fed Chair Jerome Powell said on April 9 that the Fed is watching “to see how things evolve” but does not yet think a dividend freeze is appropriate. Similarly, Japan’s regulators have encouraged banks to use buffers but have also not commented on dividends.

How Long Will the Easing Last?

Most countries have eased their buffers indefinitely, and many that have maintained or reduced their buffers have acknowledged the possibility of further decreases in capital buffer requirements. However, some have established plans for recovery and reestablishment of their capital buffers. Norway does not anticipate increasing their CCyB until at least 2022. Ukraine eased its CCB by no longer requiring banks to adhere to capital buffer guidelines, and plans on rebuilding it to the full 2.5% by 2023. Malaysia said it “fully expects” banks to restore their buffers “within a reasonable period” after the end of 2020. Hungary, as noted, has reduced its D-SIB buffers to zero, but has outlined plans for increasing them, starting in 2022.

Conditions for Use of Capital

More than 25 countries cited increased support for lending to businesses and households and maintaining financial stability as primary reasons for freeing up capital by reducing capital buffers. In the words of the Hong Kong Monetary Authority’s chief executive: “Lowering the countercyclical capital buffer at this juncture will allow banks to be more supportive to the domestic economy, in particular those sectors and individuals that are expected to experience additional short-term stress due to the impact arising from the outbreak.”

Some countries, like Belgium and Estonia, said they were releasing their buffers to absorb the impact of greater loan losses that may occur during the expected COVID-19 recession. France, Sweden, Poland, and others cited expanding credit to small businesses as the goal of reducing their CCyBs. Sweden’s central bank head said: “[W]hat we are doing is freeing up significant lending capacity for the banks.”

Quality of Capital

The European Central Bank said it will allow banks to use lower-quality Additional Tier 1 or Tier 2 capital to meet their core-capital requirements. Slovenia took that advice. However, we are not aware of other countries, either in Europe or elsewhere, that have pursued this option.

Changing Risk Weights
Risky assets have higher risk weights than safe assets like Treasuries and consequently require a bank to hold higher capital buffers to mitigate potential losses. By reducing the risk weight calculations of certain categories of assets, governments can ease a bank’s regulatory capital requirements and support the supply of credit to those assets.

The Netherlands has postponed the implementation of a floor on the risk-weighting of mortgages; this means there is no minimum risk weight for mortgages, as planned, which would have required holding a higher capital buffer. The Russian central bank recommended that banks and other credit institutions, when calculating their capital adequacy ratios, disregard adjusting the risk weights of loans to individuals that have been infected with coronavirus. Like the Netherlands, Russia has reduced the add-ons to risk weights for mortgage loans. Russia is also eliminating risk weights for foreign currency loans until the end of September for companies making pharmaceutical or medical products.

Kazakhstan has reduced risk weights for loans to small and medium-sized enterprises from 75% to 50%, and for foreign-exchange loans from 200% to 100%, to support lending.

The Federal Reserve changed its supplementary leverage ratio rule to exclude Treasury securities and deposits held at the Federal Reserve banks from the calculation of the leverage ratio for bank holding companies. This temporarily reduces the Tier 1 capital requirements for financial institutions with over $250 billion of assets by about 2% relative to their 3% minimum. The United States has also recently passed legislation to implement the Paycheck Protection Program, which will support provisioning of partially forgivable loans to SMEs. New loans made under this program will have a zero risk weight.

Similarly, the Japanese central bank and regulator said they would temporarily revise the leverage ratio to exclude banks’ accounts at the Bank of Japan.

**Countercyclical Capital Buffer (CCyB)**

- **Released:** Belgium (from 0.5%), Denmark (1.0%), France (0.25%), Germany (0.25%), Iceland (2%), Ireland (1%), Lithuania (1%), Sweden (2.5%), Switzerland (remains 2% on mortgage exposures), UK (1%)

- **Lowered:** Hong Kong (from 2% to 1%), Norway (2.5% to 1%)

- **Cancelled planned increase:** Bulgaria (held at 1%), Czechia (1.75%), France (0.25%)

- **Set at zero indefinitely:** India, Italy, Russia, Spain

**Capital Conservation Buffer (CCB)**

- **Specifically lowered:** Brazil (to 1.25%), Oman (1.25%), Sri Lanka (1.5% for large banks, 2% for others), UAE (1%)

- **Lowered but with no new target specified:** European Central Bank, Malaysia, Russia, Slovakia, South Africa

- **Delayed implementation of full buffer:** India (now at 1.88%), Ukraine (0.63%)
### Systemic Risk Buffer (SRB) and Domestic Systemically Important Bank (D-SIB) Surcharge

<table>
<thead>
<tr>
<th>Lowered</th>
<th>Australia (various to 0%), Canada (from 2.25% to 1%), Estonia (1% to 0%), Denmark (3% to 2% for Faroe Island exposures), Finland (range of 1%-3% to 0%), Hungary (0.5%-2.0% range to 0%), Netherlands (3% to range of 1.5%-2.5%), Poland (3% to 0%), UAE (various to 0%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maintained</td>
<td>United Kingdom</td>
</tr>
</tbody>
</table>

### Other capital easing

- **Aruba** (lowered capital adequacy ratio from 16% to 14%), **US** (allowed bank holding companies to exclude Treasuries in calculating the supplementary leverage ratio; lowered leverage ratio for community banks from 9% to 8%), Japan (allowed banks to exclude central bank accounts in calculating the leverage ratio)

### Generic statements on use of buffers

- **US**, Japan
Governments Provide Financial Regulatory Relief
By Aidan Lawson and Greg Feldberg

Original post here.

The COVID-19 crisis has led governments across the world to temporarily ease the operational burden of supervisory and regulatory activities on the financial institutions they regulate. These regulatory relief efforts can be broken down into three major categories:

1. Reducing supervisory activities such as stress tests and bank examinations.
2. Delaying the implementation of new rules or laws.
3. Reducing reporting requirements.

The YPFS Financial-Intervention Tracker shows 85 such regulatory relief measures to date, as summarized in our Resource Guide. As the COVID-19 crisis unfolds, regulators have pledged to continue to find new ways to help financial companies focus on their COVID-19 response in a safe and sound manner.

Reducing supervisory activities

In many cases, supervisors have reduced the scope of their annual stress tests and other supervisory activities.

The U.S. Federal Reserve announced on March 24 its intent to significantly scale back its annual examination activities. The Fed will not conduct examinations on-site at the banks it supervises “until normal operations are resumed at the bank and Reserve Banks.” Instead, it will focus on off-site monitoring. “Monitoring efforts will concentrate on understanding the challenges and risks that the current environment presents for customers, staff, for firm operations and financial condition, and for the largest firms, the risks to financial stability.”

The Fed has deferred “a significant portion” of examinations for institutions with greater than $100 billion in total consolidated assets. However, the Fed did not suspend its annual stress test exercise, conducted only by the largest bank holding companies (see here, pp. 2). It has ceased all regular exam activity for smaller institutions, “except where the examination work is critical to safety and soundness or consumer protection, or is required to address an urgent or immediate need” (see here). Banks that are not highly rated, or have existing liquidity, asset quality, consumer protection, or miscellaneous issues will continue to receive regular examinations. The Fed also said that banks will have an additional 90 days to remediate existing supervisory findings, unless otherwise specified.

Many countries similarly curtailed regular supervisory activities. For example, the Central Bank of Hungary (MNB) postponed on-site inspections unless absolutely necessary and said it would not use its supervisory powers if banks breached their Pillar II capital buffers. South
Korea, Egypt, and others have suspended ongoing investigations during the crisis. Romania postponed the deadline for collecting contributions to its Bank Resolution Fund for three months, with a possible extension of up to six.

The Bank of England cancelled its 2020 stress tests, cut back on in-person supervisory visits, and postponed the publication of its 2019 biennial exploratory scenario on liquidity buffers and facilities to “alleviate burdens on core treasury staff at banks.”

The European Banking Authority postponed its Europe-wide stress test exercise to 2021 to “allow banks to focus on and ensure continuity of their core operations, including support for their customers.” In place of the stress test, the EBA will carry out an additional transparency exercise to update information about banks to market participants. The ECB also published guidance indicating that affiliate supervisors would be postponing on-site inspections, certain compliance measures, and reviews of internal models for six months.

While the Bank of Russia did not cancel its stress tests, it advised non-governmental pension funds to use a scenario as of September 30, 2019, rather than a more recent one. The National Bank of Ukraine reduced the number of scenarios it required banks to submit as part of their annual stress testing, but added COVID-19 risk assessments to those scenarios.

The Financial Action Task Force (FATF), which acts as an international standard-setter for illicit financing, money laundering and financing of terrorist groups, simplified due diligence and emphasized flexibility in using their risk-based approach in combating these illegal activities (see here).

Delays in Implementing New Laws and Rules

Many countries have also deferred the effective dates of recently passed regulation or even suspended ongoing discussions about potential regulatory improvements.

The European Central Bank said it would consider “extending deadlines for certain non-critical supervisory measures and data requests.” The Bank for International Settlements (BIS) pushed back for one year the implementation of the final phases of its framework for margin requirements for non-centrally cleared derivatives. These requirements were put in place to reduce systemic risk and promote central clearing by imposing higher costs on market participants holding non-standard derivatives, which make up a sizable portion of the market (see here, pp. 2 – 4). The effective implementation date is now September 1, 2021, for entities with non-centrally cleared derivatives totaling more than €50 billion outstanding, and a year later for smaller market participants (see here).

The Fed postponed for six months the implementation of policies regarding the provision of intraday credit, as well as its revised control framework. The changes to the intraday credit provision would modify how the Fed evaluated net debit caps, which are the maximum amounts of overdrafts institutions could incur in their Federal Reserve accounts (see here, sec. 2). The revised control framework “simplifies and increases the transparency of [the Board’s] rules for
determining when one company controls another company,” so that if a company has control over any banking organization, it would generally be subject to Fed regulations (see here).

**New Zealand** has deferred several new initiatives and programs. These include reviews of existing supervisory and stress testing policies and increases in capital requirements (see here). Russia is delaying certain compliance requirements for non-governmental funds that will be participating in stress tests until January 2021, and Canada has suspended “all consultations on regulatory matters,” including the publication of its new benchmark rate for qualifying uninsured mortgages. Australia has “suspended the majority of its planned policy and supervision initiatives” and deferred the implementation of new reporting standards for fee structures and derivatives until April 2021. Peru has deferred new reporting standards for parallel credit lines, or secondary lines of credit, until January 2021.

Regulators have also taken steps to reduce the operational burden on regulatory staff. Australian regulators, for example, suspended issuing new banking, insurance, and superannuation fund licenses for at least six months.

### Reduced Reporting Requirements

Many of the more substantial measures outlined above have also been accompanied by reductions or complete moratoriums on the required publication of financial data, such as annual and quarterly reports. According to our tracker, at least 15 countries, as well as EU regulators and the BIS, have reduced reporting requirements.

The European Securities and Markets Authority (ESMA) has provided substantial guidance to member states on how to approach reporting during the crisis. On March 27, it recommended that all National Competent Authorities (NCAs), which are government institutions designated by their individual nations to be points of contact with the ESMA about specific policy areas, defer publication of all financial reports. The ESMA also delayed reporting obligations for Securities Financing Transactions, which involve the use of securities to borrow cash or other investment-grade securities, for all transactions settled until July 13. However, ESMA said it expects reporting for these activities to resume by July 13.

In the U.S., the Securities and Exchange Commission (SEC), Commodities Futures Trading Commission (CFTC), and Fed have all either reduced requirements or extended deadlines for reporting financial information. The SEC provided a 45-day extension for publicly traded companies to file disclosure reports that would have been due between March 1 and July 1, so long as they file a form explaining “why the relief is needed in their particular circumstances for each periodic report that is delayed.” The CFTC has granted 30-day forbearance for furnishing compliance reports, exempted dealers and brokers from recording oral communication and timestamping, and provided longer-term forbearance from periodic reporting for commodity pool operators. The U.S. federal banking agencies indicated they would not take supervisory action against financial institutions that needed additional time to file their quarterly Call Reports, so long as these reports are submitted within 30 days of the official filing deadline.
The BIS has reduced reporting requirements for its 2020 global systemically important bank (G-SIB) assessment exercise. The exercise instead will be based on 2019 data, and the BIS will not collect memorandum data, which are used to “assess if changes should be made to the overall G-SIB framework” (see here, pp. 23). Memorandum data include items that measure interconnectedness, complexity, foreign exposures, and short-term funding (see here, pp. 23 – 28). There are 30 G-SIBs.

Several other countries have implemented similar measures. Italy (60 - 150 days), Malaysia (30 days), Sri Lanka (14 – 30 days), Denmark (90 days), South Africa (60 – 120 days), New Zealand (60 days) and Russia all have provided some form of deferral or lessening of reporting requirements. On March 21, the U.K. requested an immediate moratorium on the publication of any preliminary financial statements for at least two weeks. The Bank of Russia indicated that it would not apply its supervisory measures to companies violating reporting requirements and also reduced supervisory reporting requirements for the second quarter of 2020 (see here). Brazil has temporarily prohibited both reporting and increases in remuneration for managers and executives of financial institutions until September 30.

<table>
<thead>
<tr>
<th>Regulatory Relief Category</th>
<th>Jurisdictions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reducing supervision</td>
<td>Bank for International Settlements, Denmark, European Union (1) (2) (3), Egypt, Hungary, Korea (1) (2), Romania, Russia, Sri Lanka, Ukraine, United Kingdom, United States (1) (2) (3)</td>
</tr>
<tr>
<td>Delaying Implementation of new regulation</td>
<td>Australia, Bank for International Settlements, Brazil (1) (2), Canada, New Zealand, Peru, Russia, United States</td>
</tr>
<tr>
<td>Reducing reporting requirements</td>
<td>Australia, Bank for International Settlements, Brazil (1) (2), Denmark, European Union (1) (2), Indonesia (1) (2), Italy, Malaysia (1) (2), Romania, Russia, South Africa, Sri Lanka (1) (2), Sweden, Ukraine, United Kingdom (1) (2) (3) (4) (5), United States (1) (2) (3) (4), Vietnam</td>
</tr>
</tbody>
</table>
Conventional Monetary Policy and the Zero-Lower-Bound

By Pascal Ungersboeck

Original post here.

Central banks across the world have eased monetary policy to facilitate smooth market functioning during the Covid-19 crisis. Interest rate cuts are their primary policy tool. Global interest rates are now at historic lows, with 14 of the 38 central banks in a Bank for International Settlements (BIS) database setting their nominal key policy rates at or below 0.25 percent; three are below 0.

This post provides an overview of recent policy rate trajectories and discusses the constraints that policymakers face, as well as possible avenues for further accommodation through the interest-rate channel, with nominal rates at or approaching zero in many countries.

Global interest rates

All countries in the BIS database with positive policy rates before the crisis have announced cuts since the beginning of the year, with the exception of Hungary and Croatia. The United States and Canada have cut their rates the most among major economies, both by 150 bps. Canada lowered its overnight target rate from 1.75 percent to 0.25 percent in three announcements between March 4 and March 27. The current target rate is lower than the rate of 0.5 percent that the bank targeted at the height of the Global Financial Crisis (GFC) between April 2009 and May 2010. Similarly, the Fed lowered its target for the federal funds rate by 150 bps following two unscheduled FOMC meetings on March 3 and March 15. With a target range between 0 and 0.25 percent, the funds rate returned to the level it stood at in the wake of the GFC, before the Fed engaged in a series of interest rate hikes starting in December 2015.

Most countries have cut their target rates in one or two announcements, with only a small number of central banks making three or more successive cuts. Among countries that have only made a single announcement, India and New Zealand made the largest adjustments to their policy rate; both countries cut their target rate by 75 bps. The Reserve Bank of New Zealand cut its official cash rate from 1 to 0.25 percent on March 15, the lowest target in the bank’s history.

Argentina and Turkey cut their rates the most. The central bank of Argentina has cut its rate by 1700 bps since the beginning of the year. However, those adjustments don’t constitute an immediate reaction to Covid-19, but reflect the slowdown of inflation in the country; they are part of an ongoing effort to normalize monetary policy. Turkey announced four successive cuts between January 17 and April 23, lowering its target rate by 325 bps from 12 percent to 8.75 percent. While the first two announcements were made in the context of an ongoing disinflation process, the central bank mentioned a need to address weakening economic activity due to the Covid-19 crisis in its two most recent announcements.
Some central banks have not cut rates at all. This is the case for the Swiss National Bank (SNB), the Bank of Japan (BOJ), and the European Central Bank (ECB). All three had a target rate at or below zero at the onset of the crisis and did not provide further accommodation through this policy channel. The central bank of Hungary also maintained its target rate despite having a positive policy rate at 0.9 percent. The central bank of Croatia uses the exchange rate of the euro against its domestic currency to guide monetary policy, it did not include an interest rate target in its response to the current crisis.

Denmark was the only central bank to raise its target rate. Danish policymakers raised the target rate from negative 0.75 to negative 0.60 percent on March 19 to ease downward pressure against the Danish crown and maintain its fixed exchange rate with the euro.

The Zero Lower Bound constraint

Negative interest rates are one possible avenue for further accommodation through the policy rate channel at the Zero Lower Bound (ZLB). Another avenue is forward guidance, that is, expressing the central bank’s commitment to maintain rates at a low level for a prolonged period of time.

As the nominal interest rate approaches zero, central banks’ ability to cut interest rates through open market operations is limited as investors can choose to hold currency instead of securities. Currency holdings carry zero interest and thus provide a natural floor to interest rates. In practice, however, large cash holdings have associated risks and costs, allowing some central banks to set negative interest rates.

Currently, Switzerland, Japan, and Denmark have the only central banks with a negative interest rate target, which all three implemented before the current crisis. The central bank of Sweden had a negative policy rate since February 2015 but returned to a target at a nominal rate of zero on January 8, 2020.

The Swiss National Bank (SNB) has the lowest target rate globally. Its policy rate has stood at negative 0.75 percent since January 15, 2015, to counter the upward pressure on the Swiss franc and to maintain its exchange rate with the euro within an appropriate range. The BOJ has maintained a low rate since the Asian financial crisis. Its policy rate has not exceeded 0.5 percent since September 8, 1995; it has been negative since September 21, 2017. The ECB has maintained its key policy rate, the rate on main refinancing operations (MRO), at zero since March 2016.

Finally, a number of central banks recently set policy rates at or below 0.25 percent, leaving them with limited room for further accommodation through conventional rate cuts. This is the case for the central banks of Australia, Canada, Israel, New Zealand, Norway, Peru, the United Kingdom, and the US.

Banks that do not set negative policy rates can provide further relief to market participants by communicating a commitment to maintain accommodative policy rates for some time. This can
be explicitly stated as a period of time during which the bank commits to maintain its rate or implicitly by communicating that rates will be maintained until a policy objective is achieved. The Reserve Bank of New Zealand issued explicit forward guidance with its most recent rate cut, promising to maintain the target rate at 0.25 percent for 12 months. Meanwhile, the ECB tied expectations to a quantified policy objective, committing to announce no further changes in interest rates until “the inflation outlook robustly converges to a level sufficiently close to, but below, 2%.” In the US, the Fed promised to maintain its range until “it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals.”
Authorities Urge Prudence in Loan Loss Accounting

By Aidan Lawson, Arwin Ziessler, and Greg Feldberg

Original post here.

Banks and government authorities have tried to help struggling borrowers during the COVID-19 crisis, through widespread payment moratoria and modifications in the terms of loans. But such efforts are costly to banks. Accounting standards require lenders to set aside reserves against borrowers who are unable to meet payments. Setting aside reserves diminishes banks’ income and equity. Nonpayment of interest also hits their income and cash flow.

Meanwhile, recently implemented accounting standards based on lifetime expected credit losses could require banks to sharply increase their loan-loss reserves, further impacting capital.

Of course, credit losses will likely be substantial during this severe economic crisis. Authorities would like to encourage banks to keep working with borrowers, while easing pressure on their earnings and capital to the extent possible.

This blog discusses measures that bank supervisors have taken in two categories:

- Flexibility in classifying individual loans as troubled or nonperforming.
- Easing the capital impact of the transition to lifetime expected loss accounting.

The blog then describes key concerns about the flexibility that supervisors have granted.

The discussion illustrates the tradeoff supervisors face. On the one hand, they want to prevent the procyclicality inherent in regulatory and accounting standards from worsening an already severe credit crunch. On the other hand, they have a responsibility to maintain the integrity and transparency of financial-institution accounting for the long run.

Global regulators, through the Bank for International Settlements, recommend that any regulatory relief to banks should: (1) be effective in supporting economic activity in the long-run; (2) ensure that banks remain well-capitalized, liquid, and profitable; (3) avoid undermining the long-run credibility of financial policies.

Policy options for flexibility in troubled-asset classification

Borrowers who are experiencing financial hardship may need the terms of their loans eased through restructurings or modifications. Authorities across the world have sought to help such borrowers through payment moratoria and regulatory relief. Loan forbearance, a common form of relief, typically lasts three to six months, in the hope that borrowers’ cash-flow issues will be temporary. (See YPFS’ discussion on forbearance for businesses and individuals).

But accounting standards typically require banks to reclassify modified loans into higher-risk categories, which means that they must set aside additional capital to compensate for the
increased risk. Although a modification may increase the long-run likelihood that a borrower is able to repay, the increased provisioning and lower capital levels that result can disincentivize lenders to work with borrowers.

To reduce that disincentive, governments and regulators have introduced a number of policies, including:

- Guidance stating payment moratoria can be excluded from the number of “past-due” days for a loan.
- Guidance stating that loans for borrowers benefiting from government assistance programs should not automatically be reclassified as nonperforming or in forbearance.

The Basel Committee on Banking Supervision (BCBS) has endorsed these strategies, so long as supervisors make sure banks use the flexibility prudently (see here, pp. 5).

In the U.S., financial regulators issued an interagency statement on March 22, emphasizing that lenders should work with borrowers affected by the virus and providing guidance on accounting for loan modifications and reporting of past-due loan balances.

On March 27, the U.S. Congress passed the CARES Act. Section 4013 of the Act gives financial institutions the option not to classify modified loans as troubled debt restructurings (TDRs), provided that the borrowers were adversely affected by COVID-19 and that they were current on their payments at the end of 2019. Section 4013 applies to modifications made between March 1 and the end of 2020, or later if the national emergency is still in effect. Under the CARES Act, lenders are also not required to report loans affected by Section 4013 as TDRs in reports to regulators or calculate impairment losses that would normally be associated with such modifications.

After the CARES Act passed, regulators revised the March 22 guidance to incorporate the language in Section 4013. The revised guidance was more flexible than the law. Even modifications that do not qualify under Section 4013 are still not automatically classified as TDRs. The regulators -- with the support of the independent accounting standard-setter, the Financial Accounting Standards Board (FASB) -- stated that “short-term modifications made on a good faith basis in response to COVID-19 to borrowers who were current prior to any relief are not TDRs” (see here, pp. 3).

Many countries -- for example, Sri Lanka, Romania, Estonia, Kenya, Brazil, South Africa, Australia, Hungary, Nigeria, and Indonesia -- have explicitly stated that loans modified to help borrowers affected by COVID-19 should not be automatically classified as restructured. Romania’s rule applies to non-bank financial institutions (NBFIs) as well as banks. South Korea allows banks to not label loans to closed businesses as “sub-standard,” provided the owners have demonstrated sufficient repayment capabilities.

Banks in the Philippines can receive similar relief, but only if they have used or are planning to use the central bank’s (BSP) rediscounting facility. Both Russia and Vietnam recommend that
lenders assess loans affected by COVID-19 by using a date that precedes the pandemic. Russia also recommends that restructurings or reassessments should not show up on credit histories (see here).

Indian financial institutions are still required to provision for restructured loans. However, they are only required to set aside a provision of 10 percent of the amount outstanding of term loans and interest payments to working capital facilities that were deferred until May 31 (see here). These provisions will be phased in over the first two quarters of 2020.

**Policy options for easing the impact of lifetime expected loss accounting**

The implementation of new accounting standards is another source of increased loss provisioning. These standards require lenders to conduct forward-looking assessments of expected credit losses (ECLs) over the lifespan of each asset. The earlier “incurred loss” (IL) models allowed banks to set aside provisions only when it was probable that an asset would fail; they were “too little, too late” during the Global Financial Crisis (GFC). In contrast, the new lifetime expected-loss standards require banks to provision more and earlier. This could theoretically mitigate procyclicality by having banks build loss provisions for use during a downturn.

Lifetime expected-loss models depend on each bank’s ability to accurately forecast and model expected losses. However, by definition, expected-loss models cannot prepare banks for unexpected events such as the COVID-19 crisis. For that reason, the potential capital effects of COVID-19 may be more pronounced than they would have been under an incurred-loss model (see here, pp. 5, 36-37). According to quarterly filings, provisions for credit losses for the six largest U.S. banks increased $20 billion in the first quarter of 2020 due to the combined impact of COVID-19 and their switch to expected-loss accounting.

**Table 1: Expected credit loss provisions of major U.S. financial institutions**

<table>
<thead>
<tr>
<th>Institution</th>
<th>Provision (Q4 2019)</th>
<th>Provision (Q1 2020)</th>
<th>Difference (Q4 2019 and Q1 2020)</th>
</tr>
</thead>
<tbody>
<tr>
<td>JPMorgan Chase</td>
<td>$1.4 billion</td>
<td>$8.3 billion</td>
<td>$6.9 billion</td>
</tr>
<tr>
<td>Citigroup</td>
<td>$2.2 billion</td>
<td>$7.0 billion</td>
<td>$4.8 billion</td>
</tr>
<tr>
<td>Bank of America</td>
<td>$941 million</td>
<td>$4.8 billion</td>
<td>$3.9 billion</td>
</tr>
<tr>
<td>Wells Fargo</td>
<td>$845 million</td>
<td>$4.0 billion</td>
<td>$3.2 billion</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>$336 million</td>
<td>$937 million</td>
<td>$600 million</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>$53 million</td>
<td>$388 million</td>
<td>$335 million</td>
</tr>
<tr>
<td>Total</td>
<td>$5.8 billion</td>
<td>$25.4 billion</td>
<td>$19.7 billion</td>
</tr>
</tbody>
</table>
To mitigate the impact of expected-loss provisions on capital during this crisis, regulators have pursued the following options:

- Flexibility in interpreting loss provisions.
- Temporary sterilization of the effect of new rules on regulatory capital.
- Allowing banks to temporarily suspend application of the new standard.

Background: CECL and IFRS 9

In the U.S., the Current Expected Credit Losses (CECL) standard was scheduled to come into effect for large, publicly traded banks in 2020. CECL does not specify a given method for measuring expected credit losses. It allows methods such as historical loan loss, roll-rate, and discounted cash flow analysis. Banks are only required to forecast conditions under a timeframe that is “reasonable and supportable.” Beyond that, they are allowed to use historical averages to model long-run behavior (see here, pp. 10 and here, pp. 30 - 31).

The new IFRS-9 standard, now common outside the U.S., is also based on expected losses, but works differently. It requires businesses to dynamically provision for expected losses based on the credit risk of the assets. The standard classifies assets in three stages. Lower-risk (stage 1) assets only require banks to provision for the next 12 months of expected losses (see here). Restructuring, renegotiating, lack of payment, and other behaviors can cause assets to be labeled as having a “significant increase in credit risk” (SICR), resulting in reclassification into high-risk groups (stages 2 and 3).

The primary difference between the two standards is that CECL requires lifetime expected provisions for all loans and IFRS-9 requires them only for loans that have had a SICR and moved into Stage 2 or 3. IFRS-9 was implemented in 2018, which limits the tools that regulators can use.

Table 2: Overview of IFRS-9 Expected Credit Loss (ECL) provisioning

<table>
<thead>
<tr>
<th>ECL Classification</th>
<th>Threshold</th>
<th>Loss Provision</th>
<th>Interest Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stage 1 (Performing)</td>
<td>Immediately after origination.</td>
<td>12-month expected credit losses</td>
<td>Calculated on the gross carrying amount</td>
</tr>
<tr>
<td>Stage 2 (Underperforming)</td>
<td>If credit risk increases significantly and is not considered low.</td>
<td>Lifetime expected credit losses</td>
<td>Calculated on the gross carrying amount</td>
</tr>
<tr>
<td>Stage 3 (Nonperforming)</td>
<td>If credit risk increases to the point that it is credit-impaired</td>
<td>Lifetime expected credit losses</td>
<td>Calculated based on the amortized cost</td>
</tr>
</tbody>
</table>
Basel Committee recommendations during COVID-19

The sudden onset and uncertainty during the COVID-19 crisis amplifies the procyclicality of capital and accounting standards. To mitigate this, the Basel Committee has issued several recommendations on expected credit-loss accounting.

In its guidance, the Basel Committee first emphasized flexibility in determining whether a SICR under IFRS-9 standards has actually occurred. If loans are affected by relief efforts, they should not automatically be reclassified as Stage 2 or 3 on that basis alone.

Second, the Basel Committee expanded the use of transitional arrangements, which allow lenders to phase in the effect that ECL accounting would have on their Tier 1 capital. The Basel III capital agreement already includes transition arrangements that allow banks to phase in the capital effects of expected-loss accounting over five years. Because of COVID-19, the Basel Committee says that lenders now can either continue to use transition arrangements under the existing framework or defer the capital impact of expected-loss accounting until 2022; after that, banks can phase in the impact on a “straight line basis” over the following three years (see here, pp. 2-3).

However, these transition arrangements have a limited effect (see here, pp. 6). The Financial Stability Institute argues that combining these arrangements with increased flexibility could provide more relief to lenders. However, they warn that doing so could widen the gap between accounting and prudential measures of capital.

Many regulatory bodies -- such as the European Securities Markets Authority (ESMA) and European Banking Authority (EBA) -- have followed the Basel recommendation and stated that loans affected by economic recovery programs should not be considered as having a SICR and moved into high-risk groups. They emphasized that the high degree of uncertainty caused by COVID-19 could adversely affect estimated credit losses and damage the reliability of short-term forecasts (see here, p. 4). To resolve this issue, the European Central Bank (ECB) recommended that “banks give a greater weight to long-term macroeconomic forecasts evidenced by historical information when estimating long-term expected credit losses for the purposes of IFRS 9 provisioning policies” (see here).

In the U.S., the CARES Act states that U.S. banks would not have to adopt CECL until the end of 2020 or the end of the national emergency, whichever is earlier.

Also, U.S. financial regulators offered institutions that had already adopted CECL the option of delaying its effect on their regulatory capital ratios for two years. After two years, banks have a three-year transition period to phase in the capital impact (see here, pp. 4223). Banks that already adopted CECL can continue to follow the three-year transition period or adopt the new
five-year plan instead. Regulators issued a policy statement on May 8 that provides flexibility for management in forecasting and estimating credit losses under CECL.

The Bank of England (BOE) and Prudential Regulation Authority (PRA) first discussed IFRS-9 and echoed some of the same points as their Euro-area counterparts (see here). The PRA discussed many of these points in greater detail in a letter on March 26, specifically emphasizing the importance of using long-term trends when forecasting and not immediately classifying borrowers into stages 2 and 3. The PRA reiterated that the economic shock from COVID-19 “should be temporary, although its duration is uncertain;” it said that the likelihood of an increase in lifetime credit risk for most borrowers remained unchanged (see here, p. 6). The Australian Prudential Regulation Authority recommended similar post-ECL forecasting adjustments: “If the effects of covid-19 cannot be reflected in models, post-model overlays or adjustments will need to be considered.”

Countries recommending flexibility in calculating expected credit losses include Germany, South Korea, Brazil, New Zealand, Singapore, and Chile. Russia stated that loans affected by COVID-19 restructuring should not be classified as worse than stage II (underperforming). Similarly, Malaysia stated that temporary COVID-19-related shocks can be interpreted as only affecting 12-month expected credit losses, and not lifetime losses.

Some central banks have supplemented the Basel Committee’s guidance on transitional arrangements by incorporating additional ways to stagger the capital impact that increased provisioning will have. The Central Bank of the UAE required banks to apply a “prudential filter” to IFRS-9 expected loss provisions. This filter allows banks to stagger any IFRS-9 provisions over five years to mitigate the impact on bank capital levels. The Bangko Sentral ng Pilipinas implemented a similar five-year filter.

**Concerns**

The fundamental tradeoff that regulators must consider when implementing these policies is how to mitigate procyclicality while retaining credibility. Credibility is hard to gain and easy to lose, especially in periods of economic stress. The more extensive the relief, the larger the tradeoff.

Flexibility could erode comparability

One concern is that flexibility will erode the comparability of financial statements, the main value of accounting standards. Temporary suspensions of already-implemented standards, such as the CECL measures in the CARES Act, may also reduce the comparability of financial statements across and within countries. Of the 17 countries and six international regulators that YPFS identified as having implemented some form of accounting relief, the U.S. and Romania are the only ones that suspended the adoption of new standards. See Table 3 for a full breakdown of country-based relief. CECL forbearance could cause global financial statement comparability
issues if enough U.S. banks choose to maintain incurred-loss standards while the rest of the world continues to use lifetime-loss models, as they have since 2018.

As it turned out, most major American financial institutions have not opted to use the CECL relief provided by the CARES Act. But most large banks and many small banks did take advantage of the regulatory guidance and delayed the regulatory capital effects of the transition to CECL. The largest U.S. financial institutions have all adopted CECL, and all but three of them -- Wells Fargo, State Street, and Bank of New York Mellon -- have elected to phase in the capital impact over the longer, five-year plan that the regulators made available in the guidance.

The very nature of expected-loss provisioning, which requires managers to make subjective judgments about the future course of the economy, can also erode comparability (see here). Varying national guidance on the application of IFRS-9, as well as increased flexibility in transitional arrangements, may alleviate market-based distress but could compromise comparability. Reduced financial statement comparability and increased heterogeneity across bank forecasts and estimations, on the other hand, can dampen procyclicality as financial institutions increase their provisions at different rates.

Regulators may allow forbearance to last for too long

Prolonged forbearance had an adverse effect in both the Japanese banking crisis in the 1990s and the U.S. savings and loan (S&L) crisis in the 1980s.

Japanese financial regulators liberalized their rules throughout the 1970s and ‘80s. Strong regulation had previously substituted for bank risk management. As controls were relaxed, it became apparent that financial institutions had not begun using modern risk management techniques (see here, pp. 257-259).

The Japanese government responded with broad regulatory forbearance and flexibility, allowing banks to understate the extent of their problems (see here, pp. 49). Ultimately, lax loan classification and provisioning rules, continued dividend payments, competing regulatory authorities, and other factors unique to the Japanese banking system harmed the health of banks (see here, pp. 26-28). In the end, the banking system required aggressive government intervention, consisting of tens of trillions of yen in bank rescues and additional assistance. (For more, see the YPFS cases: Unnava 2020a, Unnava 2020b, and Unnava 2020c).

Prolonged forbearance also played an exacerbating role in the U.S. S&L crisis. S&Ls, or thrifts, lent money mainly for long-term, fixed-rate mortgages and funded themselves primarily with short-term deposits at interest rates that were capped by the government. As interest rates rose in the late 1970s and early 80’s, thrifts experienced deposit outflows and faced catastrophic losses because they could not raise their rates alongside commercial banks (see here).

In response, the U.S. government relaxed accounting and ownership standards and passed legislation that relaxed regulations. Thrifts shifted from mortgages into riskier assets (see here, pp. 180). Large numbers of new thrifts were chartered, and many “goodwill mergers” took
place, resulting in the overstatement of capital levels. Ultimately, the federal deposit insurer for the industry went bankrupt amidst a deluge of failures (see here, table 8). Many considered the regulatory forbearance to have been a core cause (see here, pp. 32). (For more, see the YPFS case).

The origins of these crises are very different from COVID-19. In these cases, the extensive, and in some cases exclusive, use of forbearance reflected “the hope that in time a changed economic environment would take care of the problem” (see here, pp. 49). While this rationale still may be a justification for forbearance in the COVID-19 crisis, these policies have complemented large-scale monetary and fiscal policy initiatives supporting both financial and nonfinancial organizations.

**Table 3:** Summary of International and National Reclassification and Accounting Relief Policies

<table>
<thead>
<tr>
<th>Measure</th>
<th>Nation / Institution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan Reclassification exclusions</td>
<td>Philippines, Egypt, India, Sri Lanka</td>
</tr>
<tr>
<td>- Past due day</td>
<td>Australia, Russia (1) (2) (3) (4), Philippines, Nigeria, Ireland, ECB, United States</td>
</tr>
<tr>
<td></td>
<td>Kenya, Romania, ESMA, India (1) (2), Sri Lanka (1) (2), South Africa, Ukraine, Korea,</td>
</tr>
<tr>
<td></td>
<td>Estonia, EBA, European Commission, Malaysia</td>
</tr>
<tr>
<td>Accounting Changes</td>
<td>Russia, ECB (1) (2), Kenya, Brazil, IASB, European Commission, South Africa, New Zealand,</td>
</tr>
<tr>
<td>- Flexibility in interpreting loss</td>
<td>BCBS, ESMA, EBA, United Kingdom (1) (2), Korea, Singapore, Australia, Hong</td>
</tr>
<tr>
<td>provisions</td>
<td>Kong, Chile, Germany, Malaysia</td>
</tr>
<tr>
<td>- Sterilization of capital effects</td>
<td>BCBS, Philippines, UAE, United States</td>
</tr>
<tr>
<td>- Temporary suspension of new</td>
<td>IFRS (1) (2), Romania, United States</td>
</tr>
<tr>
<td>standards</td>
<td></td>
</tr>
</tbody>
</table>
COVID-19 and Insurance (1 of 3): Helping Individuals and Businesses

By Greg Feldberg and Alexander Nye

Original post here.

Insurance companies face unusual challenges during the COVID-19 crisis. This blog describes efforts by companies and their supervisors to:

- Reduce financial burdens on insurance customers, for example, by allowing them to defer premium payments.
- Resolve the controversy over whether existing insurance coverage extends to businesses that have lost revenue during the crisis.

To date, crisis impacts on insurers have come mainly through financial markets rather than through extraordinary claims. Two later blogs will describe measures providing operational regulatory relief to insurers and measures encouraging insurers to conserve capital and avoid procyclical behavior.

1. Reducing financial burdens on customers

The most visible COVID-19-related interventions in the insurance sector offer protection and assistance to customers, whether individuals or organizations.

Some of these measures allow customers to defer paying their insurance premiums and give them grace periods for renewing their policies. Some expand, modify, or clarify existing policies to better protect policyholders from the brunt of COVID-19. Others seek to resolve the problems of insurers who are overwhelmed by claims while customers demand a quick response. A few countries have also encouraged insurance companies to allow deferred payments on loans they hold as assets.

Perhaps the most important measures have been those directly providing customers with financial relief.

Belgium has taken several measures. For unemployed workers, the National Bank of Belgium postponed premium payments for death, disability, and hospitalization policies related to employer-contracted insurance until September 30. Consumers in Belgium who demonstrate that they have faced financial difficulties due to COVID-19 can also suspend paying outstanding insurance premiums linked to mortgage loans until September 30. Businesses interrupted by COVID-19-related lockdowns can obtain premium suspensions for certain types of insurance.

Hong Kong’s government is directly paying the insurance premiums of bus companies and ferry operators for six months.
India’s government allows consumers to forbear on their premium payments for the duration of its lockdown; it offers a more generous forbearance policy for life insurance premiums (IRDAI Circular 1, IRDAI Circular 2) than for health insurance or motor vehicle insurance. The government has repeatedly extended this policy as it extended the lockdown. India and the UK are also allowing consumers to pay life insurance premiums in installments. India froze auto insurance premium rates at their 2019-20 levels, although, with the decrease in automotive traffic, one would have expected motor vehicle insurance premiums to decrease.

Countries have also extended to insurance companies loan-forbearance programs that they had originally created for banks. In Belgium, mortgage borrowers can now suspend principal and interest payments to insurance companies through September 30. They can also postpone non-mortgage loan repayments to insurance companies through September 30. India has a similar mortgage forbearance policy.

Many insurance companies are expanding or offering more generous interpretations of their policies for customers impacted by COVID-19. This is frequently at the urging of supervisors. Insurance supervisors have given insurers breathing room to help consumers with more flexible supervision policies and forbearance measures that incentivize insurers to provide relief to customers.

Some countries have asked insurance companies to expand or modify the coverage consumers have in their existing policies to fit the extenuating circumstances of COVID-19. They attempted to do this while imposing little risk on the insurers, balancing the generosity of relief with the cost to insurers or the government. For example, Ireland’s government negotiated a voluntary agreement with insurance companies to maintain coverage for businesses’ buildings that have been left unoccupied. The agreement also allows businesses to change which property is being covered by a policy.

Thailand’s insurance regulator compelled insurers to cover risks relating to COVID-19, so long as the relevant policies were sold before March 17 and the policyholder did not have the disease.

Some regulators have tried to make it easier for customers to acquire insurance. Thailand and India called on insurers to create affordable microinsurance policies related to COVID-19. In India, these plans act as a substitute for conventional insurance, as most of the country does not have health insurance. Thailand is allowing non-life insurers to offer auto insurance policies with less than one-year terms. Thailand’s measures have one side effect that may help insurers. They might bolster insurer income from premiums in the small short-term auto-insurance market.

In Canada, insurance regulators expanded the eligibility criteria for lenders to access portfolio insurance for their mortgages. This provision also benefited lenders overall, because it made it easier for them to access the government’s Insured Mortgage Purchase Program (IMPP).

Many countries have also loosened regulations surrounding policy underwriting and distribution to allow consumers to purchase policies while remaining socially distant. This involves cutting
requirements for complete paper documentation or ensuring that consumers will not have to pay their premiums in person.

As COVID-19 inundated insurers with questions and claims, regulators have tried to ensure that consumers can access their insurance benefits easily and promptly. India issued regulations telling insurers to establish systems that approve or reject claims within 24 hours and to have all insurance claims related to COVID-19 reviewed by a claims review committee before they can be rejected. Saudi Arabia moved the examination of insurance claims online, while Malaysia’s central bank told insurers to facilitate and expedite claims related to COVID-19.

Some regulators have also sought to give insurers some breathing room to respond to the wave of claims. Italy’s regulators gave insurers additional time to respond to complaints and customer inquiries. While Peru extended the period of time that policyholders could submit claims to insurers, it also told insurers to prioritize responding to managing and paying claims related to health insurance or life insurance.

2. Resolving the controversy over business-interruption insurance

Business-interruption insurance is a common form of property and casualty insurance in the U.S. and other developed countries. It covers a business’s loss of revenue due to a covered incident, such as a natural disaster. However, business-interruption policies usually require a policyholder to prove physical damage to the business premises, a condition that most businesses affected by COVID-19 lockdowns have not experienced.

Although some policies don’t require physical damage to pay out, they may also exclude pandemics or viruses from their coverage. Many are unclear about their coverage of pandemics or of business closings that government authorities have broadly mandated. That lack of clarity has led to conflicts between insurers and policyholders. (To some extent, this is because a large number of insurance contracts rely on standardized forms that embody “boilerplate” wording. These forms are then customized to the policyholders’ situation, but the amount of customization and negotiation varies greatly and is often limited to larger customers. Because many policies have common wording, they allow for common interpretations to develop. However, because they are reused so often, one problem can quickly taint an entire group of policies.)

Authorities have taken various approaches to resolve these conflicts. For example, the South African regulator provided guidelines to insurers and consumers on May 12. Those guidelines noted that the regulator had spoken to regulated insurers and found that most business-interruption policies required physical damage; and even policies that covered contagious diseases didn’t cover government lockdowns.

The Financial Conduct Authority in the UK announced on May 1 that it was seeking a court declaration to help determine the basis on which insurance firms should decide whether to accept business-interruption claims. On June 1, the authority said that it had reviewed more than 500 relevant policies and selected a representative sample of 17 policy wordings to discuss in court.
In the U.S., where states regulate insurance, 28 state insurance departments have issued guidance to insurers and consumers on business-interruption coverage during the COVID-19 crisis. The NAIC had earlier asked insurers to provide data about their business-interruption policies, saying that it hoped the data call would help state insurance regulators evaluate the nature of business-interruption coverage, the size of the market, the extent of exclusions related to COVID-19, and claims and losses related to COVID-19. It has not yet published an analysis of the data it received.

Some governments have considered requiring insurers to retroactively cover COVID-19-related losses that policies didn’t cover before the crisis. The state legislatures of Louisiana, Massachusetts, Michigan, New Jersey, New York, Ohio, Pennsylvania, and South Carolina have introduced legislation along these lines, although none of these bills have passed.

The industry and its supervisors have warned against such initiatives, including the NAIC on March 25, and the International Association of Insurance Supervisors (IAIS) on May 7. The IAIS said such actions could “threaten policyholder protection and financial stability.” On April 1, the European insurance supervisor, in guidance to insurers, said: “As a general principle, imposing retroactive coverage of claims not envisaged within contracts could create material solvency risks and ultimately threaten policyholder protection and market stability, aggravating the financial and economic impacts of the current health crisis.”

As an alternative, some countries are considering using government resources to backstop business-interruption insurance provided by the private sector. (See the YPFS blog). Proposals vary, but they typically limit the losses a private insurer must cover before the government backstop kicks in.
COVID-19 and Insurance (2 of 3): Operational Regulatory Relief

By Greg Feldberg and Alexander Nye

Original post here.

Many insurance supervisors have provided temporary relief to help companies manage during the COVID-19 crisis.

Most of this relief comes in the form of extended deadlines for submitting various reports or provisions that make remote compliance easier. Regulators have also suspended supervisory activities and loosened accounting rules.

This blog discusses such measures. An earlier YPFS blog described similar regulatory relief measures that bank supervisors have taken during this crisis.

1. Extending deadlines

At least 27 national and transnational insurance regulators extended insurers’ deadlines for submitting their regular supervisory reports, according to an April brief from the Bank for International Settlements (BIS). For example, India’s insurance regulator provided extensions for submitting periodic compliance documents, providing a 30-day respite for filing half-yearly and yearly returns, a cyber security audit, and a “Board approved Final Re-insurance Programme.”

The EU insurance regulator advised its member countries to provide companies with extended deadlines for 2019 annual reports, 2019 annual solvency and financial condition reports, and 2020 quarterly reports for Q1. It also called on insurers to publicize information on the effects of COVID-19 on their businesses.

U.S. state insurance regulators have taken similar actions. For example, California’s regulator issued a 90-day deadline extension for insurers to file their 2019 annual statements, 2019 supplemental filings, and 2020 first-quarter filings. Regulators in at least six states issued similar policies. Several states also extended their deadlines for compliance with various licensing requirements; for example, with respect to continuing education.

2. Limiting supervisory activities

COVID-19 has also made some relatively simple supervisory activities risky. Some regulators (including in Botswana, Germany, Italy, Liechtenstein, North Macedonia, Poland, Portugal, Russia, and Singapore) have postponed on-site inspections while others, like Malta’s Financial Supervisory Authority, shifted to remote supervision. A number of U.S. states have used other tools to reduce insurers’ administrative burden—including, for example, loosening regulations around the provision of telemedicine.
Some regulators have suspended initiatives or exercises altogether. The UK’s insurance regulator decided not to publish the results of its 2019 insurance stress test and postponed the next insurance stress test to 2022. Australia’s insurance regulator postponed a number of reforms to health insurance data collection. At least eight national and transnational regulators have also delayed public consultations on new or revised regulatory rules.

Regulators have also provided regulatory relief to insurers who provide forbearance to customers on premiums and to borrowers on mortgage payments. For example, as they have done with bank loans, regulators have allowed insurers to treat loans as performing if borrowers miss payments because of COVID-19.

For example, Canada’s insurance regulator has incentivized insurers to provide premium forbearance to consumers impacted by COVID-19. It did this by changing the capital treatment of the insurance for the duration of the forbearance, up to six months. South Africa also has tried to provide these incentives by telling insurers that its Prudential Authority would exclude the impact of the foregone premiums from its default risk calculation in situations in which insurers make concessions that increase their outstanding premiums.

In the U.S., the National Association of Insurance Commissioners (NAIC), the organization of state insurance regulators, issued an interpretation of its accounting principles in mid-April that modified the rule categorizing “premiums and similar receivables as non-admitted assets if they are uncollected for more than 90 days.” The interpretation allows insurers not to recognize those assets as non-performing or non-admitted for their first and second quarter 2020 financial statements.

By Greg Feldberg and Alexander Nye

Original post here.

Insurance supervisors around the world outside the U.S. have urged companies they supervise to conserve capital during the COVID-19 crisis by limiting payouts to shareholders and bonuses to executives.

At the same time, many supervisors have sought to help insurers avoid procyclical behavior by mitigating the impact of volatile market swings on the value of insurance company assets and, in turn, on measures of their capital adequacy.

This blog describes such measures. Our online spreadsheet provides further details and links to country-specific actions. An earlier YPFS blog described measures bank regulators have taken to ease capital regulations during this crisis. YPFS blogs this week discussed measures to help insurance customers and provide insurance companies with operational regulatory relief.

1. Measures to conserve capital

Insurers were generally well-capitalized going into the COVID-19 crisis. However, the lockdown recession could generate an unprecedented shock to their balance sheets in the long run. For that reason, supervisors in more than 19 countries have encouraged, but mostly not required, insurers to conserve their capital by curtailing dividends, other capital distributions to shareholders, and executive compensation, according to a BIS brief. (Many bank supervisors have also done this, as we noted in an earlier blog).

For example, the UK’s Prudential Regulation Authority (PRA) sent a letter calling on insurers thinking about distributing their profits to shareholders or executives to “pay close attention to the need to protect policyholders and maintain safety and soundness.” Of course, some existing contracts may make it difficult to withhold executive pay even if companies want to. Although the only tool the PRA really deployed here was moral suasion, it apparently was enough to convince some insurers to pause dividends.

The EU’s supervisor has urged insurers to “temporarily suspend all discretionary dividend distributions and share buybacks.” In a statement, it asked any insurers that believe they are legally required to pay dividends or provide significant variable pay for executives to explain their reasoning for doing so to their national insurance regulator. However, insurers were not convinced to modify or suspend their variable pay plans. The EU was not the only body looking to adjust variable pay plans; a BIS brief states that at least eight national and transnational insurance regulators asked insurers to modify their variable pay.
Italy's insurance regulator sent a letter to the industry requesting that its companies “adopt, at individual and group level, extreme prudence in the distribution of dividends and in the payment” of variable pay. Austria offered the “urgent recommendation to insurance undertakings to refrain from distributing dividends for the previous and current financial year as well as from share buybacks.”

India was also assertive in its call for insurers to “refrain from dividend pay-outs from profits pertaining to the financial year ending 31st March 2020.” Croatia's insurance regulator took a more aggressive approach; it banned insurance companies from distributing dividends until April 30, 2021. However, it did not ask insurers to suspend share buybacks or modify variable compensation for executives, unlike some other countries in Europe.

The U.S. has been an exception. The NAIC has been silent on this issue, and no state has asked the companies it regulates to refrain from paying dividends, share buybacks, or paying executive compensation.

2. Measures to avoid procyclical behavior

Supervisors have also used a handful of tools, both automatic and discretionary, to discourage insurance companies from aggravating market stress during the COVID-19 crisis.

To be sure, insurance companies, as long-term investors, are less likely than banks or investment funds to sell assets in market downturns (Timmer, 2016). They do not have to mark the value of their portfolios to market prices as frequently and they are less likely to face funding pressures that require them to raise liquidity in a pinch. As such, it is too early in the COVID-19 crisis to see significant market losses at insurance companies, and markets, for now, have recovered from their recent lows. Early on, Thailand’s regulator concluded in a stress test that its insurers were well-capitalized to handle potential COVID-19-related stresses.

Nonetheless, the international association of insurance supervisors has acknowledged that insurers could be prone to procyclical behavior, for example, in response to actions by rating agencies or supervisors (Insurance Core Principles, 2019, p. 245). In particular, an insurer whose capital falls below a regulatory trigger may face restrictions that lead it to sell assets.

To address this procyclical bias in the rules, the Core Principles encourage supervisors to be flexible in applying triggers during market stress.

Supervisors have exercised such flexibility during the COVID-19 crisis. For example, supervisors in Canada, Europe, the Netherlands, and South Africa have said they will allow more time for companies to restore capital levels that have fallen below supervisory triggers due to the crisis. Thailand’s Office of the Insurance Commission (OIC) relaxed its capital adequacy ratio for insurance companies in mid-March. Canada’s supervisor said it “considers the specific circumstances of the insurer and recognizes that the restoration of Capital Resources levels may take longer for some insurers when operating in a difficult environment.” The Dutch supervisor
said it “takes into account the expected temporary duration of this exceptional situation” when evaluating health insurers’ capital.

Several countries have taken other ad hoc measures to discourage procyclical behavior during the COVID-19 crisis. Canadian and Malaysian supervisors have eased capital requirements for interest-rate risk. The Swiss supervisor said it would allow insurers to temporarily smooth yield curves to dampen the impact of market volatility on regulatory capital. When Korean insurers decided to help prop up domestic financial markets, Korea’s supervisor modified the risk assessment application system it uses to determine insurers’ liquidity ratios.

The European Union (EU) supervisor also has automatic stabilizers, introduced after the global financial crisis of 2007-09, that are intended to dampen the impact of volatile market prices on insurers’ capital ratios. These include the matching adjustment, the volatility adjustment, and the symmetric adjustment for equity holdings. They are part of the EU’s Solvency II framework for insurance supervision.

The matching adjustment and volatility adjustment allow companies to reduce the net present value of their liabilities in response to declines in the market values of their assets. When market-wide spreads rise above predetermined thresholds, the mechanisms allow companies to increase the discount rate they use to value their liabilities.

The two adjustments work differently. The matching adjustment is for insurers that offer long-term guarantee products, such as annuities, and hold assets to match the maturity of those liabilities. The volatility adjustment can be applied to an insurer’s business more broadly and is intended to reduce the impact of large and sudden changes in market prices.

Solvency II also includes a symmetric adjustment for equity holdings. It requires companies to hold slightly more capital against their equity holdings after markets have risen, and to hold slightly less after markets have fallen.

These adjustments use market data provided by the European insurance supervisor. During the COVID-19 crisis, the supervisor increased the frequency of its reporting of these data inputs from monthly to weekly on April 30, but reduced the frequency to biweekly on May 19.

What issues still need more action?

On May 6, the European Systemic Risk Board (ESRB) met and discussed the macroprudential aspects of their response to COVID-19. One of the key topics it addressed was the impact of market illiquidity on insurers and the implications for financial stability. They argued that the tools for avoiding the procyclical behavior discussed above may not be enough to head off a run by holders of unit-linked insurance products, which are something like an insurance-investment product hybrid, “if the macroeconomic outlook worsens by more than is currently anticipated.”

The ESRB noted that outflows from high-yield bond funds could put more pressure on the value of less liquid assets, or assets that have become temporarily illiquid, which insurers tend to hold. In such a situation, the ESRB said that the private sector and regulators will have to rely on
central banks to maintain financial stability. A recent article by KPMG’s Global Head of Insurance stated that the “EU’s Solvency II regime is very sensitive to financial market volatility and movements in bond yields and credit spreads.”
Banks’ Second-Quarter Results Boosted by Non-Interest Income and Official Support

By Junko Oguri

Original post here.

In the midst of the COVID-19 lockdown, earnings beat expectations for most large US banks in the second quarter, as a surge in non-interest income offset rising loan-loss provisions, and banks benefitted from Federal Reserve liquidity programs and regulatory forbearance.

Large US banks started reporting their second-quarter earnings last week. Their European peers are expected to follow at the end of this month.

In this blogpost, we analyze 14 large US banks that have published their earnings as of July 20. They are among the 33 firms that participated in this year’s Dodd-Frank Act Stress Test (DFAST 2020, see related post here). They include eight global systemically important banks (G-SIBs, as of 2019) and six non G-SIBs.

Given the deep recession and prolonged COVID-19 crisis, earning reports can serve as a thermometer of the economy and the financial system.

For the second quarter, investors focused on revenues, credit quality, and loan-loss provisioning. While financial markets have calmed, the real economy has slowed markedly. Unemployment has surged and consumer activity has plummeted due to lockdowns, although the numbers of positive cases and business closings are uneven across the United States. Small and medium-sized enterprises (SMEs) are facing particular difficulties in financing themselves. Various government measures, including the establishment of lending facilities and introduction of relief programs, have been implemented to support households and businesses.

In this blogpost, we analyze earnings reports in terms of six areas: 1) CET1 capital ratio, 2) Net income and revenues, 3) Non-performing loans, 4) Loan loss provisioning, 5) Other regulatory relief and forbearance, and 6) Market reaction and equity price.

G-SIBs: 8 financial institutions

<table>
<thead>
<tr>
<th>Reporting Date</th>
<th>Firm name</th>
</tr>
</thead>
<tbody>
<tr>
<td>7/14</td>
<td>Citigroup Inc.</td>
</tr>
<tr>
<td></td>
<td>JPMorgan Chase &amp; Co.</td>
</tr>
<tr>
<td></td>
<td>Wells Fargo &amp; Company</td>
</tr>
<tr>
<td>7/15</td>
<td>The Bank of New York Mellon Corporation</td>
</tr>
<tr>
<td></td>
<td>The Goldman Sachs Group, Inc.</td>
</tr>
</tbody>
</table>
7/16 Bank of America Corporation
Morgan Stanley

7/17 State Street Corporation

Non G-SIBs: 6 financial institutions

<table>
<thead>
<tr>
<th>Reporting Date</th>
<th>Firm name</th>
</tr>
</thead>
<tbody>
<tr>
<td>7/15</td>
<td>The PNC Financial Services Group, Inc</td>
</tr>
<tr>
<td>7/16</td>
<td>Truist Financial Corporation</td>
</tr>
<tr>
<td></td>
<td>U.S. Bancorp</td>
</tr>
<tr>
<td>7/17</td>
<td>Ally Financial Inc.</td>
</tr>
<tr>
<td></td>
<td>Citizens Financial Group, Inc.</td>
</tr>
<tr>
<td></td>
<td>Regions Financial Corporation</td>
</tr>
</tbody>
</table>

1. CET1 Capital Ratio

The common equity Tier 1 (CET1) capital ratio, an important regulatory indicator of bank solvency, increased quarter-on-quarter (QoQ) for 13 of the 14 financial institutions; the outlier was Regions Financial Corp (Figure 1-1). CET1 capital (the numerator) increased for 12 firms while risk-weighted assets (RWA, the denominator) decreased for 12 firms (Figure 1-2 and 1-3). The increase in CET1 capital for many financial institutions reflected the increase in net earnings in the second quarter.

Some financial institutions attributed the decrease in RWA to reduced exposures; for example, Bank of America said that clients in the second quarter paid down $62 billion of the $67 billion of loan growth the bank saw in the first quarter (see slide 7 here).
Figure 1-1: CET1 regulatory ratio

(Sources) Bloomberg, Bank quarterly reports

Figure 1-2: CET1 capital

(Sources) Bloomberg, Bank quarterly reports
2. Net Income and Revenues

The earnings rose for three of the 14 firms, stayed roughly the same for one firm, and fell for the other 10, compared to the first quarter. However, the results were better than market expectations (Figure 6-1). That result was mostly due to solid non-interest income, which increased for 10 of the 14 firms (Figure 2-1).

Non-interest income was backed by strong non-interest income (Figure 2-2). Trading profit surged, particularly for the G-SIBs, due to the higher client trading activities induced by wider trading spreads in volatile financial markets.
Some financial institutions noted that their equity and fixed-income underwriting business in investment banking sector also contributed to the rise in non-interest income; given the attractive low interest rate, clients’ demand on bond issuance has been growing.

Bank executives said that the strong non-interest income is likely to be transient and that the impact of the trading bonanza is likely to diminish in the second half of 2020. The Economist notes that more banks may post a net loss in the third quarter if the profits in investment-banking taper while loan-loss provisions keep rising.

3. Non-Performing Loans

While banks’ earnings were stronger than expected, non-performing loans (NPLs) increased 24.1% for the 10 banks compared to the second quarter (Figure 3). The ratio of NPLs to total loans increased for 9 of the 10 financial institutions. Many banks noted that in addition to small and medium-sized corporate borrowers, commercial real estate and energy-sector borrowers face severe challenges.
However, reported nonperforming loans would have been worse if banks had not provided relief to many borrowers, under the cover of accounting and other forbearance provided by the Federal Reserve Board and Congress in response to the COVID-19 pandemic. Many loans went under deferral programs or had their terms modified. (See here for more details on Loan Modifications, Non-Performing Loans, and Accounting relief).

Banks varied widely in the details they reported on the impact of payment deferrals and other COVID-19 relief. For instance, Ally Financial exhibited its weekly auto deferral program, while Regions Financial Corp listed the number of customers’ loan modifications. US Bancorp noted that 130,000 accounts and over $17 billion in loans have been modified through forbearance programs. JPMorgan said it has provided assistance to nearly 1.7 million accounts, representing $79 billion in loans, since March 13; the company said its payment deferral activity had trailed off by the end of the quarter (see here, slide 3).

4. Loan Loss Provisioning

For the 14 financial institutions combined, the loan loss provision increased from $30.3 billion in the first quarter to $41.6 billion in the second quarter (Figure 4-1a).

“Current expected credit losses” (CECL), a new accounting methodology for provisioning adopted by large US banks, requires banks to take into account reasonable and supportable forecasts in addition to past and current information. The loan loss provision increased significantly after the introduction of the CECL. The majority of provisioning were in consumer banking (Figure 4-1b).

Large US financial institutions adopted CECL in the first quarter, so this reporting was the second time banks report their loan loss provisioning under the new accounting methodology.
Under the CECL methodology, which requires a more forward-looking, quantitative, model-based approach, banks’ provisioning is likely to diverge across banks. In second-quarter

Because of regulatory forbearance, the surge in loan-loss provisioning did not all show up in banks’ regulatory capital calculations. In March 2020, the Fed and other U.S. banking agencies provided banks an option to temporarily delay the impacts of CECL on regulatory capital (see here for more details). Under these rules, firms that adopt CECL can calculate the estimated impact of CECL on regulatory capital as the day-one impact of adoption plus 25% of the subsequent change in allowance during a two-year deferral period. Most banks that have already adopted CECL reported their CET1 capital based on this rule.

Figure 4-2 indicates the impact of the CECL capital-deferral benefit on CET1 ratios for the first and second quarters. The differences between reported and actual capital ratios are relatively
subtle, at most 0.88%. However, the gap between the CET1 ratio without deferral and CET1 ratio with deferral seems to be widening. Moreover, it should be noted that the US banks will enjoy the transition period a year longer than their international peers, due to the discrepancy of deferral end-dates between the agreements published by the Basel Committee on Banking Supervision (BCBS) and the CARES Act.

5. Other Regulatory Relief and Forbearance

Since the outbreak of the crisis, the US regulatory agencies, along with their international peers, have implemented various regulatory relief and macroprudential policies.

(a) Supplementary Leverage Ratio (SLR)

One of the reported numbers that has been impacted by this relief is the Supplementary Leverage Ratio (SLR), the US implementation of the Basel III Tier 1 leverage ratio. Systemic US banks are required to maintain an SLR of at least 5%.
### Table: PPP Loans and Loan Characteristics

<table>
<thead>
<tr>
<th>Name of the Institution</th>
<th>PPP Loan / Total Loans (%)</th>
<th>Mention on PPP (quote from presentations and earning reports)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Citigroup</td>
<td>0.05</td>
<td>Small Business: issued ~30K loans totaling $3.4B through SBA’s Paycheck Protection Program</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$25MM in initial proceeds from Citi's participation in SBA’s Paycheck Protection Program to support Community Development Financial Institutions</td>
</tr>
<tr>
<td>Regions Financial Corp</td>
<td>0.49</td>
<td>Began receiving PPP applications April 3rd</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Through July 8th, funded ~45,000 loans totaling ~$5B</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Average loan size ~$106K</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- 98% of funds to companies with &lt;100 employees</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Supported over 600,000 jobs</td>
</tr>
<tr>
<td>Citizens Financial Group</td>
<td>0.36</td>
<td>$4.7 billion PPP loan balance at June 30, 2020</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Customer profile skews to small businesses</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- ~$98,000 average loan size</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- ~84% of loans under $100,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- ~93% of loans for companies with under 25 employees</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Over 540,000 jobs supported</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Expect high percentage to be forgiven over third and fourth quarter</td>
</tr>
<tr>
<td>US Bancorp</td>
<td>0.23</td>
<td>U.S. Bank has also loaned $7.3 billion to over 101,000 customers participating in the Paycheck Protection Program stemming from the CARES Act passed by Congress as a stimulus response to the potential economic impacts of COVID-19. Approximately 87 percent of these loans were for less than $100,000.</td>
</tr>
</tbody>
</table>
Wells Fargo funded 179,000 commercial loans totaling $10.1 billion with an average loan size of $56,000 - 60% were for loan amounts less than $25,000 - 41% were to companies in low- and moderate-income areas or at least 50% minority census tracks - 84% were for companies that had fewer than 10 employees - 90% of companies had less than $2 million in annual revenue

The PNC funded $13.7 billion of PPP loans during the second quarter.

JP Morgan At June 30, 2020 […] $19.9 billion of loans under the Paycheck Protection Program (“PPP”)

Bank of America Completed ~334,000 PPP loans YTD to deliver $25B of funding to small business owners (average of $78k, 99% of loans to businesses with <100 employees)

Truist Financial Corp CARES Act Impacts - Third largest PPP lender based on gross fundings - Provided accommodations to clients on $21.2 billion of commercial loans, $13.8 billion of consumer loans, and $211 million of credit card loans as of June 30, 2020, representing 11.2 percent of loans and leases held for investment

On April 1, the Federal Reserve allowed the largest bank holding companies to temporarily exclude reserves and Treasury securities from their calculation of total assets for determining the supplementary leverage ratio. A media comment notes that the Fed relief had a “huge effect” on banks’ balance sheets. The most recent banks’ reports illustrate that impact.

Figure 5-1 compares the SLR for the first quarter without Fed relief, the second quarter without Fed relief, and the second quarter with Fed relief (the reported SLR). For instance, Morgan Stanley benefitted from the relief the most. Its SLR would have been 0.9% less without the relief. The impact of the regulatory forbearance on the SLR is expected to end on March 31, 2021.

(b) Risk weights on loans related to the Fed’s lending facilities

Banks’ balance sheets also reflect their participation in Fed lending facilities in response to COVID-19. Many banks reported their participation or plans to participate in programs including the Paycheck Protection Program (PPP), Money Market Mutual Fund Liquidity Program (MMLF), and Main Street Lending Program (MSLP).

In particular, nine banks have reported their participation in PPP, many underscoring their lending to the SMEs in their presentations for investors.

Figure 5-2 indicates the outstanding PPP loans for each bank. The amount is expected to increase for the next quarter, supported by strong demand. Banks are also expected to report the impact of the MSLP in third-quarter earning reports.
In April, the Federal Reserve and other US regulatory agencies issued a final interim rule on the regulatory treatment of the PPP loans. In order to facilitate use of the PPP, the regulatory capital effects of participating in the PPP will be neutralized; the PPP loans will be excluded from leverage exposure, consolidated assets, and risk-weighted assets. In terms of CET1 ratio calculation, the PPP loans will be granted 0% risk weights.

Additionally, non-recourse loans provided under the Money Market Mutual Fund Liquidity Facility also receive regulatory neutralization.

6. Market reaction and equity prices

The earning reports, overall, were better than market participants had expected. Figure 6-1 exhibits the differences between Bloomberg’s consensus estimates and the actual adjusted earnings per share (EPS); for the 12 financial institutions that did not have negative adjusted EPS, the actual results outperformed the market estimates, sometimes with wide margins.
However, market prices suggest that the financial sector still faces many significant challenges. Figure 6-2 show financial firms’ slow recovery in equity prices, while the S&P 500 benchmark index has returned to levels reached prior to the outbreak of the COVID-19 crisis. As the crisis and the recession are expected to prolong, the investors expect the next quarter to be as challenging, particularly for non G-SIBs that cannot benefit from the trading profit bonanza or lending in foreign countries, where COVID-19 cases have dwindled.
Risks May Suggest a Role for an Extension of Bank Debt Issuance Guarantees

By Steven Kelly

Original post here.

Included in the U.S. Coronavirus Aid, Relief, and Economic Security (CARES) Act passed by Congress in March was temporary reauthorization of federal bank debt guarantees first (and last) used in the Global Financial Crisis (GFC).

During the GFC, the Treasury used the Exchange Stabilization Fund (ESF) to guarantee money market funds (MMFs) and charged fees to do so. The Federal Deposit Insurance Corporation (FDIC) used a novel legal interpretation to create the Debt Guarantee Program (DGP) and Transaction Account Guarantee Program (TAGP), both of which saw the FDIC guarantee various forms of bank debt for a fee.

The TAGP provided unlimited insurance to certain otherwise-uninsured transaction accounts while the DGP guaranteed new unsecured debt issuance by banks, bank holding companies, and eligible holding company affiliates (henceforth, “banks”). The DGP—created in October 2008—gave banks approximately a year to issue guaranteed debt and the guarantee lasted to the sooner of either the debt’s maturity or December 31, 2012. This program insured the debt of 121 entities, peaked at $350 billion outstanding, and collected fees of $10.4 billion, while paying out only $153 million in claims on defaulted debt.

After the crisis, Congress barred the FDIC from creating another TAGP and the Treasury from guaranteeing MMFs with ESF funds. However, in the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, Congress made it possible for the FDIC to set up a new DGP if “a liquidity event exists that warrants use of the guarantee program” as certified by the Boards of the FDIC and the Federal Reserve (the Fed) and the Secretary of the Treasury in consultation with the President—but now only if Congress also approves it directly.

The CARES Act preemptively granted this approval, subjected to the condition that the guarantees end no later than December 31, 2020. CARES also temporarily removed the outright ban on creating a new TAGP or an ESF-funded guarantee of MMFs, again provided that both end by year-end.

Congress is now working to pass another major economic relief act. It should consider extending the DGP approval, even if it decides not to extend the authority for money market and transaction account guarantees.

U.S. policymakers have not spoken publicly about debt guarantees in recent weeks. Still, it’s clear that an extension of the guarantee authorities would give them valuable flexibility in a future crisis response.
Extending the duration of the guarantees would be particularly valuable. While the issuance period Congress granted in the CARES Act was reasonably consistent with the issuance period of the GFC’s DGP (roughly eight and 12 months, respectively), the guarantee period as provided by CARES does not persist thereafter. This may make any new DGP ineffective at supporting term funding or addressing the persistent effects of the current economic crisis. Having an authorized, robust DGP, even if not activated, could provide a financial stability backstop through the end of the coronavirus crisis that reduces the odds of this economic crisis becoming a financial crisis.

**Future Financial Sector Strength Is Not Certain**

Unlike the GFC, the current crisis did not begin in the financial sector; it does, however, carry the potential for negative implications for the financial sector via numerous channels: particularly loan losses, risk aversion, and liquidity demands. The pandemic’s economic effects have thus far been attenuated by the fact that banks had a historically strong capital and liquidity position (pp. 41-42, 50-51) at the outset. If the ongoing pandemic places enough cumulative stress on the financial sector, however, the financing of banks themselves may only come on tighter terms, with shorter maturities, or not at all. This is the general mechanism by which a recession becomes a financial crisis — amplifying and perpetuating the economic damage.

We know that, for instance, during the GFC, financial firms either failed or were rescued (publicly or privately) over the course of days, not weeks or months. This is because increasingly short-term funding could not be rolled over, and firms became conditionally insolvent. Lehman Brothers, for its part, was funding 1/3 of its portfolio in overnight repurchase agreements — “repo” — at the time of its failure. Again, no major banks are near this situation at present, but it’s illustrative of how pressures can build absent a sufficient policy response. Market liquidity was strained early in the pandemic before the Fed intervened.

A DGP could help to avoid this bad equilibrium of increasingly unstable funding of banks, sensitive to drying up at any moment. By allowing banks to retain access to term funding at reasonable rates, guarantees on debt issuance could ensure that they continue term lending, credit risk assumption and other banking activities that support the economy with more certainty. Banks can avoid having their capital position eroded by increasing interest costs and haircuts on their collateral, or worse: in the case of lenders simply deciding to avoid the risk of funding a bank or banks altogether, even a well-capitalized bank could fail quickly.

A DGP’s fee structure (essentially insurance premiums) can help limit moral-hazard concerns and partially protect the FDIC’s Deposit Insurance Fund. The knowledge that guarantees are available as a backstop could itself be enough to prevent private lenders stepping away from term risk. Some of the Fed’s lending programs this year have provided such reassurance without being used extensively.
Re-Run on the Financial System at the Outset of COVID-19 Disruption

We saw the aforementioned “flight from maturity” and outright withdrawals of unguaranteed funding start to occur in repo, commercial paper and other financial debt during the onset of the pandemic. There’s a risk we could see it again as the health crisis continues, particularly in a so-called “double-dip” recession scenario—what the Fed is calling a “W-shaped” recovery in its bank stress tests (more on this below).

This is particularly the case for foreign banks who lack a stable base of dollar retail deposits. They are especially dependent upon the unguaranteed dollar funding markets to execute dollar-denominated credit extension. As such, the run on prime MMFs—primarily institutional, cash stockpiles that purchase risky, short-term private sector assets—in favor of government-only funds (which invest in Treasuries and Agency debt) was particularly disruptive for these banks.

Approximately $200 billion flowed out of prime funds in February and March, and over $1 trillion flowed into government funds by April. This repeated a pattern seen in the GFC and showed that various regulatory reforms have been inadequate to prevent recurrent disruption; this MMF disruption necessitated the Fed standing up various facilities, including a backstop to lend non-recourse against banks’ purchases of these assets from MMFs.

In the wake of this damage, several notable prime funds have even been closed due to the volatility. As quoted in Bloomberg, Nancy Prior, the President of Fixed Income at Fidelity Investments—the largest holder of MMF assets—said upon the closing of its prime institutional funds, “Time and again we’ve seen a rapid shift from institutional prime funds to government funds.” The Bloomberg article also notes, “Prior said Friday that Fidelity believes its institutional clients’ liquidity needs are better addressed by government-only funds.”

Furthermore, due to profitability concerns as the Fed has cut rates to zero, we’ve also witnessed some government MMFs rejecting new money and forfeiting management fees to boost returns. Thus, there is both a borrower and investor desire for more stability in this space.

Even without a new guarantee of prime MMFs—which may be less feasible given the fund shutterings, previous Congressional desire to restrict them outright and the growing policymaker chorus calling for more MMF reform (see below)—a DGP could help stabilize this funding (and institutional cash management) market.

By wrapping privately-issued bank paper in an FDIC guarantee that pays immediately upon a missed payment, the debt becomes legally eligible for purchase by government-only funds (15 U.S.C. 80a-2(a)(16)). This wrapping thus expands the universe of eligible repo collateral for government MMFs, partially alleviating the downward pressure on rates causing government funds to turn away investors looking for safe, liquid stores of value. A DGP might thus allow policymakers to strike the proper balance between longer-term financial stability concerns (several have called for new restrictions on prime funds to avoid future public backstopping, if
not their outright closure) and the availability of short-term credit via money market investors throughout the pandemic.

Maintaining banks’ market-based funding will be particularly important if we see another financially volatile period like we saw in March and April. In this period, commercial and industrial (C&I) firms drew on their credit lines with banks for at least several hundred billion dollars (see also: page 47 of the Fed’s latest Financial Stability Report). Foreign banks alone—those most dependent upon wholesale dollar liquidity—increased their C&I loan book by about $150 billion within a few weeks starting in March. The Fed, meanwhile, did not make any direct nonfinancial credit extensions until the middle of April, and to date, has had less than $10 billion of such extensions outstanding.

Bank credit lines were able to provide “instant liquidity” to their customers—many of whom eventually paid them down with longer-term bond financing. While the Fed has begun intervening in the bond and commercial paper markets—which also may taper off before a volatility resurgence occurs, these are still a slower and less inclusive form of financing (and more public) than drawing on revolving credit. Banks retaining access to liquidity will be essential in the event of another set of rapid economic shutdowns and cancellations. Indeed, banks’ relative nimbleness in extending credit—at least to existing customers—has been seen as an asset when designing other economic relief programs such as the Paycheck Protection Program and the Main Street Lending Program (see Appendix C, p. 10).

It remains a risk that absent a DGP, funding pressures on banks, which become funding pressures on firms, would be worse during a second round of volatility—potentially leading directly to financial firm failures or indirectly via commercial firm failures.

It is also worth noting the potential for a DGP to support the goals of other emergency measures already put in motion.

**Capital Supporting Public and Private Bond Markets**

Given that the DGP offers the U.S. Treasury’s full faith and credit to the bond issuances of financial institutions, banks can replace their outstanding funding with new AAA-rated term funding. This would have a number of important synergies with outstanding policies.

In addition to the aforementioned funding stability directly helping limit illiquidity-induced bank capital losses from a new round of flight from unguaranteed term funding of banks, this credit quality upgrade could reasonably be expected to increase the prices of legacy securities. This would reduce the incentive for investors to reallocate to underpriced legacy securities thereby starving new investments of capital—the avoidance of which is a goal of the Fed’s legacy-bond-buying Secondary Market Corporate Credit Facility (SMCCF), among other facilities. As per the ICE/BofA index, banking firms make up over 20% of the U.S. investment-grade bond market. The collateral upgrade (or, again, even just the announcement of the backstop thereof) and pursuant price appreciation, would also add capital to bond buyers and dealers and reduce
their risk metrics—the levels of which both provide limits on their ability to support bond markets.

Indeed, the Fed has justified its vast scale of Treasury and mortgage-backed securities purchases and its temporary exemptions to the constraints of the Supplementary Leverage Ratio as necessary to reduce banks’ and dealers’ balance sheet constraints, so they can continue to intermediate financial markets. (Regulators have also neutralized the impact of certain federal lending programs on all regulatory capital ratios.)

As bank balance sheets expand, however, it will be important that bank solvency remains unimpeachable. A second round of stress tests may soon provide an update on banks’ status in that regard.

**Stress Test Legitimacy**

While the Fed recently completed its annual Dodd-Frank Act stress test (DFAST) of bank capital levels, the stress scenarios were designed before the coronavirus pandemic and the tests executed were based on balance sheets from 12/31/19. Given the relative staleness of such data (bank balance sheets have grown by approximately 12% during the pandemic) and the fact that many economic indicators have already moved more adversely than the stress test’s severely adverse scenario, two extra tests were born.

First, the Fed released with the standard results the results of a “sensitivity analysis” in which the 33 banks subject to DFAST were also subjected to various coronavirus-related forward-looking scenarios: a “V-shaped” recovery, a more prolonged “U-shaped” recovery, and a “W-shaped” economic recovery in which the U.S. experiences a second wave of economic lockdowns associated with a virus resurgence.

Unlike the standard stress tests, however, the results of this analysis were not released on a by-bank basis, subjecting them to criticism and skepticism on grounds of transparency and legitimacy—not least because, in the W-shaped scenario, 25% of banks were shown to be nearly at or below their required regulatory minimum common equity tier 1 (CET1) capital ratio. How the banks’ other capital requirements (p. 22) would be expected to evolve under the sensitivity analysis scenarios was also not disclosed.

The W-shaped scenario showed the bottom quartile of banks falling below 4.8% CET1 to risk-weighted assets; the minimum requirement is 4.5%. The 4.8% figure also does not include the effect of Q1 and Q2 capital distributions, which reduced aggregate capital by another 50 basis points; see page 20 of the analysis.

Second, the Fed is designing a more robust pandemic scenario and, once released, will require banks to resubmit their capital plans within 45 days. The Fed’s Vice Chair of Supervision Randal Quarles has said the Fed will only release bank-specific information following the incipient additional analysis if it can do so confidently--in other words, if it feels, unlike with June’s sensitivity analysis, that the bank-specific data is granular and precise enough.
This may be especially important in the case of firm-specific capital actions; for instance, Wells Fargo booked its first loss since 2008 in Q2, while Morgan Stanley booked a record profit (and even *spoke of increasing capital distributions*). Fed officials may decide to issue firm-specific capital actions which, given the scale of the current crisis, may indeed encourage a reallocation by investors from relatively affected institutions in favor of the unaffected—a phenomenon that can be tempered by the presence of public guarantees. Or, in the case of a blanket dividend ban in which regulators also encourage raising fresh capital, the Fed may want to offset any *pursuant increase* in banks’ cost of capital.

As alluded to, it is generally considered *best practice* in a crisis to avoid sparking a run on a relatively weak, but conditionally sound financial institution by releasing bank-specific data. During the GFC, however, the then-unprecedented transparency of the seminal stress tests *helped afford them legitimacy and public trust*. This was made possible by the fact that the stress tests were backstopped by Troubled Asset Relief Program funds: if a firm was found to need to raise capital, but could not raise capital on the market, *over $100 billion* (*see p. 270*) of allocated and released TARP funds was left to recapitalize these firms—on *publicly-known terms* (*see p. 272*). No such funds exist today.

Thus, the Fed is in a *difficult situation if it wants to use the updated stress analysis to drive firm-specific capital actions*. As noted, in a more severe scenario, a quarter of tested firms were already near or below CET1 regulatory minimums in the less-developed sensitivity analysis. Again, this is but one of the capital ratios banks must meet. Given that, unlike in 2009, there is no public capital backstop proactively in place, firm-specific results of any new stress analysis may cause specific banks to experience renewed stress on market-based funding. In the event that public funds are needed to recapitalize these firms, but are not yet appropriated, a “liquidity event” may indeed occur in the interim. By extending its DGP approval before such an event, Congress could buy itself time to negotiate a recapitalization package if that becomes necessary.

As policymakers consider how to appropriately respond in a lasting way to the scale of the current crisis, provisioning for a robust DGP could provide them with the option of a valuable tool going forward.
Governments are temporarily tilting their bankruptcy laws in favor of debtors to help businesses survive the crisis. Some have taken advantage of the crisis to propose permanent pro-debtor bankruptcy reforms.

Many countries have found that their current bankruptcy laws do not offer enough relief to debtors in these difficult times. This even applies to countries with pro-debtor systems, like Chapter 11 in the United States, that aim to avoid liquidations and restructure all companies that are viable as going concerns. Due to COVID-19, many otherwise viable businesses see themselves without a strategy for recovery until social-distancing measures end. Policymakers fear that this will force countless businesses to liquidate, leaving even more workers unemployed. So many bankruptcies could overwhelm bankruptcy courts, drawing out an already painful process.

In response, countries with creditor-friendly bankruptcy systems—those that focus on the orderly liquidation of insolvent firms for the benefit of creditors—are taking on more of the characteristics of debtor-friendly systems—which favor restructuring for the benefit of debtors. Creditor-friendly UK and Germany focus on equitably compensating all creditors through liquidation and typically discourage or forbid debtor-friendly practices. The more debtor-friendly US system makes it difficult for creditors to execute an involuntary bankruptcy and allows companies to continue to conduct transactions after a company has become insolvent, a practice known as “insolvent trading.” Italy and France have restructuring procedures that are arguably more debtor-friendly than Chapter 11.

This blog focuses on the temporary measures that governments are taking to save businesses from liquidation and help bankrupt businesses restructure more easily. We survey the following nine tools:

- Moratoria
- Changing the definition of insolvency
- Extended notice periods for debtors
- Changes to preferential transfer rules
- Relaxed rules mandating that managers file for bankruptcy
- Relaxed rules against “wrongful trading”
- Expanded access to simplified bankruptcy procedures
• Modification of existing bankruptcy payment plans
• Preferred status (payment seniority) for lenders to troubled businesses

Moratoria

Governments can impose moratoria on bankruptcy applications to close bankruptcy courts to new cases. They can also put a stop to bankruptcy proceedings for existing cases. Another alternative would be to delay deadlines for creditors and debtors to take certain actions in bankruptcy courts, similar to the automatic stay in US bankruptcy law.

Some moratoria appear to be tied to other lockdowns of non-essential government services and are thus more about public health policy than macroprudential policy. (We define “macroprudential” as policies that seek to promote financial stability). For example, on March 18, Switzerland ordered a moratorium on debt collection and bankruptcy proceedings through April 4. Similarly, the Government of India declared a 21-day lockdown on March 25. The Insolvency and Bankruptcy Board of India (IBBI) responded on March 29 with a statement that the remaining days of the lockdown would not count toward the various timelines imposed by India’s bankruptcy code.

Turkey has implemented what is close to a blanket moratorium on bankruptcy. Beginning March 22, Turkey suspended nearly all access to creditor-debtor law through April 30. The “Decree to Suspend Enforcement and Bankruptcy Proceedings” halted all new and current bankruptcy proceedings. The only proceedings exempted from Turkey’s moratorium are those related to the enforcement of child support.

An alternative to a moratorium is to make it more difficult for creditors to impose bankruptcy on debtors. This approach leaves open the possibility of debtors voluntarily filing for bankruptcy because they need relief during a crisis.

Russia recently passed a six-month moratorium during which creditors can take no bankruptcy actions against companies impacted by COVID-19. The law grants the government discretion over who will benefit from the moratorium. After May 1, government creditors will be exempt from the rule and will be allowed to file against debtors. The moratorium also halts the enforcement of debts and any financial sanctions that might be imposed as part of bankruptcy proceedings. The moratorium law imposes behavioral expectations on debtors who benefit; it forbids debtors from distributing dividends or buying back their shares during the moratorium. On the other hand, it also allows creditors to maintain existing attachments on a debtor’s assets and imposes other restrictions on the disposal of assets.

Similarly, creditors in Czechia will not be able to file bankruptcy petitions against debtors until the state of emergency ends or August 31, whichever comes first. Czechia also proposed what it called extraordinary moratoria for companies that are still solvent. These are temporary moratoria on payments that can be obtained with fewer administrative barriers, can last up to six months, and do not require the consent of creditors to be approved. Businesses can apply for
these moratoria until August 31. Czechia also will change its bankruptcy code to offer moratoria to debtors who are not yet insolvent, but will probably become insolvent if not helped soon.

Germany has implemented a version of this policy. Debtors can file for bankruptcy, but creditors are not allowed to file against a debtor between March 1 and June 30 unless the debtor’s insolvency or over-indebtedness had occurred before March 1. Similarly, France has stopped creditors from filing insolvency proceedings against a debtor who is unable to meet its outstanding liabilities with its available assets until three months after the end of the country’s health emergency period. This protection is only available for debtors who became cash-flow insolvent after March 12.

Changing the definition of insolvency

Some countries are trying to stem the flow of bankruptcies by temporarily increasing the amount of defaulted debt at which a company is deemed insolvent. Australia increased the threshold for insolvency from AU$5,000 to AU$20,000 (from $2,998 to $11,992), India increased from Rs 100,000 to Rs 10,000,000 (from $1,308.56 to $130,855.80), and Singapore plans to increase from S$10,000 to S$100,000 ($5,996 to $59,960).

Extended notice periods for debtors

Government can also give debtors more time to stave off a liquidation by simply increasing the amount of time debtors have to respond to a bankruptcy notice. This can slow down the bankruptcy process at its earliest stages and relieve some of the administrative burden on the courts. For example, Australia gave debtors six months, rather than 21 days, to respond to a creditor’s bankruptcy notice.

Changes to preferential transfer rules

Governments can also use temporary changes to their bankruptcy laws to incentivize creditors to do business with or lend to companies rendered temporarily insolvent by COVID-19. During normal times, many bankruptcy codes (including the US Bankruptcy Code) allow the estate of the debtor to void or “claw-back” certain transactions executed in the period leading up to the bankruptcy. These transactions are known as preferential transfers. These rules ensure that similar kinds of creditors are treated equitably. However, they also can discourage banks from lending to or helping rescue a troubled company. A number of countries have made these rules less stringent or provided even larger incentives for creditors to aid a company that may be insolvent.

Germany implemented two policies attempting to reduce disincentives for new lending to and payments by these businesses. First, all loans granted to companies between March and September cannot count as “an illegal delay of insolvency” and be voided until September 30, 2023. Second, agreements between an insolvent business and its creditors are insolvency-proof until September 30.

Relaxed rules mandating that managers file for bankruptcy
A number of European countries have temporarily modified laws that oblige a company’s management to file for bankruptcy within a certain period after the company has become cash-flow insolvent, that is, when it cannot pay its debts as they come due. These efforts also aim to prevent the court system from being flooded with bankruptcy petitions from managers of only temporarily insolvent firms that would ordinarily be forced to file.

**Luxembourg** usually mandates that management file for bankruptcy within one month of having missed a payment to a creditor. On March 25, Luxembourg suspended this requirement until June 25.

Other countries have taken an approach that is more generous to debtors. For example, **Germany** has suspended management’s obligation to file within three weeks after the company has become over-indebted or cash-flow insolvent, through September 30. However, the policy does not protect businesses that became cash-flow insolvent for reasons not related to COVID-19 and businesses where there is "no prospect of eliminating the insolvency." The government also built a statutory assumption that expands the number of debtors who can benefit from the policy. The law assumes that any company that became insolvent in 2020 can blame COVID-19. Usually, company managers are liable under both criminal and civil law for failing to file for bankruptcy within three weeks of becoming over-indebted or cash-flow insolvent.

Similarly, **Czechia** has proposed a law that, among other things, abolishes the management’s obligation to file for insolvency until six months after the country’s emergency measures lapse. Only insolvencies that occurred because of COVID-19 are eligible for this relief and the government will have to pass a law to extend this policy if the emergency measures are still in effect at the end of 2020. Usually, Czechia takes a discretionary approach to punishing those who fail to file after knowing they are insolvent. The law normally specifies that insolvent debtors have to file without undue delay after learning of the insolvency or “after it should have learned of its insolvency if it had exercised due care.”
What macroprudential policies are countries using to help their economies through the Covid-19 crisis?

By Sigridur Benediktsdottir, Greg Feldberg, and Nellie Liang

Original post here.

Countries around the world are reeling from the health threat and economic and financial fallout from COVID-19. Legislatures are responding with massive relief programs. Central banks have lowered interest rates and opened lender-of-last-resort spigots to support the flow of credit and maintain financial market functioning.

Authorities are also deploying macroprudential policies, many of them developed or improved since the global financial crisis of a decade ago. In this blog, we describe the main macroprudential measures that countries have taken recently. We summarize specific actions and factors considered when relaxing bank capital, loan forbearance, and liquidity requirements. Since late January, about 50 countries have made more than 230 announcements, with up to 500 separate actions, based on current entries in the new Yale Program on Financial Stability 2020 Financial-Intervention Tracker. Macropudential announcements represent 40 percent of the announcements in the tracker, which also includes those for fiscal, monetary, and emergency liquidity (see figures).
The temporary relaxation of financial requirements with clear guidance should mitigate the immediate economic harm from the pandemic. Banks can absorb more losses and support lending, can help borrowers harmed by COVID-19 by modifying loans, and can work to distribute quickly any funds from fiscal, monetary and emergency liquidity programs to support households, businesses, and market liquidity. Acting swiftly now can lead to better outcomes in the long run.

1. Using capital buffers

Easing bank capital requirements is the most common macroprudential policy that national authorities are using. The Basel III international capital framework included a countercyclical capital buffer (CCyB) that banks can build in good times and draw down to absorb higher losses in bad times to ensure that credit is extended during a crisis. Most countries that had activated their CCyB have released some or all of it during the current crisis. As of March 24, 13 of the 15 countries identified in a recent Brookings paper as having a positive CCyB before year-end 2019 had cut it. Canada also lowered its domestic stability buffer, which is similar to the CCyB.

Some countries have reduced requirements or given guidance that banks can operate below other capital buffers. The European Central Bank (ECB) told banks it supervises directly that they can operate temporarily below their tailored (Pillar II) supervisory buffers. The ECB also supported banks partially meeting core capital requirements with non-core capital instruments. The U.S. has encouraged banks to draw on capital buffers during the current crisis; although U.S. regulators had not raised the CCyB, some of the largest banks were operating with capital above levels required by regulations and previous stress tests. The Federal Reserve also recently allowed the largest bank holding companies to temporarily exclude reserves and Treasury securities from their calculation of total assets for determining the supplementary leverage ratio.

In reducing the CCyB or similar buffers, the UK and others, such as Sweden and Norway, have explicitly advised banks to use the additional space created by releasing the buffer to meet increases in expected losses and support credit, rather than to increase dividends or employee
bonuses. In addition, some countries are asking banks to consider cutting dividends to conserve capital to absorb future losses. The ECB asked banks to suspend dividends until at least October. UK regulators asked banks to scrap dividends and review bonuses this year. While Basel III requires automatic reductions in payouts if a bank falls into its capital conservation buffer, regulators are asking banks with capital above the buffers to consider cutting payouts now, given the steep falloff in activity and highly uncertain economic outlook.

U.S. regulators have not imposed a freeze on shareholder distributions. Former Fed Governor Jeremy Stein, at a recent Brookings forum, argued that is a significant policy mistake. While the eight U.S. globally systemically important banks have voluntarily suspended share repurchases through the second quarter, the Fed is currently assessing capital positions in its annual stress tests. The Fed explicitly asked banks, in the proposed rule that eases the leverage ratio, that they not increase shareholder distributions.

2. Easing the approach to nonperforming loans

Many countries are encouraging banks and other financial firms to work with borrowers temporarily affected by the crisis. Some authorities have provided guidance on loan forbearance. It is standard practice for banks to increase loan-loss revenues for borrowers who miss payments. But actions that require banks to increase loan-loss provisions for a system-wide and transitory shock would put a large strain on their capital and not be consistent with macroprudential objectives.

Some authorities have provided clear guidance that banks should not automatically downgrade borrowers if they cannot make payments for reasons related to COVID-19. U.S. banking regulators will not require banks that defer payments or extend maturities to automatically categorize these loan modifications as troubled debt restructurings.

Authorities also have asked banks to take government assistance into account when evaluating a borrower’s ability to repay a loan. For example, the Bank of England said it would not be reasonable or supportable to reevaluate a borrower’s idiosyncratic risk at this time; if banks do reevaluate a borrower’s risk, they should take into account government relief measures, including repayment holidays, in calculating expected losses. The ECB said that it would “exercise flexibility” regarding the classification of borrowers as unlikely to pay when banks call on new COVID-related public guarantees, and when borrowers are covered by legally-imposed payment moratoria.

3. Using liquidity buffers

Authorities in many countries also are easing banks’ required liquidity buffers. Some have argued that the new liquidity rules for large banks put in place after the GFC are “microprudential” policies, because the focus is to keep individual banks liquid. However, if all banks were to try to maintain their buffers in a systemic event, it could starve the broader financial system of liquidity. Thus, in the current situation, the motivation for encouraging banks to use their liquidity buffers is macroprudential.
Most authorities have told banks they may operate below Basel III liquidity coverage ratios (LCRs), the ratio of high-quality liquid assets to short-term obligations. The European Banking Authority issued guidance to national authorities that the LCR “is also designed to be used by banks under stress. Supervisors should avoid any measures that may lead to the fragmentation of funding markets.” The ECB will allow banks it supervises to “operate temporarily below” the LCR. The Swedish regulator expanded this to different currencies by allowing banks to temporarily “fall below the liquidity coverage ratio (LCR) for individual currencies and total currencies.” The Fed said it would support firms that choose to use their liquidity buffers to “lend and undertake other supportive actions in a safe and sound manner.”

South Africa’s central bank specifically lowered its LCR to 80% from 100%. But most authorities have not specified precisely how much banks can draw down their buffers. The lack of guidance could potentially limit their usefulness as a macroprudential safeguard, as argued in a recent Brookings blog. Indeed, the use of liquidity buffers during the current crisis should be relatively aggressive, considering the encouragement by many central banks for banks to access the discount window and other central bank funding.

Several central banks have eased foreign exchange LCR requirements. These regulations are similar to the LCR but are focused on foreign exchange liquidity. Similarly, most did not say how much banks could draw down. The Bank of Korea was an exception, lowering its foreign exchange LCR from 80% to 70%.

Some central banks have also lowered the reserve requirement for depository institutions. While reserve requirements are traditionally a monetary policy tool, the purpose this time has been almost entirely to support banks’ liquidity and lending through the crisis. The Federal Reserve lowered its reserve requirement to zero, stating that this will action “will help to support lending to households and businesses.” The Reserve Bank of India lowered its cash reserve ratio from 4% to 3%, giving forward guidance that the liquidity released would be available for at least one year. The central banks of the Philippines, Malaysia, and Iceland also lowered reserve requirements to ensure sufficient domestic liquidity.

4. Other measures

Authorities can use other tools to help banks help borrowers. For example, the CARES Act in the U.S. allows homeowners with a government-backed mortgage to request forbearance for up to a year. Other examples: The Philippine central bank raised single-borrower limits and the Swedish financial regulator relaxed temporarily a macroprudential rule that required high-loan-to-value borrowers to amortize their mortgage loans.

Banking authorities also are easing the costs of compliance so that financial institutions can focus their limited resources on lending and working with troubled borrowers; such measures can be considered macroprudential. The Bank of England’s and ECB’s decisions to delay 2020 stress tests are in this category. The Basel Committee delayed implementation of Basel III to “provide additional operational capacity for banks and supervisors to respond to the immediate financial
stability priorities resulting from the impact of the coronavirus disease (COVID-19) on the global banking system.” Canada’s regulator suspended consultations on regulatory matters until conditions stabilize. The Fed temporarily reduced exam activities and delayed some reporting deadlines. U.S. regulators will allow banks to delay implementation of the new accounting rule for current expected credit losses and to complete the transition over five years instead of three.

Conclusion

Macroprudential policies are an important complement to the unprecedented fiscal, monetary, and emergency liquidity actions taken to offset the painful economic effects of COVID-19. One lesson is that countries with stronger financial systems can respond in many more ways. That scope for action may greatly improve the ability of national authorities to limit damage to their economies. This is dramatically different from the global financial crisis, when a weak financial system was the primary cause and itself needed government support. A second lesson is the critical role of macroprudential policies in promoting financial and macroeconomic stability, by building buffers when the economy is strengthening so that they can be used to offset contractions in credit when the economy weakens.
Short-Selling Restrictions During COVID-19

By Sharon Nunn and Adam Kulam

Original post here.

Financial regulators restricted short selling in March 2020 after global stock markets declined in response to the COVID-19 pandemic (Otani 2020). As market participants grappled with uncertainty about quarantine measures, travel restrictions, and other impediments to commercial activity, authorities identified short-selling as a potential threat to market stability. By limiting the trading strategy, authorities attempted to keep financial markets fair, orderly, and efficient. Though scholars argue that short-selling restrictions can exacerbate market turbulence, policymakers banned short-selling for several months in a row.

An investor conducts a “short sale” by borrowing a security, then selling it to another party. If the security’s price later drops below the original sale price, the investor repurchases the security at the lower price, returns the security to the original lender, and profits on the difference in prices; if the price rises, the short-seller may take a loss. In a so-called “naked” short sale, the investor agrees to sell a security to a third party without first obtaining the security. A short sale becomes “covered” once the investor repurchases the security so that it may be returned to the original lender. Regulators have restricted both kinds of short selling at various scopes: for entire securities exchanges, specific security, or sectors. Other restrictions include short-selling volume limits and “uptick” rules, which require investors to wait until a given security’s price rises before they are allowed to short-sell it.

Regulators implementing short-selling restrictions or bans in the wake of the COVID-19 pandemic primarily structured the policies to expire after a few months and largely banned short sales on entire exchanges. Others that did not prohibit short selling altogether approved measures that attempt to limit the practice or curb harms they associated with short sales. European regulators tended toward broader bans, while various Asian policymakers tweaked financial market rules to restrict short selling.

During the Global Financial Crisis (GFC), policymakers implemented various short-selling restrictions (SSRs). Regulators in various countries, including Denmark, Switzerland, and the U.S., banned short selling of shares in certain financial institutions that were later lifted (Beber and Pagano 2013). Japan’s Financial Services Agency banned naked short selling in October 2008, extended the ban 12 times, then made the ban permanent five years later (Osaki 2013; Financial Services Agency 2014).

One decade later, regulators pursued similar SSRs, captured in Table 1. Authorities said they were restricting short selling to preserve market confidence and financial stability, which were threatened by the rapid onset of the COVID-19 outbreak: market participants had little time to absorb information about the virus and public health interventions, evaluate securities based on the information, or trade according to those valuations. As global prices plunged and volatility...
spiked, authorities said they hoped to prevent traders from trading on imperfect information, betting on market turmoil, and threatening the viability of the underlying companies.

However, research has consistently shown that banning short selling during stretches of particularly volatile equity market activity intensifies the volatility. Such prohibitions impede investors from determining accurate prices of assets and reduce market liquidity. Moreover, short-selling bans in one market can increase volatility in other markets as some investors try to circumvent the ban.

**Table 1**

<table>
<thead>
<tr>
<th>Country</th>
<th>Enactment Dates</th>
<th>Policy Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>March 18 to May 18, 2020</td>
<td>Index/Exchange-Wide Ban</td>
</tr>
<tr>
<td>Belgium</td>
<td>March 17, 2020 Trading Day</td>
<td>Securities-Targeted Ban</td>
</tr>
<tr>
<td>Belgium</td>
<td>March 18 to May 18, 2020</td>
<td>Index/Exchange-Wide Ban</td>
</tr>
<tr>
<td>European Union</td>
<td>March 16, 2020 to March 19, 2021</td>
<td>Heightened Transparency Measure</td>
</tr>
<tr>
<td>France</td>
<td>March 17, 2020 Trading Day</td>
<td>Securities-Targeted Ban</td>
</tr>
<tr>
<td>France</td>
<td>March 18 to May 18, 2020</td>
<td>Index/Exchange-Wide Ban</td>
</tr>
<tr>
<td>Greece</td>
<td>March 18 to May 18, 2020</td>
<td>Index/Exchange-Wide Ban</td>
</tr>
<tr>
<td>India</td>
<td>March 23 to October 29, 2020</td>
<td>Derivative Short Position Limits</td>
</tr>
<tr>
<td>Indonesia</td>
<td>March 2, 2020 to Further Notice</td>
<td>Index/Exchange-Wide Ban</td>
</tr>
<tr>
<td>Italy</td>
<td>March 13, 2020 Trading Day</td>
<td>Securities-Targeted Ban</td>
</tr>
<tr>
<td>Italy</td>
<td>March 17, 2020 Trading Day</td>
<td>Securities-Targeted Ban</td>
</tr>
<tr>
<td>Country</td>
<td>Date Range</td>
<td>Measure</td>
</tr>
<tr>
<td>-------------------</td>
<td>-----------------------------</td>
<td>----------------------------------------------</td>
</tr>
<tr>
<td>Italy</td>
<td>March 17 to May 18, 2020</td>
<td>Index/Exchange-Wide Ban</td>
</tr>
<tr>
<td>Malaysia</td>
<td>March 24 to December 31, 2020</td>
<td>Index/Exchange-Wide Ban</td>
</tr>
<tr>
<td>Pakistan</td>
<td>April 1 to April 30, 2020</td>
<td>Uptick Rule</td>
</tr>
<tr>
<td>South Africa</td>
<td>March 12 to Present</td>
<td>Settlement Procedure Changes</td>
</tr>
<tr>
<td>South Korea</td>
<td>March 10 to March 13, 2020</td>
<td>Lowered Threshold that Prompts Stock-Specific Short-Selling Ban</td>
</tr>
<tr>
<td>South Korea</td>
<td>March 13 to March 15, 2021</td>
<td>Index/Exchange-Wide Ban</td>
</tr>
<tr>
<td>Spain</td>
<td>March 13, 2020 Trading Day</td>
<td>Securities-Targeted Ban</td>
</tr>
<tr>
<td>Spain</td>
<td>March 17 to May 18, 2020</td>
<td>Index/Exchange-Wide Ban</td>
</tr>
<tr>
<td>Taiwan</td>
<td>March 19 to June 10, 2020</td>
<td>Uptick Rule</td>
</tr>
<tr>
<td>Taiwan</td>
<td>March 19 to June 10, 2020</td>
<td>Limited Short-Selling Volumes</td>
</tr>
<tr>
<td>Thailand</td>
<td>March 13 to September 30, 2020</td>
<td>Uptick Rule</td>
</tr>
<tr>
<td>Turkey</td>
<td>February 28 to Further Notice</td>
<td>Index/Exchange-Wide Ban*</td>
</tr>
<tr>
<td>Turkey</td>
<td>July 6, 2020 to Further Notice</td>
<td>Banned 6 Banks from Short Selling</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>March 9 to Further Notice</td>
<td>Index/Exchange-Wide Ban</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>March 13, 2020 Trading Day</td>
<td>Securities-Targeted Ban</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>March 17, 2020 Trading Day</td>
<td>Securities-Targeted Ban</td>
</tr>
</tbody>
</table>
*Turkey’s regulators lifted the ban for Borsa Istanbul’s top 30 stocks on June 30.

As Table 1 shows, regulators have included various features in short-selling restriction policies. Their key design decisions include:

- Administration
- Coordination
- Justification
- Restriction Type
- Scope
- Timing and Duration
- Related Short-Selling Rules.

**Administration**
SSRs are typically enacted by a financial regulator, such as a securities commission, and an exchange. Exchanges are typically private organizations and are considered “self-regulatory organizations” in the U.S. and other countries. During the COVID-19 crisis, some regulators issued new SSRs to exchanges, others approved SSRs proposed by exchanges, and several jointly declared SSRs alongside their exchanges. For the European Union, the European Securities and Markets Authority (ESMA) is an overarching financial regulator that works with member states’ national authorities to construct and coordinate the restrictions.

**Coordination**
Coordination minimizes the risk of regulatory arbitrage that could arise from the nonuniform application of SSRs. Securities representing the same company often trade on several exchanges across several countries at once. The targets of one country’s SSR, including multinational financial products and indexes, sometimes represent securities overseen by multiple countries’ regulators. Though a regulator may seek to maintain market confidence, its regulatory turf is limited to domestic securities exchanges. For that reason, financial market authorities often seek to harmonize their restrictions across regulatory territories. In practice, this means that a domestic regulator must depend on a foreign regulator to extend the same ban. Otherwise, domestic securities listed abroad become vulnerable to the effects of short selling when short selling is not possible elsewhere.

For example, European countries coordinated short-selling bans during the stock market turbulence in March 2020. The national authorities in Italy, Belgium, Spain, and France issued one-day bans on the short selling of specific securities. Under EU Regulation No. 236/2012, Article 23, regulators who have observed price declines of at least 10% from the previous day are legally able to ban the short selling of the particular instruments for the following trading day. Article 26 requires the authorities to disclose to the European Securities and Markets Authority (ESMA) and other national authorities details about the intended measures (scope, duration,
justification, and evidence) before imposing them. Article 26 permits other competent authorities, upon receiving the notification, to take supportive measures. For example, the United Kingdom’s Financial Conduct Authority (FCA) received notification of impending one-day bans from Italy and Spain on March 13, and from Italy, France, and Belgium on March 17. The FCA reciprocated the bans on the London Stock Exchange at the same time as the others. Similarly, the Bank of Ireland replicated the French one-day ban on Irish trading venues on March 17 without prohibiting the short sale of any Irish securities, and Germany took similar measures on its Tradegate Exchange, according to an ESMA Decision on March 16. Though none of the German, British, or Irish policymakers implemented broader short-selling bans on their domestic markets, they were able to assist the regulatory efforts of other European authorities.

Regulators worked through ESMA to take longer and broader actions. Under Article 27 of the EU Regulation No. 236/2012, ESMA has the power and responsibility to ensure that short-selling measures are consistent across competent authorities with respect to restriction type, scope, timing, and duration. ESMA arranged Austria, Belgium, France, Greece, and Spain’s short-selling ban commencements on March 17-18, renewals on April 15, and termination on May 18. Italy terminated its short-selling restrictions on the same day as the other countries—one month shy of Italy’s original end date, according to ESMA.

European regulators in non-participating countries addressed other bans in the bloc in March 2020. In the midst of Europe’s regulatory spate, the German regulator, BaFin, noted the European indexes that were exempt from restrictions. The Portuguese Securities Market Commission (CMVM) did not prohibit short selling, but suggested it would keep the option open and expressed preference for short-selling intervention at the EU-level rather than the national level. Bulgaria’s Financial Supervision Commission signalled a similar message about its regulatory options, and explained that short sales were an “insignificant part” of Bulgarian financial markets and did not pose a threat to the country’s financial system.

Justification
Regulators observed both large price movements and uncertainty surrounding global health developments that threatened market confidence in implementing SSRs. Authorities acknowledged that these forces created market environments that were vulnerable to the effects of speculative short selling. They suggested that if short sales were left unchecked during a public health crisis, it could exacerbate ongoing market turbulence, create a crisis of confidence, damage the underlying companies, and compromise financial stability. Governments aimed to preserve market integrity by insulating their trading venues from the potentially negative effects of short-selling.

Late February to mid-March 2020 was a chaotic stretch for financial markets. The Dow Jones Industrial Average dropped 4.4% on February 27 (Tappe 2020). The next day, the German DAX fell 4.5% and the French CAC 40 index fell 4% (Smith 2020). Seven Asia-Pacific market measures, including South Korea’s KOSPI and Thailand’s SET composite index, also fell into
correction territory on February 28 (Huang February 2020). After Pakistan’s benchmark index, the KSE-100, had triggered a circuit breaker on March 9, it ended the trading day at a 3% decline (Zubairi 2020). European stocks posted some of their worst one-day drops in history on March 12: the DAX was down 12.2%, the CAC 40 fell 12.3%, Italian stocks suffered single-day losses around 17%, and the pan-European Stoxx 600 index plunged 11% by the close (Smith and Ellyatt 2020). The Indonesian Stock Exchange halted trading for 30 minutes, after the JCI fell over 5% (Changole 2020). Thailand’s SET composite index plunged by 10% during the day, triggering a circuit breaker, and South Korea’s KOSPI index fell 7% (Huang March 2020). Malaysia’s FTSE Bursa Malaysia KLCI Index fell 4.42%. These trends are shown in Figures 1 and 2.

Figure 1: US and European Equities

![Graph showing US and European equities from 2020]

Source: Bloomberg
Of those that adjusted SSRs, most regulators spoke qualitatively about market turbulence. The South Korea’s Financial Services Commission (FSC) cited “market volatility amid concerns over a resurgence in COVID-19 cases” in August 2020, the Taiwan’s Financial Supervisory Commission (FSC) mentioned in May that “global financial conditions have recently triggered volatility” in securities markets, and Spain’s CNVM attributed March measures, in part, to “extreme volatility taking hold of European securities markets.” Authorities referred to prices from trading venues’ main and sector-specific indices. European regulators juxtaposed national volatility with global volatility, including the VIX (US) and VSTOXX (EU), in their comparisons. At least one Asian exchange, the Indonesian Stock Exchange, referred to month-over-month declines in the ASEAN countries’ most prominent indices (IDX 2020). The data spanned periods of time anywhere from a few days to over a month before the measures were implemented.

In addition to citing price movements, regulators described informational threats to market confidence: the uncertainty surrounding global health developments, an inability to price securities correctly, and constraints on supervisory and managerial duties. In March 2020, ESMA published opinions on the actions taken by several regulators, including Spain’s National Securities Market Commission (CNMV), Austria’s Financial Market Authority (FMA), and France’s Financial Markets Regulator (AMF). The opinions noted the spread of rumors and “false news,” through media outlets and social networks, about government decisions and the state of public health. They suggested this misinformation could negatively impact individual

---

**Figure 2: US and Asian Equities**

![Graph showing US and Asian equities](image)

*Source: Bloomberg*
companies and investor confidence even during times of “efficient markets,” with publicly accessible and reliable information. However, during the COVID crisis, some authorities expressed their doubt that investors had “accurate and public information on the impact of the public health crisis on each listed company”—especially when large-scale health measures arrived suddenly and unexpectedly. They questioned the efficiency of markets during a pandemic, a time when “price formation may take place in an environment of partial information.” Multiple regulators claimed there was a disconnect between recent market movements and the underlying information that drove them. Austrian authorities referred to their policy measure as a “ban on speculative short-selling,” Belgian officials opined that “the market had difficulties correctly valuing the impact of COVID-19 crisis,” and the Italian regulator CONSOB claimed that the “information background [did] not fully validate the above-mentioned price fluctuation” (FMA 2020; FSMA 2020; CONSOB 2020). Finally, authorities noted that sudden lockdown and quarantine measures could hamper the critical functions of market infrastructures and supervisors, “putting both infrastructures and the supervisor at enormous strain to monitor, supervise, and manage markets.” Several European authorities suggested that issuers and financial market participants faced similar constraints on human resources. Regulators justified their SSRs because additional short-selling could exacerbate informational threats to market confidence, which could precipitate downward price spirals and increase systemic risk.

After recognizing the market-based and informational threats, regulators stated that the purpose of SSRs was to maintain market confidence. Indonesian authorities suggested that their market measures were meant to provide “legal certainty in facing the current circumstances” (OJK 2020). Belgian officials suggested that “the prohibition to open or increase net short positions would eliminate a factor that may play a significant role in exacerbating the fall of prices of shares admitted to trading on EU trading venues and therefore threaten financial stability” (FSMA March 2020). Malaysian authorities said that their ban was meant to “mitigate potential risks arising from heightened volatility and global uncertainties,” and referred to the intervention as a “short-term measure that sets to provide stability and confidence” (SC and Bursa Malaysia 2020). Regulators neither quantified market confidence nor described how it might be assessed or measured. Notably, no regulator cited theoretical academic evidence or past short-selling restrictions as evidence for the bans’ efficacy.

Restriction Type
“Covered” Short-Selling Restrictions
The most general short-selling limitation implemented in the wake of the COVID-19 pandemic prohibited transactions conducted with the intent of profiting from a decline in a given stock’s price. These general bans included both covered short sales, when a trader already secured the share or shares they intended to sell, and naked short sales, when the trader had not. All European regulators that banned shorting included such covered sales. None of the 17 countries that enacted new SSRs in 2020 had permanent bans on covered short sales of all stocks on their domestic exchanges and indices.
“Naked” Short-Selling Restrictions

Eleven of the 17 countries that implemented SSRs during the COVID-19 pandemic already had permanent bans on naked short-selling, heightening the chance of a failed trade. A trade fails (known as a failure-to-deliver, or FTD), when a buyer or seller fails to uphold the terms of a securities transaction by the settlement date (Bradford 2012). In the context of short-selling, a trade fails when the short-seller is unable to repurchase the shorted security from the open market and return it to the original lender. Scholarship exhibits a positive relationship between increased short-selling activity and the level of FTDs (Jain and Jain 2012). The individual consequences of FTDs can range from operational costs and fines to reputational damage (Sloan 2020). However, research also associates high levels of FTDs with high trading volumes more generally, which carry positive market effects, including reduced pricing errors, volatility, spreads, and order imbalances (Fotak et al. 2014). Though naked short-selling bans are proven to lower the level of FTDs overall, they also lower the market quality associated with higher levels of short sales (Jain and Jain 2015; Fotak et al. 2014). No new naked short-selling bans were implemented as part of broader financial stability measures in 2020. The Johannesburg Stock Exchange (JSE) Settlement Authority issued a market notice in March reminding its participants of its prohibition on naked short selling; however, the exchange did not broaden its restrictions during the crisis.

Net Short

Rather than prohibit short selling in its entirety, some regulators prohibited the creation or increase of net-short positions. Such prohibitions meant that market participants were able to short sell as long as they also took larger long positions on the same security. For example, Austria’s initial March 2020 ban applied to any short-selling transaction, but when the FMA extended the ban in mid-April, the regulator prohibited only actions causing net short positions. Belgium, France, Italy, and Spain followed a similar movement from covered bans to net-short bans. Only EU bloc countries and India enacted variations of net short-selling bans.

In addition to short selling, investors can also profit from a firm’s declining share price by using derivatives, such as buying put options. European policy makers stated in EU Regulation No. 236/2012 that the “calculation of short or long positions should take into account any form of economic interest which a natural or legal person has in relation to the issued share capital of a company or to the issued sovereign debt of a Member State or of the Union.” The calculation EU bloc authorities use if a regulator implements a net short-selling ban incorporates any benefits obtained directly or indirectly from derivatives such as options, futures, contracts for differences and spread bets relating to shares or sovereign debt, and indices, baskets of securities and exchange-traded funds. European policy makers stated significant sovereign debt net short positions could create systemic risk, and required national authorities to include credit default swaps relating to sovereign debt issuers when considering positions relating to sovereign debt.

The Securities and Exchange Board of India (SEBI) restricted exposure to index derivatives in March, stating short positions in these instruments could not exceed in value an investor’s holding of stocks held in cash. No other regulators limited index derivative holdings.
Scope

Index/Exchange-Wide

Financial regulators largely adopted broad bans, spanning the main indices, trading venues, and exchanges that comprised the home country’s capital markets. Twelve of the 17 countries that implemented SSRs during the COVID-19 pandemic prohibited short selling of any stock listed on indexes, trading venues, or exchanges. In its original March 2020 short-selling restriction announcement, the French regulator stated the new limitations applied when “the position involves a share admitted to trading on a trading venue in France and the share falls under the jurisdiction of the AMF within the meaning of the regulation.” The breadth of the bans reflected the pervasive effects of the COVID-19 outbreak across multiple markets and sectors within a given country, including systemically important institutions. In its corresponding March opinion, ESMA suggested that in lieu of broad bans, successive narrow restrictions, including sector or market-specific bans, might not have been as effective.

Several of the net-short bans also applied to instruments (including index-related instruments, exchange-traded instruments, or baskets of financial instruments) for which banned shares comprised a threshold proportion of the instrument’s weight. All of the European bans incorporated this condition; most regulators set their thresholds at a majority (at least 50%) of the instrument’s weight. On April 15, Belgium and Greece relaxed their relatively stringent thresholds from 20% to 50% of instrument weight, while Italy maintained 20% through the duration of its restriction. ESMA identified these related instruments as a part of each ban’s “strictly necessary scope,” yet the authority said it did not want to prohibit trading strategies that “provided an important service in terms of increasing liquidity and reducing volatility.”

Stock- and Sector-Specific

Several European authorities relied on short-selling regulations to protect specific stocks that experienced especially steep price declines. On March 12, Spanish regulator CNMV banned short sales of liquid shares admitted to Spanish stock exchanges whose price had fallen more than 10% and of illiquid shares whose price had fallen more than 20%. The regulator attached to its announcement a list of 69 companies that fit the description, which included travel firms and financial institutions, among others. Italian, French, and Belgian regulators made similar moves. Policymakers from the four countries eventually expanded the bans to their full stock exchanges.

Prior to the COVID-19 pandemic, the South Korean government enacted a rule that designates a stock as overheated if it meets certain performance thresholds, then temporarily bars investors from shorting it. South Korea’s FSC tightened these thresholds on March 10 to stem market volatility. A Korea Composite Stock Price Index (KOSPI) stock was labeled “overheated” if its price fell 5% or more compared to the previous day’s closing price and if its short-selling trading volume was three times higher than the normal average. The original volume limit was six times the average. A Korean Securities Dealers Automated Quotations (KOSDAQ) stock was considered overheated if its price fell 5% or more compared to the previous day’s closing price and had a short-selling trading volume of two times above the normal average. The limit was previously five times the average. The stock deemed overheated could not be shorted for 10
trading days, up from the one trading day required prior to the pandemic. FSC banned short selling entirely three days later.

No countries in YPFS’s survey enacted restrictions on short selling of shares in specific sectors, such as finance, during the COVID-19 pandemic. In contrast, most of the world’s leading stock exchange regulators used the finance-targeted approach during the Global Financial Crisis out of concern for financial institutions’ systemic risk. Thirteen countries, including various European nations, South Korea, and the US, banned the short selling of financial stocks, naked and not (Beber and Pagano, 2013; Beber et al., 2018). The U.S. Securities and Exchange Commission’s September 2008 ban included nearly 800 companies in the financial services industry, one of the most comprehensive and stringent. The regulator said it took the measure because there was an “essential link” between a financial company’s stock price and “confidence in the institution.” Then-SEC Chairman Christopher Cox said the sector-specific ban on short selling would “restore equilibrium to markets,” linking the financial services industry’s stock performance to broader market stability.

**Exemptions**

All of the EU bloc countries that implemented SSRs during the COVID-19 pandemic exempted actors performing market-making activities. A market maker, according to the U.S. SEC, “is a firm that stands ready to buy or sell a stock at publicly quoted prices.” Some researchers have argued that short-selling curbs make it difficult for market makers to provide liquidity (Jones 2012), which is all the more necessary in economic downturns. Greece’s March ban exempted market-making actions when the short-selling transactions were “conducted for hedging purposes.” Investors “hedge,” or offset potential losses, by taking the opposite position in the same security (or an index, option, or future that represents the same security). For example: an investor taking a long/buy position on security ABC might hedge against potential a decline in ABC’s share price by short-selling ABC at the same time.

In June, four months into its index-wide ban, Turkey exempted the top 30 shares in its sole exchange, Borsa İstanbul, from the short-selling ban.

**Seller-Targeted**

Turkey’s Istanbul Exchange attempted to block specific financial institutions from short selling on markets within its jurisdiction. Turkey in July announced that six international banks—Goldman Sachs Group Inc., JPMorgan Chase & Co., Merrill Lynch International, Barclays Bank Plc, Credit Suisse Group AG and Wood & Co.—were prohibited from short selling on the country’s stock market. Policymakers in other countries did not implement institution-targeted restrictions.

**Timing and Duration**

Sixteen of the 17 regulators that enacted SSRs during the COVID-19 pandemic implemented initial short-selling bans and restrictions in mid-March when governments began shuttering economies and markets began to decline in response. Turkey’s CMB was the first with an initial ban on short selling on February 28. Most European regulators that implemented restrictions
initially reacted to volatile markets in mid-March by blocking short sales of particular stocks that had seen particularly sharp declines and later broadened their bans to entire indexes. Malaysia’s SC was the last to implement a short-selling ban, on March 23.

Many of the restrictions were extended while market conditions remained unstable. Most of the European bans were extended once and then collectively ended on May 18. Some regulators made their restrictions indefinite or extended them into 2021. In March, Turkey’s CMB said its short-selling ban would remain in place “until further notice,” the United Arab Emirates’ Securities and Commodities Authority (SCA) did not announce an end date for its prohibition, and on August 27, South Korea’s FSC extended its short-selling ban until March 2021.

Related Short-selling Rules

Transparency Requirements

Policymakers can also expand various reporting requirements for short sellers that are normally in place, such as EU authorities during the COVID-19 pandemic. Though it did not enact an EU-wide short-selling ban, ESMA in March 2020 lowered its short position reporting threshold, requiring holders of net short positions to notify the relevant EU regulating authority if the holding surpasses or meets 0.1% of the issued share capital of the company being shorted. The regular requirement previously kicked in at 0.2%. ESMA invoked Article 28 of EU Regulation No. 236/2012 to heighten reporting requirements in the EU. Requisite conditions must hold for the regulator to lawfully implement such an SSR, including addressing a threat to market integrity or financial stability in the bloc and taking an intervention measure the national authorities haven’t adequately implemented. When the requisite conditions are met, Article 28 also gives ESMA the power to implement broader SSRs, including a bloc-wide short-selling ban, but the regulator abstained.

Six other countries whose 2020 SSRs are described in this survey had variations of permanent short-selling transparency requirements prior to the COVID-19 pandemic. South Korea requires investors to disclose short-sale positions at or above 0.01% of a company’s outstanding listed shares. Short sellers in Thailand and Turkey have to mark their orders as such in the countries’ trading systems. Malaysia and Taiwan require investors to use specific systems to make short trades. Indonesia requires prospective short sellers to apply to make short trades on its exchange.

Managers of hedge funds, which contribute significantly to the practice, claim such disclosure requirements allow other investors to copy their short-selling strategies and thereby undermine them (McGavin 2010). Regulators claim reporting requirements allow them to police market manipulation, and the U.K.’s FSA has even argued that short-selling disclosure could “temper speculation and overreaction by investors to short-selling induced volatility” (McGavin 2010).

Uptick Rules

Regulators in three Asian countries, Taiwan, Thailand, and Pakistan enacted uptick rules. If a share on the Taiwan Stock Exchange declined 3.5% or more during the previous trading day, it could not be short sold below the previous day’s closing price—a measure adopted on March 20. The country originally had a 10% rule in place. In Thailand, short sellers could only execute...
trades when a share’s price was higher than its last quote, beginning March 13. Normally, the
country mandates a share’s price be equal to or higher than the last trading price (known as a
“zero-plus tick” regime) to conduct short sales.

The Securities and Exchange Commission of Pakistan (SECP) subjected 36 shares listed on its
futures market to an uptick rule on March 18, targeting mostly energy and finance firms, such as
Pakistan State Oil and the Bank of Punjab.

Volume Limits
Taiwan’s FSC implemented a curb on the total amount of short selling in which investors can
participate. The policy, which took effect on March 19, limited the volume of short-sale trading
orders to 10% of the average trading volume in any security over the last 30 days. This was
down from an original 30%. It exempted certain market-making functions. The FSC was the
only regulator YPFS has identified that used this strategy.

Settlement Procedure Changes
South Africa’s JSE Settlement Authority stated in March that it could force short sellers to
borrow securities on the open market if it became aware that a market participant would not be
able to settle a transaction. The regulator typically considers borrowing on behalf of investors
who are short from 10 a.m. on the settlement date.

Related Policies
Regulators also enacted other policies in tandem with short-selling restrictions. In some
countries, policymakers relaxed share buyback regulations in an attempt to support markets.
Indonesia’s regulator announced in March that it would allow firms to buy back shares without
prior approval in a general shareholders meeting. It also increased the maximum treasury stock
resulting from the buyback to 20% from 10% from paid up capital. South Korea lifted stock
buyback limits in March for certain qualifying companies.

Various circuit breaker changes were implemented in Asian countries in an attempt to stem
market volatility, with regulators primarily lowering the drop percentage that would trigger an
exchange closure. On March 17, policymakers in Thailand lowered the so-called “Level 1” circuit
breaker trigger, the size of the drop on the exchange which halts trading for 30 minutes, to 8%
from 10%. Thai regulators also tightened the Level 2 breaker and added a third.

Several countries closed their financial markets in response to the financial and health-related
effects of the COVID-19 Crisis. The Jordan Securities Commission shut down the Amman Stock
Exchange on March 17 to “protect Jordanian traders and companies from the great negative
effects that the global financial markets are experiencing.” Similarly, the Kuwait Capital Markets
Authority stopped trading on Boursa Kuwait from March 12 to 15 to combat “the fast-paced
changes and turbulence facing the local exchange market, as well as regional and international
exchanges, as a result of the COVID-19 outbreak” (Kamel 2020; Boursa Kuwait 2020). Sri
Lanka’s Securities and Exchange Commission shuttered the country’s stock market from March
25 to May 11, holding that “under the prevailing conditions, the stock market will not be able to function in a fair, orderly and equitable manner.”

Though some authorities suspended financial activity with the aim of stemming market declines, several exchanges moved to remote trading for health reasons. On March 17 and 18, the Philippines Stock Exchange halted trading to comply with enhanced community quarantine guidelines, and moved to full offsite trading from March 19 to May 29. In the United States, the Chicago Board Options Exchange temporarily closed its options trading floor on Monday, March 16, and the New York Stock Exchange enacted similar measures one week later (CBOE 2020; Li 2020).

Evaluation

Analysis Conducted Pre-COVID-19

Scholarship asserts that covered short sales are generally beneficial to financial markets, though they can exacerbate the negative effects of market downturns. Subsequently, covered bans decrease the benefits of covered short sales, and push investors to rely on alternative strategies to establish short positions. Research also reveals that naked short sales have both market benefits and drawbacks, yet naked bans can cause overpricing and do not fully eliminate naked short sales and FTDs. Stock and sector-specific bans are generally regarded as ineffective.

Covered Short Selling

Research suggests short sellers can correctly predict price changes (Boehmer et al. 2008; Diether et al. 2009; Aitken et al. 1998) and are responsible for quicker movement of stock prices to their underlying value after a drop occurs (Lee 2016). Short sellers also appear to contribute to price discovery and efficiency by decreasing the prices of overvalued securities (Diether et al. 2009; Boehmer and Wu 2013).

Short-selling bans implemented during the wake of the GFC harmed market liquidity and slowed price discovery, according to a study by Beber and Pagano (2013). Boehmer et al. (2013) found a similar impact from the U.S.’s September 2008 ban. The U.K.’s September 2008 ban did not prevent financial stock price declines, though aimed to protect such stocks, and led to fewer price-forming trades (Marsh and Payne, 2012). Moreover, a study of short selling on the Hong Kong Stock Exchange suggested that short-selling does not cause irregular price movements during periods of heightened uncertainty (Crane et al. 2019).

Short sellers may shift their strategies to other instruments or markets, and evidence suggests the spillover can sometimes negatively impact the newly targeted market. Such sellers reroute their short positions to other venues where bans are not in effect, Shkilko et al. (2012) shows. As a result, liquidity shifts from regulated to over-the-counter (OTC) markets, according to Marsh and Payne (2012). Various studies have shown that the U.S.’s September 2008 ban resulted in inordinately higher spreads in the banned stocks’ option contracts (Battalio and Schultz 2011; Cakici et al. 2018; Grundy et al. 2012).
However, during periods of heightened market volatility, short sales contribute to downward price movements, but not as significantly as long sales, selling a security already owned, and there is no evidence that the short sales caused the initial downward movement, Shkilko et al. (2012) finds. Additionally, evidence suggests that shorting via high frequency trading (HFT) exacerbates illiquidity (Brogaard et al. 2017). However, the impact of short selling on price movements during calmer market periods is mixed. Short sellers could force down a given stock’s price by shorting in high volumes, a scheme known as a “bear raid,” but such stock manipulations are already prohibited by various statutes in most jurisdictions (Knowledge at Wharton 2008).

Naked Short-Selling
Research about naked short selling is limited because investors are not required to identify naked short sales, making them difficult to study. Researchers have argued that “both covered and naked short sales are generally transacted without actual prior or contemporaneous borrowing of shares,” and “the distinction between a covered and a naked short sale becomes functionally relevant only on the date of delivery when the naked short seller fails to deliver the security to the buyer” (Fotak et al. 2010). Researchers typically use FTDs as proxies for naked short sales.

Existing research about naked short selling’s impact on market quality is mixed. Lecce et al. (2008) used a list of Australian securities that were approved for naked short selling to study its effects. The practice causes a systematic increase in stock return volatility and deteriorates liquidity “via wider bid-ask spreads, decreased order depth and reduced trading volumes” (Lecce et al. 2008). The results of Culp and Heaton (2008) indicate that naked short selling may cause more volatility than covered short selling, largely because price drops take longer to recover from naked sales.

Fotak et al. (2010), however, studied a random sample of NYSE securities and found that an increase in naked short selling led to smaller pricing errors, lower pricing error volatility, reduced stock price volatility, and lower order imbalances. “The market impact of covered and naked short selling is very similar” (Fotak et al. 2010). Naked short sellers may be “contrarian investors who tend to target stocks following positive abnormal returns,” which is contrary, Boulton and Braga-Alves (2012) state, to arguments regulators make when curtailing the practice: naked short sellers intensify downward price movements.

Analysis of specific naked SSRs suggest such limits harm market quality. Particularly binding short sale constraints lead to extreme overpricing and subsequent reversion, according to Autore et al. (2015), a study of lists of excessive FTDs released by the U.S.’s three major exchanges. The authors use the SEC’s Regulation SHO as an example. The measure requires broker-dealers to close out failed short sales the day after the fail occurs. The Autore et al. (2015) findings suggest the SEC’s efforts to eliminate fails “could lead to greater overpricing as investors are forced to either borrow costly shares or forgo short selling stocks that are too costly to borrow.”

Two studies of the SEC’s 2008 ban on naked short sales of 19 financial stocks concluded that the prohibition adversely impacted various measures of market quality. The targeted stocks’ bid-
ask spreads widened and trading volume decreased, according to Boulton and Braga-Alves (2010). Fotak et al. (2010) found “significantly higher absolute pricing errors and significantly lower trading volumes, indicating that the naked short selling ban hampered price discovery and reduced liquidity.”

Yet some evidence suggests that permanent bans on naked short selling do not fully stem the practice anyway. “The number of fails reported per quarter is an indication of the persistence of naked short selling, often in spite of regulations in place to bar” it (McGavin 2010). Stratman and Welbourn (2016) investigated stocks with high levels of FTDs, and the authors found that naked bans were not costly enough, or sufficiently “binding,” to deter informed investors from engaging in naked short sales. Rather, informed investors were willing to incur the regulatory penalties and high borrowing costs of illiquid stocks. Regulators in various jurisdictions have struggled to shore up legal tweaks to stamp out remaining naked short sales.

Stock- and Sector-Specific
Research also does not show that the narrow application of short-selling regulations to particular stocks or sectors is effective. The European Systemic Risk Board, responsible for EU financial stability oversight, found that short-selling bans attempting to protect institutions in the finance sector did not improve bank stability (Beber et al. 2018). In fact, their estimates, “even controlling for the endogeneity of the bans, point to the opposite result, namely that bans on short sales tend to be correlated with higher probability of default, greater return volatility and steeper stock price declines, particularly for banks” (Beber et al. 2018). It appears that short-selling regulations are ineffectual microprudential tools.

COVID-19
Preliminary research does not evaluate the effectiveness of COVID-era short-selling restrictions in achieving regulators’ goals, which they tended to define broadly in terms of market fairness, integrity, and confidence. Though supervisors attempted to maintain orderly and stable financial markets during the market upheaval, recent COVID regulations reinforced a scholarly consensus on the detrimental market effects associated with short-selling bans: market illiquidity, poor price performance, and increased informational asymmetries. The restrictions underwent political and corporate scrutiny before and after implementation.

It is a challenge to evaluate SSRs according to the authorities’ stated purposes because regulatory vocabulary is fluid (Austin 2017). Securities regulators that sometimes rely on a similar diction may actually follow different regulatory agendas. According to the International Organization of Securities Commissions, the objectives of securities regulation are to: (1.) protect investors; (2.) ensure that markets are fair, efficient, and transparent; and (3.) protect markets from systemic risk. Though COVID-era SSRs were often aimed towards achieving the second goal, the definitions of market fairness, integrity, and confidence are undefined—though often intertwined—in national securities regulation. If there is no explicit definition for “market integrity” in a single country, it becomes challenging to understand how policy interventions—such as short-selling restrictions—might satisfy that definition. The advantage of this
nonspecificity is regulatory flexibility, while the downsides include the uncertainty of regulatory progress and the possibility of overreach (Austin 2017). Additionally, conceptions of “market integrity” and related terms may differ from country to country, resulting in different regulatory practices once the terms are incorporated into law. One regulator might interpret “integrity” as a call to minimize market abuse and other illicit activity, while another authority might emphasize reliable price formation and equal access to information by market participants. The end result is that the regulatory success of SSRs could appear different from country to country. Overall, formal evaluations of SSRs appear to follow conceptual issues, and resist measurement along the regulator’s original language.

Emerging literature suggests that the COVID-era restrictions were similar to the GFC-era restrictions in terms of their effects on financial markets. Two recent studies investigated the effects of short-selling restrictions in six countries (Austria, Belgium, France, Greece, Italy, and Spain) and contrasted them with European counterparts that did not employ bans. Siciliano and Ventoruzzo (2020) observed higher informational asymmetries (via widened bid-ask spreads) and increased Amihud illiquidity (a ratio of stock returns to trading volume) in the ban countries compared to the non-ban countries during the SSR periods. The study shows that banned stocks underperformed comparable non-banned stocks, with average excess returns lower by about 0.1%. The negative effects were more pronounced with financial firms’ securities, an outcome that the authors attributed to the more widespread ownership of financial industry stocks.

Della Corte et al. (2020) also associated the COVID-19 bans with lower stock returns and increased illiquidity (via bid-ask spreads).

In a more narrow analysis, the Spanish market regulator CNMV observed the performance of stocks that were both banned on the Spanish Ibex 35 index and not banned on the German Dax 30 index (López and Pastor 2020). The authors found that banned stocks exhibited higher bid-ask spreads compared to their unbanned counterparts, yet the study could not attribute negative market consequences to the ban itself. The CNMV study demonstrates that individual European regulators did not achieve perfect coordination, though the alignment of restrictions was meant to prevent regulatory arbitrage.

All of the COVID-era studies acknowledged the issue of endogeneity, meaning that they were unable to conclude that the bans either caused or fixed market issues. However, the academic papers re-emphasized the ineffectiveness of short-selling restrictions and urged policymakers to reconsider instituting them during future market routs.

In a 2020 literature review of short-selling restrictions and stock exchange holidays, Luca Enriques and Marco Pagano claimed that market regulators and national competent authorities, by ignoring evidence and enacting the bans, had failed to learn the lessons of past mistakes. They quote former US SEC Chair Christopher Cox: “Knowing what we know now, I believe on balance the commission would not do it again. The costs (of the short-selling ban on financials) appear to outweigh the benefits.”
As authorities rolled out restrictions during the early stages of the COVID-19 pandemic, prominent policymakers and market representatives came out against the measures and cited a decade of evidence suggesting that these bans constituted poor policy. The former US SEC Chairman Jay Clayton resisted calls to ban short-selling, claiming, “You need to be able to be on the short side of the market in order to facilitate ordinary market trading” (Kiernan 2020). The World Federation of Exchanges, an industry group representing global stock exchanges with a collective capitalization of $95 trillion, warned regulators in March 2020 of the backwards effects of these market restrictions, and publicly asked policymakers to reconsider their positions in April and May of the same year.

In mid-2020, several media outlets accredited short sellers with the discovery of Wirecard’s massive accounting fraud, and some used the scandal to argue against recent SSRs (Bryant 2020; The Economist 2020). Wirecard is a large financial technology company headquartered in Ascheim, Germany. In 2019 a pair of Financial Times reporters raised doubts about Wirecard’s accounting practices, which caused volatility for the company’s listed shares and spurred German regulator BaFin to enact a short-selling ban of the company’s shares from February 18 to April 18, 2019 (Reuters 2019). A spokeswoman for BaFin, which did not implement broad SSRs during the COVID-19 pandemic, told media outlets earlier last year that the regulator did not plan to implement another ban on short selling of Wirecard shares (Reuters Staff 2020). The company later acknowledged in June 2020 that the company’s auditors were unable to find nearly $2.1 billion of its reported net cash, and admitted that the sum likely never existed (CNN 2020). After the company’s market value tanked and high-ranking executives were arrested on fraud charges, hedge fund representative Bryan Corbett wrote in the Financial News that short-sellers (of Wirecard) performed a public service by combatting the market desire to overprice a popular company. In light of the short-selling success, the author argued, regulators ought to have scrutinized corporate accounting practices rather than trading strategies.

On November 3, 2020, ESMA released a Peer Review report that characterized the German financial supervisory treatment of Wirecard as “deficient.” ESMA claimed that the 2019 short-selling ban prompted a misunderstanding between German regulators, convincing another supervisor that BaFin “had no indications of wrongdoings by Wirecard” (ESMA 2020). The 2019 ban contributed to one of the many inter-regulator hiccups, which led to a lack of oversight on a fraudulent firm.

Despite the presence of strong anti-ban evidence and voices, some regulators still felt public pressure to take action to stem falling prices and heightened volatility at home, according to Bloomberg reporters (Weber and Brush 2020). In March 8 Tweet, Matteo Salvini, head of the Italian League Party, called for CONSOB to ban short-selling because “it is not tolerable for someone to take advantage of a national emergency by speculating to the detriment of Italian savings.” On March 17, French Minister of Finance Bruno Le Maire welcomed the AMF’s short-selling ban, and suggested the French government was willing to do whatever it took to keep French companies from going under, according to Reuters Staff. Short selling is a type of speculation on negative price movements, so the practice might become “politically
unpalatable… or characterized as tainted by unethical goals” in the midst of a health crisis (Siciliano and Ventoruzzo 2020). Subsequently, short selling is ripe for prohibition during times of political and financial distress.
Largest Banks’ Capital Set to Moderate, Payouts to Triple  

*By Steven Kelly*

*Original post [here.]*

After the Federal Reserve released the results in December of its first mid-cycle stress test, designed to test large banks’ resilience against downside pandemic scenarios, it allowed large banks to resume share buybacks starting in the first quarter of 2021, subject to limits. Fed Governor Lael Brainard cast the lone dissenting vote, noting the risks to bank capitalization and lending of raising payout limits to a level that “nearly doubles the amount of capital permitted to be paid out relative to last quarter.” In the case of the six largest banks on the heels of strong trading and investment banking revenues, however, aggregate payouts are set to triple.

**Distribution Limits Phased In and Out**

As U.S. financial volatility soared at the onset of the pandemic in March, the country’s largest banks, after consultation with the Fed, committed to suspend share repurchases “to provide maximum support to individuals, small businesses, and the broader economy.” Share repurchases tend to account for about 70% of large U.S. banks’ capital distributions.

Following the results of the Fed’s annual stress test and an additional, pandemic-related “sensitivity analysis” at the end of the second quarter, the Fed issued its own blanket payout restrictions. Per the Fed’s conditions, the 34 largest banks were to suspend share buybacks, could not increase their dividends, and could not pay dividends larger than their average net income over the previous four quarters. As a result of this latter rule, Wells Fargo had to reduce its quarterly dividend. The Fed also announced it would conduct its first mid-cycle stress test, to specifically test large banks’ balance sheets against downside pandemic scenarios.

Upon releasing the results of the mid-cycle stress test in December, the Fed announced it was “extending the current restrictions on distributions, with modifications.” While the Fed would continue to require that dividends remain static and total payouts not exceed recent income, it would no longer mandate a ban on share repurchases as of the first quarter of 2021. In short order, several large banks announced plans to resume share buybacks in 2021. The ultimate buyback amounts would depend on fourth quarter earnings, per the Fed’s restrictions.

**Banks Announce Increased Payouts**

Following their fourth-quarter earnings releases this month, Bank of America, Citi, Wells Fargo, Goldman Sachs, and Morgan Stanley all stated their intent to execute share repurchases in an amount consistent with the Fed’s newly loosened restrictions. JPMorgan’s CFO Jennifer Piepszak said that the company had the capacity to buy back $4.5 billion in shares, but she was not certain that JPMorgan would “do the full amount.”

Goldman Sachs’s decision comes despite reporting a common equity tier 1 capital ratio that, at 13.4%, is below its total requirement of 13.6%. However, a large bank that falls into its uppermost layer of required capital—the so-called stress capital buffer—faces payout restrictions.
consistent with the blanket restrictions temporarily in place for all large banks. As such, Goldman faces the same income-based payout caps as its competitors currently do under the Fed’s temporary restrictions.

The graph below shows the Fed’s maximum quarterly payout permitted for each bank. Assuming banks proceed with their buyback plans for the first quarter (and with the possible exception of JPMorgan), these limits also demonstrate the actual level of payouts that banks will have effected.

Since suspending share repurchases near the end of the first quarter of 2020, the largest six banks have paid out approximately $22 billion to common shareholders. This quarter, banks can
disburse up to about $21 billion.

The Path for Bank Capital

While the Fed received mixed reactions to its decision to allow share buybacks to resume, including the internal dissent from Governor Brainard, it did leave a limit in place. The Fed permitted banks, going forward, to make total shareholder distributions—dividends plus buybacks—only up to 100% of recent income, saying, “The modified restriction will continue to preserve capital.”

Despite making payouts only out of recent income, bank capital levels could still fall as a result of these shareholder distributions. The allowable payout formula averages the bank’s previous four quarters of income. Thus, if a bank’s income falls going forward, its payouts that quarter could exceed that quarter’s income, leading to falling capital. This may become relevant to bank capital levels this year: several bank executives noted factors that portend lesser earnings in upcoming quarters (see, for instance, here, here, and here).

Several executives said that the elevated earnings from their trading desks are unlikely to continue as the pandemic-induced market volatility subsides. Some executives similarly expected loan demand to fall. Furthermore, several banks booked material releases of loss reserves as loans have held up better than they expected at the pandemic’s outset. Banks have discretion when booking this kind of income, and it is non-recurring. JPMorgan CEO Jamie Dimon said of reserve releases boosting net income, “We don’t consider it profit. It’s ink on paper.”
Banks entered this crisis with historically high levels of capital, materially expanded credit over the course of this crisis, have demonstrated strong earnings in recent quarters, and passed the Fed’s pandemic-specific stress test—all of which would suggest the Fed’s discretionary, blanket payout restrictions are not necessary. On the other hand, these shareholder distributions also raise the risk of banks yet becoming undercapitalized if the COVID-19 crisis continues to stress the economy and the financial system for an extended period. As Boston Fed President Eric Rosengren said in 2010 with respect to the early days of the Global Financial Crisis, “Regulatory dividend policy was focused on the ability of banks to pay dividends out of earnings. However, earnings declines occurred later than the financial market responses to emerging problems.”

The Fed’s December announcement did not offer any guidance on payout restrictions beyond the first quarter of 2021. While it’s uncertain how much banks would increase payouts if the Fed removed the restrictions, it’s clear the Fed’s limits are directly influencing the dollar amount of the largest banks’ payouts.
Case Studies and Policy Changes

UK, EU Move to Ease Impact of Accounting Rules for Borrowers Affected by COVID-19
By Greg Feldberg

Original post here.

On March 20, the Bank of England and European Central Bank (ECB) provided guidance to banks on how to follow accounting rules in evaluating loans to borrowers affected by the COVID-19 crisis.

The new IFRS 9 accounting standard, implemented in most of the world outside the U.S., requires banks to set aside loan loss allowances against all future expected losses for loans to borrowers who are categorized in high-risk groups. For borrowers in the low-risk group, the standard only requires banks to set aside allowances for 12 months of expected losses.

Most borrowers are now in the low-risk group. But IFRS 9 could require banks to downgrade borrowers into a high-risk group if they miss payments because of the crisis. Such downgrades would affect banks’ capital negatively, making it harder for them to keep lending or provide forbearance to affected borrowers.

In different ways, UK and EU regulators gave guidance to banks to be flexible in such cases. Specifically, they said that banks should take into account government relief measures in evaluating borrowers and calculating expected losses on their loans. The guidance says that those relief measures, such as payment holidays or loan guarantees, should not automatically lead banks to move borrowers from 12 months of expected losses to lifetime expected losses.

The Bank of England said that, when firms calculate future losses, it expects they will “reflect the temporary nature of the shock, and fully take into account the significant economic support measures already announced by global fiscal and monetary authorities.”

The ECB said it would “exercise flexibility” regarding the classification of borrowers as unlikely to pay when banks call on new COVID-related public guarantees and on borrowers covered by legally imposed payment moratoria.

In the U.S., the Financial Accounting Standards Board (FASB) implemented the Current Expected Credit Losses (CECL) standard for large banks at the beginning of this year. Like IFRS 9, CECL provides a forward-looking framework for banks’ calculation of expected losses. Bankers and some U.S. regulators this week called on FASB to loosen or delay the standard. FASB has said that is the regulators’ call.
Denmark Plans to Pay Fixed Costs for SMEs Hit by Coronavirus Lockdown

By Alexander Nye

Original post here.

On March 18, the Danish Minister of Finance introduced a plan to pay a significant portion of the cost of small and medium businesses whose revenues fall by more than 25% during the coronavirus pandemic. The plan, which the Parliament passed on March 19, would cost the government roughly 40 billion Danish crowns ($5.8 billion or about 1.6% of GDP) for the first three months (see details here in Danish).

The Minister also announced programs for self-employed people and for owner-operated businesses with 10 or fewer full-time employees. These programs will complement Denmark’s strong existing unemployment insurance program.

Denmark is the latest country to introduce a program to help small businesses struggling with an unprecedented global revenue shock. These programs range from asking banks to voluntarily delay payment dates to broader tax or debt holidays. In some cases, governments may ease the cost for banks through regulatory forbearance. In other cases, governments provide direct subsidies to prevent SMEs from missing payments (see India’s vast farm loan waiver programs).

In normal times, such programs may be criticized for creating moral hazard and raising long-term borrowing costs. During the coronavirus pandemic, though, such programs may not raise moral hazard concerns if they will sunset when the virus has passed. Also, the Danish government, by linking eligibility to dramatically falling revenues, can be relatively assured that the funds will go to companies that need them (See Table 1).

<table>
<thead>
<tr>
<th>Decline in Expected Revenue (%)</th>
<th>Government Compensation of Fixed Costs under Program</th>
</tr>
</thead>
<tbody>
<tr>
<td>100% (business ordered to close by the government) 100%</td>
<td>100%</td>
</tr>
<tr>
<td>80%-100%</td>
<td>80%-100%</td>
</tr>
<tr>
<td>50%-80%</td>
<td>60%-80%</td>
</tr>
<tr>
<td>25%-50%</td>
<td>40%-60%</td>
</tr>
</tbody>
</table>

In its SME compensation program, the Danish government noted six principles:
• Businesses in any sector should be eligible for compensation;
• Compensation will be targeted at companies with a large decrease in revenues earned domestically;
• The compensation will cover at least 25% and as much as 100% of fixed costs;
• The compensation will cover up to three months of fixed costs and will be dispensed as soon as possible;
• If revenue decreases less than expected, SMEs must repay the government; and
• Companies that are compelled to close due to a ban on staying open will receive compensation for 100% of fixed costs.

The Danish program will seek to keep the administrative costs down by requiring outside accountants to audit the reported fixed costs and the decline in revenues. To receive aid, companies have to send audited statements of their fixed costs for the past three months and hire accountants to confirm that business revenue has or is expected to fall. The government will cover 80% of these auditing costs if a company joins the program. The government will also rely on auditors to identify fraud. Supervisors will conduct random checks, and checks at the end of three months, of auditors’ VAT reports. The government will use these VAT reports to adjust its aid to reflect the actual revenue losses these firms eventually suffer.
US Eases Impact of Accounting Rules for Borrowers Affected by COVID-19

By Arwin G. Zeissler

Original post here.

On March 27, the US acted to delay the implementation of a new accounting rule to ease its impact on banks whose borrowers have been affected by COVID-19.

The new accounting standard, known as “current expected credit losses” (CECL), had been set to take effect this year for the largest US banks and over the next two years for other banks. It requires banks to provision for all “expected” losses over the life of a loan. The previous “incurred loss” standard, which is still in place as banks transition to the new standard, requires them to recognize losses only when they become “probable.”

In an interim final rule, US bank regulators on March 27 gave banks the option to delay the estimated effect of CECL on their regulatory capital, relative to the effect of the incurred-loss method, by up to two years. As in an earlier 2019 rule, banks will be allowed a three-year transition period, so the new rule gives them five years to fully implement CECL. Banks that have already adopted CECL can continue with the three-year transition provided by the 2019 rule, or they can change to the longer five-year option announced on March 27.

Also, in the CARES Act, Congress on March 27 offered optional temporary relief from the CECL standard. Banks, other insured depository institutions, and their affiliates will not have to comply with CECL until the national emergency is over or until December 31, 2020, whichever comes first.

US regulators clarified in a March 31 statement that banks may avail themselves of both the short-term statutory relief provided by the CARES Act and the longer-term regulatory relief contained in the interim final rule. However, the time period of these relief provisions will overlap and not be additive, as the five-year transition option in regulators’ interim final rule still begins January 1, 2020, for the largest US banks.

CECL is similar to the IFRS 9 international accounting standard, which regulators in most of the world outside the US have implemented. IFRS 9 requires banks to set aside loan loss allowances against all future expected losses for loans to borrowers who are categorized in high-risk groups. Several countries have asked banks to be flexible in applying IFRS 9 in the current crisis. On March 20, the Bank of England and the European Central Bank said banks should take into account government relief measures in evaluating borrowers and calculating expected losses on their loans.

Accounting standard-setters developed both CECL and IFRS 9 in response to the perceived shortcomings in the incurred-loss method that they had required banks to use in the years before the global financial crisis of 2007-09.
As banks and other financial institutions suffered steep credit losses during the global financial crisis, these institutions as well as users of their financial statements expressed concern that the incurred-loss standard limited a financial institution’s ability to record credit losses that were expected, but not yet probable. (See the YPFS case study on the Irish experience with the incurred-loss standard and its transition to the new expected-loss standard).

In the US, the Financial Accounting Standards Board introduced CECL in 2016 in Accounting Standards Update 2016-13 (ASU 2016-13). Under the rule, an entity must estimate lifetime expected credit losses for all of its loans, leases, debt securities, trade receivables, and other financial assets that are measured at amortized cost (as opposed to fair value). Estimated losses are based on past events, current conditions, and reasonable and supportable forecasts of future collections. For public business entities that file with the US Securities and Exchange Commission, ASU 2016-13 is effective for fiscal years beginning after December 15, 2019 (that is, in most cases, starting January 1, 2020).

US bank regulators incorporated ASU 2016-13 into US banking regulations in a 2019 joint rule. Since banks only recognized probable losses under the old rules but are required to recognize probable and expected losses under the new rules, regulators have noted that “various analyses suggest that credit losses under CECL can be expected to be higher than under the incurred loss methodology.” For this reason, the 2019 rule included a transition option allowing banks to phase in the effects of CECL on regulatory capital ratios over three years.
Dividend bans: ECB extends, APRA eases, and BoE promises further analysis

By Junko Oguri

Original post here.

European, Australian, and British regulators took divergent paths on bank dividend guidance this week.

The European Central Bank extended its guidance on dividend suspensions from October to January, the Australian Prudential Regulation Authority eased its guidance, and the Bank of England said it will decide later this year whether to extend dividend restrictions into 2021.

The purpose of dividend restrictions is to ensure banks have enough capital to cover losses while preserving the lending activities essential for households and firms. As of early May, a BIS report counted 11 jurisdictions that had taken action to suspend or limit dividends or share repurchases in the second quarter of 2020, including Europe, Australia, and the UK. In June, the US Federal Reserve also limited growth in dividends and banned share buybacks in the third quarter.

On July 28, the European Central Bank (ECB) announced it has extended its recommendation that eurozone banks suspend dividend payments and share buybacks until January 2021. The ECB emphasized that the updated recommendation remains “temporary and exceptional” and is aimed at preserving banks’ capacity to absorb losses and support the economy amidst uncertainty caused by the COVID-19 lockdown. The ECB noted that it would keep evaluating the economic situation and consider whether to further suspend distributions after January 1, 2021.

While the ECB’s recommendation on dividends is not legally binding, Andrea Enria, the head of the ECB’s supervisory board, noted that the ECB’s Single Supervisory Mechanism (SSM) could issue binding requirements on a bank-by-bank basis.

On the same day, the ECB’s SSM also published the aggregate results of its vulnerability analysis. The SSM assessed banks under three scenarios: (i) a baseline scenario that does not consider the impact of COVID-19, (ii) a COVID-19 central scenario assuming an 8.7% decline in gross domestic product (GDP) in 2020, and (iii) a COVID-19 severe scenario with a 12.6% GDP decline in 2020. Under the COVID-19 central scenario, banks were found to be resilient, with an average capital depletion of 1.9 percentage points. But the severe scenario leads to a capital depletion of 5.7 percentage points and the ECB noted that “several banks would need to take action to maintain compliance with their minimum capital requirements.”

Given that uncertainty, the ECB determined the need for its temporary and exceptional recommendation to suspend dividends. The Bank also asked banks “to be extremely moderate
with regard to variable remuneration payments.” The ECB underscored that banks with sustainable capital position could resume dividend payments “once the uncertainty requiring this temporary and exceptional recommendation subsides.”

Also on July 28, in noting the ECB’s announcement, the Bank of England (BOE) announced that its Prudential Regulatory Authority (PRA) would undertake in the fourth quarter an assessment of distribution plans at banks beyond the end of 2020. According to the statement, the assessment will be “based on the current and projected capital positions of the banks and will take into account the level of uncertainty on the future path of the economy, market conditions, and capital trajectories prevailing at that time.”

On July 29, Australian Prudential Regulation Authority (APRA) updated guidance on capital management for banks and insurers. Under the updated guidance, banks can now pay out their dividends while seeking to “retain at least half of their earnings when making decisions on capital distributions”. Three of the country’s four major banks (Westpac, ANZ and National Australia Bank) have either deferred or cut dividend payments following the earlier recommendation by the APRA. The APRA notes that decline of the uncertainty in the economic outlook as the reason to ease the dividend restriction policy.

While banks in eurozone and the UK have followed the supervisory recommendations to suspend dividends, US banks so far have been paying out dividends (see here and here). The Fed has acted more slowly than many of its peers. However, the largest US banks voluntarily suspended buybacks in the second quarter. In June, in announcing the results of its annual stress test, the Fed said it would limit third-quarter dividends to the average payout over the prior four quarters or net income, whichever is lower. It also restricted buybacks in the third quarter. The Fed said it will conduct another stress test later this year to determine whether to take additional action on payouts to shareholders.
Senate Bill Temporarily Restores Treasury, FDIC Guarantee Authority Eliminated Post-GFC

By Christian McNamara

Original post [here](#).

The coronavirus rescue bill that the US Senate passed unanimously on March 25 temporarily restores the ability of the Treasury Department and the Federal Deposit Insurance Corporation (FDIC) to guarantee money funds, transaction accounts, and senior bank debt, a reversal of the elimination of these authorities by Congress following the Global Financial Crisis (GFC).

**Treasury Guarantees of Money Funds**

During the GFC, Treasury responded to a run on money market mutual funds by introducing a temporary guarantee on such funds’ existing balances on September 19, 2008. This Temporary Guarantee Program for Money Market Funds (the focus of a YPFS case study) relied on the Exchange Stabilization Fund (ESF) for funding because Treasury did not believe it would be able to secure timely approval for the program from Congress. Established pursuant to the Gold Reserve Act of 1934, the ESF’s mandate as amended in the 1970s is to ensure “orderly exchange arrangements and an orderly system of exchange rates.” In pursuit of this goal, the Treasury Secretary, with approval from the President, “may deal in gold, foreign exchange, and other instruments of credit and securities.” Treasury previously used this authority to respond to a financial crisis without congressional approval in providing a [20 billion support package](#) to the Mexican government during the 1994-1995 peso crisis.

The Temporary Guarantee Program expired on September 18, 2009. No claims were ever made against the guarantee, and Treasury generated $1.2 billion in participation fees. Prior to this expiration date, Congress specifically prohibited the Treasury Secretary from using the ESF “for the establishment of any future guaranty programs for the United States money market mutual fund industry” as part of the legislation establishing the Troubled Asset Relief Program. This prohibition was part of the backlash against crisis rescues and reflected Congress’s desire to approve future guarantees.

Money market mutual fund redemptions have reemerged during the current pandemic and affected the liquidity of their sponsors. For example, Goldman Sachs announced on March 23 that its banking subsidiary had injected $1.8 billion into two sponsored funds the previous week. Investors withdrew [8 billion](#) from those funds between March 11 and 20, representing one-third of their assets as of [February 29](#).

To stem redemptions in the money market, the US is reintroducing versions of GFC-era programs. On March 18, the Federal Reserve announced the [Money Market Mutual Fund Liquidity Facility](#) to lend funds to financial institutions to purchase assets from money funds. On
the same day, Treasury proposed establishing another temporary guarantee on money fund balances.

To lay the groundwork for such a program, the Senate’s rescue bill would temporarily allow the Treasury Secretary to use the ESF to guarantee money funds. Under Section 4015(a) of the bill, this authority will end on December 31, 2020. Any guarantee programs established pursuant to this temporary authority must expire by this date and be limited to fund balances in place prior to the programs’ announcement. This latter requirement mirrors a provision in the GFC-era Temporary Guarantee Program that had been designed to prevent runs elsewhere in the financial system. If only balances in place prior to a program’s announcement are guaranteed, there is no incentive post-announcement to transfer funds from non-guaranteed accounts to newly guaranteed money funds.

Section 4015(b) of the Senate bill would provide that Treasury shall reimburse the ESF for any losses it sustains from the program.

**FDIC Guarantees of Transaction Accounts and Senior Debt**

The FDIC also made use of guarantees during the GFC. In October 2008, the FDIC adopted the two-pronged Temporary Liquidity Guarantee Program (TLGP) as part of its response to continued deterioration in credit markets following Lehman Brothers’ bankruptcy. Under the Debt Guarantee Program prong (the focus of a YPFS case study), the FDIC fully guaranteed senior unsecured debt issued by eligible financial institutions. Under the Transaction Account Guarantee Program prong, the FDIC fully guaranteed all domestic noninterest-bearing transaction deposits at participating financial institutions.

The legal authority for the TLGP came from the Federal Deposit Insurance Corporation Improvement Act of 1991. Pursuant to this Act, the FDIC is typically required to provide assistance to troubled insured depository institutions in a way that minimizes the cost to the Deposit Insurance Fund. However, there is a “systemic risk exception” which allows the FDIC to deviate from this approach if following it “would have serious adverse effects on economic conditions or financial stability” and overlooking it “would avoid or mitigate such adverse effects.” The decision to invoke the systemic risk exception is made by the Treasury Secretary in consultation with the President, following a written recommendation by a two-thirds majority of both the FDIC Board of Directors and the Federal Reserve Board. On October 13, 2008, Treasury Secretary Hank Paulson invoked the systemic risk exception following this procedure to establish the TLGP.

Having guaranteed almost $350 billion in senior bank debt at its peak, the Debt Guarantee Program saw its last guarantee expire on December 31, 2012. The program generated over $10 billion in fees and experienced less than $200 million in claims.

The Transaction Account Guarantee Program expired on December 31, 2010 and suffered about $1.5 billion in cumulative losses.
Post-crisis there has been significant questioning of the propriety of invoking the systemic risk exception for the TLGP. Specifically, it is arguably unclear whether the authorizing legislation allows an exception to be declared based on a threat to financial stability from the banking system as a whole or based just on a threat from a single institution. There are also questions about what FDIC procedures must be followed once the exception is invoked. As required by law, in 2010 the GAO reviewed the systemic risk exception determination for the TLGP and found that while there is “some support” for the interpretations on which it relies, the interpretations are subject to question. The GAO recommended that the statutory requirements be clarified given the significance of the issues involved.

In the Dodd-Frank Act, Congress significantly restricted the ability of the FDIC to establish a program like the TLGP in future. While something like the Debt Guarantee Program is still possible upon a “liquidity event determination” similar in procedure to the systemic risk exception, under the Dodd-Frank Act such a program requires congressional approval. Programs like the Transaction Account Guarantee Program, meanwhile, are specifically prohibited by Dodd-Frank.

While the current pandemic has not yet had the effect on bank funding that the GFC did, some have argued that restoring the ability of the FDIC to enact guarantee programs like the TLGP will help calm depositors and creditors who might ultimately grow skittish. The Senate bill would provide a temporary restoration of this authority. Section 4008 of the bill would eliminate Dodd-Frank’s prohibition on interventions like the Transaction Account Guarantee Program. Furthermore, Section 4008 would authorize the FDIC to establish a widely available guarantee program upon a liquidity event determination without further congressional approval, provided that such program and its guarantees expire by December 31, 2020.
U.S. Bank Regulators Modify Liquidity Regulation to Support Participation in Fed Programs

By Kaleb Nygaard

Original post here.

On May 5, U.S. bank regulators issued an interim final rule modifying the Liquidity Coverage Ratio (LCR) to support banks’ use of the Paycheck Protection Program Liquidity Facility (PPPLF) and Money Market Mutual Fund Liquidity Facility (MMLF).

The Fed established the PPPLF and MMLF using its emergency lending authority under Section 13(3) of the Federal Reserve Act. The PPPLF allows financial institutions to use government-guaranteed loans made to small businesses under the Paycheck Protection Program (PPP) as collateral for low interest rate loans from the Fed. Under the MMLF, financial institutions can use high-quality assets purchased from eligible prime money funds as collateral for loans from the Fed. Congress established the PPP in March in the CARES Act.

The new LCR rule allows banks to exclude PPPLF and MMLF loans, as well as the underlying collateral, from the calculation of total net cash outflows.

The existing LCR rule requires that banks maintain sufficient high-quality liquid assets (HQLA) to cover their total net cash outflows over a 30-day stress period. Without the proposed rule change, all of the inflows and outflows of loans from the PPPLF and MMLF with maturities of less than 30 days would have caused “an inconsistent, unpredictable, and more volatile calculation of LCR requirements,” the regulators wrote in the interim rule. The interim rule will be subject to a 30-day comment period beginning on May 6, the day the rule was published in the Federal Register.
Fed Reveals Details of First Mid-Cycle Stress Test

By Steven Kelly

Original post here.

The Federal Reserve Board has announced the details of its first-ever mid-cycle stress test. Following the release of its regularly scheduled annual stress test results in June, the Fed committed to develop a mid-cycle stress test by September 30 given the ongoing uncertainty of the coronavirus pandemic.

The stress test results released in June found that all large banks were “sufficiently capitalized.” However, that stress test was based on banks’ year-end 2019 balance sheets and thus did not take into account the historic economic volatility experienced in the spring of 2020 associated with the coronavirus pandemic. Indeed, by the June release date, several economic variables had already moved more adversely than the Fed had anticipated in its most extreme stress test scenario.

On September 17, the Fed released the details of its newly developed adverse macroeconomic scenarios designed to re-test 34 large banks’ resilience against downside pandemic scenarios.

The previous “severely adverse” scenario started in the first quarter of 2020. It featured a hypothetical severe global recession in which the U.S. experienced seven successive quarters of negative real GDP growth and its unemployment rate rose by 6.5 percentage points to 10%, among other stressors.

The new “severely adverse” scenario starts in the third quarter of 2020. It includes 24% annualized growth in GDP in this quarter, followed by five successive negative growth quarters and unemployment rising 3 percentage points to 12.5%.

Instead of basing the unemployment shock on the June 30 unemployment rate of 13.5% consistent with the start date of the stress test, the Fed has used the Blue Chip Economic Indicators forecast for September 30 unemployment of 9.5%. The Fed ascribed this adjustment to its release of these scenarios coming late in the third quarter.

In its choice of a 3 percentage point increase, the Fed cites its “Scenario Design Framework, which calls for a smaller increase in the unemployment rate when the unemployment rate is already elevated.” In the Fed’s Scenario Design Framework for Stress Testing (12 CFR 252, Appendix A), the Board states unemployment should be raised 3 to 5 percentage points in the severely adverse scenario, with the final number pending the Board’s view of “cyclical systemic risks” and whether the initial unemployment rate was seen as high or low, subject to a 10% floor. This approach is intended to “avoid adding sources of procyclicality to the financial system.”

Banks’ capital plans will also be subject to an “alternative severe” scenario in which unemployment increases less—to 11%—but is slower to recover, falling just 2 percentage points
to 9% by September 2023. This scenario features just one quarter of GDP decline—by 9.1%—following a 24% increase in the current quarter.

The Fed described the alternative severe scenario’s stressors as “comparable to those for the W- and U-shaped” scenarios in the “sensitivity analysis” it released alongside the June stress test results. Without a complete coronavirus stress test designed at the time, the Fed released the sensitivity analysis to approximate banks’ resilience to the updated reality of the pandemic—which had precipitated marked growth in bank balance sheets and macroeconomic shocks more severe than anticipated by the annual stress test.

The sensitivity analysis included “V”-shaped, “U”-shaped, and “W”-shaped stress scenarios, of which the latter two were the most adverse. Notably, the W-shaped scenario resulted in about 25% of the tested banks falling below the common equity Tier 1 regulatory minimum ratio of 4.5% of risk-weighted assets. The sensitivity analysis also excluded the impact of the capital distributions already paid by the banks in the first half of the year (p. 14).
While the Fed did not release bank-specific results for the sensitivity analysis in June, its September 17 press release stated that it intends to do so for the updated stress test—as per its usual stress test protocol. The Fed intends to release these results by the end of the year.

Furthermore, the Fed stated it will decide by the end of September whether to extend the capital conservation measures it put in place for the third quarter following the June results. The Fed in June suspended bank share repurchases for the third quarter and limited dividend payouts to the lesser of the second quarter payout and a bank’s average net income over the previous four quarters. Of the eight U.S. global systemically-important banks (GSIBs), only Wells Fargo cut its dividend in the third quarter.
Despite Stated Exclusion, the Fed Is Buying Bank Debt

By Steven Kelly

Original post here.

The Federal Reserve has said it won’t directly buy bonds issued by banks as part of its COVID financial rescue facilities. But a close review of its holdings reveals that by buying exchange traded funds, it has indirectly bought $2 billion of bank bonds—over 15% of its total corporate bond holdings.

The Fed unveiled two facilities to purchase corporate bonds on the primary and secondary markets in March, as the growing pandemic roiled financial markets, causing selloffs across risk assets and impeding the financial intermediation of dealers and lenders.

The two facilities are the Primary Market Corporate Credit Facility (PMCCF) and Secondary Market Corporate Credit Facility (SMCCF). The Treasury originally capitalized them with existing funds in its Exchange Stabilization Fund (ESF). It later replaced those funds with new, specific ESF funds allocated by the CARES Act.

The Fed designed the PMCCF and SMCCF to leverage the capital provided for loss protection by the new Treasury funds into up to $500 billion of new corporate bond purchases and $250 billion of secondary market corporate bond purchases. For a full description of the PMCCF and SMCCF, see here and here.

While, to date, no firms have issued bonds to the PMCCF, the SMCCF has purchased securities on the open market. It has bought investment-grade and high-yield corporate bond exchange-traded funds (ETFs) since May, and a portfolio of individual-name corporate bonds that tracks a broad market index since June. As of the Fed’s September 8 report of its August 31 holdings, the SMCCF holds over $12 billion of corporate bonds and corporate bond ETFs. It has considerably slowed its purchases given the recent calm in bond markets.

Buying Bank Bonds through ETFs

When the Fed laid out its terms for the purchase of corporate bonds, it said it would only buy the bond of “an issuer that is not an insured depository institution, depository institution holding company, or subsidiary of a depository institution holding company.” Following that policy, none of the Fed’s purchases of individual-name bonds in the secondary market have been bank bonds.

However, the Fed said that ETFs it purchased wouldn’t be held to the same criteria as individual bonds. According to the Fed’s initial terms for the SMCCF: “In some cases...ETFs may include underlying bonds that have a remaining maturity longer than 5 years at the time of purchase, or include underlying bonds that would otherwise be ineligible for purchase by the SMCCF.”
This made it clear that the Fed might buy ETFs that held bank debt. Indeed, banks make up 21% of the investment-grade credit market, based on the industry-standard ICE/BofA corporate credit indexes. It should be expected that ETFs designed to broadly track that market would include some bank debt.

However, given that it was excluding bank debt from its individual corporate bond purchases, the Fed also explicitly said that it would consider “the amount of debt held in depository institutions” in an ETF before making a purchase decision. Yet, when looking at outcomes, it’s not clear that this restriction has been binding.

Unlike with its individual-name bond holdings, the Fed does not provide a breakdown of the industry allocation of its ETF holdings. However, it is possible to deduce that allocation by reviewing the public disclosures that ETF managers provide.

Based on August 31 data, the Fed held just over $7.5 billion of investment-grade ETFs. Those ETFs, in turn, held $7.5 billion in bonds, of which about $2 billion, or 26%, were bank bonds. (There is also a slim percentage of bank holdings—less than $20 million—in the Fed’s holdings of high-yield ETFs. It is uncommon for banks to be rated below investment-grade: banks make up just 2% of the high-yield bond market, per ICE/BofA.)

Based on a review of public filings, eight of the nine investment-grade ETFs the Fed has bought have a higher allocation to banks than the market benchmark of 21%. Three of the nine have bank weightings exceeding 30%, and two have weightings of 35%.

<table>
<thead>
<tr>
<th>Ticker</th>
<th>Fund Name</th>
<th>Federal Reserve Holdings - Market Value as of August 31, 20201 (US $)</th>
<th>Bank allocation as of 9/14</th>
<th>Implied bank holdings (US $)</th>
</tr>
</thead>
<tbody>
<tr>
<td>IGIB</td>
<td>iShares Intermediate-Term Corporate Bond ETF</td>
<td>492,137,395</td>
<td>22%</td>
<td>109,500,570</td>
</tr>
<tr>
<td>IGSB</td>
<td>iShares Short-Term Corporate Bond ETF</td>
<td>685,785,992</td>
<td>30%</td>
<td>206,284,426</td>
</tr>
<tr>
<td>LQD</td>
<td>iShares iBoxx US Dollar Investment Grade Corporate Bond ETF</td>
<td>2,421,905,903</td>
<td>23%</td>
<td>568,179,125</td>
</tr>
<tr>
<td>SLQD</td>
<td>iShares 0-5 Year Investment Grade Corporate Bond ETF</td>
<td>43,993,194</td>
<td>35%</td>
<td>15,221,645</td>
</tr>
<tr>
<td>SPIB</td>
<td>SPDR Portfolio Intermediate Term Corporate Bond ETF</td>
<td>486,263,580</td>
<td>27%</td>
<td>129,200,233</td>
</tr>
<tr>
<td>SPSB</td>
<td>SPDR Portfolio Short Term Corporate Bond ETF</td>
<td>281,438,678</td>
<td>35%</td>
<td>99,010,127</td>
</tr>
<tr>
<td>USIG</td>
<td>iShares Broad US Dollar Investment Grade Corporate Bond ETF</td>
<td>183,094,061</td>
<td>19%</td>
<td>34,604,777</td>
</tr>
<tr>
<td>VGT</td>
<td>Vanguard Intermediate-Term Corporate Bond ETF</td>
<td>1,433,807,901</td>
<td>23%</td>
<td>330,922,864</td>
</tr>
<tr>
<td>VCSH</td>
<td>Vanguard Short-Term Corporate Bond ETF</td>
<td>1,515,313,576</td>
<td>31%</td>
<td>465,807,393</td>
</tr>
<tr>
<td><strong>All Investment-Grade ETFs</strong></td>
<td></td>
<td>7,543,740,279</td>
<td>26%</td>
<td>1,958,731,161</td>
</tr>
</tbody>
</table>

Sources: Federal Reserve, Bloomberg, author calculations

The result is that, despite the self-imposed restriction against buying individual bank bonds, over 26% of the SMCCF’s ETF holdings and 15% of its total holdings are claims on bank bonds.

**Unprecedented?**

The federal government has borne the credit risk of term bank bonds before. In 2008, during the Global Financial Crisis (GFC), the Federal Deposit Insurance Corporation (FDIC) rolled out its Debt Guarantee Program (DGP). For participating banks, the FDIC extended the full faith and credit of the U.S. government to guarantee privately issued bank debt in exchange for a fee—akin
to an insurance premium. The program peaked at $350 billion of issuance, collecting $10.4 billion in premiums and paying out $153 million to cover defaults.

However, following post-crisis legislative reforms, such guarantees now require explicit Congressional approval, in addition to the pre-existing requirements for approval from the Fed, FDIC, and Treasury in consultation with the President.

Via these ETF purchases, the market for bank debt is receiving federal support, if on a much smaller scale. The Fed has said that if financial market volatility picks up again during this pandemic, both ETF purchases and individual bond purchases would be scaled back up. Under such circumstances, the Fed's holdings of bank bonds would be expected to grow as well.

Yet, with the SMCCF currently capped at $250 billion (and lower to the extent it includes high-yield assets, which it's leveraging at a lower ratio) and bank bonds representing just a fraction of holdings, the total amount of federally-supported bank debt would remain a fraction of the peak outstanding DGP debt during the GFC, and the credit risk-bearing would not be as targeted. That is assuming no major expansion of the facility, shift to buying bank-only ETFs, or some similar repurposing takes place.
Spain Implements Tranched, Adaptive Credit Guarantee Program to Meet Firm Demand

By Sharon Nunn

Original post here.

Spanish companies borrowed nearly €100 billion by the end of August through Spain’s tranched credit guarantee program that targeted small and medium-sized enterprises (SMEs), businesses disproportionately impacted by the COVID-19 pandemic. The scheme, announced in mid-March, allowed policymakers to tweak the program’s rules as they opened each funding pool.

Under a typical credit guarantee scheme, a sovereign guarantees part or all of a loan to a business, minimizing the lending financial institution’s risk and encouraging credit flow. Spain is one of many countries that have instituted such a program since the start of the pandemic.

Spain’s credit guarantee scheme split an initially announced €100 billion ($120 billion) in funding into five sections, as shown below, initially backing business financing through banks, then allocating a small portion of the funding through capital markets. In its last funding pool, the Spanish government allocated funds explicitly for the country’s tourism sector and firms looking to acquire new vehicles.

To qualify for the guarantees, businesses and freelancers with registered offices in Spain must not be deemed delinquent as of the end of 2019 in Spain’s public credit register, the Bank of Spain’s Risk Information Center (CIRBE), which details most transactions between financial institutions and their customers. Additionally, the borrowers must not have been in the middle of bankruptcy proceedings as of March 17, 2020.

Banks and other financial institutions eligible to offer these guaranteed loans must be registered and supervised by the Bank of Spain and have a contract with Spain’s Instituto de Crédito Oficial (ICO), a state-owned bank. Eligible companies and self-employed individuals can request guaranteed financing through Spain’s program at a qualifying financial institution, which will decide to grant the financing based on its own internal procedures. Financial institutions granting guaranteed loans must indicate the government backing for specific loans in their risk management systems and in the CIRBE and must keep financing costs for the borrower in line with costs the financial institution charged prior to the COVID-19 pandemic.

The ICO will pay the financial institution the percentage of the loan the government guaranteed, a unique approach. Every year, the financial entities will pay the ICO between 20 and 100 basis points of the balance of the total amount guaranteed, based on the borrower’s firm size and the loan’s maturity. The financing firm will also repay the ICO the guaranteed percent of the loan as the borrower makes payments.

Spain appears to be one of few countries that tranched its backing to such a detailed extent over time. As a result, the government was able to make adjustments to its program administration.
and requirements as it went. For example, in its third round of guarantees, Spain clarified that its backing could not be used to support financing designated for dividend payments and that its funds would not benefit companies headquartered in tax havens.

The guarantee request period for all tranches ends September 30, 2020.

<table>
<thead>
<tr>
<th>Tranche</th>
<th>Target</th>
<th>Total Allocated</th>
<th>Max Amount</th>
<th>Guarantee</th>
<th>Max Length</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Loan guarantees: Businesses, including SMEs and the Self-Employed</td>
<td>€20 billion</td>
<td>€1.5 million, with capability to borrow more, subject to EU state aid regulations</td>
<td>80% for new loans and 70% for renewed loans for self-employed and SMEs</td>
<td>5 years</td>
</tr>
<tr>
<td>2</td>
<td>Loan guarantees: Businesses, including SMEs and the Self-Employed</td>
<td>€20 billion</td>
<td>€1.5 million, with capability to borrow more, subject to EU state aid regulations</td>
<td>80% for new loans and 70% for renewed loans for self-employed and SMEs</td>
<td>5 years</td>
</tr>
<tr>
<td>3</td>
<td>Loan guarantees: Businesses, including SMEs and the Self-Employed</td>
<td>€20 billion</td>
<td>€1.5 million, with capability to borrow more, subject to EU state aid regulations</td>
<td>80% for new loans and 70% for renewed loans for self-employed and SMEs</td>
<td>5 years</td>
</tr>
</tbody>
</table>
### Promissory note guarantees:

Per company, the amount of the note program the business incorporated prior to April 21, 2020.

<table>
<thead>
<tr>
<th>Amount</th>
<th>Duration</th>
<th>Conditions</th>
</tr>
</thead>
<tbody>
<tr>
<td>€4 billion</td>
<td>2 years</td>
<td>70%</td>
</tr>
</tbody>
</table>

### Indirect loan guarantees:

€500 million, allocated to support small business societies throughout Spain that help guarantee loans for smaller businesses.

### Loan guarantees:

- **SMEs and the Self-Employed**

<table>
<thead>
<tr>
<th>Amount</th>
<th>Duration</th>
<th>Conditions</th>
</tr>
</thead>
<tbody>
<tr>
<td>€10 billion</td>
<td>5 years</td>
<td>80% for new loans and 70% for renewed loans for self-employed and SMEs</td>
</tr>
<tr>
<td>€5 billion</td>
<td>5 years</td>
<td>60% to larger businesses</td>
</tr>
</tbody>
</table>

- **Businesses, including SMEs and the Self-Employed**

<table>
<thead>
<tr>
<th>Amount</th>
<th>Duration</th>
<th>Conditions</th>
</tr>
</thead>
<tbody>
<tr>
<td>€20 billion</td>
<td>5 years</td>
<td>80% for new loans and 70% for renewed loans for self-employed and SMEs</td>
</tr>
<tr>
<td>€10 billion</td>
<td>5 years</td>
<td>60% to larger businesses</td>
</tr>
</tbody>
</table>

### Tourism sector SMEs

<table>
<thead>
<tr>
<th>Amount</th>
<th>Duration</th>
<th>Conditions</th>
</tr>
</thead>
<tbody>
<tr>
<td>€2.5 billion</td>
<td>Not</td>
<td>announced</td>
</tr>
</tbody>
</table>
and self-employed

Loan guarantees:

| SMEs and self-employed financing new road transport vehicles | €500 million | Varies, depending on demand | Not announced | Not announced |

**Tranches 1 and 2 – Bank Lending to Businesses, including SMEs and the Self-Employed**

On *March 24*, the Spanish government opened the first loan guarantee pool of €20 billion targeting self-employed individuals and companies that meet the European Union’s definition of an SME: employing fewer than 250 people and having an annual balance sheet less than €43 million.

Though the first tranche targets SMEs and the self-employed, the government earmarked half of the allocated pool of guarantees for companies that do not meet the formal SME requirements.

The Council of Ministers opened the second pool of guarantee funding on *April 10*, targeting the same swath of companies with identical coverage methodology. Additionally, the government noted in its second announcement that financing costs for loans guaranteed by Spain should generally be lower than other, all else equal loans, given the government’s shouldering of risk.

**Tranche 3 – Backing Expanded to Capital Markets**

The government on *May 5* released €24.5 billion of funds. This included €20 billion for loan guarantees, repeating the backing methodology and funding amounts of the first two tranches. It also included €4 billion to guarantee promissory notes that non-financial companies issue through Spain’s alternative fixed-income securities market (MARF); and €500 million for Spain’s Reinsurance Company (CERSA), which shores up loan backing that the country’s Reciprocal Guarantee Societies offer to SMEs. These societies, which are located throughout Spain, assemble business owners and their capital to back member financing through financial institutions.

The government clarified in its third tranche announcement that guaranteed loans cannot be used to make dividend payments and that funds cannot benefit companies headquartered in tax havens.

**Tranches 4 and 5 – Tourism and Transportation**

On *May 19*, Spain opened the fourth €20 billion tranche, another SME- and self-employed-targeted pool of loan backing, utilizing the process from the first three sections.
The government released its fifth section of guarantees on June 16, this time aimed at supporting the tourism industry and automotive sector. The final tranche was €15.5 billion. It included €7.5 billion for self-employed individuals and SMEs, €5 billion for large companies, €2.5 billion for the tourism sector, and €500 million for companies and self-employed individuals to acquire vehicles.

Credit Guarantee Usage Figures

As of September 30, 2020, Spanish business owners have used 78% of the €100 billion originally earmarked for credit guarantees.

<table>
<thead>
<tr>
<th>Percent of Credit Guarantee Funds Used</th>
<th>Overall Value of New Operations Granted Through Scheme</th>
</tr>
</thead>
<tbody>
<tr>
<td>SMEs and Self-Employed 57% (€57 billion)</td>
<td>€71 billion</td>
</tr>
<tr>
<td>Larger Companies 21% (€21 billion)</td>
<td>€31 billion</td>
</tr>
<tr>
<td>Total 78% (€78 billion)</td>
<td>€102 billion</td>
</tr>
</tbody>
</table>

New Set of Guarantee Tranches

The Council of Ministers in early July established another tranched credit guarantee program, worth €40 billion, aimed at business investments and productivity growth, specifically those related to process digitization and cleaner energy. Spain’s ICO also managed these guarantee lines. On July 28, the government released the first section of such funding. It also allowed businesses to take advantage of the line for non-investment liquidity needs, such as employee pay.

<table>
<thead>
<tr>
<th>Guarantee Request Period</th>
<th>Total Allocated</th>
<th>Use of Funds</th>
<th>Guarantee Proportion</th>
<th>Max Loan Length</th>
</tr>
</thead>
<tbody>
<tr>
<td>Until December 1, 2020</td>
<td>- €5 billion for self-employed and SMEs - €3 billion for larger companies</td>
<td>- New investments - Worker pay - Supplier payments - Other liquidity needs, such as tax payments</td>
<td>- 80% for SMEs and self-employed - 70% for larger companies</td>
<td>8 years</td>
</tr>
</tbody>
</table>
Fed Deems Banks Have Enough Capital Following COVID-19 Stress Test

By Steven Kelly

Original post here.

On December 18, the Federal Reserve announced the results of its first-ever mid-cycle stress test. The test showed the 33 largest banks in the U.S. remain well-capitalized against pandemic-induced stress scenarios designed to be more adverse than those designed pre-COVID.

With the release of these results, the Fed loosened payout restrictions it put in place in June. It will allow these banks to make total shareholder dividends and repurchases in the first quarter of 2021 up to the quarterly average of their 2020 net incomes. Previously, it had capped dividends at the levels banks paid in the second quarter of 2020; allowed dividends up to the four-quarter running average of net income; and temporarily banned repurchases.

When the Fed released its regularly scheduled stress test results in June, large banks likewise all passed. However, the scenarios in those tests did not reflect the financial stresses of COVID-19. As a precaution due to the ongoing pandemic, the Fed announced blanket payout limits. It also said it would run a second, mid-cycle stress test to better reflect the plausible downside economic scenarios of the COVID-19 pandemic as its effects continued. For a discussion of the new stress test’s design, see this YPFS post.

Despite the more severe scenarios, all 33 banks—whose average common equity tier 1 (CET1) capital ratio was 12.2% as of the stress-test start date—remained above the minimum 4.5%, with the average, post-stress CET1 ratio bottoming out at 9.6% over the course of the nine-quarter severely adverse scenario, starting from June 30. This is only slightly lower than the 9.9% post-stress average found in June, for which banks started with a 12.0% CET1 ratio.

As noted, banks have been subject to capital-distribution restrictions in the second half of 2020, while the largest banks voluntarily suspended share repurchases as early as March. The Fed noted that this capital conservation and banks’ material buildup of loss reserves in the first half of 2020 bolstered their updated post-stress results.

In the severely adverse stress scenario, several banks fell below their minimum supplementary leverage ratio (SLR), which eschews risk-weighting and is intended to backstop risk-based capital measures for the largest banks. HSBC fell below its minimum of 3%, while four of the eight U.S. global systemically important banks (GSIBs) – Citigroup, Goldman Sachs, JPMorgan Chase, and Morgan Stanley – fell below their 5% enhanced SLR minimums. Under the Fed’s new stress-test framework, finalized in March, large banks no longer face restrictions if the stress test shows them falling below their leverage ratio minimums.

The Fed temporarily loosened the SLR on April 1 to ease the ability of large banks to support the Treasury market and their customers during the early days of the pandemic. The Fed allowed large banks’ holding companies to exclude Treasuries and reserves deposited with the Fed from
their SLR calculations through March 31, 2021. On May 15, the federal banking regulators expanded this exemption to these companies’ depository subsidiaries.

**Distributions Allowed to Pick Up with Rise in Earnings**

With the release of the stress test results, the Fed also loosened its restrictions on large banks’ payouts that it put in place in June. Governor Lael Brainard again cast the lone dissenting vote. She said that the payout limit modification “nearly doubles the amount of capital permitted to be paid out relative to last quarter” and argued for stricter restrictions limiting banks to “more modest payouts to preserve lending to households and borrowers during an exceptionally challenging winter.”

In June, the Fed barred large banks from share repurchases in the third quarter and said banks could not increase the size of their dividends over the amount paid in the second quarter. The Fed also limited total quarterly dividend payouts to banks’ average net income over the preceding four quarters. In September, the Fed extended this restriction through the fourth quarter as a precaution, as it deemed banks to be “well capitalized.”

Following the release of the December results, the Fed stated it was “extending the current restrictions on distributions, with modifications.” The share repurchase restriction will be dropped in the first quarter of 2021, while the requirement that dividends remain at or below their second quarter level and total payouts not exceed the recent income formula will remain.

Given that dividends typically account for about 30% of large U.S. banks’ shareholder payouts in the U.S. (with the balance being accounted for by repurchases), removing the share repurchase ban could allow for a significant boost in capital distributions. As long as dividends do not increase, a firm may pay out in the first quarter of 2021 as much 100% of its average quarterly income over the previous four quarters in dividends and repurchases combined.

Several large banks announced plans to resume share buybacks in 2021 following the release of the test results. The Fed offered no guidance on its capital distribution policies beyond the first quarter.

**Capital Requirements Will Not Be Adjusted**

Breaking with annual stress test practice, the Fed did not update firms’ capital requirements based on this mid-cycle stress test. The capital requirements determined by the annual stress test released in June will remain in place, as of the fourth quarter of 2020. The Fed assessed that “with the current capital requirements and distribution restrictions in place, banks have built capital over the past year” and that the ongoing income-based limitations would serve to keep them well-capitalized going forward.

However, the Fed also extended the period during which it can inform firms of a new capital requirement. While it is normally to provide notice within 75 days, the Fed is “extending the time period to notify firms whether their stress capital buffer requirements will be recalculated until March 31, 2021” due to the ongoing uncertainty of the pandemic.
Mortgage Relief

Mortgage and rent costs constitute a major component of many individuals’ cashflows. As fixed cost commitments, measures taken to alleviate the payment burden can greatly improve the likelihood of homeowners’ staying in homes. Policies targeted to aid these individuals must take account of the duration of financial struggle, underlying financial circumstances of borrowers and renters, and the impacts such policies can have on lenders.
Analysis

Residential Mortgage and Rent Relief During Crises
By Shavonda Brandon, Vaasavi Unnava, Rosalind Z. Wiggins, and Greg Feldberg

Original post here.

Cash flows around the world have dropped dramatically as more governments require non-essential businesses to close and individuals to stay at home in order to fight the COVID-19 pandemic. In a fairly short time, such actions have led to massive layoffs and job losses. In the United States, for example, the country has swung from historically low unemployment levels to historically high numbers of claims for unemployment benefits; similar effects can be observed in other countries. As a consequence, individuals are experiencing, and are expected to continue to experience for some time, difficulty in paying their housing costs. Whether mortgage or rent, housing is usually the largest fixed cost for households and many governments have responded by announcing various packages to provide relief. This post begins by examining the fundamental challenge presented by the need to provide residential expense relief on a grand scale. It then details multiple programmatic interventions utilized in crises past and present. Finally, this post provides some key takeaways to consider when implementing residential expense relief policies.

Statement of the Challenge

National or state-wide residential mortgage and rent relief policies in response to broad financial duress date back as early as the Great Depression. Such policies may provide immediate relief to individuals through instruments like mortgage or rental forbearance or eviction moratoria. Governments may also institute longer-term policies, such as mortgage restructuring or repurchasing.

The need to provide respite to individuals during times of crisis places governments in a delicate position in which they must implement policies that provide financial relief to individuals experiencing difficulties making their mortgage or rental payments while simultaneously maintaining the functional integrity of the mortgage lending and servicing system. Difficulty may arise in balancing these two competing objectives as the individual homeowner’s or tenant’s interest conflicts with that of the landlord, lender, or mortgage servicer. Thus, to achieve a balance, governments that provide short-term or long-term mortgage or rent relief often also provide flexibility or incentives for landlords, lenders, and servicers administering or participating in such programs. Should a government employ one set of relief without the other, or a method of relief that doesn’t fit the problem well, then the debt burdens for homeowners (including landlords) may persist unaddressed, further exacerbating the crisis.
To determine policies that optimally address such a problem regarding mortgage and rental payment, governments must consider the following key questions:

- **Type of Problem**: What is the problem that creates the need for residential relief? When is the problem expected to end?
- **Type of Relief**: What are the best tools to address the problem? Who are the various stakeholders?
- **Underlying Borrower/Renter Circumstances**: What is known about the underlying circumstances of the borrowers or renters?
- **Lender Impact**: Can lenders and their servicers execute the program efficiently? What will the impact of the program be on them? What relief might they need?
- **Existing Structural Issues**: How might differing market incentives or structural issues impede the success of the program?

Residential relief programs may address these considerations in different ways based on the circumstances presented. We will discuss these questions further as we review different intervention strategies below.

**Types of Programs**

- **Mortgage Forbearance** - allows homeowners to temporarily delay making payments
- **Mortgage Restructuring** - permanent modifications to existing at-risk mortgages
- **Mortgage Purchasing** - outright purchase of at-risk mortgages by a government or agency
- **Renter’s Aid** - providing forbearance and rent subsidies to tenants
- **Flexibility in Debt Restructuring** - modifications to accounting and regulatory frameworks to aid lenders in restructuring mortgages

**Mortgage Forbearance**

If decreased cash flows amongst individuals is the only economic problem they face, forbearance may be a suitable relief strategy, since it grants mortgage holders a short period during which they can defer payment and repay the unpaid balance months later. Because of the nature of the current COVID-19 pandemic, where the cash flow issues are expected to be of limited duration—reversing once the widespread government-imposed economic shutdowns are lifted—several countries have used forbearance for short 3-6 month durations. In this instance, the period of forbearance may also be extended as needed. Additionally, in connection with forbearance relief, late payment penalties and foreclosures are usually stayed. Credit reporting may also be stayed so that the individual does not experience a drop in creditworthiness after accepting forbearance.
Governments may implement mortgage forbearance by passing legislation that provides direct legal relief for nonpayment, as the United States has done in the current COVID-19 outbreak. The CARES Act provides homeowners whose mortgages are federally backed (approximately 80% of those outstanding) the right to request a 180-day forbearance. (See a YPFS blog on the US program here). Officials in the United Kingdom have instituted a three-month mortgage holiday, during which borrowers do not have to make any payments. Ireland has implemented a similar payment moratorium on mortgages, as well as on business and personal loans for individuals. Some countries may institute government-mandated forbearance, but with more limited coverage.

Other countries have implemented similar relief through the private sector. Hungary stopped short of legislating such relief and instead urged banks to provide forbearance for household payments. In Ireland, during the Global Financial Crisis (GFC), the government emphasized forbearance by lenders but did not require such policies until 2013. In the Bahamas, the government has arranged for lenders to provide a three-month mortgage forbearance to borrowers who were in good standing prior to the pandemic. In this case, missed payments will accrue interest throughout the forbearance period. Private-sector solutions can provide coverage for substantial numbers of individuals if all major banks participate.

It should be noted, however, that forbearance is a delay, not forgiveness. Individuals are still responsible for the deferred payments, and repayment plans must be negotiated with the respective lender or landlord. As discussed below, governments often provide incentives for the lenders to reach agreements that are manageable to the homeowner and keep them in their homes. Depending on the structure of the country’s mortgage system, homeowners may have to negotiate this restructuring with a mortgage servicer who represents the lender; either party may have conflicting incentives that impact the ease of agreement.

Mortgage Restructuring

If the perceived problem is with the fundamental economics of the mortgage rather than a short-term cash flow issue, then longer-term solutions provide opportunities for mortgage restructuring in an effort to avoid delinquencies or foreclosures, and maintain people in their homes. These solutions may also need to be employed if forbearance fails to address the problem effectively, as occurred in Ireland during the GFC (discussed below).

Historically, the manner in which debt restructuring is implemented varies widely. Some programs attempt to restructure loans to provide easier paths to pay off extant mortgages. Other programs simply purchase homes outright from the lender, including any outstanding mortgage balances, leaving original owners of dwellings as tenants who pay rent to the new homeowner. The choice between the two programs may depend on whether or not the mortgages are “underwater” — the case in which the outstanding principal payment is greater than the value of the home. Mortgages that significantly exceed the value of the home may be strong candidates for outright purchase rather than restructuring, as there is a lesser incentive for the homeowner to continue payments. By contrast, restructurings or modification programs are aimed at
reworking the mortgage on the assumption that the homeowner will continue to occupy the home and pay the mortgage. However, as discussed below, the methods and objectives sometimes overlap.

The Home Affordable Mortgage Program (HAMP) instituted by the United States during the GFC, when many mortgages exceeded home values due to a broad market correction, encouraged privately negotiated modifications by incentivizing mortgage lenders and servicers to participate in the program with cash payments and by providing a required modification framework. The required framework expressly reduced all mortgage payments to 31% of an individual’s monthly income, relying first on a reduction of interest rate for five years, followed by a reduction of principal payments to reach this target. The program thus established an industry standard for modifications which sought to avoid foreclosures. The Homeowners Support Mortgage Scheme (HSM) in the United Kingdom took a different approach to creating a modification framework. That scheme allowed homeowners to defer up to 70% of their interest payments for two years, with 80% of the deferred interest payments guaranteed by the government for banks participating in the scheme.

Also during the GFC, Ireland utilized split mortgages, a novel restructuring option that split mortgage debt into two pieces: one piece warehoused for later payment, and one piece that the borrower makes payments on until their financial situation improves.

Some restructuring options do not rely on changing the terms of an existing mortgage. During the Great Depression in the United States, a style of lending called “equity of redemption” allowed debtors to re-attain their foreclosed properties if outstanding mortgage debt was paid off within a certain time period after foreclosure. Many states extended the equity of redemption period to provide relief for mortgage owners.

Mortgage Purchasing

In comparison to private-sector modification programs, government-funded mortgage repurchase programs purchase loans and then offer favorable refinancing if the homeowner can afford it. During the Great Depression, the Home Owners Loan Corporation in the United States purchased mortgages directly from lenders and issued new mortgages to the borrowers, refinancing many on much more favorable terms.

In some cases, if homeowners could not afford to refinance, they were permitted to stay in their homes as tenants. During the GFC, Scotland created the Homeowner Support Fund, under which a local council purchased distressed houses at 90 percent of their value and then rented them to the former homeowners, allowing families to remain in their homes.

Also during the GFC, the United Kingdom implemented a two-part scheme, called the Mortgage Rescue Scheme, designed to help vulnerable homeowners stay in their houses. Local councils had the ability to purchase a home at market rate and offer a short-term tenancy to those already living in the home at 80% of market rent. The scheme also allowed local councils to make a “shared equity” loan to the household to help it maintain the mortgage by temporarily paying a
reduced amount. The scheme was ultimately criticized for miscalculating demand and completing too many costly purchase rescues; a more balanced usage of the two schemes had been forecasted.

Examples of restructuring or modification frameworks have yet to emerge in the current COVID-19 crisis. However, if the crisis persists, the need for such relief may arise as the prolonged effects of unemployment and economic downturn impair owners’ ability to maintain their mortgages.

**Renter’s Aid**

Renters may also face reduced cash flows as unemployment rises during economic crises. Similar to mortgage forbearance, governments may provide rent forbearance to renters, where they are granted a short period during which they may defer payment and repay the unpaid balance months later. Renters also may be protected from late-payment penalties and negative marks on their credit report as a result of utilizing the forbearance benefit. The risks associated with a tenant who takes a rental forbearance differ from those of a homeowner or mortgagor. Rental contracts are short-term commitments and do not carry the possibility of equity. In contrast, a mortgage creates an incentive for the borrower to remain in the home. There may be a greater risk that tenants, especially tenants who have difficulty returning to work or other basic financial difficulties, may not be able to repay the forbeared amount, creating a problem for landlords and their own ability to pay related mortgages and expenses.

Governments may implement rent forbearance by passing legislation that provides direct legal relief for nonpayment, as the United States has done in the current COVID-19 outbreak. The CARES Act provides a rental moratorium and suspends evictions for the duration of mortgage forbearance for properties that are financed by federally backed multi-family mortgages. (See a YPFS blog on the program here.) Greece has provided relief using a different method; businesses and individuals directly impacted by the pandemic will be permitted to pay only 60% of their rent for the months of April and May. Both methods increase the flexible cash-flow for renters who choose to take advantage of the benefit and illustrate the differing breadth that such relief can take.

Governments may also implement rental subsidies, aimed at reducing rental costs rather than deferring them. Government subsidies provide the additional benefit of guaranteeing payments to landlords and lenders who may not receive payments if renters are unable to repay outstanding rent after the forbearance period. Some rent subsidies are a direct government payment to landlords. In British Columbia, government-funded rent relief of CAD$500 per person per month for up to three months is intended to help tenants impacted by the COVID-19 pandemic continue to pay their rent. Related provisions prohibit evictions and rent increases during this period; also, the government has asked banks to work with landlords who may experience a drop in rents. Malta has also established a new Private Rent Housing Benefit Scheme, through which individuals unemployed due to the COVID-19 outbreak will receive governmental rent subsidies.
Governments may also reduce housing costs that are not typically included in rent. Bahrain will cover electricity and water payments for three months; Ukraine has prevented the disconnection of utilities for customers late on utility payments.

**Flexibility in Providing Debt Restructuring**

When economic shocks demand large-scale residential mortgage relief, lenders face barriers to efficiently carrying out government mandates. These include liquidity issues due to slowed cash flows; an increase in loans classified as “troubled debt,” due to restructurings that reduced principal or interest payments; and other increased administrative costs associated with high volumes of activity.

To provide flexibility for lenders who provide mortgage forbearance, governments may seek to ease the application of accounting principles. For example, restructuring loans to reduce principal or interest payments is typically classified as troubled debt. A government may specify that restructurings in compliance with its mandate will be excluded from this classification. This policy enables lenders to restructure more loans without taking massive losses on their balance sheets.

In response to the COVID-19 outbreak, the United States provided that mortgages that benefit from forbearance will not be categorized as troubled debt. Peru’s Superintendence of Banks notified financial institutions that any modifications to loan terms due to the COVID-19 crisis would not change the classification of the loans.

The government may also provide relief to lenders’ cash flows. In the United Kingdom, in response to the GFC, the government guaranteed the interest-only payments of borrowers in exchange for lender participation in the mortgage forbearance program. In response to COVID-19, Canada has promised to purchase CAD$150 billion in loans from banks to free up their capital.

In developing economies, it may be necessary to restructure loans denominated in foreign currencies. For example, leading up to the GFC, it was common in many countries in central and eastern Europe for mortgages to be denominated in Swiss francs. As the Swiss franc strongly appreciated after the crisis, many of these loans became non-performing. In response, the governments of Hungary and other countries allowed foreign-denominated mortgages to be redenominated in local currency or even a third currency, providing relief to borrowers from the pressure of increasing exchange rates on mortgage payments. In the COVID-19 crisis, Sri Lanka has broadly allowed banks to recover loans in Rupees as a last resort, when recovery of loans in a foreign currency appears remote.

**Key Takeaways**

*Fit the solution to the problem.*

When considering whether to provide aid to residents or tenants of a mortgaged property, the nature and expected duration of the problem will be a key question. Mortgage and rent
forbearance programs provide short-term solutions to address cash-flow shortfalls for mortgage owners or renters. They can provide quick relief to individuals having trouble paying their bills because of unemployment or other cash-related issues until circumstances change.

However, forbearance may not adequately address problems with the fundamental economics of a mortgage, as generally existed during the GFC. Then, longer-term solutions are needed to provide opportunities for mortgage restructuring or purchasing in an effort to avoid delinquencies or foreclosures, and keep people in their homes.

*Forbearance relief may create secondary problems once the forbearance period ends.*

Forbearance is not forgiveness, but this may be fundamentally misunderstood by some individuals, or just disregarded when faced with a balloon payment or larger monthly payments needed to make-up the forbearance amount. Others, just may be financially unable to make up the payments. For homeowners, history has shown that there is no guarantee that restructured loans will not default. But every crisis is different. If the COVID-19 crisis ends sooner and there is no dislocation in the housing market, the effects should be much different than experienced in the GFC under the HAMP program restructurings, when significant defaults on restructured loans with underwater mortgages but also prolonged unemployment were cited as major factors of the prolonged foreclosure crisis.

There is a similar risk that renters will fail to repay forbearance amounts. Some tenants may have underlying financial difficulties not related to the immediate crisis. Governments should consider that they may be confronted with a mass problem of unpaid forbearance rent and thus, possibly increased evictions and or bankruptcies once the forbearance period ends.

In total, governments should consider the possibility of such secondary impacts and how they might be addressed should they occur. Additional fiscal assistance may be needed.

*Some residential relief programs may create moral hazard.*

There is some evidence that forbearance policies create moral hazard. In other words, homeowners may take advantage of the opportunity to not pay their mortgage even if they are capable of doing so. In Greece, during the Sovereign Debt Crisis, many homeowners received the benefit of a foreclosure moratorium. It is estimated that as many as 37% of the homeowners utilizing the moratorium to delay payments did so strategically rather than because of need.

*Understand the underlying circumstances of homeowners and renters.*

For both homeowners and renters who take advantage of forbearance benefits, factors that contribute to the ability and willingness to repay center around issues of income, unemployment, debt load, and credit worthiness. If the assistance provided does not take into consideration the full financial profile of the borrower, then the mortgage assistance program may not succeed in stabilizing the borrower’s situation.
Such was the case in Ireland in the aftermath of the GFC. The country’s initial response relied on broad implementation of short-term mortgage forbearance, which did not account for the broader underlying problem of excessive mortgage debt that had arisen during the GFC (by 2009, the ratio of mortgage debt to GDP was 92%). With a significant number of mortgages underwater and increased unemployment, many homeowners participated in forbearance but were ill-equipped to resume payments when their forbearance periods ended. The government ultimately encouraged large-scale permanent mortgage restructuring to keep homeowners in their homes, rather than temporarily restructuring for forbearance needs.

Similarly, in the United Kingdom, a miscalculation of the desirability of two options under the Mortgage Rescue Scheme resulted in budgetary underallocation and undermined the efficacy of the program. Although the shared equity option provided a cheaper alternative for the government, it was far less popular than the mortgage purchase option. More homeowners than expected chose to have their council purchase their mortgages and rent the home back to them than the number of homeowners who chose to take a shared equity loan to help them manage mortgage payments. The first option was significantly more expensive and therefore, the number of homeowners assisted was less than planned, while the cost of assistance received by each was significantly greater than expected. The scheme points out the pitfalls of providing an open choice to the homeowner when trying to also serve as many people as possible. A modification to the plan, such as limiting the budget allocated to each option, could have maintained choice but also better positioned the government to achieve its service objectives.

In particular, the choice to reduce payments rather than the principal of a loan may not be effective if a borrower’s equity is very negative. Some argue instead that programs should focus on ameliorating the immediate consequences of job losses to help borrowers maintain liquidity in the long term.

Lender experience and incentives may affect a program’s efficiency and participation rate.

Lenders may struggle with implementation due to a lack of experience in renegotiating loans. In financial environments where a majority of lenders do not regularly restructure debts, the implementation of various loan restructuring policies may take longer than expected. Such was the case with the US Home Affordable Modification Program (HAMP) during the GFC. The experience also highlighted the importance of the government understanding the way the industry is structured and incentivized.

Attempts to correct currency mismatch in loans may not reduce lenders’ risks.

In some cases, restructuring foreign-denominated debts to local or third-country currencies can provide the necessary leeway for lenders to properly implement government policies. However, it’s unclear that changes to currency denomination reduce risk for lenders overall. They may reduce currency mismatch in the original currency but create another in the new currency. Such exchanges may also be difficult to administer.

Conflicting policies may hamper the success of residential relief programs.
As discussed above, because of the nature of housing, it is useful to combine forbearance policies with restructuring incentives and foreclosure and eviction moratoria. However, when existing or newly implemented rules do not properly allocate risk among housing market participants, they can hamper efficient enforcement of housing policies aimed at providing residential mortgage relief for both borrowers and tenants.

Protections that overshield borrowers from the risk of default (or renters from eviction) may affect the ability to enforce residential mortgage relief policies. In the case of Ireland during the GFC, homeowners slipped into default on mortgages for years, as a result of the country’s strong homeowner protections that created a one-sided mortgage forbearance regime. This was facilitated by a repossession law that effectively made foreclosures impossible and left mortgage lenders with little recourse. By December 2012, about 12% of Irish mortgages were late by more than 90 days. In this case, homeowners were incentivized to stop paying mortgages when there were few options to permanently restructure debts with mortgage servicers, exacerbating the mortgage debt problem for both homeowners and lenders.

Structural issues may undermine utilization of residential relief programs.

The degree of separation between mortgage owner and homeowner can lead to difficulties in the enforcement of mortgage aid programs. In the United States, before the GFC, the popularity of securitization of mortgages meant that mortgages would often be sold and resold, creating several degrees of separation between mortgage owners and homeowners. This distance between lender and borrower, as well as the complexity of claims on a mortgage created by securitization, often led to litigation negatively impacting the effectiveness of relief programs.

Additionally, due to the separation between mortgage servicer and mortgage owner, differing compensation incentives hampered efficient mortgage restructuring. This incentive mismatch manifested under HAMP, where 28% of modified loans defaulted again, including half of the loans modified at the height of the financial crisis. While the program required restructuring of loans in a way that supported homeowners—specifically through the introduction of mandatory terms to reduce monthly payments to 31% of the individual’s monthly income—the program permitted mortgage servicers to determine which borrowers could restructure. Because the servicer was compensated by the unpaid principal balance of performing loans, servicers had the incentive to reduce interest payments and instead opt for adding unpaid loan balances to the outstanding principal of the loan, which was not effective in ensuring the long-term performance of the loan. As a result, many servicers were incentivized to deny restructuring to eligible borrowers, reducing participation in the program dramatically.

In the case of the HSM in the United Kingdom, also during the GFC, the additional onerous requirements placed on lenders in terms of documentation and reporting lead to only 32 borrowers participating in the program. Additionally, few lenders provided forbearance through the HSM program directly, instead opting to offer their own forms of forbearance. However, it was concluded that through such intervention, the government was able to influence most
lenders’ forbearance policies, leading to indirect aid for even those not participating in the program.

For more specific information about specific types of programs and their usage in the most recent crisis, see Mortgage Forbearance and Eviction Moratoria in Response to the COVID-19 Outbreak and Expanding Debt Restructuring Options for Mortgage Lenders in Response to the COVID-19 Outbreak.
Mortgage Forbearance and Housing Expense Relief in Response to the COVID-19 Outbreak

By Shavonda Brandon, Vaasavi Unnava, and Rosalind Z. Wiggins

Original post here.

With US unemployment claims at record highs due to the nation’s directive to close many businesses and shelter-in-place, many individuals are struggling to pay recurring fixed costs, such as mortgages and rent. In response, the United States instituted the CARES Act, providing opportunities for mortgage forbearance and moratoria on evictions for all holders of federally backed loans. Other countries have instituted similar policies, but with varying time-frames and coverage for homeowners and renters.

Mortgage and Rent Forbearance

More than 20 countries have instituted some form of mortgage forbearance in response to the ongoing COVID-19 pandemic. The CARES Act endows borrowers with federally-backed mortgages the right to request forbearance. It provides a general framework for mandatory forbearance policies, while leaving the terms of agreement to the original lenders, with flexible windows for forbearance as determined by borrower need. Canada strongly emphasized that lenders should negotiate directly with mortgage borrowers to determine the terms of forbearance on individual loans. Some countries provide forbearance for a fixed time period. For example, the United Kingdom provides a fixed window of three months for forbearance.

Forbearance is not restricted to mortgage borrowers. Putting a moratorium on rent payments is one approach to provide temporary relief for renters. British Columbia, in Canada, has promised to pay CAD$500 a month, for three months, directly to renters’ landlords to provide a direct subsidy of rental payments. Greece has restricted rent payment for those directly affected by the outbreak to 60% of rent for the months of March and April.

To emphasize that forbearance is not forgiveness, lenders offer flexible repayment options. For example, there is the paused payment option, in which borrowers pause payment and either choose to make a balloon payment once their regular loan payment commences, or when the mortgage reaches its term. Borrowers can also opt to reduce their payment by some fraction for a set period. Any individual who seeks repayment accommodations due to the impact of COVID-19 will remain current for purposes of credit reporting.

To fully account for housing-related fixed costs, some countries are paying utilities or providing forbearance for citizens on utility payments. Argentina has extended forbearance clauses to utility bills for households in arrears in addition to covering mortgages. Bahrain will pay residents’ electrical and water utility bills for three months beginning in April, though it hasn’t instituted any form of mortgage forbearance or rent. Ukraine has outlawed disconnecting utilities for customers late on payments.
Typically lenders use caution when determining if a borrower is eligible for renegotiation of the terms of a loan. Doing so may expose lenders to balance sheet losses and require them to categorize the renegotiation as a troubled debt restructuring (TDR). TDRs require strict reporting, tracking, and accounting requirements that are administratively costly. Since forbearance is a form of term renegotiation, regulators have modified guidance around the reporting of TDR to increase the expediency of the forbearance process in response to the pandemic. To read more on the expansion of loan restructuring options that countries have employed to provide flexibility to lenders, such as changing loan classification or accounting requirements, click here.

Eviction Moratoria

To prevent evictions for individuals who are behind on payments, countries have instituted moratoria on evictions and foreclosures. In some cases, this has not been codified into law. Barbados has not passed legislation, but has “strongly encouraged” landlords to not evict their tenants during this time; it plans to legally enforce the rule if not upheld without legislation. Other countries have extended the timeline for foreclosures. In the United Kingdom, landlords must now give renters three months’ notice before eviction, through September 2020.

Other governments have implemented stricter tenant protections. British Columbia, in Canada, has placed a ban on evictions for three months. In addition to moratoria, Ireland has paired a three-month moratorium on evictions with a ban on rent increases for the duration of the COVID-19 emergency in the country. New York City has placed a moratorium on residential evictions for 90 days; the United States Congress has prevented eviction for 120 days after enactment of the CARES Act on March 27, and foreclosures for 60 days after March 18, for federally guaranteed mortgages. In addition, US landlords receiving forbearance on their mortgages are prohibited from bringing eviction proceedings against tenants, or charging penalties during the forbearance period.

To read more about debt restructuring for mortgages, click here.
Expanding Debt Restructuring Options for Mortgage Lenders in Response to the COVID-19 Outbreak

By Shavonda Brandon, Vaasavi Unnava, and Rosalind Z. Wiggins

Original post here.

With the outbreak of the COVID-19 virus, many countries have instituted some form of right to mortgage forbearance and protection from foreclosure or eviction. Homeowners may request a forbearance of payment for a negotiated or predetermined fixed period. At the end of the forbearance period, lenders work directly with borrowers to recoup the payments missed, by finding alternative payment schedules. Lenders may change the outstanding principal, interest rates, or term of the loan to help the borrower.

Loan Classification

Governments providing forbearance support to borrowers have taken steps to protect lenders who otherwise might experience a dramatic increase in their troubled debt. Typically, such restructuring constitutes a troubled debt restructuring for the lender. When debts are designated as troubled, they are categorized as a loss on balance sheets and a lender must adhere to strict reporting, tracking, and accounting requirements that are administratively costly. Several governments have changed accounting practices so that lenders may avoid classifying restructured mortgages as troubled.

The United States provides such amnesty for mortgages modified pursuant to the CARES Act. Peru has pursued a similar strategy, with the Superintendence of Banks notifying financial institutions that any modifications to loan terms due to the COVID-19 pandemic would not change the classification of the loans. Russia allows banks to restructure loans without impacting their classification, so long as regulatory requirements continue to be satisfied.

Regulatory Requirements

Outside of loan classification, countries have modified regulatory requirements to provide greater flexibility in lending.

Israel has increased the loan-to-value cap on residence-backed loans from 50% to 70%. Residence borrowers are now eligible for the lowest rate of interest on a home loan at a 30% down payment instead of the original 50% down. Separately, governments are modifying bank capital requirements to improve liquidity conditions; Russia has specifically reduced risk weighting of mortgages to alleviate the burden of mortgage debt restructuring.

Meanwhile, Norway has increased the amount of risk banks may take to provide greater flexibility for loan restructuring. Now, 20% of mortgages may deviate from amortization requirements, providing extra room for borrowers to suspend payment or reduce...
payment. **Sweden** has followed a similar strategy, allowing some loans to be exempt from amortization requirements under recognition of income loss for borrowers.

**Freddie Mac**, a government-sponsored entity (GSE) in the United States, has also provided more flexible options for its lenders, by extending options for restructuring typically only available to lenders during natural disasters.

Unified Loan Restructuring

Rather than provide individualized opportunities for loan restructuring, some governments have elected to provide broad, prescriptive terms for loan restructuring. The US did this in the GFC by encouraging restructure options. This may restructure loans quickly in an environment with less experienced lenders, who have trouble restructuring loans in a timely manner.

In the **Philippines**, members of the Government Service Insurance System have been extended the ability to settle debts through the government pension fund. Individuals may also consolidate and restructure debts with the organization without penalty. The broad restructuring does not leave space for individual negotiations, with all participants receiving the same reduced interest rate of 7-8 percent from the original 12 percent interest rate.

The Philippines is not the only country setting unified terms of restructured loans at a national level. In the **United Kingdom**, mortgage forbearance is mandated for three months, already setting one of the terms for lenders for any relief that may be provided. Similarly, **El Salvador** has extended a three-month payment exemption for mortgages and other critical services whose repayment would be spread over two years with no risk of default or interest.

Other countries determined payment terms of the mortgage forbearance restructuring. **Palau** requires interest-only payments, rather than forbearance outright. **Bolivia**, similarly, is suspending only principal payments for mortgage forbearance. **New Zealand** is suspending principal and interest payments for six months for all individuals affected by the COVID-19 virus.

Aid to Lenders

By providing flexible options for debt restructuring that do not penalize the lender for borrower non-payment, governments may be attempting to mitigate the sharp drop in capital flows that will soon affect lenders due to the many mortgage forbearance and eviction moratoria that have been instituted worldwide.

Extensive but temporary regulatory changes as well as broader guidances in debt restructuring may help banks, but still leave room for difficulty amongst nonbank lenders. As a team of Fed economists wrote in a recent paper, “Nonbank mortgage companies also need to finance the costs associated with servicing defaulted loans for extended periods of time. Obtaining this financing can be difficult in times of strain.”
It remains to be seen how this liquidity stress will be mitigated as forbearance extends into the future. In the US, lenders have asked for the Federal Reserve to institute a mortgage liquidity facility, though nothing has been created yet. The Federal Housing Finance Agency director has expressed confidence that private banks will continue to extend credit to lenders for the short term.

To read more about residential mortgage forbearance and eviction moratoria, click here.
Case Studies and Policy Changes

FHFA Relaxes Standards for GSE Mortgage Servicers

By Vaasavi Unnava

Original post here.

On April 21, the Federal Housing Finance Agency (FHFA) announced that it was changing standards for mortgage servicers in an effort to reduce burdens brought on by drastic increases in mortgage nonpayment. Quickly following, on April 22, the FHFA announced that Fannie Mae and Freddie Mac would purchase some mortgages in forbearance due to COVID-19.

New forbearance policies under the CARES Act are creating liquidity issues for mortgage servicers. Typically, mortgage servicers collect payments of mortgage principal and interest from borrowers whose mortgages are in mortgage-backed security (MBS) pools and use the funds to make payments to investors who contractually own the rights to the cash flows from the mortgages in the pool. Fannie Mae usually requires that the servicer advance payments of loan principal and interest for up to 12 months, even if a borrower is in arrears. Freddie Mac only requires that servicers advance interest-only payments for up to four months.

The new changes reduce the required advance period under Fannie Mae mortgages from 12 months to four months. This aligns the advance periods for all Fannie Mae and Freddie Mac single-family mortgages. The new policies apply to all single-family mortgages backed by Fannie Mae or Freddie Mac and to all servicers, regardless of type or size.

While Fannie and Freddie usually buy loans more than four months in arrears out of MBS pools to replace them with performing loans, the FHFA has instructed the GSEs to treat loans in COVID-19 forbearance as if they were subject to temporary natural disaster relief, which would allow the loans to remain in the MBS pool for the period of forbearance. The change in treatment reduces liquidity demands on the two government-sponsored enterprises (GSEs).

Also, as of April 22, FHFA announced that Fannie and Freddie would purchase mortgages that have gone into forbearance almost immediately after closing. FHFA had previously treated such loans as ineligible for purchase. Mortgages originated between February 1, 2020, and May 31, 2020, are eligible for purchase. Mortgages cannot be more than 30 days delinquent. The GSEs will price these purchases to account for the increased risk of the mortgage in forbearance. By relaxing mortgage purchasing standards, FHFA hopes to encourage mortgage origination in a slow credit market, in which servicers are unwilling to originate mortgages for fear that GSEs may not buy them.

Through the CARES Act, the government made forbearance available to all borrowers with federally backed single-family or multi-family mortgages. The forbearance period for single-family mortgages can extend as long as a year. As of April 19, the share of loans in forbearance
rose to 6.99%, up from 0.25% on March 6. Industry officials expect forbearance requests will continue to rise with unemployment. As COVID-19 continues to depress demand and employment, it remains unclear when homeowners in forbearance may be able to resume mortgage payments. The Mortgage Bankers Association estimates that in a worst-case scenario, servicers might need to fund as much as $75-100 billion in advances.

Though these changes in regulation provide a welcomed and needed reprieve for mortgage servicers, servicers continue to push for a mortgage liquidity facility to ease strain on cash flows during the forbearance period. Beginning in late March, many called for the Federal Reserve to set up a mortgage liquidity facility to ease the liquidity pressures on mortgage servicers that emerged as a result of the CARES Act. On April 8, a bipartisan group of senators explicitly requested that the Federal Reserve set up a mortgage liquidity facility, something the central bank has resisted doing. Mortgage experts believe that the Federal Reserve will create a funding facility, but not until there is a meaningful increase in forbearance activity.
FHFA Allows Payment Deferral for Forbearance Payments While Extending Foreclosure and Eviction Moratoria

By Vaasavi Unnava

Original post here.

On May 13, the Federal Housing Finance Agency (FHFA) announced that homeowners who take advantage of COVID-19 mortgage forbearance will have the option to defer payment of the missed amounts until the home is sold or refinanced, or the mortgage matures, once they return to making their normal monthly mortgage payments. The next day, the FHFA announced an extension of its foreclosure and eviction moratoria to June 30.

The CARES Act, passed in March, instituted an optional 180-day moratorium period, beginning on March 15, for payments on any federally-backed mortgage in response to businesses’ rapid and large furloughs of workers due to social distancing and isolation orders. The 180-day period can be extended for an additional 180 days, for up to a year of forbearance.

The ability to miss mortgage payments provided much-needed relief to homeowners. However, the prospect of widespread non-payment raised liquidity concerns for mortgage servicers who service mortgage-backed securities (MBS) backed by Fannie Mae, one of the two government-sponsored enterprises (GSEs) that support the secondary market for mortgages. Servicers of Fannie Mae securities were responsible for covering 12 months of payments to MBS investors when borrowers have missed mortgage payments.

To help servicers, the FHFA reduced the number of months of advances to MBS pools that mortgage servicers with Fannie Mae loans were responsible for. Rather than the original 12 months’ payments for mortgages in arrears, the FHFA required servicers to pay four months’ payments, the same number of payments that servicers with Freddie Mac loans were responsible for.

However, as social distancing guidelines are extended and few Americans return to work, many homeowners may not be able to soon restart their mortgage payments or pay the deferred amounts, which may continue to increase as forbearance continues.

In response, the FHFA announced an option for homeowners to defer repayment of amounts not paid pursuant to the mortgage forbearance. Under this policy, borrowers who can return to normal mortgage payments can pay off unpaid forbearance balances when the home is sold, the mortgage is refinanced, or when the mortgage loan matures. Fannie Mae and Freddie Mac will offer this option on their mortgages beginning July 1, 2020.

Referred to as “payment deferral” by the FHFA, this new alternative is part of a range of options available to borrowers who take advantage of the forbearance. On April 27, the FHFA announced it would not require lump-sum payments at the end of forbearance. Instead, it proposed that borrowers could set up repayment plans for the forbearance amounts, modify the
loans so that the missed payments are added to the end of the mortgage, or modify the loans so that they have a reduced monthly payment. Now, borrowers can pay the entire missed amount at sale, refinancing, or maturity. However, the choice of payment plan will require agreement between the servicer and borrower.

As mortgage servicers are no longer responsible for making more than four months of payments into mortgage pools, Fannie Mae and Freddie Mac will have to fill the funding gap for the remaining duration of forbearance. Freddie Mac wrote in its 10-Q statement, “we expect to advance significant amounts to cover principal and interest payments to security holders for loans in forbearance in the coming months. … We had a $1.2 billion provision for credit losses in 1Q 2020 due to our forecast of higher expected credit losses from our single-family credit guarantee portfolio as a result of the pandemic, but these estimates are subject to significant uncertainty and may increase substantially in the future depending on the depth and severity of the economic downturn caused by the pandemic.” Fannie Mae and Freddie Mac currently account for 62% percent of the market for first-lien mortgages, according to the Urban Institute.

Other agencies are following similar strategies. In April, Ginnie Mae expanded its Pass-Through Assistance Program (PTAP), advancing principal and interest payments for mortgage servicers whose loans are in forbearance. Under the COVID-19 PTAP extension, issuers may request PTAP assistance once per month to cover missed principal and interest payments to MBS investors.

The Veterans Administration (VA) also allowed homeowners to make missed forbearance payments at the end of the loan, rather than immediately at the end of forbearance. In that case, the balloon payment will be non-interest bearing. Homeowners with VA-backed loans can also make modifications to their loans or set up a repayment plan, as established under the CARES Act.

The Federal Housing Administration (FHA) has also provided repayment options to homeowners. Homeowners can defer paying forbearance balances until the mortgage is paid off. In requesting forbearance, homeowners authorize mortgage servicers to advance funds on their behalf, creating a partial claim: an interest-free subordinate mortgage on the property that homeowners pay off once the original mortgage is paid off.

The Mortgage Bankers Association (MBA) welcomed the FHFA policy changes, saying that they improved efficiency in the mortgage process. Though the current FHFA foreclosure and eviction moratorium would have expired on May 17, on May 14, the FHFA announced an extension until at least June 30. As of May 3, 2020, the share of loans in forbearance rose to 7.91%, up from 0.25% on March 6th. The MBA estimates that in a worst-case scenario, servicers and GSEs might need to fund as much as $75-100 billion in advances.

Though talks to privatize the two GSEs continued as late as February, on May 20, FHFA Director Mark Calabria said that the two GSEs should hold $240 billion in capital before exiting government conservatorship--a figure far larger than the current $23 billion in capital they
collectively hold. If forbearance continues for an extended period of time, it’s unclear whether Fannie Mae and Freddie Mac will need to procure funding to continue making payments to MBS pools for forborne mortgages. With the two agencies still under government conservatorship, it is possible that additional funding would come from the Treasury since, pursuant to the Senior Preferred Stock Purchase Agreements with the GSEs, Treasury in effect pledged to provide funding as needed to maintain the agencies’ solvency. Under both agreements, Treasury cannot commit more than $100 billion to each GSE.
SIGTARP Proposes Using Leftover TARP Funds for COVID Relief

By Vaasavi Unnava

By Original post here.

On April 8, the Special Investigator General for the Troubled Asset Relief Program (SIGTARP) recommended the Treasury use extra funds remaining from TARP’s Hardest Hit Fund to provide mortgage relief for unemployed homeowners.

The Obama administration established the Hardest Hit Fund (HHF) in 2010, in an effort to directly aid unemployed homeowners who were struggling with making payments on their mortgages. The program offered opportunities for unemployed homeowners to receive mortgage payment assistance, principal reductions, and transitions into more affordable homes. It also included funds for blight elimination.

“Many people do not realize that TARP housing programs are still open,” Special Inspector General Christy Goldsmith Romero said. “TARP’s Hardest Hit Fund program could be a strong tool to help with the recent significant rise in unemployment, as there are already existing infrastructures in 19 states that could be quickly employed.”

The Treasury originally targeted HHF to serve five states, but as the effects of the global financial crisis spread, it expanded the program to serve 18 states and the District of Columbia with $9.6 billion in funding. Treasury selected eligible states based on whether state unemployment rates exceeded the national level or home prices in the states decreased by more than 20 percent during the GFC; it’s unclear whether the states eligible to administer the program would change during the present crisis. The program is administered on the state level. Approximately $579 million of the funding is still available through 2022.

Potential COVID relief could also include unspent TARP funds from other housing programs, such as the $4.3 billion in unspent funds for the Home Affordable Modification Program (HAMP) and other mortgage programs. The Treasury has already moved $2 billion in funding from HAMP to HHF, rather than simply deobligating the funding.

The targeted assistance intends to provide states with the flexibility to aid homeowners in the ways they need on a local basis. However, some found a lack of take-up in such housing relief programs. Barriers to entry included multiple requirements for applications from local agencies and long distances to application centers from homes. Additionally, the program has faced issues managing the spending of local offices. In 2017, a report found $3 million in wasted HHF funding, which SIGTARP noted resulted from excessive spending on the state level and lack of accountability on the federal level.

As the pandemic continues and few Americans return to full-time jobs, it’s unclear whether the existing fiscal stimulus will be enough to help many individuals through a period of reduced employment or unemployment while businesses struggle to keep afloat. Federal Reserve
Chairman Jay Powell has repeatedly called for additional fiscal spending, warning of a longer period of weaker economic growth than originally expected. Utilizing existing TARP allocations would enable the Treasury to provide more fiscal relief without waiting for an additional stimulus package.

Most recently, the Federal Housing Finance Agency also responded to homeowners’ troubles making mortgage payments, creating an opportunity for homeowners to defer forbearance payments until the end of their mortgage, or at refinancing or sale.
CARES Act Provides Mortgage Forbearance

By Vaasavi Unnava

Original post here.

The $2 trillion CARES Act, signed by the President on March 27, 2020, provides consumer credit and mortgage forbearance to keep people in their homes while the coronavirus lockdown continues.

For homeowners and renters, Title IV of the CARES Act includes mortgage forbearance and renter protection, a foreclosure moratorium, eviction protection, easing accounting standards for borrowers who miss payments, and changes to credit reporting requirements.

**Mortgage Forbearance**

Borrowers with federally backed mortgages are eligible for mortgage forbearance under Section 4022 of the CARES Act.

Individuals with single-family mortgages may write to their mortgage servicer requesting forbearance for 180 days due to COVID-19–related difficulties. In such a case, no additional fees, penalties, or interest outside of normally scheduled terms may be levied on the borrower. The servicer may extend the period for an additional 180 days at the borrower’s request. The borrower may also request the initial or extended period be shortened. The mortgage servicer may not require any additional documentation of distress outside of the original claim of the borrower.

Landlords with multifamily mortgages are provided 30 days of forbearance with the option to extend for an additional two 30-day periods (Section 4023). These borrowers also cannot charge any fees or penalties related to rent nonpayment, or late payment, for any tenants on properties funded by multifamily mortgages.

**Foreclosure Moratorium**

With the exception of vacant properties, the servicer of a mortgage may not initiate a foreclosure, move for a foreclosure or order of sale, or execute a foreclosure sale in the 60 days beginning March 18, 2020 (Section 4022).

**Eviction Protection**

For 120 days after the enactment of the CARES Act, no tenant residing in a federally subsidized housing or in a dwelling covered by a federally backed mortgage loan can be forced to change dwellings through the filing of evictions by the lessor. The lessor cannot issue an eviction notice until the expiration of the moratorium period (Section 4023).

Mortgage servicers may not evict anyone in the 60 days following March 18, 2020 (Section 4022).
Modifications to Generally Accepted Accounting Principles

Banks will not have to recognize loan modifications related to COVID-19 as troubled debt restructurings under the new law (Section 4013). These include forbearance arrangements and changes to interest rates, repayment plans, and other changes in payments. The suspension is applicable for the duration of the modification, but only to the terms directly modified for the COVID-19 outbreak. Loans that were overdue by 30 days as of December 31, 2019 are not eligible.

Credit Reporting Requirements

Between January 31, 2020 and the later of 120 days after enactment of the CARES Act or 120 days after the end of the national emergency concerning COVID-19, if a borrower is accommodated for making late payments, then the creditor must report the obligation as “current” in credit reporting (Section 4021). If the borrower was delinquent prior to this period and brings the account to current during this period, then they will be reported as “current” in credit reporting. This will not apply to consumers whose loans have already been charged-off.

The costs of the mortgage forbearance programs will generally be borne by the federal agencies and government-sponsored entities that own or guarantee the loans. However, mortgage market participants have noted that nonbank mortgage servicers now handle close to half of all mortgages. Also, as a team of Fed and other economists pointed out in a recent paper: “Nonbank mortgage companies also need to finance the costs associated with servicing defaulted loans for extended periods of time. Obtaining this financing can be difficult in times of strain.”

The industry has asked the Fed and Treasury to use other powers in the CARES Act to create a new liquidity facility to support the forbearance policies included in the CARES Act.
Governments Extend Mortgage Forbearance and Other Relief as Virus Endures

By Vaasavi Unnava

Original post here.

As coronavirus cases continue to rise around the world, governments have started to extend mortgage forbearance and other relief policies that they launched back in March and April when the crisis began.

These policies, intended as a temporary relief for people facing sudden loss of income, allow homeowners and renters to temporarily suspend payments of mortgages or rent for a fixed duration.

On June 17, the US Federal Housing Finance Agency (FHFA) extended its foreclosure moratorium for borrowers with mortgages backed by Fannie Mae and Freddie Mac, the major government-sponsored enterprises, and its eviction moratorium for borrowers whose landlords have government-backed mortgages. Set to expire on June 30, the measures will now extend through at least August 31, though there is an opportunity for more extensions. The CARES Act allows borrowers to ask their mortgage servicer to forbear on payments for six months, extendible to up to one year.

Similarly, the National Bank of Costa Rica extended its original two-month moratorium on mortgage payments, due to expire in May, through December 31. The Vietnamese government extended deferral of land taxes for 12 months, lengthening an original term of five months. Greece extended its rent reductions for an additional month beginning in May.

Italy has expanded availability of its forbearance vehicle. As part of the Italian government’s “Cura Italia” package, through the Gasparrini Fund, individuals can apply for suspended mortgage payments on “first home” mortgages—mortgages taken out for an individual’s primary residence. Recently, eligibility expanded to freelance workers and self-employed workers. If an individual has experienced at least a 33% drop in business from the last quarter of 2019 as a result of closures or restrictions on their business activities, they are eligible to suspend payments on mortgages worth up to €400,000.

Forbearance is largely a temporary measure that assumes a quick return to economic normalcy. Balances from extended ongoing forbearance can ultimately become too large to quickly pay off. As these measures extend longer than expected, losses have accrued. In the US, 8.48% of mortgages are in forbearance, up from 0.25% on March 6, prior to the emergency shelter-in-place orders.

Ongoing forbearance has proven challenging in the commercial real estate sector, where payment delinquencies in commercial real estate (CRE) mortgages have caused shortfalls in CRE cash flows. As forbearance continues as the dominant stability strategy for residential mortgage relief,
unpaid balances can loom and remain unresolved when forbearance ends if repayment strategies aren’t thoughtfully constructed.

As mentioned in a previous blog post, forbearance relief can create secondary problems once the forbearance period ends. For example, in Ireland during the Global Financial Crisis (GFC), the country’s initial response relied largely on the broad implementation of short-term mortgage forbearance. However, the response did not account for the underlying problem of excessive mortgage debt, leaving many residential mortgages underwater. Paired with increased unemployment, many homeowners exiting forbearance did not have the means to repay their accrued unpaid mortgage balances, sending many underwater mortgages into arrears. Only years after the GFC did the government encourage large-scale permanent mortgage restructuring.

One solution promoted by Fannie Mae and Freddie Mac allows consumers to move lump-sum payments to the end of their mortgage terms. Consumers can set up repayment plans or modify loans to extend the term of the mortgage by adding on missed payments at the end, reducing their monthly payments, or increasing the term of the mortgage permanently. Additionally, homeowners can pay the entire missed amount at sale, refinancing, or maturity.

Rather than continuing forbearance, some countries have attempted to tackle the fundamental economics of a mortgage, providing subsidized interest rates for homeowners facing prolonged cash flow troubles. Mongolia has resumed its Affordable Housing Finance Program temporarily, to provide subsidized mortgages to prospective homeowners. In Denmark, the government has effectively banned predatory mortgage lenders by instituting caps on interest rates in mortgage financing.

As phased reopening continues, and in some countries COVID-19 case totals decrease, economic recovery provides promise in mitigating cash flow woes and providing homeowners in forbearance with the ability to begin repayment of unpaid balances. However, with risks of another spike in cases causing shutdowns again in some countries, forbearance periods may be more prolonged than originally expected or intended and we may yet see additional creative solutions to address the potential problems after forbearance.
HFA Announces Several Changes to Residential Mortgage Market Relief Programs

By Sean Fulmer

Original post here.

In quick succession at the end of August, the Federal Housing Finance Agency (FHFA) announced three policies to assist homeowners affected by the COVID-19 pandemic and ensuing economic crisis.

First, the FHFA delayed the implementation of a proposed fee on mortgage refinancings until December 1, in response to widespread criticism of the proposal amidst a booming refinance market. Second, the FHFA extended the moratoria on foreclosures and evictions on federally-backed properties by Fannie Mae and Freddie Mac (the government-sponsored enterprises, or GSEs). Third, the FHFA allowed the GSEs to purchase loans that have benefited from forbearance for another month, until September 30.

Refinancing Fee

On August 12, Fannie Mae and Freddie Mac announced that they would levy a new 0.5% one-time fee on refinanced mortgage loans, with the FHFA’s approval, to take effect on September 1. The institutions project that the pandemic will cost them $6 billion, largely in loan losses, which the new fee would partially offset. The GSEs argued that, due to record low mortgages rates, consumers are already refinancing at a lower rate than their initial mortgages, which has driven a massive boom in the refinancing sector as well as high profit margins for the lenders. Therefore, the GSEs argued that their new fee would not be damaging to the market and that lenders could take on the fee.

However, lenders and consumer groups pushed back against this measure and the timing of its implementation. The Mortgage Bankers Association estimated that the new fee would require lenders to pay approximately $750 million to the GSEs. Additionally, since the implementation of this fee is so rapid, the fee would possibly be passed on entirely to the consumer, if their refinancing is not locked. This would add about $1,400 in costs on the average loan backed by GSEs over the length of the loan, if the entire fee is passed on to consumers. The White House criticized the measure as unfairly harming consumers, but has no direct oversight over the FHFA, which is an independent federal agency.

On August 25, the FHFA responded to the criticism of the new fee by delaying it until December 1. Additionally, the measure will now exempt refinancing loans that have a loan balance below $125,000, which are held mostly by lower-income borrowers. The Mortgage Bankers Association applauded the decision and said that the delay will allow lenders to close refinance loans that are currently in the pipeline.

Extension of Foreclosure and Eviction Moratoria
On August 27, the FHFA extended the moratoria on foreclosures and evictions until December 31. The current moratoria would have expired on August 31. The foreclosure measure applies to GSE-backed, single-family mortgages, a category that includes more than 28 million homeowners. The FHFA projects that the moratoria, as extended, will cost the GSEs $1.1 to $1.7 billion in loan losses.

The moratorium on evictions only applies to properties that the GSEs acquired through foreclosure or deed-in-lieu-of-foreclosure transactions. The GSEs have offered other forms of relief for homeowners, such as forbearance for up to a year, waiving penalties or late fees, and loan modifications.

According to a report from Black Knight, a mortgage data and technology company, mortgage delinquencies fell 9% in July from the month prior. This was driven by a decrease in early-stage delinquencies, which signals that the flow of Covid-19 related delinquencies has eased up. However, seriously delinquent mortgages rose to a 10-year high in July.

The CARES Act provided a four-month eviction moratorium, which ended on July 24 (see here, pp. 492-493). Since the lapse of that protection, Congress has passed no further policies to benefit struggling renters and homeowners. President Trump issued an executive order on August 8 promising to provide assistance to renters and homeowners. However, the executive order created no new concrete programs or protections. A recent report by housing advocates claims that 30-40 million people are currently at risk of eviction in the United States.

Extension of Loan Purchasing

On August 26, the FHFA announced that the GSEs will buy loans in forbearance until September 30, a month after the previous deadline. Initially launched on April 22, this program has provided liquidity to the mortgage market and encouraged further lending to new mortgage borrowers. See this YPFS blogpost for additional information on the program. Additionally, this announcement extended loan origination flexibilities, such as alternative appraisals and alternative methods for documenting income and verifying employment. The FHFA says it hopes that these actions will encourage more mortgage origination in a slow market.
Centers for Disease Control and Prevention Halt Evictions for the Rest of 2020

By Sean Fulmer

Original post here.

On September 1, the Centers for Disease Control and Prevention (CDC) announced a widespread, but not universal, residential eviction moratorium (the Order) until December 31 to prevent the further spread of the COVID-19 pandemic.

The CDC’s Agency Order comes after President Trump issued an Executive Order on August 8, asking the CDC to consider measures to protect homeowners and renters. The Household Pulse Survey by the Census Bureau reports that about 20% of tenants did not make a rental payment in June.

This eviction moratorium is wider than the 120-day eviction ban included in the CARES Act. The CARES Act moratorium applied only to renters of properties with federal assistance or federally related financing, about 12 million tenant households or 30% of the national total. And that ban expired on July 24, 2020.

Prior to the CDC’s Agency Order, the Aspen Institute estimated that 29-43% of tenant households, or as many as 40 million people, were at risk of eviction, partly due to the lapse in the federal eviction ban instituted by the CARES Act. Additional local and state level eviction moratoriums have expired, as have supplemental federal unemployment insurance benefits.

The CDC’s Order described the measure as a public health necessity. If tenants are evicted, the Order said, they are likely to move into crowded spaces in shared quarters, which risks exacerbating the spread of COVID-19.

Provisions of the CDC’s Agency Order

The CDC’s Agency Order is applicable to every rental property used for residential purposes, and is available to all tenants meeting certain income restrictions. The Order provides that no “landlord, owner of a residential property, or other person” shall evict any “covered person” from any residential property prior to December 31. The Order does not apply to those living in hotels, motels, or temporary housing.

The Order does not excuse individuals from their payment obligations. Therefore, tenants who take advantage of the eviction moratorium will still owe unpaid rent at the end of the moratorium period. Also, landlords are allowed to charge or collect fees, penalties, and interest related to non-payment of rent as provided in applicable contracts.

There are five declarations that a renter must make to be a “covered person” eligible for the moratorium.
• First, the individual has undertaken “best efforts” to obtain government assistance to help pay the rent.

• Second, the individual has under $99,000 of income in 2020, or $198,000 if filing a joint tax return. Also, individuals who were not required to report any income in 2019 or received an Economic Impact Payment are eligible.

• Third, the individual is unable to make a full payment of the rent due to loss of income, job, or hours, or because of “extraordinary out-of-pocket medical expenses” (i.e., any unreimbursed medical expense likely to exceed 7.5% of one’s adjusted gross income for the year).

• Fourth, the person is using “best efforts” to make partial payments toward the rent.

• Fifth, the eviction from would likely result in homelessness or force the individual to move into close quarters in a new home.

In order to benefit from the moratorium, individuals must attest to these requirements by signing a Renter’s Declaration form that will be posted on the CDC website. (A similar statement may also be used). The declaration is sworn testimony and lying can be prosecuted as perjury. It is unclear how aggressively landlords will pursue litigation against tenants for falsely claiming eligibility. Every person listed on the lease, housing contract, or rental agreement needs to fill out a separate declaration and provide it to the landlord.

The sworn declaration includes the clause: “I further understand that at the end of this temporary halt on evictions on December 31, 2020, my housing provider may require payment in full for all payments not made prior to and during the temporary halt.” Therefore, tenants must be prepared to provide a full lump-sum payment of their missed payments at the end of December.

Both landlord and tenant groups criticized the Order moratorium for not addressing the real financial needs of renters. If there is no ensuing fiscal stimulus to help those who would have been evicted without this moratorium, then this measure prolongs the eviction process without addressing the underlying causes, they say. Individuals at risk of eviction are unlikely to have the full amount of their deferred rent and fees available to them by the end of December, especially with the ongoing sluggish recovery.

Additionally, the Order does not address the economic hardships that the moratorium could inflict on small landlords who do not have the cash reserves to make up the deferred rent. Individual landlords account for nearly half of all rental units nationwide and 75% of small apartment buildings.

The Order does not forbid all evictions. Landlords are still able to evict tenants for criminal behavior, threatening the health and safety of others, damage to property, violating building codes, or violating any contractual obligations, except those related to nonpayment covered by the moratorium.
The CDC said it intended the eviction moratorium to function as the minimum level of protection offered to tenants. Therefore, state, local, territorial, or tribal governments are allowed to issue further protection to tenants beyond what is contained in the CDC’s measure; such existing laws remain in force. Those governments can not offer less protection than the CDC moratorium.

Justification and Legal Overview

This action taken by the CDC relies on an expansive reading of the Public Health Service Act. Section 361 of said Act states that:

“The Surgeon General, with the approval of the Secretary, is authorized to make and enforce such regulations as in his judgment are necessary to prevent the introduction, transmission, or spread of communicable diseases from foreign countries into the States or possessions, or from one State or possession into any other State or possession… For purposes of carrying out and enforcing such regulations, the Surgeon General may provide for such inspection, fumigation, disinfection, sanitation… as in his judgment may be necessary.”

Since, according to the Census Bureau, 15% of moves occur interstate, the CDC concluded that mass evictions would lead individuals to travel across states, providing it a basis to use its authority to issue this eviction moratorium. However, some commenters questioned whether this type of action falls within Congressional intent given the statute’s reference to very different types of actions, “inspection, fumigation, disinfection, sanitation.” However, Section 361 is also the basis of the CDC’s authority to impose quarantine and isolation requirements on individuals. Other interpretations of the section involving the FDA have focused on the regulation of stem cell research and the interstate sale of pet turtles. The eviction moratorium has been called “ambitious and unorthodox” because of its broad reach.

(Due to administrative reorganization in 1966, the Director of the CDC, subject to review by the Secretary of Health and Human Services, has the authority vested by this Section, since the Surgeon General is now an educational and advisory role.)

Beyond the Public Health Service Act, the Order relies on 42 CFR 70.2 to justify its eviction moratorium. That federal regulation states that the Director of the CDC may implement regulations if the measures of states or local governments are deemed insufficient to deal with the spread of a communicable disease. As with Section 361 of the Public Health Service Act, the main examples described in such regulations regard disinfection, sanitation and fumigations, not wide-reaching policies like a national eviction moratorium.

Experts say the Order is likely to face legal challenges due to its expansiveness. Landlord associations sued local (San Francisco) and state (Illinois) governments over their COVID-related eviction moratoriums in the earlier stages of the pandemic. Judges in San Francisco and Illinois, and in seven other similar cases, have supported eviction moratoria implemented by various governments.
Furthermore, it is unclear what “best efforts” means in the Renter’s Declaration. Landlords might choose to litigate against tenants in order to evict or obtain payments. Additionally, the process for receiving protection under the Order is incumbent on proactive action by the individual tenant. They must sign the written certification that they meet the requirements of the Order and be responsible for defending their eligibility for the eviction moratorium in court if landlords decide to sue en masse.

If landlords violate the Order, they are subject to a fine of $100,000 or one year in jail, if the eviction does not result in death. If the eviction does result in death, then the maximum fine is $250,000 or one year in jail. If the landlord is an organization rather than a person, the fine is $200,000 or $500,000 if there is a death. The Department of Health and Human Services is directed to cooperate with local and state officials to enforce the Order. The CARES Act eviction moratorium did not carry landlord penalties.

The eviction moratorium becomes effective when the Order is published in the Federal Register, which is expected to be September 4, and remains in effect through December 31, 2020.
Multinational organizations comprise the IMF, the World Bank, the European Union, the G-20, and other various regional multilateral development banks. These organizations provide programs and financing facilities to assist governments and the private sector in responding to the COVID-19 crisis. Actions of multinational organizations include loans, grants, guarantees, forbearance, and technical assistance. Many of these actions tend to target vulnerable countries and populations around the world.
Analysis

Multinational Organizations’ Efforts to Assist Countries through COVID-19 crisis

By Aidan Lawson, Manuel Leon Hoyos, and June Rhee

The International Monetary Fund (IMF), World Bank, and other multinational organizations have announced plans to make hundreds of billions of dollars available to emerging markets in response to the COVID-19 crisis. But their own experts have said these funds will probably be insufficient, and they have collectively released only a small fraction of that amount so far.

Since March, the IMF has doubled the access limit to its existing emergency loan programs, whose demands could reach up to $100 billion, and launched a new liquidity line to help countries meet balance-of-payments needs. The European Stability Mechanism has announced plans to provide €240 billion to help its members with support in financing healthcare, cure and prevention related to the COVID-19 crisis. Meanwhile, the World Bank and other multilateral development banks have announced more than $250 billion in COVID-19-related programs.

While resources are being deployed through credit lines, expanded lending arrangements, and support to developing countries, multinational organizations will require additional resources through increased contributions or additional debt issuances to adequately respond to the economic damage caused by the pandemic (see the YPFS reports here). Table 1 shows the amounts available and deployed in response to the COVID-19 crisis under each organization. It is not meant to be exhaustive and will continue to be updated.

This post discusses different efforts by multinational organizations set forth thus far in response to the COVID-19 crisis and highlights the key elements in these efforts that ensure the support adequately meets the needs of the most vulnerable member countries facing the global pandemic.

1. Purpose: what is the mission and mandate of different multinational organizations?
2. Form of action: loan, grants or forbearance? Other forms of action?
3. Size: how do you determine the size of assistance ensuring a country’s needs are covered?
4. Funding for programs: how do multinational organizations fund these assistances?
5. Speediness: how does assistance reach member countries in a timely manner?
6. Eligibility: who is eligible for support – i.e. governments or private entities?
7. Term: how long is the assistance for?
8. Limitations and other conditionalities: are there conditionalities and if there are, what conditionalities accompany the assistance?

9. Coordination and cooperation: how are different multinational organizations coordinating and assisting their efforts?

10. Post-crisis plan: do these actions consider means to rebuild the economy after the crisis has ended?

**Table 1: Multinational Organization Resources for COVID-19 and Deployment**

<table>
<thead>
<tr>
<th>Multinational Organization</th>
<th>Available Resources</th>
<th>Deployment</th>
</tr>
</thead>
<tbody>
<tr>
<td>International Monetary Fund (IMF)</td>
<td>$1 trillion (current total lending capacity of the IMF, including amounts already allocated. The IMF allows augmentation and/or rephasing of existing arrangement to respond to COVID-19 crisis)</td>
<td>$17.6 billion in emergency financing, grants and augmentation of existing arrangements</td>
</tr>
<tr>
<td>European Stability Mechanism (ESM)</td>
<td>€240 billion</td>
<td>N/A (expects to open June 1)</td>
</tr>
<tr>
<td>Multilateral Development Banks</td>
<td></td>
<td></td>
</tr>
<tr>
<td>World Bank Group</td>
<td>$160 billion will be made available in the next 15-months ($14 billion fast-track package)</td>
<td>$2,73 billion from fast-track $2.3 billion from broader resources and redeploying existing financing</td>
</tr>
<tr>
<td>European Investment Bank (EIB)</td>
<td>€25 billion guarantee €5.2 billion to EU response for outside EU (part of €20 billion Team Europe response to support partner countries)</td>
<td>€16 million (€11 million to outside EU)</td>
</tr>
<tr>
<td>European Bank for Reconstruction and Development (EBRD)</td>
<td>€21 billion</td>
<td>€162.5 million</td>
</tr>
<tr>
<td>Asian Development Bank (ADB)</td>
<td>$20 billion</td>
<td>$5.1 billion</td>
</tr>
</tbody>
</table>
Inter-American Development Bank (IDB)  $12 billion  $99 million
Asian Infrastructure Investment Bank (AIIB)  $10 billion  $355 million
African Development Bank (AfDB)  $10 billion  $50 million

Source: Authors’ analysis

1. PURPOSE

The IMF’s mandate is to ensure the stability of the international monetary system. This includes the system of exchange rates and international payments that enables countries to transact with each other, and was extended to include all macroeconomic issues relating to global financial stability in 2012. Its main activities to fulfill this mandate consists of (i) economic surveillance, (ii) lending, and (iii) capacity development. The main focus of the IMF’s COVID-19 response has been lending, with a focus on solving balance of payment problems to help rebuild international reserves, stabilize currencies, continue paying for imports, and restore conditions for strong economic growth.

The ESM’s purpose is to financially assist euro area countries if it is necessary to protect financial stability of the entire Euro area. Additionally, the European Investment Bank (EIB) is the lending arm of the EU, promoting equality for EU citizens and helping the economy in developing member states.

On the other hand, the World Bank Group and other multilateral development banks promote long-term economic development and poverty reduction. The International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA) form the World Bank. The World Bank, together with three other organizations - the International Finance Corporation, the Multilateral Investment Guarantee Agency and the International Centre for Settlement of Investment Disputes - makes up the World Bank Group. The IDA focuses on the world’s poorest countries, while the IBRD assists middle-income and creditworthy poorer countries.

2. FORM OF ACTION

Actions of multinational organizations include loans, grants, guarantees, and forbearance. As the IMF mainly focuses on solving balance of payment problems, it provides medium-term loans and grants. For example, the IMF’s Rapid Credit Facility (RCF) and Rapid Financing Instrument (RFI) disburse emergency loans to meet balance of payments needs and the Catastrophe Containment and Relief Trust (CCRT) provides grants for debt relief so a
country has enough resources to meet exceptional balance of payments needs created by disasters rather than having to assign those resources to debt service.

During the COVID-19 crisis, the IMF has also established a Short-term Liquidity Line (SLL), which provides 12-month repurchase obligations to serve as a revolving international liquidity backstop. The SLL builds on the framework of the Short-term Liquidity Swap (SLS) discussed by the IMF Board in 2017. At the time in 2017, the SLS did not secure consensus necessary for implementation.

The ESM provides a credit line designed to serve as an insurance for member countries. If a member country applies for the credit line, funds do not necessarily have to be drawn.

The European Commission’s Coronavirus Response Investment Initiative (CRII) allows member states to hold the unspent pre-financing by the European Structural and Investment Funds (ESIFs) for 2019 and this provided the member states with an immediate liquidity buffer of €8 billion. Normally, the member states would have to reimburse the unused pre-financed ESIF funds by the end of June 2020. Additional amounts are also available for member states.

Multilateral development banks, including the World Bank, generally have two major lending windows. One is to provide assistance on market-based terms, in the form of loans, equity investments, and loan guarantees. For example, the ADB provides loan guarantees to partner financial institutions to support supply chains. The other is to provide concessional assistance at below market-based terms, in the form of loans and grants.

Additionally, the IMF and the World Bank called for a standstill of debt service to official bilateral creditors for the world’s poorest countries and the G-20 responded with a plan to allow requests for forbearance to suspend repayment starting on May 1. The World Bank also called on private creditors to participate in the initiative on comparable terms and asked the IMF to review the debt challenges of middle-income countries and explore solutions to fiscal and debt stress in those countries on a case-by-case basis. For further discussion on debt challenges of emerging markets, see this YPFS blog post.

3. SIZE

The IMF has doubled the access limit to its two existing emergency facilities, the RCF and RFI, in response to the COVID-19 crisis and it projects that the demand could be as high as $100 billion. The IMF determines the size of individual assistance using quotas, which are broadly based on a country’s relative position in the world economy. In response to urgent COVID-19 related financing needs, the IMF increased the access limit for the RCF. Normally, the facility is limited to 50% of a member’s quota per year and 100% of quota on a cumulative basis, but the IMF temporarily increased the limit from 50% to 100% of quota per year and from 100% to 150% on a cumulative basis. The higher access limits are scheduled to apply until October 5 and may be extended by the Board. Regardless of the increase, this assistance is still based on quotas and not on the need of a country. This may mean countries in dire need of IMF assistance may not be able to receive the necessary amount.
On the other hand, for the IMF’s FCL, there is no cap on access; support is based on the member's actual or potential balance of payments needs. For more information on the size of existing IMF measures, see Table 2 below.

The World Bank has vowed to make $160 billion available for the next 15 months, including $14 billion of fast-track financing. Support to an individual country under the IBRD’s Catastrophe Deferred Drawdown Option is limited at $500 million or 0.25% of GDP. The ESM grants 2% of the respective member states’ GDP as of end-2019 under its pandemic credit line. If all 19 member states were to draw from the credit line, this would amount to a combined volume of around €240 billion.

The ADB’s Supply Chain Finance Program determines the amount of funds partnering financial institutions will receive based on their “risk appetite[s], presence in [Developing Member Countries], and monitoring capabilities.” The EU Solidarity Fund (EUSF) provides assistance as a percentage of total public expenditures on COVID-19-related measures, and successful applicants can request up to 25% of this funding to be advanced immediately.
### Table 2: IMF facilities currently used for COVID-19 crisis

<table>
<thead>
<tr>
<th>Program</th>
<th>Size</th>
<th>Term</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Rapid Financing Instrument (RFI)</strong></td>
<td>• 100% of quota per year</td>
<td>• 1 to 2 years</td>
</tr>
<tr>
<td></td>
<td>• 150% of quota on a cumulative basis</td>
<td></td>
</tr>
<tr>
<td><strong>Short-term Liquidity Line (SLL)</strong></td>
<td>• 145% of quota per year</td>
<td>• 12 months</td>
</tr>
<tr>
<td></td>
<td>• Revolving access</td>
<td></td>
</tr>
<tr>
<td><strong>Flexible Credit Line (FCL)</strong></td>
<td>• No outright limit</td>
<td>• 1 to 2 years</td>
</tr>
<tr>
<td></td>
<td>• Determined case-by-case</td>
<td></td>
</tr>
<tr>
<td><strong>Catastrophe Containment and Relief Trust (CCRT)</strong></td>
<td>• Approximately $500 million available for grants to pay debt service owed to the IMF</td>
<td>• Up to 6 months to 2 years</td>
</tr>
<tr>
<td><strong>Precautionary and Liquidity Line (PLL)</strong></td>
<td>• 125% of quota (can be extended up to 250%) for 6 months; or</td>
<td>• 6 months (can be extended once); or</td>
</tr>
<tr>
<td></td>
<td>• 250% of quota for the first year and a total of 500% of quota for the entire arrangement</td>
<td>• 1 to 2 years</td>
</tr>
<tr>
<td></td>
<td>• 500% of quota on cumulative basis</td>
<td></td>
</tr>
<tr>
<td><strong>Poverty Reduction and Growth Trust</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Rapid Credit Facility (RCF)</strong></td>
<td>• 100% of quota per year</td>
<td>• 10 years with 5 ½ year grace period</td>
</tr>
<tr>
<td></td>
<td>• 150% of quota on a cumulative basis</td>
<td></td>
</tr>
<tr>
<td><strong>Extended Fund Facility (EFF)</strong></td>
<td>• 145% of quota per year</td>
<td>• 4½–10 years</td>
</tr>
<tr>
<td></td>
<td>• 435% of quota on cumulative basis</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(These limits can be exceeded in exceptional circumstances)</td>
<td></td>
</tr>
</tbody>
</table>

### 4. FUNDING

Based on the projected needs of the emerging markets alone, it is clear that further fundraising efforts may be necessary, despite current efforts to maximize available funding.

The IMF is composed of 189 member countries and member quotas are their main source of funding. Additionally, the IMF can supplement its resources through the New Arrangements to Borrow (NAB). Forty higher-capacity members stand ready to lend if member countries representing 85% of committed funds agree to activate the NAB. The IMF last activated the NAB...
during the 2007-09 global financial crisis (GFC). At that time, the US and G-20 led an initiative to increase the NAB, and the IMF tripled its lending capacity to $750 billion. Under the CARES Act passed in the US to cope with the COVID-19 crisis, the Treasury may expand the NAB it can provide to the IMF through loans for up to $28.2 billion. The leaders of the US response to the GFC have argued that the US plays a leadership role in ensuring international financial institutions have enough resources to vigorously address emerging economic and financial crises.

The third line of defense for the IMF are Bilateral Borrowing Agreements (BBA), providing additional resources that will only be drawn “after resources from quotas and the New Arrangements to Borrow are substantially used.” Currently, 40 members have agreed to contribute to the BBA; activation requires the approval of creditor countries whose contributions represent 85% of the total. The Board approved on March 31 a framework for a new round of bilateral borrowing by the IMF from January 1, 2021, and this helped the IMF maintain its lending capacity of $1 trillion.

Lastly, concessional lending and debt relief for low-income countries are financed through separate contribution-based trust funds. For example, the IMF’s CCRT was able to extend its capacity after the UK, Japan, Germany, Singapore, the Netherlands and China pledged additional contributions. The IMF hopes to increase the commitment to $1.4 billion. Figure 1 provides an overview of the IMF’s lending capacity at the end of March.

Figure 1. IMF lending capacity ($ billions, end-of-March 2020)

Source: IMF & Authors’ analysis
While the IMF reports that total lending capacity sits just shy of $1 trillion, the amount readily available for lending is lower. The [IIF calculates](#) that the IMF has $270 billion readily available and can access an additional $508 billion if members agree to activate extraordinary resources. [Another calculation](#) concludes that $787 billion is the maximum lending capacity as of March 20 due to the possibility of borrowings by members whose quota is expected to be available for lending and uncertainty around continued availability of funds from borrowed sources.

The ESM’s current [lending capacity is €410 billion](#) and the pandemic credit line is expected to take up less than €240 billion. It is also planning to [issue social stability bonds](#) to finance this credit line. The ESM has paid-in capital of €80 billion from the [19 member countries](#) but this cannot be used to make loans. With this backing from member countries, the ESM raises [money](#) from the financial markets to provide liquidity assistance to its member countries.

Multilateral development banks raise funding from international capital markets to make non-concessional loans. They are backed by shareholder member governments and thus are [able to raise funding at very low market rates](#). For example, the World Bank’s IBRD, which lends mostly to middle-income developing countries, raises most of its funds from issuing bonds in the capital markets. Additionally, the ADB sold [2-year](#) and [5-year](#) global benchmark bonds in the US dollar bond market to facilitate its capacity and enhance its liquidity in responding to the COVID-19 crisis. The AfDB raised $3 billion by selling a [Fight COVID-19 Social Bond](#), which was the largest dollar denominated Social Bond ever launched in the international capital markets to date. Moreover, they can increase non-concessional lending by increasing all members’ shares through a general capital increase (GCI). Following the GFC all multilateral development banks [simultaneously increased](#) their members’ capital allocations. For 2020, the US Congress [authorized](#) the country to participate in a World Bank GCI.

On the other hand, concessional lending windows are [generally funded](#) by contributions of their member countries. For example, the World Bank’s IDA, which lends mostly to low-income countries, is financed by grants from donor nations that are replenished every 3-5 years. They also transfer some of the net income from their non-concessional loans to help fund concessional loans and grants. In 2018, however, the IDA started issuing bonds to finance its concessional programs.

### 5. ELIGIBILITY

Generally, the assistance is provided to member countries of the multinational organizations. Different facilities within the organization have different criteria of eligibility. For example, the IMF’s CCRT is exclusively for the most vulnerable low-income countries, while the SLL is available to members with very strong macroeconomic fundamentals and track records of strong policy implementation. Similarly, members eligible for concessional and non-concessional loans in multilateral development banks have different economic backgrounds.
To be eligible for [EU Solidarity Fund](#) (EUSF) assistance, EU member states must sustain economic damage that exceeds the lesser of 0.3% of gross national income or €1.5 billion. On the other hand, the ESM’s credit line is available to all EU member countries.

Some multilateral development banks have partnered with financial institutions to support certain industries. The ADB’s [Supply Chain Finance Program](#) provides financing to suppliers in developing member countries that have minimum 2-year relationships with any buyers they associate with, and have “solid production and delivery track record[s].” The suppliers obtain financing through partner financial institutions and the ADB either loans funds directly to these institutions or provides assistance in the form of a guarantee.

### 6. SPEEDINESS

Multinational organizations are responding to the COVID-19 crisis by generally relying on existing facilities and lending arrangements to deploy resources as fast as possible. The IMF is disbursing its emergency funds mostly through its [Rapid Credit Facility (RCF)](#) and [Rapid Financing Instrument (RFI)](#). Both are designed to deploy resources quickly by providing eligible members with funds where there are urgent balance of payments needs, without the need or capacity to have a full-fledged economic program.

On the other hand, the World Bank rolled out the [Covid-19 Fast-Track Facility](#) on April 2, with the first group of projects assisting 25 countries amounting to $1.9 billion. The purpose of the facility is to rapidly reach countries with no established funding line. The World Bank’s existing [Pandemic Emergency Financing Facility](#) was only activated for COVID-19 response on [April 17](#), which raised [criticism](#) for not responding fast enough. This facility was launched in 2016 as an additional source of financing to the world’s poorest countries facing infectious diseases. It had come under [scrutiny](#) when it failed to release funds for a year as the 2018 Ebola outbreak in the Democratic Republic of Congo killed more than 2,000 people. A major reason for the delay was that funds can only be released [12 weeks after the World Health Organization (WHO) publishes its first situation report, and complex criteria including outbreak size, growth rate, deadlines and death tolls have to be satisfied](#).

On the other hand, the ADB has revised its policies and business processes “to respond more rapidly and flexibly to the crisis.” For example, it [streamlined internal business processes](#) and widened the eligibility and scope of various support facilities.

### 7. CONDITIONALITIES AND LIMITATIONS ON THE USE OF FUNDING

The IMF’s facilities used for emergency disbursement of COVID-19 funding do not have conditionalities. The [Flexible Credit Line (FCL)](#) and RFI provide resources without on-going conditions and RCF support comes without ex-post program-based conditionality or reviews. However, only two disbursements are allowed under the RCF in any 12-month period and repeated use may trigger transition into the [Extended Credit Facility](#), which is a medium-term support for low-income countries with some conditionalities.
IMF conditionality in the past has raised concerns. A study in 2007 found that “a significant number of structural conditions are very detailed, and often felt to be intrusive and to undermine domestic ownership of programs.” Since then, the IMF has reformed its rules around its lending to do away with “hard” conditionality. Hard conditionality for all IMF loans was phased out by May of 2009.

The ESM’s Pandemic Support Credit Lines utilize the existing Enhanced Conditioned Credit Lines (ECCL). The ECCL typically requires members accessing the credit lines to adopt specific measures, but for the pandemic support, fewer conditions exist.

Most programs, however, prescribe and limit the usage of provided funds. For example, the ESM only allows countries to use the Pandemic Support Credit Lines to support direct and indirect healthcare, cure, and prevention costs due to the COVID-19 crisis. ESIFs generally have distinct investment objectives that limit the uses of their funding, but the CRII eased enforcement of these “thematic objectives” to facilitate a broader range of assistance.

8. TERM

Depending on the mandate of the organization and the purpose of the program, the term of the loan varies. The World Bank and other multilateral development banks have mandates that promote long-term economic development and poverty reduction. For example, the World Bank provides long-term concessional loans with maturities between 30 and 40 years and additional grace periods ranging between 5 and 10 years for low-income countries.

On the other hand, the IMF, with its mandate to ensure the stability of the international monetary system, generally extends mid-term loans for eligible members. For more information on the term of existing IMF measures, see Table 2. The IMF’s SLL, which aims to be an international liquidity backstop, provides revolving funding through a 12-month repurchase obligation and is only available for member countries with very strong macroeconomic fundamentals and strong policy implementation records that are experiencing moderate capital flow volatility.

The ESM loans under the pandemic credit line currently do not have a limit set on the term. In a recent interview, its managing director stated that there is flexibility around the maturity for these loans, more so than for IMF loans. The amended ESM treaty, the discussion of which was halted by the COVID-19 crisis, had sought to impose a maximum average maturity of five years.

The EU’s macro-financial assistance program to 10 neighboring countries operates in tandem with and to complement IMF disbursements to these countries. Therefore, this program will only make two disbursements of loans with shorter terms than those extended by the IMF.

9. COORDINATION AND COOPERATION

Multinational organizations consult and coordinate their response to a crisis. The IMF and the World Bank continue to issue joint statements. The G-20’s debt relief was a response to their
joint request and they are now urged to cooperate further in providing mechanisms to coordinate this standstill and ensure that the associated debt relief is directed towards pandemic funding.

The EU’s macro-financial assistance program operates to complement IMF disbursements, as seen above. Additionally, in formulating country-level responses, the ADB states that it continues to prioritize close collaboration with the IMF, the World Bank, and other bilateral and multilateral development partners. These partnerships include not only co-financing projects but also setting overall strategies responding to the COVID-19 crisis. Furthermore, in its private sector operations, the ADB collaborates with the International Finance Corporation, the European Bank for Reconstruction and Development, and other development finance institutions and reports that the frequency of communication has been stepped up during the COVID-19 crisis.

Further collaboration and coordination also goes beyond organizations concerning economic development and financial stability. Due to the nature of the pandemic, these institutions are closely coordinating and exchanging information with the United Nations, including the WHO, to ensure alignment in addressing the COVID-19 crisis.

10. POST-CRISIS RECOVERY PLAN

The IMF has yet to announce specifics but its managing director recently acknowledged the importance of considering how to avoid a prolonged recession emerging from the pandemic. For emerging economies, she said the IMF envisions that these measures will include regular lending instruments, including those of a precautionary nature. She acknowledged that this may require considerable resources and stands ready to deploy its full lending capacity and to mobilize all layers of the global financial safety net. For the poorest members, the IMF considers more concessional financing.

She said she was also aware that more lending may not always be the best solution for every country; adding to high debt burdens may lead members down an unsustainable path. Therefore, the IMF is contemplating innovative approaches in collaboration with other multinational organizations and the private sector.
The Limits of the G20’s Debt Service Suspension Initiative

By Alexander Nye and June Rhee

Original post here.

As of May 1, G20’s Debt Service Suspension Initiative (DSSI) for 76 International Development Association (IDA) countries and least developed countries (LDCs) has become operational. However, it remains unclear whether private-sector creditors will collaborate on such efforts for those countries and the question on what to do about the much larger debts of low- and middle-income countries is still open.

On April 15, the G20 announced the DSSI, which is an eight-month official bilateral sovereign debt payment suspension if requested by International Development Association (IDA) countries and least developed countries (LDCs) that are current on their International Monetary Fund (IMF) and World Bank (WB) obligations. The DSSI allows 76 IDA countries and Angola to suspend principal or interest payments on their debts to G20 members from May 1 through the end of 2020.

Once the eight months elapse, the countries will have to pay the deferred principal and interest over the three years following a one-year grace period. This deferral is net present value neutral, and therefore, does not reduce the total payment debtors will make to participating creditors. The Paris Club, the informal group of official creditors for negotiating sovereign debt restructuring, has endorsed the DSSI and is trying to secure China’s participation.

The G20 also urged private-sector creditors to participate in this initiative on comparable terms. The Institute of International Finance (IIF) is leading the discussion on voluntary participation in the DSSI. The IIF is a global association for the financial industry that has historically served the London Club, the once-powerful informal committee of commercial creditors that seeks to build consensus for restructuring syndicated loans to sovereigns.

Some caution that these efforts may not be enough to address the true debt-relief needs of many low and middle-income countries struggling to deal with COVID-19 crisis. Many of these countries simply do not have the fiscal capacity to weather the storm and have a mix of creditors that make them especially vulnerable.

This post highlights the following additional actions that may help to enhance meaningful assistance to the countries in need:

- Create incentives for a wider range of creditors to provide similar suspension as the G20 announced.
- Extend the G20 standstill to more middle-income countries (non-International Development Association (IDA) countries).
• Address other problems associated with a prolonged standstill.

Overindebtedness in the developing world was one of the main concerns of 2019 IMF Spring Meetings. As COVID-19 crisis unfolds, both low and middle-income emerging markets have to grapple with increasing fiscal burdens as well as investors’ flight to safety.

What does G20 standstill amount to?

The DSSI is estimated to free up about $11 billion in funds ordinarily used for paying principal and interest to bilateral official creditors, in addition to $7 billion from multilateral official creditors. However, this is only a portion of the debt payments these 77 countries will be facing through the end of 2020. The uncertain nature of the COVID-19 crisis means that it is difficult to determine whether countries’ current sovereign debts are sustainable. A wave of sovereign defaults could be catastrophic for those countries. Although the IMF has helped countries through such temporary crises, it does not have enough resources to deal with the problem alone.

Additional actions needed

Wider participation in standstill

The IIF estimates external debt service payments across the DSSI-eligible countries to be about $35.3 billion this year, as seen in Figure 1 below. It says that private-sector creditor participation would free up an additional $13 billion. The IIF currently is discussing collaboration with private-sector creditors. But it acknowledges that negotiating private-sector participation will likely be a lengthy process due to the DSSI’s abstract terms and the unique position of each debtor country.
Some propose that the G20, by creating a “Sovereign Debt Coordination Group consisting of sovereign borrowers and representatives of the official and private creditor community,” could make restructuring within the current system more workable. Some scholars suggest that comprehensive suspension of debt obligations that compels private-sector creditors to accept less than they would receive in a restructuring should be justified on the grounds of necessity. They propose a mechanism by which the private-sector participation is mandatory and immediate through a blanket restructuring of terms. This stands in contrast to the voluntary participation pursued by the IIF, in which creditors would agree on suspension after lengthy negotiations.

However, the contract-by-contract-approach the IIF supports means at least a minority of these creditors may become holdouts. A portion of those holdouts may even litigate, further complicating restructuring, as seen in the early days of the IMF’s Heavily Indebted Poor Countries initiative. Enforcing a blanket standstill, on the other hand, could cause credit rating downgrades, shutting these countries out of international capital markets and potentially creating incentives for them to default on their obligations to private creditors.

Narrow DSSI-Eligibility

Middle-income countries have significantly more external debt (Figure 2) and are expected to pay $422.9 billion in debt service in 2020. Only 22% of this is to official creditors (Figure 1).
These countries, like the DSSI-eligible countries, may also be quickly running out of fiscal capacity to deal with the COVID-19 crisis. Capital outflows from emerging markets seem to have stabilized, after foreign investors took around $100 billion out of emerging market stocks and bonds in the first quarter. The IIF projects that emerging markets may find it hard to borrow large sums internationally this year. It also expects emerging markets to run unprecedented fiscal deficits this year.

Figure 2

<table>
<thead>
<tr>
<th>Total External Debt Stock (in billions of USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low Income Countries (LIC)</td>
</tr>
<tr>
<td>Lower-Middle Income Countries (LMIC)</td>
</tr>
<tr>
<td>Upper-Middle Income Countries (UMIC)</td>
</tr>
<tr>
<td>Middle Income Countries (LMIC+UMIC)</td>
</tr>
<tr>
<td>DSSI Eligible Countries</td>
</tr>
<tr>
<td>----------------------------------------------</td>
</tr>
<tr>
<td>150</td>
</tr>
<tr>
<td>1973</td>
</tr>
<tr>
<td>3733</td>
</tr>
<tr>
<td>5706</td>
</tr>
<tr>
<td>711</td>
</tr>
</tbody>
</table>

Source: Bolton et al. 2020

Moreover, a wave of defaults by emerging market economies may pose a threat to the financial stability of advanced economies. The last time a large portion of the sovereign debt market was at risk of default was during the Latin American debt crisis of the 1980s. Large American bank exposures to these debts triggered financial stability concerns in the US.

However, coordinating a DSSI-like action across all creditors will be even more complicated for middle-income countries. As seen in Figure 1, these countries have a heavier reliance on private-sector creditors, including bonds. This is especially the case for larger emerging market economies. Bonds can have thousands of holders in a given issue and, in spite of collective action clauses (CACs) becoming more common, it can be extremely difficult to negotiate standstills on an individual basis. CACs are structured to help coordinate the actions of holders of a specific bond issue and countries may have multiple bond issues, raising another coordination problem. Investors have also been able to amass large enough positions in specific bond issues to
block restructurings. Investment funds holding emerging market bonds may again contemplate holdout strategies.

Another complicating factor in expanding eligibility to middle-income countries is that the IIF’s effort to convince private-sector creditors to restructure DSSI debt is based on assurances that eligibility will not be extended beyond the current list of countries. In facilitating the discussion among private-sector creditors to participate in the DSSI, the IIF said that “comments from IMF and Paris Club officials noting that there is no intention to make the DSSI broader in scope have also been helpful.”

Addressing other problems

The purpose of the standstill arrangements is to help debtor countries free up resources to respond to the current pandemic. Creditor states are seeking to create a mechanism to ensure the money freed up from suspension of debt payments will be used for that purpose.

One proposal is to create a central credit facility (CCF) at the World Bank. The CCF would allow a country requesting temporary relief to deposit stayed interest payments to use for emergency funding to fight the pandemic. Multilateral institutions would monitor it to ensure that payments are used for emergency funding. The CCF would mix payments to the CCF with aid money from international organizations. To reassure creditors, it would be considered senior to other debt in any debt restructuring. The CCF has some academic support and has received some positive press. Versions of the proposal have been published by the UN’s ECOSOC and a number of academic institutions, but it is still not clear whether governments will adopt the policy.

Currently, there is no mechanism like corporate or individual bankruptcy for sovereigns. There were attempts in the past to have a sovereign resolution regime, such as the IMF’s Sovereign Debt Restructuring Mechanism (SDRM) proposal in 2002. That proposal failed to obtain necessary support due to differing views on various design features. The SDRM was proposed in light of a development of a “diverse and diffuse creditor community posing coordination and collective action problems” for sovereigns. Some scholars suggest that a broader reform of the sovereign debt restructuring regime may also be necessary to deal with the problem of holdout creditors.

In the 1930s, Herbert Hoover’s 1931 debt moratorium was followed by a wave of sovereign defaults. Defaulting countries ultimately recovered from the Great Depression faster than those that resisted default. Nonetheless, defaults contributed to a “hiatus in private foreign lending of more than twenty years during which few countries had access to commercial financing outside their own borders.” Private lending to sovereigns, as well as discourse on sovereign debt restructuring, had only begun to return in the 1970s, and sovereign bonds only returned to prominence after the 1989 Brady Plan. A wider international effort in responding to sovereign debt may become necessary as the COVID-19 crisis unfolds globally.
The Americas have become the new epicenter of the COVID-19 pandemic. The crisis has exacerbated the fall in exports from Latin America. South America is one of the regions with the largest losses in working hours.

Multilateral development banks in Latin America and the Caribbean led by the Inter-American Development Bank (IDB) have made over $40 billion available to address the crisis. This adds to funding facilities available through the International Monetary Fund (IMF) and the World Bank (see YPFS blog post on overall efforts by multinational organizations).

The IDB's 2020 Macroeconomic Report, published in April, projects that the region of Latin America and the Caribbean will experience a negative contraction of between 1.8% and 5.5% of GDP in 2020. The World Bank expects a deeper contraction of 7.2%, a far deeper recession than during the 2007-09 global financial crisis. A recent presentation from the IDB pointed out that the region is in a notably weaker position than it was in 2008.

To respond to the crisis, governments are expected to run large fiscal deficits. In regards to IDB’s resources, its President Luis Alberto Moreno recently stated that “it is going to be a drop in the bucket compared to the immense needs the hemisphere has.”

Multilateral development banks usually aim to promote long-term economic development, poverty reduction, and regional integration. In response to the COVID-19 crisis, the IDB focuses on four main areas: the immediate public health emergency, safety nets for vulnerable populations, economic productivity and employment, and fiscal policies.

Table 1 lists resources the multilateral development banks have made available in response to the COVID-19 crisis and their usage as of June 9, 2020.

<table>
<thead>
<tr>
<th>Multilateral Development Bank</th>
<th>Resources</th>
<th>Use as of June 9, 2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inter-American Development Bank (IDB)</td>
<td>Committed $21 billion for new lending: $12 billion for governments and $7 billion for the private sector through IDB Invest—the private arm of the IDB—focusing on MSMEs.</td>
<td>Over $14 billion in loans, of which over $2 billion has been allocated to six governments (Argentina, Colombia, Panama, Ecuador, El Salvador, and Belize) and over $12 billion for the private sector. Mexico announced $12 billion in loans a year to SMEs provided by IDB Invest in collaboration with the Mexican Business Council.</td>
</tr>
</tbody>
</table>
Also, up to $1.35 billion from existing projects can be redirected by governments. Over $100 million from existing projects was redirected to health initiatives in five countries (Ecuador, Bolivia, Honduras, Panama and Belize).

For COVID-19, countries can request up to $90 million or 0.6% of GDP (whichever is less) through the recently expanded Contingent Credit Facility for Natural Disaster Emergencies (CCF).

<table>
<thead>
<tr>
<th>Development Bank for Latin America (CAF)</th>
<th>Emergency regional credit line of $50 million per country for health emergency investments</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$2.5 billion Emergency Credit Line to support and complement government fiscal measures</td>
</tr>
<tr>
<td></td>
<td>Non-reimbursable technical cooperation for up to $400,000 per country</td>
</tr>
</tbody>
</table>

Eight countries—Argentina, Bolivia, Colombia, Ecuador, Panama, Uruguay, Paraguay, and Trinidad and Tobago—have accessed the Emergency Credit Line to support and complement government fiscal measures.

<table>
<thead>
<tr>
<th>Central American Bank for Economic Integration (CABEI)</th>
<th>$1.96 billion Emergency Support and Preparedness Program for COVID-19:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$8 million provided for each country of the Central American Integration System: Guatemala, El Salvador, Honduras, Nicaragua, Costa Rica, Panama, Belize and the Dominican Republic.</td>
</tr>
<tr>
<td></td>
<td>$8 million in non-reimbursable funds – $1 million</td>
</tr>
<tr>
<td></td>
<td>Up to $2.1 million purchase and supply of medicines and medical equipment</td>
</tr>
<tr>
<td></td>
<td>$600 million in emergency</td>
</tr>
</tbody>
</table>

Over $835 million to three countries (Honduras, Guatemala, Costa Rica): Also, $8 million in non-reimbursable funds – $1 million.
sovereign loans to member countries

- $1 billion to support central banks’ liquidity
- $350 million Financial Sector Support Facility for MSMEs

**FONPLATA Development Bank**

In 2019, total lending capacity was over $3 billion, with $883 million available for lending.

Over $100 million disbursed (Argentina, Brazil and Uruguay).

Provided $1.1 million in non-reimbursable funds to purchase medical equipment ($300,00 to Brazil and $200,000 each to Argentina, Bolivia, Paraguay, Uruguay).

**Caribbean Development Bank (CDB)**

Utilizing $347 million available for funding approved in 2019: $297 million in loans and $50 million in grants.

$3 million for medical equipment in response to COVID-19.

Over $200 million disbursed ($140 million to borrowing member countries and $67 million to seven Caribbean countries).

These resources are generally made available through a combination of existing facilities. Table 2 below provides a summary of facilities that each institution has available to respond to the COVID-19 crisis.

**Source of Funding**

Multilateral development banks’ loans and grants to member countries are funded from member countries’ subscriptions and contributions, borrowings from capital markets, equity, and co-financing ventures.

Multilateral development banks also raise funding on international capital markets. On April 21, the IDB, which is rated AAA, launched a $4.25 billion sustainable development bond, its largest ever, with a 3-year term.

Other recent bond issues include:
- On April 13, the IDB launched the [IDB Indonesian Rupiah Sustainable Development Bond](#) at a 3-year fixed rate, valued at 55 billion Indonesian rupiah ($3.4 million).
- On May 27, the IDB launched an [Australian Dollar Sustainable Development Bond](#) with a 10-year fixed rate, valued at 350 million Australian dollars ($226 million).
- On April 24, [IDB Invest](#) launched its largest US dollar benchmark bond of $1 billion to strengthen support for the COVID-19 response.
- On May 7, [CAF](#) issued $800 million in 3-year bonds and on May 27, €700 billion in social bonds.

### Table 2: Facilities and programs used for COVID-19 response

<table>
<thead>
<tr>
<th>Multilateral Development Bank</th>
<th>Facilities</th>
</tr>
</thead>
</table>
| **Inter-American Development Bank (IDB)** | **Public sector** support: [Ordinary Capital](#) (OC), the [Fund for Special Operations](#) (FSO), the [Intermediary Financing Facility](#) (IFF), trust funds, the [IDB Grant Facility](#) (GRF), and the recently expanded [Contingent Credit Facility for Natural Disaster Emergencies (CCF)](#).  
**Private sector** support: loans, guarantees or capital market products, or in conjunction with local institutional investors. |
| **Development Bank for Latin America (CAF)** | Loans: commercial loans (pre-shipment and post-shipment) and working capital loans and limited guarantee loans. |
| **Central American Bank for Economic Integration (CABEI)** | Loans: co-financed loans, structured loans, syndicated loans and A/B Loans, loans for investment projects, and refinancing.  
Credit lines: the [Global Credit Line (GCL)](#) to commercial banks and other financial institutions, the [Line to Support the Liquidity Management of the Central Banks](#) to central banks of CABEI’s founding countries to support liquidity, and the [Credit Line for Decentralized Public Entities and Central American Integration Institutions](#) to meet working capital needs.  
CABEI also offers guarantees and letters of credit. |
| **FONPLATA** Development Bank | Loans and credit lines. |
| **Caribbean Development Bank (CDB)** | Loans and credit lines. |

- On April 29, CABEI, with an “AA” rating, executed its largest issuance for a total of $750 million in 5-year bonds. On June 5, it issued $156 million in the Swiss market at a 5-
In some instances, multilateral development banks are able to attract resources from non-regional members. For example, in 2019 CABEI welcomed Korea as its seventh non-regional member with an $450 million investment for a 7.2% stake. Since the COVID-19 crisis, some of CABEI’s regional borrowing members have received financing from the Korea Development Co-Financing for Central America. On May 27, the IDB and Sweden established a risk transfer mechanism in which Sweden will provide a $100 million guarantee to enable the IDB to lend up to $300 million to Bolivia, Colombia, and Guatemala.

**Conditionalities and Limitations**

In addition to the IDB’s COVID-19 goals, IDB Invest also prioritizes its lending based on sound credit fundamentals; environmental, social and financial sustainability; their contribution to the UN Sustainable Development Goals; and their ability to have a demonstration effect in local economies.

IDB President Moreno has said that private sector institutions that receive IDB Invest financing will not be able to distribute dividends.

**Selected Country Highlights**

Argentina, the third-largest Latin American economy, struggles with a debt crisis. This May, the country missed a $503 million payment in interest on $65 billion in sovereign debt. It remains in debt restructuring negotiations with its creditors, with technical support provided by the IMF. In response to COVID-19, the country has received around $6 billion in financing through multilateral development banks, including the World Bank, IDB, CAF and FONPLATA.

Ecuador has been hit hard with the fall of commodity prices – particularly crude oil. In April, the country was able to delay, until August, interest payments of $811 million on part of its sovereign debt. Carmen Reinhart, recently appointed World Bank chief economist, said the probability that Ecuador will default on its debt is very high. Ecuador has received financing for over $1 billion from the IMF, World Bank, IDB, and CAF. On June 4, Ecuador’s Deputy Finance Minister Esteban Ferro said the country still faces a $3.5 billion financing gap.

Venezuela, similarly, has been hit hard by the fall in crude oil prices. On March 15, the country requested $5 billion from the IMF, but was rejected. In late May, the central bank of Venezuela sued the Bank of England to release $1 billion in gold reserves after the Bank of England refused to release its gold reserves.

The largest two Latin American economies, Brazil and Mexico, have seen their currency depreciate by over 20%. Both central banks have provided extensive measures to support liquidity (see YPFS blog post on the Bank of Mexico’s actions).
Who's afraid of some (not so big or bad) debt relief?

By Alexander Nye

Original post here.

By early July 2020, top officials at the IMF and World Bank admitted that the Debt Service Suspension Initiative (DSSI), the G20’s debt relief program faced challenges. They hoped to make some progress at the mid-July G20 meetings, but the July G20 meetings came and went without major action on the program. Considering that the DSSI was supposed to be one of the international community’s marquee responses to the most severe instance of capital flight from developing economies in recent memory, it is important for billions of people that they get the program right.

What is the DSSI?

The G20 launched the DSSI in April to help emerging market governments meet the costs of their COVID-19 responses. (See here for our earlier analysis). The World Bank estimated that the program would free up to $11.5 billion in debt-service payments from the 77 DSSI-eligible governments (though the number of eligible governments has shrunk to 73) to official creditors in 2020; they would make up those payments over 2022-24.

Countries participating stand to save somewhere between 0.1% and 8.4% of their 2019 GDP. However, that $11.5 billion is not distributed evenly among participants. Pakistan and Angola would receive nearly half of the relief. The relief for Angola would amount to 3.1% of its 2019 GDP, but Pakistan’s translates to only 1.0% of its 2019 GDP.

Unfortunately, the DSSI is falling short. The program is having a difficult time getting enough debtors to participate, is facing roadblocks from some important official sector creditors, and is having trouble persuading private sector creditors to participate at all. Without support from creditors, the DSSI can at best compliment the IMF and World Bank’s COVID-19 aid (see our May 6 blog post).

Inconsistent creditor participation

Official creditors hold close to two-thirds of the sovereign debt of DSSI-eligible countries. These creditors are government actors (whether coming from the government of a state or an international organization) that extend loans to a country for some government purpose. Bilateral creditors are states that have extended loans to the governments of other states; multilateral creditors are development banks or international organizations like the IMF.

Most bilateral creditors have been willing participants in the DSSI. In some sense this is remarkable, because many of them have a significant proportion of their 2018 debt stock lent to DSSI-eligible countries coming due in 2020. Unfortunately, having a large number of willing
bilateral creditors does not necessarily translate into a participant getting a larger proportion of their potential relief under the DSSI.

It is also particularly difficult to understand how bilateral creditors that are not members of the Paris Club (an informal, yet important group of creditor countries) will implement the DSSI. Three examples of these are the People’s Republic of China (PRC), the United Arab Emirates, and Kuwait.

MULTILATERAL CREDITORS

Multilateral creditors usually like to consider themselves lenders that are de facto senior (in their language, “preferred”) to bilateral creditors and private creditors. They are only de facto senior creditors because sovereign debt is not subject to a set of laws that formally determine seniority. It is entirely held up by a set of norms. Considering this status, their reluctance to participate in the DSSI themselves would be understandable. This is because they are the creditor group most exposed to DSSI-eligible countries (See Figure 1).

The IMF granted debt service relief to 25 low-income countries from April to October, though some other multilateral development banks have been less cooperative. However, the World Bank and other multilateral development banks (MDBs) have preferred supporting countries by providing more lending and grants to providing debt relief. In late June, the World Bank president explained that such relief could “hurt the institution’s credit rating and impair its ability to lend because the World Bank depends on current borrowers to repay their loans so it can make new ones.” Still, some countries have criticized the multilateral banks for not practicing what they preach.

One might as well ask all multilateral lenders to join the G20 in providing DSSI relief, but for one significant problem. While maintaining the rest of the DSSI’s current form, expanding the DSSI to provide relief from multilateral lenders would effectively give private sector creditors a free ride and run counter to the MDBs’ preferred creditor status. It would force international institutions that are supposed to be dramatically increasing their lending right now to increase provisioning or suffer increased borrowing costs.

Figure 1.
CHINA

The PRC is the most influential bilateral creditor for DSSI-eligible countries. It accounts for approximately 20% of the total foreign debt owed by DSSI-eligible-governments (and approximately 30% of their 2020 debt service) and has eclipsed the Paris Club in lending (See Figure 2). The PRC’s dominance is especially visible in Africa, where PRC lending constitutes over 25% of the debt stock in seven African countries (all DSSI-eligible) at risk of or in debt distress.

Historically, lending from the PRC has been difficult to analyze. Data has been selective, and there have been quality problems, making it difficult to understand the impact of the PRC on the fiscal situations of many least developed countries (LDCs). The World Bank has been releasing more comprehensive data as part of the DSSI. Most of the PRC’s lending is considered “private,” so the PRC’s participation in the DSSI will not have a major impact. The PRC is only offering relief on a small portion of its lending, but will be able to benefit from an advantageous negotiation position when it comes to this “private” lending.

Figure 2.
Policymakers are also slowly getting a better understanding of PRC lending policies as a whole. Chinese lending terms and rates vary considerably by lender and project type. Johns Hopkins University’s China-Africa Research Initiative sorts them into six categories: foreign-aid loans from the Ministry of Commerce; export buyers' credits from banks; foreign-aid loans from China Eximbank, a policy bank; suppliers' credits from firms; and other commercial bank loans.

Although there is limited public information on the terms of the PRC’s participation in DSSI and on its offers of debt relief, more details have emerged over the past few months regarding lending to Africa. There is still limited data about its lending elsewhere.

Of the six categories, the PRC defines only the interest-free loans (category 1) to African countries as official lending that would be eligible for relief under the DSSI. The PRC said it would cancel interest-free loans to African countries that are scheduled to mature in 2020. But interest-free loans are only 5% of the PRC’s lending to Africa, though forgiving those loans would apparently be useful beneficiary countries trying to expand their fiscal space. Some commentators have described the measure as “too little too late.”

However, this leaves 95% of the sovereign debt held by Chinese interests formally categorized as private. These debts are largely owed to state controlled and state owned organizations like policy banks. This is reflected in the PRC’s guidance for its creditors’ participation in the DSSI. The PRC’s ambassador to Ethiopia claimed that

---

Data Source: World Bank
China encourages Chinese financial institutions to respond to the G20’s Debt Service Suspension Initiative (DSSI) and to hold friendly consultations with African countries according to market principles to work out arrangements for commercial loans with sovereign guarantees.

This continues the PRC’s tradition of negotiating debt restructuring on an informal case-by-case basis outside the view of the Paris Club. Relief from the PRC does not tend to require that participants refrain from pursuing commercial loans for the rest of the year; and (the PRC does not require participating countries to pursue relief from private sector creditors based on similar terms. With most Chinese debt categorized as private, the PRC could free-ride on other G20 countries’ restructuring efforts. For example, after a country receives debt relief from G20 countries and its official PRC debt, the PRC could impose a more onerous restructuring for its “private” creditors. According to Jan Friederich of Fitch (as well as several other scholars), the PRC should at the very least consider its commercial loans with sovereign guarantees to be official bilateral debt that is therefore eligible for the standstill. Allowing the PRC count these debt as “private” lending may grant them an advantage in any restructuring process where private creditors are refusing to provide comparable treatment.

As currently designed, the DSSI leaves some Western countries worried about PRC participation. While fiscal relief is welcome here, there is a perception that the PRC will use its case-by-case negotiations to control participating countries and ultimately infringe on their sovereignty. Some of these fears, as explained by a recent paper (and Webinar) from Johns Hopkins University’s China-Africa Research Initiative, are not justified. However, a June 17 statement by Xi Jinping on how the PRC intends to treat its preferential lending via China Eximbank, raises some concerns. In a June 17 speech, Xi Jinping declared that “any related difficulties regarding repayments could be solved by multiple financial or other approaches, such as the PRC adding grants to help bring projects back to life, conducting debt-to-equity swaps, or hiring Chinese firms to assist operation.” Some observers have expressed the concern that debt-for-equity swaps might put state-controlled PRC banks in control of companies that had previously belonged to emerging-market governments.

As for Chinese government or Chinese government controlled creditors, most of the concerns have been about potential asset seizures that look like something out of the late nineteenth century. Fortunately, it does not look like the PRC is moving toward a policy of taking advantage of countries in debt distress. A John Hopkins University research team said that “there were no ‘asset seizures’ in the 16 restructuring cases” involving the Chinese government in Africa and they had “not yet seen cases in Africa where Chinese banks or companies have sued sovereign governments.”
PRIVATE SECTOR CREDITORS

Private-sector participation has been limited, although private-sector creditors have a smaller proportion of their lending to DSSI countries coming due this year than a number of the major official creditors (See Figure 3, in which “non-official” refers to private-sector loans).

Figure 3.

The DSSI relies on private-sector creditors to participate voluntarily in the program. While the lack of a bankruptcy code for sovereign debt means that all sovereign debt workouts are technically voluntary, The president of the World Bank recently called for greater participation.

While creditor groups have started collaborating on restructuring plans for countries like Zambia, where they already expect a significant debt restructuring. But there is not much public reporting about private-creditor participation in the DSSI. This may be because many of the participating countries are too afraid of the impact on their credit rating to ask. Countries have thus far only put forward informal requests to private creditors for forbearance under the DSSI.

Private creditors, particularly bondholders, are an extremely powerful group. Although the PRC is currently the most significant lender to DSSI-eligible countries overall, bondholders are the largest creditor in ten countries (Côte d’Ivoire, Grenada, Ghana, Honduras, Mongolia, Nigeria, Rwanda, Senegal, St. Lucia, and Zambia) (see Figure 1). Bondholders and private lenders have only offered relief on an ad hoc basis and do not release much data. It is also difficult to understand whether some of these loans are actually from the private sector, especially for lending by state controlled banks in the PRC. Another set of loans difficult to understand are
those from trade creditors. These are “secured” generally by the proceeds of selling the collateral to the lender at a given price. One recent example of restructuring with trade creditors comes from Angola, which is currently negotiating with its oil importers and pays some of its debts to the PRC using oil cargo.

A corollary to this issue is that since a large portion of foreign-denominated debt is under New York or London law, many holdout investors might attempt to enforce their claims in domestic legal systems when countries are unable to restructure their debt and default. This could imperil any kind of an effective restructuring and cause problems for future restructurings. The worst case scenario would be a repeat of Argentina’s tussles with Elliott Capital and NML Capital, where the hedge fund litigated for fifteen years, seized an Argentine navy ship, and pushed Argentina into technical default.

Lack of debtor participation

Three months into the DSSI, a little under 60% of the 72 eligible countries have said that they will participate. The World Bank said that 42 of the 72 eligible countries are participating in the DSSI as of July 13, and on June 30, the Paris Club said that 32 of the eligible countries have officially requested a standstill under the DSSI. Only 18 of the 32 countries mentioned by the Paris Club had signed a MOU implementing the standstill by June 30 (Burkina Faso, Cameroon, Chad, Comoros, Dominica, Ethiopia, Grenada, Guinea, Ivory Coast, Kyrgyzstan, Mali, Mauritania, Myanmar, Nepal, Niger, Pakistan, Republic of Congo and Togo).

Several design flaws in the DSSI hinder participation among eligible countries, box out countries that need the aid, allow some official creditors to stay out of the fold, and incentivize private creditors to stay out of the program. (See our earlier analysis here).

THE RISK OF A DOWNGRADE FOR A SMALL REWARD

The small size of the program and the prospect of credit ratings downgrade made eligible countries think twice about participating. The public sector side of the DSSI is not freeing up much fiscal room globally. While creditors seem to be making a huge deal out of the DSSI, Fitch describes the program as follows

While emergency support from the [...] G20 Debt Service Suspension Initiative (DSSI) provided useful fiscal and external financing, [...] "moderate in size" at around 1.2% of GDP.

One Atlantic Council article said “some African governments are signalling that they prefer to preserve their hard-earned credit ratings by trying to stay current in their obligations.” This is because “any suspension of interest payments would probably trigger ratings downgrades for borrowing nations and limit future access to private capital,” something that isn’t attractive to states or financial institutions. The stigma may have been enough to make some large economies backtrack from participating in the DSSI. On June 23, Nigeria backtracked on its efforts to restructure its official debts, which it began back in May. Countries with outstanding
Eurobonds are also vulnerable to stigma because of the “strict terms of their Eurobond repayment plans, as well as a fear of losing market access to private creditors for a prolonged period.”

Much to the chagrin of the IMF, ratings agencies have amplified the stigma that participants would face. Various statements from ratings agencies indicated that participation in the DSSI would indicate increasing credit stress (which creditors would then price in by increasing the interest rate they lend to the country at). They were just as unhelpful when it came to private sector debts, saying that private-sector participation in the DSSI might count as a default (which would effectively lock the country out of the markets).

On the other hand, one commentator from Fitch Ratings said private sector participation that ends up counting as a default was not “sufficiently likely to affect sovereign ratings.”

AVAILABILITY OF CHEAP CREDIT

The urgency of DSSI relief has faded for some debtor countries that have been able to issue new foreign-currency debt at low rates, thanks to extraordinary liquidity injections by central banks across the world. For example, Brazil found that the combination of a swap line from the Federal Reserve, large foreign currency reserves, and very limited foreign currency debt was enough to convince investors to buy its new issue of eurobonds. El Salvador’s comparably expensive recent eurobond issuance indicates that this only really applies for foreign currency denominated debt) instead of participating in the DSSI and suffering a potential ratings downgrade.

The new borrowings have helped participating countries meet their debt payments for the time being. However, if the crisis continues for many months and fiscal costs continue to rise, they may find themselves in need of debt restructuring later in the year.

In response to the damage of a second wave, the bond market’s exuberance might go away and the cheap financing will dry up. When that happens, a number of debtor countries are going to ask for debt restructurings, and might actually have worse economic fundamentals than they had going into COVID-19. Creating even more leverage today, even if it is more convenient that negotiating a standstill or a haircut, may mean that restructuring is that much more painful for creditors. Those creditors may fight that much harder for each dollar.

Comparable treatment

The DSSI’s failure to include the norm of “comparable treatment” has also been a barrier to the program’s effectiveness. This norm holds that private creditors must endure similar (though not necessarily the same) haircuts or restructurings as the official creditors in a restructuring. Comparable treatment helps states keep private sector creditors from free-riding on their relief.

If private creditors were to refuse to abide by the comparable treatment norm, official creditors would effectively lose their informal senior status and would have less incentives to provide debt relief.
It’s unclear where the DSSI stands on comparable treatment. The DSSI’s language only states that “Private creditors will be called upon publicly to participate in the initiative on comparable terms.” But the IIF (the International Institute for Finance) interprets this language to mean that “the comparability of treatment mechanism used by the Paris Club customarily will not apply to the private sector response to the DSSI.”

**Debt sustainability**

The DSSI, like any other debt suspension, only solves liquidity problems. While we know that the DSSI was meant only to reduce pressure on sovereigns so they could spend money on their response to COVID-19, it is becoming clear that the crisis may still create unsustainable debts for many countries in the Global South. The World Bank has said that the many countries already faced unsustainable debt burdens, which are now growing to “crisis levels.”

Some larger emerging market economies that may have such issues have been moving toward structural reforms in order to please the market. This is in spite of the fact that they are going to have to continue spending generously on their response to COVID-19. If the DSSI eligibility were extended for middle income countries facing major ratings cuts or debt distress and those countries received a sufficient amount of international financial assistance, these additional countries might benefit from participating. For example, South Africa is going through some major problems right now and announced R230 billion in cuts over the next two years, while the country was still in the midst of major outbreaks. With an assistance like DSSI, South Africa could make up for lacking fiscal room caused by self-imposed structural reforms to respond to the COVID-19 crisis.

The DSSI might not actually offer a net increase in fiscal room for participants if some advanced economies are successful at changing the accounting rules for aid. This would constitute a backlash to the program from the official sector. If advanced countries start counting forbearance or forgiveness of debts as official development assistance, they might correspondingly decrease the overall amount of aid they give. A number of EU countries that loan frequently and give most of their aid as loans are considering this change. Under the revised rules, donor countries could also “claim incentives both for offering riskier loans and then for restructuring or writing them off as debt relief.” While some might say this is a benign change, others “fear that further watering down rules on debt relief could be used by donor countries to artificially inflate aid budgets” without increasing the amount of support for recipient countries. A meeting was supposed to take place on this topic in late July, but no information on it is available.

**Discussion on proposed solutions**

The G20, IMF, and World Bank are considering revisions to the DSSI. A press kit for a July 8 meeting of G20 finance ministers clarified that countries who request the DSSI from official bilateral creditors will not be obligated to “make the same request to private creditors.” This emphasized the idea that “comparable terms” is significantly more watered down than
“comparable treatment.” That same kit also notes that the G20 is considering having multilateral creditors participate in the DSSI. This signals that the World Bank and the African Development Bank might be changing their position on providing their own debt relief. Additionally, the G20 has pointed to multilateral lenders as actors that could reduce volatility in private sector financing flows by providing co-financing or credit enhancement. The latter could take the form of partial sovereign guarantees by multilateral lenders alongside an SPV that would distribute securitized DSSI sovereign debt. As for the program’s future, the G20 will use IMF analysis to determine the extent that support beyond DSSI is needed.

Another interesting idea would be to categorize certain lending of policy banks or state influenced banks as official-sector lending in exchange for imposing a uniform solution on the bondholders of some of the lower-middle income countries. This might distribute the pain of restructuring equally, as bondholders and Paris Club members together take up a similar share of DSSI-eligible country debt stock to the PRC (see Figure 4). In exchange for the PRC bringing its nominally private lending out of the shadows and into DSSI participation, these other countries would use a combination of legislation, supervisory tools, and regulations to force relevant bondholders to participate in the DSSI. While supervisory tools and regulations could provide a mix of carrots and sticks to facilitate bank participation as seen in the 1980s debt crisis, bondholders are much more difficult to corral.

**Figure 4.**

Data Source: World Bank

The IEL Collective, a legal scholarship group at University of Warwick, proposed a way to bring bondholders into the fold in the UK by amending the Debt Relief (Developing Countries) Act, 2010. The Debt Relief (Developing Countries) Act, 2010 limited the debts that can be
reclaimed via litigation if those debts are from countries benefiting from the IMF’s Heavily Indebted Poor Countries (HIPC) Initiative. The IEL Collective proposes to grant a “statutory standstill to all DSSI-eligible countries on qualifying debt owed by the country that are governed by English law.” Similar to bankruptcy legislation, this amendment would suspend the execution and enforcement of such debt contracts that are under English law. This is important because English law governs a major portion of the sovereign bonds owed by DSSI-eligible countries.

While this does sound straightforward, the IEL Collective’s proposal does have some significant flaws. Preventing execution and enforcement does not restrict creditors from declaring a default if a participating country does not pay. It also might actually improve liquidity for these countries’ sovereign debt, as the law would bring some sense of certainty to creditors, especially in situations where creditors are already expecting default. This means that countries may, at least temporarily, subject themselves to further ratings downgrades by participating. The political economy of finance in the United States and New York also mean that passing anything like the IEL Collective’s proposal in the US would require lots of political will. Unfortunately for the US, such political will is currently in short supply.

Alternatively, as proposed by Sean Hagan of Georgetown University Law Center, the IMF can change its lending policy for the remainder of the COVID-19 crisis. The IMF could state that it will only lend contingent on a debt standstill for private and official creditors. In circumstances where countries did not really need the standstill, these countries would avoid a more painful debt restructuring. In more pessimistic circumstances, on the other hand, “you would at least have the private sector there, because it would have stood still, and you would be able to use those claims as part of the restructuring process.” This would also artificially boost the IMF’s leverage over private and official creditors. With more leverage, the IMF could drive broader creditor participation in the DSSI and eventually reduce stigma for countries that wish to access the program. One bonus is that this approach emphasizes that the IMF is a creditor that has seniority over every other; there should be no circumstance where IMF liquidity funding is being used to bail out financial institutions holding those sovereign loans instead of being used to ameliorate the pandemic in the country. This would require a number of policy summersaults to work. For one, the IMF has to make it clear that the debtors have no choice but to ask for a standstill if they want IMF funding.

The United Nations Economic Commission for Africa issued its own proposed solution. They wish to have the international community offer credit enhancement along the lines of the Brady Plan that ended the Latin American debt crisis of the 1980s. The credit enhancement took the form of creditors fully collateralizing the principal of participants’ new sovereign debt issuance with 30-year zero-coupon U.S. Treasury bonds. This reduced the liquidity risk premiums for these sovereign bonds.

The pros of this plan are that we know how to implement it and there is already some support for it in central banks as well as think-tanks. Unfortunately, it’s a little early to go for a Brady plan, as we haven’t even gotten to the solvency stage of the crisis. We don’t know what
risks governments will be taking on when they provide credit enhancement. During the Brady Plan, governments had some idea of the risk they were taking on and that is a key reason why they were willing to provide credit enhancement for Brady bonds.

One approach from Eric LeCompte of the Jubilee USA Network is a new kind of financing and debt restructuring process to deal with the needs of countries responding to COVID-19. The new program would essentially build on the foundations of the IMF Highly Indebted Poor Countries (HIPC) program, which granted participating countries total debt relief from the IMF and other creditors. Based on LeCompte’s comments, HIPC would amount to something like a bankruptcy process for eligible sovereigns that would balance the interests of creditors and debtors. This dovetails with decades of calls for a formal sovereign bankruptcy process as well as calls to write off “odious debts” used to line the pockets of corrupt governments instead of being used to benefit the borrower.

Efforts in the early 2000s nearly brought a sovereign debt restructuring mechanism, an international legal structure for sovereign debt that would look much like an international bankruptcy code, into existence. Unfortunately, the US Treasury as well as a number of developing countries rejected the program.

Instead, the international community opted to start including Collective Action Clauses (CACs) in sovereign bond issues for a more decentralized approach to organizing debtors and preventing holdout creditors from torpedoing restructurings. The CAC approach has been sufficient to keep enough creditors from supporting a sovereign debt restructuring mechanism, but could be threatened by two things. First is the extremely weak fiscal state of the emerging market. In the event of a second wave of COVID-19, the economic impact could be brutal enough to trigger another flight-to-safety, right when emerging market economies need the money to respond. Financial institutions that have stocked up on emerging-market debt will find their balance sheets under such pressure that a number of them may not accept haircuts. This, on its own, is not enough to doom CACs, but recent events in Argentina point to unhappy creditors and debtors threatening to torpedo the consensus on using collective action clauses. If CACs were to fall by the wayside, a sovereign debt restructuring mechanism could again be an attractive option.
The G20’s impasse on Special Drawing Rights (SDRs)

By Alexander Nye

Original post here.

Policymakers have spent four months calling for the G20 to support a new allocation or a reallocation of special drawing rights (SDRs) at the IMF. An SDR allocation would help bolster the reserves of the world’s countries. Nevertheless, the G20’s latest July communique, much like the last one in mid-April 2020, barely mentioned the SDR. The only reference to an SDR allocation or reallocation in the communique was an admission that the G20 had indeed discussed it, but could not find a consensus on the issue. The U.S. blocked an allocation and is also blocking efforts to allow rich countries to donate their SDRs to those in need.

SDR Allocations

SDRs are an international reserve asset issued by the IMF that was created in 1969 to supplement the role of the U.S. dollar. Later, policymakers aimed to make SDRs the new “principal reserve asset in the international monetary system.” The value of the SDR is currently determined using a basket of the world’s five major currencies, the U.S. dollar, EU Euro, the Japanese yen, the UK pound sterling, and the Chinese renminbi. Their valuation can be changed by a supermajority of the IMF’s voting power (70% of the voting power to change the valuation method and 85% to change the principles underlying valuation).

The IMF issues SDRs by way of general allocations. The IMF can issue an unlimited amount of SDRs to IMF member states through general allocations so long as the issuance is in proportion to member state quotas, a figure based on a country’s size and contributions to the IMF. The IMF’s articles state that the IMF should conduct allocations only when needed to meet a long-term global need to supplement existing reserve assets in a manner that will promote the attainment of the IMF’s purposes, avoid economic stagnation, avoid deflation, avoid excess demand, and avoid excess inflation.

When the IMF “allocates” SDRs, it essentially creates money for member countries in the form of reserves. This is similar to a central bank creating reserves as a form of stimulus on a national level. As such, SDR allocations can be considered inflationary. Like loans, SDRs also carry an interest rate that recipients must pay; the interest rate is the higher of 0.050% and the combined market interest rates for the three-month government securities of the currencies in the SDR basket.

SDR allocations also stand in contrast to the other form of funding the IMF offers: lending facilities. The IMF disburses funding through lending facilities at extremely low-interest rates (currently 0%). This is considered much less inflationary than SDRs (as lending is usually considered less inflationary than helicopter money), but can frequently impose unpopular
conditions on recipient countries. Additional IMF lending also might require mobilizing resources from donor countries, which could make them more difficult to execute.

**SDR allocations during the Global Financial Crisis (GFC) and their impact**

The SDR was considered a niche feature of the IMF for the first forty years of its existence. As late as 1998, some academics asked whether the SDR was “simply a relic of the past, less “barbarous” than gold—because it is cheaper to produce—but a relic nonetheless.” There were only two allocations before the 2007-09 Global Financial Crisis (GFC). The first of these was an SDR 9.3 billion allocation in 1970-1972 and the second was an SDR 12.1 billion allocation in 1979-1981. By the time the GFC began, most people in positions of authority “had never heard of the SDR,” according to Ted Truman, a former Treasury and Federal Reserve official.

Then, in late 2008, when policymakers were trying to respond to the GFC’s impact on the international economy, the SDR crept back into the spotlight.

The G20 approved a $250 billion allocation of SDRs in April 2008. Largely due to lobbying by Truman and others, the organization wished to bolster international economic confidence. The IMF allocated the new SDRs in August and September.

A 2018 IMF Policy Brief states that the SDR allocation increased reserves by about 19% for low-income countries and over 7% for emerging economies (excluding China and fuel exporters). Although SDRs remained a small portion of the world’s international reserves, “Markets reacted favorably to the allocation, which formed part of the broader G20 crisis response.” In theory, the IMF also believed that the allocation would help countries facing short-term financing shocks adjust more smoothly and that it would also help meet what they projected to be an increasing long-run demand for reserves. The IMF also acknowledged that SDR allocations have targeting problems (as they go to all IMF members regardless of need) and may create moral hazard.

An August 2010 brief from the U.S. Department of the Treasury reflected on the 2009 allocation. It said that despite limited SDR use between 2009 and mid-2010, the 2009 SDR allocation “helped to restore market confidence and support global recovery,” in combination with other international crisis responses. The brief also noted that some countries used their SDR allocations to weather the storm of the GFC. SDRs helped to close fiscal gaps, meet external obligations, or counteract foreign exchange shortages in these countries. For some countries, the SDR allocation was especially significant; Uganda’s SDR allocation constituted 860% of its international reserves at the time.

While there had been some concerns about moral hazard and inflation during the GFC, in 2019 Ted Truman reflected that “The SDR was employed as a crisis management tool without feared ill effects.”

On the other hand, a 2016 study from the European Central Bank (ECB) that looked at the 2009 allocation, was less sanguine about SDRs. It found that countries that received SDRs worth “more than 10% of their international reserves” experienced higher inflation than other
countries. The ECB researchers attributed the results to incentives that encouraged countries to pursue more expansionary fiscal paths with the perceived safety provided by higher reserves holdings.

Still, some have reservations about the impact of SDRs. Gavyn Davies in the Financial Times said: “The size of the SDR issue had little effect on global growth in the following few years [...] because the entire allocation amounted to less than 1 per cent of the value of global trade in 2009.”

March proposals for an SDR allocation and rejection at the G20

As the world’s economy convulsed due to the COVID-19 crisis, academics started to float the idea of an SDR allocation as a response to COVID-19. What all of the proposals for SDR allocations had in common was the sentiment that the COVID-19 crisis was so significant that the current sources of global liquidity were insufficient. Swap lines and Treasury repo facilities from the U.S. Federal Reserve can provide countries with access to US dollars, but they do not create reserves and they are not available to all countries. The IMF and multilateral development banks have lending facilities, but these are under-resourced.

The first proposals were more radical; they saw an SDR allocation as an aggressive program that could work more quickly than the IMF’s lending programs. Proponents noted that the IMF’s $1 trillion in ready-to-mobilize lending was not enough and had to be supplemented. This is because only $50 billion of this figure can go to emerging market economies and only $10 billion can go to low-income countries. (For more information on the IMF’s response to COVID-19 see our blog posts here and here).

Academics and think-tankers quickly followed these first proposals with another set, which advocated for an SDR allocation and a mechanism allowing developed countries to transfer their existing SDRs to developing countries or lend excess SDRs to the IMF. The latter was accompanied by a proposed policy of having the IMF issue SDRs regularly in proportion to changes in the global demand for foreign exchange reserves and make the SDR the main financing instrument in IMF programs. Together, these would boost the IMF’s lending capacity and would make the SDR a global currency. Truman put forward and elaborated his own proposal for an SDR allocation as part of a larger G20 COVID-19 response framework. The G20 was to meet on April 15, 2020. He recommended that the G20 require the IMF to review a large, one-time SDR allocation of $500 billion to bolster countries’ reserves. One reason why he specified $500 billion is that the U.S. Treasury can vote for an SDR allocation worth up to $649 billion at the IMF without requiring approval from Congress.

Around this time, criticism of an SDR allocation started to emerge. Ousmène Jacques Mandeng of Economics Advisory argued that SDRs’ inability to be used outside the IMF and a set of designated agencies known as prescribed holders (examples of prescribed holders are the Bank for International Settlements (BIS) and the European Central Bank (ECB)) has really made their relevance limited.
Perhaps the strongest critique comes from Mark Sobel, a former IMF hand at the U.S. Department of the Treasury, who wrote that “the last SDR allocation resulted in only a paltry new net conversion of SDRs for currencies by emerging markets.” His criticism mainly revolved around the political infeasibility of redistributing SDRs, the moral hazard created by an allocation, the idea that the SDR is a long-term tool for the short-term problem of COVID-19, and the fact that SDRs impose interest charges. Sobel argued that borrowing from the IMF at a 0% interest rate made it significantly better for low-income countries than SDR allocations, as they need “less debt and more grants.” He also had an unrelated point that would eventually make it into U.S. government policy, however, was that SDR allocations give reserves to countries that have stuck their tongues out at the international community. Venezuela used its SDRs to repay official creditors in 2019.

Christopher Collins and Ted Truman of PIIE rebutted the argument that SDRs’ interest rates made them inferior to IMF lending in an April 10 article. They countered that the current SDR interest rate was 0.050 percent (it has now increased to 0.069 percent) and would constitute a low-cost way to bolster IMF members’ reserves in a time of crisis.

By this time, several countries had already asked the IMF about the possibility of a new SDR allocation and SDR supporters modified their proposals in response to criticisms. Some proposed changing the IMF quotas to solve the problem of only a fraction of the allocated SDRs going to developing and emerging economies. This would, however, face a veto from the U.S. This group also proposed that the IMF allocate SDRs counter-cyclically and establish a multilateral SDR swap facility.

As the April G20 meeting drew closer, support for an SDR allocation expanded to the Financial Times’ editorial board, which on April 12 said that the G20 should put forward an SDR 1tn ($1.37tn) allocation. They too waived away concerns about inflation and proposed setting up a special purpose trust run by the IMF, WHO, and World Bank that countries with too many SDRs can donate to. By April 14, crisis veterans Gordon Brown and Larry Summers came out in favor of an SDR allocation of over $1 trillion.

The April 15 G20 meeting ended at an impasse regarding SDRs. The U.S. said that it would not approve of an SDR allocation, backed by India and several other countries. An SDR allocation might not have looked impressive to the U.S. delegation when they saw the country that would benefit most from a $500 billion SDR allocation was Iran (followed by Turkmenistan, Zimbabwe, and Venezuela). Adam Tooze echoed this potential explanation in Foreign Policy. One paper from the Observer Research Foundation, a well-known Indian think tank, posits that the U.S. did not support an allocation because, as crises are frequently used to speed up reforms:

- crises are an opportunity to accelerate reforms. An expansion in SDRs could have been combined with a reallocation of voting rights as in 2010, thereby increasing the voice of emerging markets in the governance of the IMF. It is obvious why the U.S [...] would want to avoid this — particularly as it risks losing its veto.
Truman and Tooze also criticized the delay. Government talks of an SDR allocation slowed down significantly until July 2020.

China tries to spark a conversation in the run-up to the July G20 meeting

Policymakers and academics continued to make SDR-related proposals after the April G20 meeting. In the weeks leading up to the July 18 G20 meeting, the Managing Director of the IMF said that the IMF was working with its members to use advanced economy SDRs to help “low-income countries and tourism-dependent small island economies.”

This was followed by a July 16, 2020, op-ed from the governor of the People’s Bank of China (PBOC), which advocated for the G20 to take up an SDR allocation at their next meeting. The article again countered critics of an SDR allocation by arguing that COVID-19 represented an exogenous shock to the world economy whose responses, like the SDR, should not require conditional reforms or create concerns about moral hazard. One interesting portion of the article, later noticed by economist Anthony Elson, was the governor’s comment that “developed countries can use their SDR allocations to ease domestic fiscal pressures, leaving more resources for international aid.” It is not clear how exactly an SDR allocation would relieve China’s fiscal pressures, but this does reveal that the PBOC was not contemplating donating the SDRs it would receive in such an allocation.

This push did not lead to a change in the U.S. position and the July G20 meeting communique only contained this single sentence on SDRs:

The G20 International Financial Architecture Working Group also discussed the possibility of an Special Drawing Right (SDR) allocation or of countries that have excess SDRs granting or lending them to countries that need them.

Sobel, a critic of a COVID-19 SDR allocation, reflected that an IMF program that could redistribute already issued SDRs from rich to needy countries was not mentioned in the G20 communique.

Potential solutions to the impasse

There have not been major policy proposals aimed at breaking the impasse since July. China may go on advocating for an SDR allocation and the U.S. will continue blocking it. The main issue that academics and think-tankers seem to agree on is that SDR allocation would work best if it goes hand-and-hand with a facility for lending or donating developed countries’ excess SDRs to those in need. The more conservative version utilizing SDRs to help out those needier countries would be closer to Sobel’s proposal, in which existing SDRs are voluntarily distributed from SDR-rich to SDR-poor countries.

Since the G20 failed to reach an agreement on SDRs early enough in the crisis, we are now left with the policy question of whether it is better to distribute funding through an SDR allocation, through (concessional, low-conditionality, low-interest) lending facilities, or through both. The
next G20 meeting is scheduled for October, but one may have to wait until at least November to see a real change in the U.S. position on this issue.
On March 12, the Asian Development Bank (ADB) said it would make $200 million available to companies that make and distribute medicines and medical supplies to fight the coronavirus. The ADB will disburse this aid through its Supply Chain Finance Program, which was originally developed in 2012 to “unlock financial resources caught in the supply chain.” Suppliers were sometimes waiting for up to six months to receive payment from buyers, and the SCFP provides short-term funding so they don’t have to wait (see here, pp. 3).

The primary objective of the SCFP is to ensure that, as demand increases for medical equipment and other critical products to fight the coronavirus, suppliers will be able to expand their production without encountering any supply-chain related disruptions.

The SCFP provides financing to suppliers in developing countries that are experiencing cash-flow difficulties and unable to access financing elsewhere. Traditionally, these businesses, which are normally small and medium-sized enterprises (SMEs), faced two obstacles in obtaining financing: weak financials and lack of collateral (see here, pp. 5). The financing is obtained through partner financial institutions (PFIs), who receive predetermined amounts of money from the ADB and then lend it to suppliers.

The program requires PFIs to contribute funding equal to or greater than the amount that the ADB provides to the supplier (see here, pp. 3). After receiving the commitment to pay for the goods from buyer, the supplier asks the PFI for the money they would have received from the buyer, and the PFI finances the transaction so the supplier experiences no disruption. At the invoice date, the buyer would pay the PFI, who then remits the ADB’s part of the financing (and fees) back to them. In the event of default, the ADB shares the losses with the PFI servicing the loan, up to a maximum exposure of 50%, but never exceeding the PFI’s amount. The ADB can either loan funds directly to PFIs or provide assistance in the form of a guarantee; the term of either can be up to 180 days. Thus, the facility could provide upwards of $400 million in financing in one year. With full loss-sharing from PFIs, this amount could be as high as $800 million annually (see here).

Steven Beck, the ADB’s head of Trade and Supply Chain Finance, stated that they were working to map out “the entire supply chain for these types of goods, including the companies that are involved at each and every component phase” so that investors would be able to support...
companies at all steps of the supply chain (see here). Additionally, he stated that there would be a substantial increase in the capacity of the ADB’s Trade Finance Program in the near future.

The SCFP takes a buyer-centric approach, assisting suppliers that are often considered “unbankable” by examining the credit ratings and financial strength of their regular counterparties, which are often large, corporate buyers. Suppliers can now receive much cheaper financing since the SCFP’s risk evaluation methods emphasize the strength and longevity of supply chain relationships between businesses. (see here; here, pp. 5).

Suppliers must be from developing member countries, have minimum 2-year relationships with any buyers they associate with, and have a “solid production and delivery track record.” Buyers can be located domestically or internationally and are required to be at least BB rated (or equivalent). PFIs are required to have a global credit rating of at least A- and a supply chain finance portfolio rating of at least BB, conduct sound risk management practices, have a default rate of less than two percent on their supply chain portfolio, and report at least quarterly to the ADB about their SCFP activities. PFIs would receive varying amounts of funds from the SCFP based on their “risk appetite[s], presence in [Developing Member Countries], and monitoring capabilities.” However, the ADB stated that it would “seek to include as many PFIs as practicable” (see here, pp. 5).

The SCFP is similar in structure to the Automotive Supplier Support Program (ASSP) created by the U.S. during the Global Financial Crisis. Suppliers of automotive goods found it more difficult to obtain credit due to the precarious financial positions of and uncertainty surrounding GM and Chrysler. The ASSP used bankruptcy-remote Special Purpose Vehicles (SPVs)—funded jointly by the U.S. Treasury, GM, and Chrysler—to purchase receivables from suppliers so they would experience no supply-chain disruptions. In this case, the SPVs served essentially the same function as PFIs do for the SCFP, though the SPVs had to take any losses first, whereas PFIs jointly share any losses (up to a 50%) with the ADB. For further discussion on the ASSP, see the YPFS case.
The IMF makes funds available in response to the COVID-19 crisis

By Manuel Leon Hoyos

Original post here.

On March 27, IMF’s Managing Director Kristalina Georgieva revealed that over 80 countries had requested emergency financing from the IMF. The IMF expects the financial needs of emerging markets will be at least $2.5 trillion, and many of these countries already face significant burdens of debt.

About 50 of the requests came from low-income countries and over 30 from middle-income countries. Emerging markets have seen an $83 billion capital outflow, shortages in foreign exchange liquidity, and declines in commodity prices. The IMF aims to expand its emergency financing capacity under its existing facilities and is considering the launch of a new short-term liquidity swap line.

On March 26, Ms. Georgieva asked the G-20 to double the IMF’s emergency financing capacity. Under the recently passed CARES Act, the U.S. Treasury may expand the New Arrangements to Borrow (NAB) it can provide to the IMF through loans for up to $28.2 billion. During the 2007-2009 Global Financial Crisis, through strong efforts by the G-20, the International Monetary Fund (IMF) tripled its lending capacity to $750 billion. Since then, the IMF has expanded its mandate to play a more active role in preventing and fighting crises and preserving financial stability. Currently, the IMF forecasts a global recession in 2020 and a rebound in 2021.

During the current Covid-19 crisis, the IMF is increasing its role. Since March 26, the IMF has provided emergency financing and disbursed amounts to over ten member countries. In the IMF’s first press release for COVID-19 emergency financing, in relation to the Kyrgyz Republic, the IMF stated that it aims to provide a backstop, increase buffers, and shore up confidence. It also attempts to preserve fiscal space for essential COVID-19-related health expenditures.

The IMF is composed of 189 member countries and its current lending capacity is $1 trillion. A quota is assigned to each IMF member based on its relative position in the global economy. Member quotas are the main source for IMF’s members financing. Additionally, through the New Arrangements to Borrow (NAB), a number of members lend to the IMF and supplement IMF financing in order to cope with shocks to the global monetary system.

On March 27, the IMF announced an enhancement of the Catastrophe Containment and Relief Trust (CCRT), which was established in 2015 during the Ebola crisis. The changes expanded the qualification criteria for the facility, which is available to low-income countries and allows the IMF to deliver grants for debt relief during catastrophic natural disasters and major public health emergencies. The IMF asked the stronger members to help replenish the CCRT, which had only
$200 million at disposal. The UK, Japan, and China have already made commitments to contribute.

The IMF discussed on a conference call on April 1 its available resources to help countries combat COVID-19. Existing IMF lending facilities include the Flexible Credit Line (FCL), which is uncapped in principle and provides large-scale financing without policy conditions for members with sustained track records of strong policy implementation. The Rapid Credit Facility (RCF) provides financial assistance with limited conditionality to low-income countries facing an urgent need for balance of payments. And the Rapid Financing Instrument (RFI) is available to all members facing an urgent need for balance of payments. Under the RCF and RFI, members are allowed to borrow up to 50% of their quota. The RCF lends at very low interest rates and provides a longer repayment period. The IMF has said that to be eligible for emergency financing, members need to commit to target health policies to combat the COVID-19 pandemic and to remain on a sustainable debt path.

The IMF is considering the launch of a new facility, the Short-term Liquidity Swap (SLS), which was initially discussed in 2016. This facility would operate similarly to existing central bank swap lines. The SLS could be launched upon approval of the IMF Board and would be available for members eligible for the FCL for up to 145% of their quota. This facility would serve members with short-term capital account volatility to obtain resources on a short-term and revolving basis.
The World Bank (“The Bank”) has deployed a number of programs to support developing countries during the ongoing COVID-19 crisis. Since March, over 65 countries have received financial support in amounts ranging from USD 2 million to USD 1 billion. The programs aim to assist governments experiencing severe fiscal constraints and support healthcare infrastructure during the pandemic. Overall, the Bank committed to provide up to USD 160 billion in long term loans and grants to be deployed globally over the next 15 months. This post describes the channels, size of support, lending conditions and the way governments use funds for different World Bank programs.

Channel

There are two channels through which the Bank has provided support: through preexisting programs and through newly established programs. Preexisting programs include the Catastrophe Deferred Drawdown Option (“Cat DDO”). Cat DDO is a contingent financing line that allows approved countries to access liquidity “to address shocks related to natural disasters and/or health-related events.” The program has been used as a channel for immediate support in Romania, Morocco, Colombia, the Dominican Republic and Samoa. Other programs were used in countries where public health projects had been previously established. Examples include the Disease Prevention and Control Project in Armenia, Health Resilience Project in Lebanon and the Health System Resiliency Strengthening Project in the West Bank and Gaza. By April 2, the Bank had provided USD 1.7 billion in additional funds to preexisting projects. The use of established programs as funding channels allowed for immediate support to participating countries.

To guarantee rapid support to countries with which the Bank had no established funding line, the Bank rolled out the dedicated Covid-19 Fast-Track Facility (“FTF”) that is expected to deploy USD 14 billion. The program allows a rapid allocation of funds to countries affected by the pandemic. The first round of projects, announced on April 2, provided support to 25 countries for a total of USD 1.9 billion.

Conditions

Countries have received support on different terms through the Bank’s two lending arms: the International Bank for Reconstruction and Development (“IBRD”) and the International Development Association (“IDA”). The IBRD provides loans to middle-income or creditworthy low-income countries based on market rates under its programs, including the Cat DDO implemented in the current crisis. IDA programs focus on concessional, low to zero interest loans and direct grants to low-income governments. IDA extends long-term credit with maturities
between 30 and 40 years and additional grace periods ranging between 5 and 10 years. Both the IDA and IBRD have used the newly established FTF to guarantee rapid support to the governments that need it.

Size

The total amount of funds allocated to a specific country largely depends on the size of its economy. The programs implemented at the time of writing provide loans and grants for up to 0.5 percent of GDP. Some programs impose an upper bound on the funds that can be allocated to a specific country. For instance, funding provided through the Cat DDO is limited to the lower of USD 500 million or 0.25 percent of GDP.

The Bank’s largest program at the time of writing is the IBRD’s USD 1bn loan to the government of India through the country’s Emergency Response and Health Systems Preparedness Project, the largest health sector support to India in the Bank’s history. The largest grant has been provided to the government of Afghanistan with a USD 100.4 million commitment from the IDA, USD 19.4 million were provided immediately through the FTF.

Use

The Bank emphasizes that under current conditions the support programs are focused on one objective – saving lives. Many of the recipient countries are in the early stages of the pandemic; funds are to be used to strengthen healthcare infrastructure and provide emergency equipment. Funding will cover such measures as: provision of laboratory equipment, personal protective equipment and portable ventilators, expanding intensive care units, and building systems to prevent and limit local transmission.

In response to the COVID-19 pandemic, other international institutions are implementing and extending policies to provide support to member countries. For an overview of different types of programs, see “International Support for Governments in Response to COVID-19.”
The IMF Expands and Expedites Lending in Response to the COVID-19 crisis

By Manuel Leon Hoyos

Original post here.

Since March, the International Monetary Fund (IMF) has expanded existing lending programs and introduced new ones to help countries bear the costs of the COVID-19 crisis. As of April 21, it had approved a total of $8.7 billion in emergency financing for over 40 member countries, of the more than 100 countries that have requested assistance. (See the updated list here).

But those outlays represent a small fraction of what the IMF expects countries will need. Emerging markets will need at least $2.5 trillion in financing needs. The IMF has committed to utilize its current lending capacity of $1 trillion to support their member countries.

Prior to the crisis, the IMF had various lending facilities to help countries facing temporary shortfalls in their balance of payments. On April 15, the IMF announced a new revolving credit line, the Short-term Liquidity Line (SLL), to help eligible countries with moderate short-term balance of payments needs. It also revamped its Catastrophe Containment and Relief Trust (CCRT), which helps low-income countries bear the costs of natural disasters and public health emergencies.

About 50 of the initial emergency requests came from low-income countries; 31 from middle-income countries. Starting in early 2020, emerging markets have seen large capital outflows, shortages in foreign exchange liquidity, and declines in commodity prices. In its April 2020 World Economic Outlook, the IMF forecasts a global recession in 2020 of a 3% decline and a rebound in 2021 of 5.8% economic growth.

Existing IMF lending facilities include:

- The Flexible Credit Line (FCL), which is uncapped in principle and provides large-scale financing without policy conditions for members with sustained track records of strong policy implementation.
- The Rapid Credit Facility (RCF), which provides financial assistance with limited conditionality to low-income countries facing an urgent need for balance of payments.
- The Rapid Financing Instrument (RFI), which is available to all members facing an urgent need for balance of payments.

Under the RCF and RFI, members are allowed to borrow up to 50% of their quota. The RCF lends at very low interest rates and provides a longer repayment period. The IMF has said that to be eligible for emergency financing, members need to commit to target health policies to combat the COVID-19 pandemic and to remain on a sustainable debt path.
Funds disbursed through April 21 include:

- $2.5 billion for 14 countries under the RCF. The largest recipient is Ghana with $1 billion.
- $5.8 billion for 15 countries under the RFI. The largest recipient is Pakistan with $1.4 billion.
- $240 million for 24 countries under the CCRT. The largest recipient is Guinea with $24.1 million.

April 15 announcements

On April 15, the IMF’s Executive Board approved immediate debt service relief to 25 members under its revamped Catastrophe Containment and Relief Trust (CCRT), which was established in 2015 during the Ebola crisis. The revamp expanded the qualification criteria for the facility, which is available to low-income countries and allows the IMF to deliver grants for debt relief during catastrophic natural disasters and major public health emergencies. The IMF had asked the stronger members to help replenish the CCRT, which had only $200 million at disposal. The UK, Japan, and China have already made commitments to contribute.

Also on April 15, the IMF established the Short-term Liquidity Line (SLL). The new facility will operate on a revolving basis as a renewable backstop for eligible member countries. The design of the new SLL aims to address potential, moderate, and short-term balance of payments needs. It provides a reliable and renewable credit line, without ex post conditionality and has a qualification criteria in-line with the FCL to ensure that the facility is mainly used by members with very strong macroeconomic fundamentals and track record of strong policy implementation. The SLL can provide financing for up to 145% of each member’s quota. Managing Director Kristalina Georgieva said that “the SLL will strengthen further a country’s liquidity buffers and thus help in managing liquidity pressures. Complementing other instruments during the current crisis, the facility will fill a critical gap in the Fund’s toolkit and help to facilitate a more efficient allocation of resources.”

The SLL builds on the framework of the Short-term Liquidity Swap (SLS) discussed by the IMF Board in 2017. At the time in 2017, the SLS did not secure consensus necessary for implementation. Although most Directors considered the SLS to be broadly reasonable, a number of Directors had reservations about some key features that, in their view, “depart significantly from current Fund principles and policies, and hence warrant further reflection.” The SLL aims to further support the Global Financial Safety Net (GFSN). The GFSN comprises international reserves, central bank bilateral swap arrangements, regional financing arrangements, IMF resources, and market-based instruments. It aims to provide insurance against crises, supply financing when crises hit, and incentivize sound macroeconomic policies. The SLL has a 12-month repurchase obligation and a fee structure to support its revolving nature (e.g. 8 basis points to set up). The IMF estimates that overall SLL demand could reach up to $50 billion.
The IMF is composed of 189 member countries. A quota is assigned to each IMF member based on its relative position in the global economy. Member quotas are the main source for IMF’s members financing. Additionally, through the New Arrangements to Borrow (NAB), a number of members lend to the IMF and supplement IMF financing in order to cope with shocks to the global monetary system. Under the recently passed CARES Act, the U.S. Treasury may expand the New Arrangements to Borrow (NAB) it can provide to the IMF through loans for up to $28.2 billion. During the 2007-09 Global Financial Crisis, through strong efforts by the G-20, the IMF tripled its lending capacity to $750 billion. Since then, it has expanded its mandate to play a more active role in preventing and fighting crises and preserving financial stability.
IFC Provides $8 Billion in Fast-Track Financing to Private Sector

By Mallory Dreyer

Original post [here](#).

The [International Finance Corporation (IFC)](https://www.ifc.org) will be providing fast-track financing of $8 billion to support companies impacted by the COVID-19 pandemic. On [March 3](#), the World Bank Group approved $6 billion in fast-track financing through the IFC. It approved an additional $2 billion on [March 17](#).

The IFC is the private-sector arm of the World Bank Group. It is the largest private-sector-focused global development institution for developing countries. It provides loans, equity investments, and advisory services to over 2,000 clients around the world. The fast-track financing, which is the first phase of the IFC’s COVID-19 response, allows it to provide immediate and direct support to existing clients.

Of the $8 billion pandemic response, $2 billion is for the [Real Sector Crisis Response Facility](#), which the IFC will use to support existing clients with loans or equity investments. The support will go to companies in the infrastructure, manufacturing, agriculture, healthcare, and services industries. It will help companies increase working capital, reschedule existing debt, or cover the cost of delays in project implementation. Instruments under the facility include medium to long-term senior and subordinated loans and equity, though equity is capped at $400 million. The IFC can provide no more than 20% of the funding to a single country and no more than 10% to a single borrower.

The IFC will channel the remaining $6 billion through four different programs that leverage bank lending. Through the [Financial Institutions Response Envelope](#) (FIGE), the IFC will provide support to financial institutions in order to maintain trade flows and lending to micro, small, and medium-sized enterprises (MSMEs). It will allocate $2 billion of the FIGE for the [Global Trade Finance Program](#), which covers payment risks of financial institutions in emerging markets so they can provide trade financing to importers and exporters. It will direct another $2 billion through the [Working Capital Solutions Program](#), which provides funding to banks in emerging markets for the provisioning of working capital loans. Working Capital Solutions Program loans can be in US dollars or the local currency, and the financial institution can use the funding to provide new working capital loans or refinance existing loans. The remaining $2 billion will flow through the [Global Trade Liquidity Program](#) and the [Critical Commodities Finance Program](#). These programs offer risk-sharing support to financial institutions for continued financing of companies involved in the trade of commodities or essential trade in emerging markets.

The approval process will be made under delegated authority from the Board, except for Real Sector Crisis Response projects exceeding $100 million or those with a potential significant adverse environmental or social impact. The IFC plans to closely monitor projects and will

The $8 billion IFC phase one response is part of a $14 billion fast-track financing from the World Bank. The broader World Bank response could provide up to $160 billion over 15 months. (See here for YPFS post on broader efforts of the World Bank).

The IFC committed more than $40 billion in funding in response to the Global Financial Crisis of 2007-2009. Similar to the COVID-19 response, the IFC increased funding for the Global Trade Finance Program and the Global Trade Liquidity Program. It also established facilities for infrastructure projects, microfinance lending, and bank recapitalization. The IFC also launched the Distressed Asset Recovery Program (DARP), which focuses on the resolution of distressed assets and restructuring and refinancing of viable entities. During the Ebola outbreak in 2014, the IFC provided support to West African countries through Working Capital Solutions Program loans.
EU Programs Supporting non-EU Countries

By Priya Sankar

Original post [here](#).

On [April 22](#), the European Commission approved a €3 billion macro-financial assistance (MFA) program to ten neighboring countries outside the European Union for a period of one year to help them cover their immediate financing needs. Like the €20 billion [Team Europe](#) strategy announced earlier, this helps demonstrate the EU’s solidarity with other countries in tackling the COVID-19 pandemic.

The MFA program still requires the approval of the European Parliament and the EU Council. The first installment of the MFA aid will happen shortly after approval, whereas the second installment could happen in Q4 2020 or the first half of 2021, if recipients fulfill conditions to maintain macroeconomic stability.

If adopted, the MFA will issue 12-month loans on favourable terms. EU MFA programs typically are for 2.5 years and disbursed in multiple tranches. Allocations to individual countries correspond to estimates of their external financing needs, accounting for their capacity to finance themselves internally and externally, for example from the International Monetary Fund (IMF). The MFA program may be available to other countries on a case-by-case basis.

The MFA is intended as an exceptional crisis response instrument for countries experiencing balance-of-payments problems. Countries must meet certain requirements to be eligible. These include democratic principles in their political systems; support for human rights and rule of law; and participation in an IMF financial assistance program. The EU usually disburses MFA funds on a case-by-case basis. The EU used the program to support multiple countries in the wake of the Global Financial Crisis. An MFA program must be proposed by the EC and approved by both the EU Council and Parliament. However, in 2003 it became clear that this case-by-case and lengthy decision-making process was inefficient, and a new framework for expediting it was implemented in the Lisbon Treaty.

The MFA is a complement to IMF financing and aims to restore sustainable external financial situations, while encouraging economic adjustments and structural reforms. It takes the form of loans or grants paid directly to recipients’ central banks and can be used as they see fit. Most MFA funding is in the form of loans, though grants did become popular in the early 2000s, due in part to funding for the Balkans. Per capita income, repayment capability, and other financial factors help the EC decide whether to use loan funding, grant funding or a blend of the two.

The assistance is financed through a European Commission borrowing operation, and the budgetary impact of this assistance will be 9% of the amount disbursed in the Guarantee Fund for External Actions of the EU, to be provisioned in two years--in other words, loans disbursed in 2020 will be in the 2022 budget.
EU MFA operations are subject to an ex-post evaluation two years after the end of the availability period. So far, the EU has found MFA operations to benefit the recipient countries’ external sustainability, macroeconomic and fiscal stability, structural reforms, and balance of payments. An important and unique benefit of the EU MFA is its generous terms, which help contribute to sustainable public debt. Coordination with the IMF and the World Bank programs ensures the MFA is implemented efficiently and delivers good results. Some have criticized the MFA program for lack of transparency and a long negotiation processes.

TEAM EUROPE

Team Europe is a broader EU effort totaling €20 billion, of which the EU itself is directly contributing €15.6 billion. It seeks to support the most vulnerable countries, such as in Africa and the Balkans, and at-risk populations, particularly women and minorities. It promotes coordinated multilateral responses alongside the United Nations, international financial institutions, and the G7 and G20. The EU will ensure the flow of goods and prevent supply chain disruptions; promote and uphold democratic governance principles; and commit itself to transparency, communication, and fighting disinformation.

The majority of funds (€15.6 billion) will be allocated to several regions including neighboring countries, Africa, Asia and the Pacific, Latin America and the Caribbeans. Of the €15.6 billion, €507 million will go to immediate needs, €2.8 billion will go to research and health aid and €12.2 billion will go to mitigating the economic and social impacts of the crisis. A list of specific actions to support these goals can be found here.

The funding for Team Europe comes primarily from reorienting existing funds and programs to address the COVID-19 crisis, and includes €5.2 billion of accelerated European Investment Bank (EIB) loans. To complete the Team Europe package, these funds also mobilize private resources through budgetary guarantees, and will be supplemented with resources from member states, the EIB, and the European Bank for Reconstruction and Development.

This complements the European Commission’s existing €25 million allocation from the European Development Fund to support the World Health Organization’s response to African, Carribean, and Pacific countries as well as €30 million from ECHO (European Civil Protection and Humanitarian Aid Operations) budget reserves. Private involvement will be encouraged through the use of €500 million of the EU External Investment Plan (EIP)’s €1.55 billion guarantee. This will prioritize financing for SMEs, local currency financing, and healthcare pandemic responses.

A significant portion of EU crisis assistance will be channeled through the UN, to which the EU and its member states provide 30% of total funding. The EU has already committed to provide €1.14 million to the UN Strategic Preparedness and Response Plan led by the WHO, and committed €1.3 billion to global health initiatives.
<table>
<thead>
<tr>
<th>Country receiving MFA assistance</th>
<th>Amount (EUR)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Republic of Albania</td>
<td>€180 million</td>
</tr>
<tr>
<td>Bosnia and Herzegovina</td>
<td>€250 million</td>
</tr>
<tr>
<td>Georgia</td>
<td>€150 million</td>
</tr>
<tr>
<td>Hashemite Kingdom of Jordan</td>
<td>€200 million</td>
</tr>
<tr>
<td>Kosovo</td>
<td>€100 million</td>
</tr>
<tr>
<td>Republic of Moldova</td>
<td>€100 million</td>
</tr>
<tr>
<td>Montenegro</td>
<td>€60 million</td>
</tr>
<tr>
<td>Republic of North Macedonia</td>
<td>€160 million</td>
</tr>
<tr>
<td>Republic of Tunisia</td>
<td>€600 million</td>
</tr>
<tr>
<td>Ukraine</td>
<td>€1.2 billion</td>
</tr>
</tbody>
</table>
EU Programs in Support of Member Countries

By Aidan Lawson

Original post here.

The European Commission (EC) is still working out the details of a €37 billion plan and further extension of this initiative to support member states using existing funds to provide emergency support for distressed member states. EU leadership has also agreed in principle to a much larger recovery fund that would provide approximately €1 trillion.

The €37 billion emergency support was mobilized through the Coronavirus Response Investment Initiative (CRII). The CRII became operational on April 1 and consists of three main elements:

1. Up to €37 billion in funding for distressed member states
2. Increased flexibility for Coronavirus-related expenditures
3. Up to €800 million from the EU Solidarity Fund

Coronavirus Response Investment Initiative Plus that came into effect mid-April further extends the CRII. The operational details of these initiatives, which are designed to free up funds available from other programs to provide medium and longer-run relief to member states that are most affected by the virus, are currently being discussed by the EC.

Coronavirus Response Investment Initiative

Up to €37 billion for distressed member states

€8 billion of this funding comes from unspent pre-financing given to member states for programs approved in 2019 under agreements with European Structural and Investment Funds (ESI-Funds). ESI-Funds, which are a conduit for over half of the funding in the EU, “invest in job creation and a sustainable and healthy European economy and environment” (see here). The ESI-Funds are managed jointly by the EC and member states and are financed through the EU budget. Every funding period, which lasts six years, member states prepare general partnership agreements with each of the funds to determine how their allocations will be spent. The current funding period lasts from 2014 to 2020.

Unused pre-financing payments normally scheduled to be remitted by June 2020 can now be retained by each member state for COVID-19 relief. The EC states that reimbursement of €8 billion would not be required “provided the funds are fully spent in accordance with the relevant rules” (see here).
As this immediate liquidity of €8 billion is depleted, the member states will have an additional €29 billion financed from the EU budget available, maintaining and increasing member states’ capacity to respond to the COVID-19 crisis.

Figure 1 (below) breaks down amounts available to member states from the immediate liquidity, EU co-financing, and unallocated ESI-Fund measures. The stacked column represents both the €8 billion in repurposed pre-financing payments, as well as additional €29 billion in potential EU co-financing as discussed above. Poland and Hungary, despite having relatively low levels (a combined total of about 18,000) of cases, have the largest allocations (€13 billion) under CRII (see here). In contrast, Italy and Spain, which have had a combined case total of about 437,000, are allocated about 6.5 billion. This discrepancy has prompted criticism about the design of the program. Hungary’s allocation has been especially controversial due to increasingly autocratic behavior on the part of prime minister Viktor Orban in response to the pandemic (see here).

**Figure 1.** EU budget and ESI-Fund Amounts available, by country (€ millions)

*Increased flexibility for Coronavirus-related expenditures*

Each of the five ESI-Funds have distinct investment objectives, ranging from providing general support for small and medium-sized enterprises (SMEs) to providing more targeted funding for developing specific sectors such as agriculture and fishing. The extent of the damage caused by COVID-19 crisis prompted the EC to allow expenditures made in response to the pandemic to be eligible for ESI-Fund assistance. A total of €28 billion in unallocated funds for any investment...
programs from ESI-Funds can now be used for various forms of new COVID-19 programs. After submitting aid plans to the EC, member states are awarded an envelope of aid. They are expected to come up with investment programs to use this money by the end of the funding period (2014 – 2020).

These unallocated funds under the European Regional Development Fund (ERDF) and European Social Fund (ESF) can be used to purchase personal protective equipment, medical devices and expand health care access, among others. ERDF and ESF money can be used to provide short-term relief to SMEs experiencing cash flow issues and support national short-time work schemes, respectively (see here). Funding through the European Maritime and Fisheries Fund (EMFF) can be used to support mutual funds and stock insurance for fisherman and aquaculture farmers (see here, pp. 4, 10 - 11).

Access to the EU Solidarity Fund

Finally, the EC expanded the scope of the EU Solidarity Fund (EUSF) to include major financial aid of up to €800 million for public health emergencies created by COVID-19. Originally created in 2002 to respond to severe floods across Central Europe, the EUSF has provided a total of €5.5 billion in disaster support since then (see here).

Since its inception in 2002, the EUSF has provided assistance to 24 countries for 87 disasters (see here). Italy has used about half (€2.52 billion) of this amount. Coincidentally, Italy is the only country that has applied for EUSF aid for COVID-19. Each year the EC grants the EUSF a set amount of funding and it retains any leftover funding from the previous year in the current year. From 2002 to 2016, yearly disbursements by the EUSF were about 38% of total resources (see here, pp. 49). According to an official ex-post report, the EUSF has been successful in providing emergency financial assistance to distressed institutions after natural disasters and national emergencies, although its capacity is limited.

The EC will collect all coronavirus related applications until June 24 and then assess them all together, ensuring that the available resources are being distributed in a fair and equitable manner. The EC will then propose a total amount of aid to the Parliament and Council of the EU and, if approved, it will award the aid fully to each member state that is accepted.

Countries wishing to apply for COVID-19 aid under the fund must have sustained economic damage that exceeds a certain threshold, which is calculated either as a percentage of national income or as a general amount (see here). The application requires member states to estimate their total expenditures for emergency operations related to the COVID-19 crisis during the four months following the date when they first took official action. The EC will disperse funding as a percentage of the total amount of (projected or actual) public spending over the four months. Funding can be applied to programs that are still in development, or to re-finance expenditures already made.

Member states must disclose any funds they received from other institutions or public programs.
contribution, and all funding must be used within 18 months of disbursement (see here, pp. 29).

**Coronavirus Response Investment Initiative Plus**

A day after the implementation of CRII, the EC proposed a second set of support measures, called the **Coronavirus Response Investment Initiative Plus** (CRII+), which became operational on April 24. CRII+ expands on the initial steps taken by the original package by enhancing flexibility across ESI-Funds, simplifying administrative requirements, and providing additional assistance to some of the most vulnerable groups.

This proposal includes the ability to transfer funds between the **European Regional Development Fund (ERDF)**, European Social Fund (ESF), and Cohesion Fund (CF) as well as across categories of regions (see here, pp. 29). This allows funds to flow more freely across institutions and regions to the areas where assistance is needed most. The EC also exempts countries from having to mobilize resources under ESI-Fund agreements in accordance with the investment objectives. CRII+ also provides regulatory relief by deferring and simplifying various reporting and auditing requirements. CRII+ grants member states the ability to request 100% EU co-financing for existing COVID-19 programs.

As part of CRII+, the **EMFF** provides relief to the fishing industry by compensating out-of-work fishers and aquaculture farmers and increasing its budgetary flexibility to address new shocks. The **EAFRD** will begin offering loans or guarantees of up to €200,000 to “farmers and other rural development beneficiaries” and allow its funds to be used for healthcare centers and infrastructure in rural areas.

Finally, the CRII+ aims to help the most impacted by increasing the flexibility of the **Fund for European Aid to the Most Deprived (FEAD)**, which normally provides food, clothing, and other essential goods and services to vulnerable European populations (see here). About €3.8 billion were set aside for FEAD operations for the current funding period.

**Recovery Fund Under Consideration**

EU leaders recently agreed to the creation of an approximately €1 trillion recovery fund that would be used to offset the damage caused by the crisis. Member states are still debating the exact operational details of the program, including the exact amount, financing, and through what means aid will be disbursed (see here). On May 13, President of the EC proposed to the European Parliament that recovery fund will be financed both by EU budget resources as well as state-guaranteed borrowing arrangements in the capital markets. The money would be channeled across three pillars:

1. A new recovery and resilience tool for public investment in the hardest-hit member states.

2. A new solvency instrument that will revive private investment and “match the recapitalization needs of healthy companies who have been put at risk as a result of the lockdown”
3. A new dedicated health program, as well as strengthening existing programs

It is still unclear what the total amount for these measures will end up being, but President reiterated that the funding may be front-loaded short-term loans and grants to member states that need the most.
Update on the progress of the World Bank’s COVID-19 response efforts

By Aidan Lawson

Original post here.

In March the World Bank Group (WBG) announced $14 billion in fast-track financing to help countries respond to the COVID-19 pandemic. Since then, the WBG has provided approximately $8.3 billion in both fast-track and other financing for 339 projects across 117 countries (see here). The following lists the elements comprising the package.

- $8 billion from the International Finance Corporation (IFC)
- $2.7 billion from the International Bank for Reconstruction and Development (IBRD)
- $1.3 billion from the International Development Association (IDA)
- $2 billion reprioritized from existing World Bank projects towards COVID-19 relief

This package is specifically designed to rapidly strengthen national health systems to facilitate “disease containment, diagnosis, and treatment, and support the private sector.” The WBG also has stated its intention to make some $160 billion available over the next 15 months. This blog post summarizes the WBG’s current and proposed efforts.

Figure 1: Total New World Bank Group Commitments, by region (As of 2020/07/21, $millions)
The WBG has concentrated its aid in regions that are less developed. Nearly half of its current assistance has gone to countries in Latin America and Africa. A majority of the 86 countries that have been approved for new WBG programs are located either in Africa or Asia. Most new programs thus far have come through the IBRD, which provides loans, guarantees, and other financial assistance to middle and lower-income countries, and the IDA, which provides concessional financing to some of the poorest.

**Table 1.** Summary of World Bank Group COVID-19 Programs (as of 2020/07/21, $millions)

<table>
<thead>
<tr>
<th>Region</th>
<th>Countries Assisted</th>
<th>Number of Programs</th>
<th>Average Program Size</th>
<th>Largest Commitment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Africa</td>
<td>42</td>
<td>107</td>
<td>$12.1</td>
<td>Nigeria - $180.4</td>
</tr>
<tr>
<td>East Asia and Pacific</td>
<td>17</td>
<td>50</td>
<td>$25.5</td>
<td>Indonesia - $250</td>
</tr>
<tr>
<td>Europe and Central Asia</td>
<td>17</td>
<td>42</td>
<td>$37.9</td>
<td>Romania - $570.1</td>
</tr>
<tr>
<td>Latin America and Caribbean</td>
<td>23</td>
<td>54</td>
<td>$17.7</td>
<td>Colombia - $265</td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>10</td>
<td>31</td>
<td>$23</td>
<td>Morocco - $288</td>
</tr>
<tr>
<td>South Asia</td>
<td>8</td>
<td>52</td>
<td>$36.4</td>
<td>India - $1,035</td>
</tr>
</tbody>
</table>

Source: [World Bank Projects List](https://www.worldbank.org), [IFC investment program disclosures](https://www.ifc.org)
As seen in Table 1, average program size varies dramatically, likely due in part to the level of development in each country. Some South American and East Asian economies that received assistance, such as Colombia and Indonesia, are much larger than those in Africa, which necessitates larger packages of assistance. The single largest disbursement thus far has been for $1 billion for a program in India. See Figure 2 for more information.

In addition to its new funding, the World Bank has also relied on existing public health programs and Catastrophe Deferred Drawdown Options (CAT DDOs) for COVID-19 relief. CAT DDOs provide immediate access to pre-approved funds after a trigger event - normally the declaration of a state of emergency. To receive pre-approval, nations must have an “adequate macroeconomic policy framework” and either be preparing or have a sufficient disaster risk management program (see here). Currently, 13 countries have triggered about $1.3 billion in CAT DDO assistance. Romania has drawn about €493 million from its CAT DDO, the largest of any nation. The World Bank has also repurposed a number of existing programs for COVID-19 response. These repurposed programs are included in the data shown above.

In the WBG’s $14 billion fast-track financing program the IFC has the largest commitment. The Corporation serves as the private-sector arm of the WBG and focuses on economic development and poverty reduction by investing in developing markets. Its initial $8 billion investment has been broken up as follows:

- $2 billion via the Real Sector Crisis Response Facility to provide loans and equity investments in companies affected by COVID-19.
- $2 billion via the Global Trade Finance Program to support import-export financing to Small and Medium-sized enterprises.
Figure 2. Countries with the largest World Bank Group commitments (As of 2020/07/21, $millions)

Source: World Bank Projects List, IFC investment program disclosures

- $2 billion via the Working Capital Solutions Program to encourage financial institutions in emerging markets to provide credit to businesses.
- $2 billion via the Global Trade Liquidity Program and the Critical Commodities Finance Program to provide investment and risk-sharing support to financial institutions in emerging markets.

Thus far, the Corporation has initiated 39 investment programs worth approximately $2.6 billion. Its two largest programs, however, are not targeted investments towards individual countries and instead are focused globally. The first, under the Working Capital Solutions Program, is a first-loss guarantee of up to $216.1 million for the IDA’s Private Sector Window (IDA PSW) program. The guarantee will be used to help support working capital loans to companies in some of the poorest countries in the world. The second, under the Global Trade Finance Program, is a two-tiered, $400 million guarantee for the IDA PSW for trade finance in countries that are “fragile and conflict-affected” and would be acutely vulnerable to COVID-19-
related disruptions. The first tier of the guarantee is a pooled first loss of up to $150 million, and the second is a revolving guarantee limit enhancement of up to $250 million to ensure that trade finance can be facilitated even in periods of exceptional stress. It is unknown how the IFC plans to operationalize the remainder of the $8 billion that it pledged in March.

As the WBG continues to unveil new programs to support developing nations, YPFS will provide additional updates. For more information on the mechanics of World Bank lending, see this YPFS blog post. For more information on what international institutions generally have been doing to combat COVID-19, see our survey and accompanying resource guide.
European Stability Mechanism Establishes Pandemic Support Credit Lines

By Vaasavi Unnava

Original post here.

On April 9, the European Council approved the establishment of a new series of pandemic credit lines that will make up to €240 billion in loans available to euro area countries through the European Stability Mechanism (ESM).

In 2012, the European Council established the ESM, which provides help to euro area countries in severe economic distress. The ESM was instrumental in providing aid to euro area countries troubled during the sovereign debt crisis, and is one of the largest issuers of euro denominated debt, which funds its operations. It provides support through credit lines constructed for country-specific needs.

The ESM structures credit lines as either Enhanced Conditioned Credit Lines (ECCLs) or Precautionary Conditioned Credit Lines (PCCLs). ECCLs differ from PCCLs in that they provide access to credit for countries that do not meet the stricter requirements of PCCLs. Each pandemic credit line will be an ECCL. Typically, countries accessing an ECCL are required to adopt specific measures to prevent difficulties accessing PCCLs in the future; however, for the pandemic support ECCLs, few conditions to access exist.

Unlike previous lines of credit, the ESM will only allow countries to use the pandemic lines to support direct and indirect healthcare, cure, and prevention costs due to the COVID-19 crisis. Countries may request up to 2% of their 2019 GDP from their respective pandemic support credit lines.

All EU member countries can access the credit lines—an estimated €240 billion in loans—based on the maximum credit available to each through their respective lines; however, it is unlikely that countries utilize all €240 billion (the ESM currently has a lending capacity of €500 billion, as set by its governing treaty). The credit lines will be available until the COVID-19 crisis is over.

The lines are established under Article 14 of the ESM Treaty, which provides for the Board of Governors of the ESM to grant precautionary credit assistance if necessary to the stability of the Euro area. All precautionary credit lines through the ESM must follow an established set of guidelines. The precautionary credit lines require each member to enter into a Memorandum of Understanding (MoU) with the ESM. The ESM Board of Governors and the Board of Directors will jointly determine standardized terms of the MoUs for pandemic credit lines.

This standardized approach differs from any of the individualized lines the ESM has extended during the nearly eight years of its existence. Previously, the ESM extended lines of credit to individual countries to provide aid during the sovereign debt crisis or more generally for
country-specific difficulties. This series of lines will be the first of its kind to provide aid to all countries simultaneously.

The ESM will finalize the terms of the credit lines within the next ten days as it prepares to make the pandemic credit support lines available by April 23.

For EU countries that do not use the euro, the EU’s Balance of Payments Facility (BoP Facility) will extend pandemic lines. The EU funds the BoP Facility through EU-issued bonds in capital markets; in turn, the BoP Facility provides support to Euro area members facing trouble maintaining balance of payments through aid offered in conjunction with the World Bank and the International Monetary Fund. It has aided Latvia, Romania, and Hungary in 2010, 2008, and 2009, respectively.

It is not clear that the terms negotiated with for the Pandemic Crisis Support Lines will be extended to countries seeking aid from the BoP Facility. Presently, the European Council writes, “[The BoP Facility] should be applied in a way which duly takes into account the special circumstances of the current crisis.” However, the statement does not note an explicit requirement that the terms match terms negotiated for member states requesting support directly from the ESM’s Pandemic Crisis Support Lines.

The ESM Pandemic Support Credit Lines are part of a larger package to provide aid to countries’ fights against the coronavirus pandemic in the Euro area. The package also includes the creation of an unemployment insurance scheme and increased lending capacity of the European Investment Bank.

The ESM’s provision of credit lines joins the International Monetary Fund’s utilization of credit facilities to aid countries combating the coronavirus epidemic. See this YPFS blog post on the IMF’s policy responses to the COVID-19 pandemic for more information.
EU Member States Reach Unanimous Deal on Historic EUR 750 billion Fiscal Stimulus Package

By Lily Engbith

Original post here.

On July 21, the 27 Member States of the European Union (EU) brokered a deal for a comprehensive stimulus package to combat the economic fallout of the COVID-19 pandemic.

The announcement, which also included details on the long-term Multinational Financial Framework (MFF), laid out the terms and conditions for a collective fiscal response under the EUR 750 billion (USD 857 billion) Next Generation EU (NGEU) program. In the resulting Conclusions from the Special meeting of the European Council, leaders reaffirmed their commitment to sustainable solutions that would integrate the interests of all Member States and be “significant, focused, and limited in time” (see here).

Borrowing by EU

Perhaps the most important feature of the NGEU package is the novel provision authorizing the European Commission to borrow funds on behalf of the Union. It plans to raise EUR 750 billion on the capital markets, with new net borrowing to stop by the end of 2026. The raised funds will be used to provide EUR 360 billion in low-cost loans and EUR 390 billion in grants to combat and mitigate the effects of the pandemic, without regard for Member States’ previous economic conditions or commitments.

The repayment of debts by the Union will be scheduled in order to ensure “steady and predictable reduction in liabilities” until 2058 (see here). Outstanding amounts not used for interest payments can be used for early repayments before the end of the MFF 2021-27. The specific details of repayment have yet to be decided; it was only agreed that the Commission will establish a yield curve of debt issuance that may strain future EU budgets.

Although Member States will most likely be unwilling to increase their individual contributions, the Commission plans to levy new environmental and digital taxes to help allay the costs (see here). Principal repayments due to the Union in a specified year will not exceed 7.5% of the maximum EUR 390 billion allocated for expenditure. Finally, leaders agreed on a temporary increase in their own resource ceilings by 0.6 percentage points in order to “create sufficient budgetary space,” which will be “available (i) for the contingent liabilities from loans to Member States and (ii) for the repayment of the debt from borrowed funds for spending programmes in the future” (see here).

Funding for each Member State
Although the Commission has yet to release specific country-by-country allocations, it decided on a series of stipulations that will help guide the future disbursements that are expected to begin in 2021.

For instance, the Commission reserves, as a last resort, the right to “call more resources” from Member States as it deems necessary, without increasing the ultimate liabilities of the collective (see here). Such requests will be determined on a pro rata basis and will be limited to the Member States’ share of the temporarily increased resources ceiling (i.e., 0.6% of Member States’ gross national income (GNI)). In addition, funds distributed through the NGEU program will be considered external assigned revenues and therefore fall under the political jurisdiction of the Budgetary Authority, in consultation with the European Parliament, the Council, and the Commission. The legal commitment of top-up funds to a given program will be made by December 31, 2023, and related payments will be made by December 31, 2026. In the meantime, the programs will utilize existing funding to make disbursements starting in 2021. Table 1 below shows NGEU disbursements through various EU programs.

**Table 1: Next Generation EU Disbursement by EU Programme**

<table>
<thead>
<tr>
<th>Facility or Fund</th>
<th>Main Purpose</th>
<th>NGEU Disbursement</th>
</tr>
</thead>
</table>
| Recovery and Resilience Facility (RRF) | Provides “large-scale financial support to reforms and investments undertaken by Member States, with the aims of mitigating the economic and social impact of the coronavirus pandemic and of making the EU economies more sustainable, resilient and better prepared for the challenges posed by the green and digital transitions.” | Loans: EUR 360 billion  
Grants: EUR 312.5 billion  
Total: EUR 672.5 billion |
<p>| ReactEU | “Continues and extends the crisis response and crisis repair measures delivered through the Coronavirus Response Investment Initiative and the Coronavirus Response Investment Initiative Plus (see here). It will contribute to a green, digital and resilient recovery of the economy.” | EUR 47.5 billion |
| Horizon Europe | Supports “European partnerships with EU countries, the private sector, foundations and other stakeholders. The aim is to deliver on global challenges and industrial modernisation through concerted research and innovation efforts.” | EUR 5 billion |</p>
<table>
<thead>
<tr>
<th>Program</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>InvestEU</strong></td>
<td>Builds “on the successful model of the Investment Plan for Europe, the Juncker Plan. It will bring together, under one roof, the European Fund for Strategic Investments and 13 EU financial instruments currently available.”</td>
<td>EUR 5.6 billion</td>
</tr>
<tr>
<td><strong>Rural Development</strong></td>
<td>Reinforces “the market measures and income supports of the CAP with strategies and funding to strengthen the EU’s agri-food and forestry sectors, environmental sustainability, and the wellbeing of rural areas in general.”</td>
<td>EUR 7.5 billion</td>
</tr>
<tr>
<td><strong>Just Transition Fund (JTF)</strong></td>
<td>Supports “Small and Medium-sized Enterprises, the creation of new firms, research and innovation, environmental rehabilitation, clean energy, up- and reskilling of workers, job-search assistance and active inclusion of jobseekers programmes.”</td>
<td>EUR 10 billion</td>
</tr>
<tr>
<td><strong>RescEU</strong></td>
<td>Enhances “both the protection of citizens from disasters and the management of emerging risks.”</td>
<td>EUR 1.9 billion</td>
</tr>
</tbody>
</table>

| Total: EUR 750 billion |

As illustrated in Table 1 above, Member States will be able to access EUR 672.5 billion in funds through the Recovery and Resilience Facility (RRF). It is hoped that 70% of grants will be committed in 2021 and 2022 and 30% will be fully committed by the end of 2023. Additionally, the 2015-19 unemployment criterion for allocation will be replaced in proportion to the loss in real GDP observed over the course of 2020 and cumulative loss in real GDP observed over 2020-21, to be calculated by June 30, 2022. The maximum volume of the loans for each Member State is not to exceed 6.8% of its GNI, and pre-financing for the RRF will be paid in 2021 and should amount to 10% (see here).

Another significant outcome of the NGEU proceedings was the requirement that all Member States prepare national Recovery and Resilience plans for 2021-23. These schemes will then be assessed by the Commission within two months of submission for consistency with country-specific conditions, including plans for strengthening green and digital economies. Upon the Commission’s proposal, countries will need to obtain approval from the European Council by qualified majority (55% of Member States, which represents 65% of the EU’s population). Payment requests will thus be contingent upon successful fulfillment of these strategic goals, which will be reviewed and adapted in 2022 in order to determine final allocations for 2023.

Member States may request that the President of the European Council refer matters of other States’ “serious deviations from the satisfactory fulfillment of relevant milestones and targets” to the next European Council (see here). Dutch Prime Minister Mark Rutte, a staunch advocate of austerity, was primarily responsible for the inclusion of the oversight mechanism. However,
there is a three-month statute of limitations on such formal complaints, and the Commission retains final approval.

Reactions and concerns

Beyond the much-needed economic aid, pro-Europeanists hope that the MFF and NGEU package will act to mutually reinforce solidarity among Member States. This political signaling is particularly important, given the initially fractured and chaotic response to the pandemic. However, many questions still remain about the checks on leaders who are believed to be in violation of the EU’s rule-of-law standards. Hungary’s President Viktor Orban and Poland’s Prime Minister Mateusz Morawiecki have been criticized for their crackdowns on freedom of expression in the media and the judiciary, among other issues (see here). While the NGEU framework outlines a general process for levying official complaints against other Member States, it is unclear how effective the European Commission will be in dissuading deviations from EU values. Furthermore, the imposition of sanctions - considered to be the most consequential penalty for non-adherence - would require unanimity among the group of 27 nations. Hungary and Poland, along with the Czech Republic and Slovakia, have already promised to protect each other in such cases.

Many details have yet to be sorted before Member States see the tangible benefits of the NGEU stimulus package. Apart from the allocation of funds, each country’s government will have to individually ratify the agreement and begin to draft their Recovery and Resilience proposals for Commission and Council approval. This process is expected to last at least until the end of 2020; the facility will open in January 2021, and no new bridge funding will be provided beforehand.

Despite the contentious political debates surrounding oversight and debt mutualization, the agreement reached by Member States is an important step forward toward the creation of a European fiscal union and provides, at the very least, an architecture for collective responses to future crises.
On July 21, the European Council unveiled its latest plans for the region’s economic recovery from the ongoing COVID-19 crisis. The hotly debated package contains approximately €1.8 trillion in assistance for EU member states. Council members redesigned and reiterated the package multiple times since discussions began back in late April (see here).

Discussions about revamping the EU’s long-term budget, called the Multiannual Financial Framework (MFF), and the creation of a COVID-19 recovery plan began on April 9. On that day the Council published a report that outlined the region’s economic policy response to the COVID-19 pandemic thus far (see here).

In that report, the Council endorsed repurposing existing budgetary resources and augmenting the capacity of the European Investment Bank (EIB) to address the pandemic. It stated that it would discuss operationalizing a new recovery fund (see here). The Council also agreed on immediate relief through existing mechanisms totaling about €540 billion, to be deployed on June 1 (see here).

The MFF has two components: a multiannual financial framework regulation, which details how much the EU can spend, and an own-resources decision, which shows where the revenue comes from (see here). The European Council and Council of the EU negotiate the MFF in advance, and it typically covers a period between five to seven years. The recovery fund would be “temporary, targeted and commensurate with the extraordinary costs of the current crisis.” There would be heated debate over the structure, amount, and type of aid that this fund would give.

On April 23, the Council had its first meeting to discuss the MFF and recovery fund. Member states had opportunities to bring forth their proposals, and France, Italy, and Portugal strongly endorsed a Spanish plan to provide up to €1.5 trillion in grants to distressed nations. However, other nations - the Netherlands, Germany, and Sweden - argued against financial transfers and stated that they would prefer loans instead. President of the European Commission Ursala von der Leyen said that the eventual recovery fund would likely contain a mixture of the two (see here).

On May 13, von der Leyen provided more details about the recovery fund in a proposal to the European Parliament (see here). The proposal stated that the money in the fund would be spent across three major pillars:

1. A new recovery and resilience tool for public investment in the hardest-hit member states.
2. A new solvency instrument that will revive private investment and “match the recapitalization needs of healthy companies who have been put at risk as a result of the lockdown”

3. A new dedicated health program, and efforts to strengthen existing programs

Von der Leyen went on to say that the recovery fund would be short-term, focused on areas that were most in need, and include grants, as well as the possibility to frontload some of the investment if needed. The proposal did not include specific amounts, however.

Two weeks later, von der Leyen announced the name of the €750 billion recovery fund: Next Generation EU (see here). The European Commission would fund this separate program by issuing bonds on behalf of the EU on financial markets, something that has never been done before.

The majority of this borrowing would take place from 2020-24 (see here). The EC would distribute €500 billion of the aid as grants, and the other €250 billion as loans. Additionally, the revamped MFF would total about €1.1 trillion from 2021-27.

Under this plan, a total of €2.4 trillion in assistance would be available via Next Generation EU, the MFF, and the aforementioned aid passed in April. Member states generally reacted positively to the proposal, although some (namely the “frugal four” group of Austria, Denmark, the Netherlands, and Sweden) professed the importance of budgetary discipline and advocated for a more even balance between grants and loans (see here, pp. 2).

The Council discussed the Next Generation EU and the MFF in a meeting on June 19. While difficulties remained, Council President Charles Michel stated that there was an “emerging consensus” and that the Council would further discuss the plan in July (see here). In a special session from July 17-21, the Council agreed to a proposal that was largely similar to the one in May (see here).

The final package of aid is broken up as follows:

1. A total of €750 billion for Next Generation EU. This would be funded through borrowing in financial markets by the European Commission on behalf of the EU. Up to €390 billion can be given in the form of grants, and up to €360 billion as loans (see here, pp. 3).

2. A revamped MMF totaling €1.074 trillion. Additional flexibility has been added to help the EU tackle exceptional circumstances created by the COVID-19 crisis. Annual GNI-based contributions of the frugal four and Germany have been reduced for the years 2021-2027 (see here, pp. 8).

For more details on the final package, see this YPFS blog post.

The nearly €1.1 trillion in the MFF will not go entirely towards COVID-19 economic relief. The primary goal of the MFF is to “allow the EU to fulfill its long-term objectives and preserve the
full capacity of [Next Generation EU]” (see here). To this end, the MFF also includes funds to tackle climate change, gender equality, digitization, and other key areas. However, the Council has increased health expenditures and introduced spending flexibility to “address new priorities in light of the rapidly changing situation following the COVID-19 pandemic” (see here, pp. 12). For more information on the EU’s immediate response to COVID-19 see this YPFS blog post.

The passage of this plan represents a dramatic shift in the dynamics of EU funding and debt mutualization efforts. Large contributors such as Germany have recently and historically opposed burden sharing, even when the region was rocked by a sovereign debt crisis barely a decade ago.

However, bonds issued and guaranteed jointly by European states are in fact not a new instrument and have been used in extraordinary times since the 1970s. They were used first during the 1973 oil crisis as part of the Community Loan Mechanism, which issued its first bonds to Italy and Ireland in 1976 (see here). Much like today, the EU budget was used to guarantee repayment to private creditors, with a second set of quota-based guarantees from each European nation in case there weren’t enough budgetary resources.

The European Central Bank (ECB) and European Stability Mechanism (ESM) have already provided relief to some of the most heavily indebted nations, such as Italy and Greece. Both the ECB and ESM have helped keep funding costs low for these nations by purchasing hundreds of billions of euros in sovereign debt or providing low-cost credit lines as an alternative to issuing expensive debt. While this isn’t direct burden-sharing in the same way that issuing joint European debt is, the shareholders of the ECB - that is, euro-area members - would ultimately be liable for any losses.

It has taken several months, but a combination of Next Generation EU, the revamped MMF, and the efforts by the ECB and ESM may prove to be a potent enough mixture to provide substantial relief from the economic damage wrought by COVID-19.
Argentina’s Path to Debt Relief from Private Creditors

By Manuel Leon Hoyos

Original post here.

On August 4, after a default, months of tense negotiations, and multiple deadline extensions, offers and counteroffers, Argentina and its private creditors reached an agreement to restructure $65 billion of dollar-denominated sovereign debt. The agreement will give the country $37.7 billion in debt relief over the next 10 years.

Upon entering office in December 2019, President Alberto Fernández, who campaigned on the promise to restructure Argentina’s debt, focused on initiating debt-restructuring negotiations with private creditors with the aim to preserve debt sustainability for Argentina. President Fernández appointed as Minister of Economy Martín Guzmán, a 37-year-old economist who specializes in sovereign debt. Over the following months, President Fernández garnered support for debt restructuring from the international community and the International Monetary Fund (IMF).

Argentina, Latin America’s third largest economy, has been in recession since 2018. In February 2020, prior to the start of the COVID-19 crisis, IMF staff concluded that Argentina’s sovereign debt was unsustainable. It noted that since July 2019, the Argentinian peso depreciated by over 40%, sovereign spreads increased by 1100 basis points, international reserves declined by $20 billion, and real GDP contracted more than anticipated. As a result, gross public debt rose to nearly 90% of GDP at the end of 2019 (Feb 19).

The IMF later estimated Argentina’s total sovereign debt at $323 billion at the end of 2019, of which it owed $207 billion to official and private-sector creditors. The country entered default on $65 billion of loans on May 22 after a 30-day grace period expired on $503 million in interest payments.

Looking to garner support from the international community, in January Pope Francis promised President Fernández to help Argentina in its debt crisis (Jan 31). The Vatican held a conference with the participation of the IMF’s Managing Director Kristalina Georgieva, multiple finance ministers, and Nobel Laureates in economics.

On March 20, IMF staff released a technical note on a feasible macroeconomic framework and on the country’s debt-carrying capacity over the medium-to-long run. It provided a view of debt restructuring that it argued would likely be sustainable (March 20 Note, Summary).

Argentina and its private creditors spent months in negotiations that included multiple deadline extensions, offers, and counteroffers. Throughout the negotiations, IMF staff provided the country with technical assistance and recommendations on the sustainability of various offers (Argentina).
On April 7, Argentina formally requested the rescheduling of its debt with the Paris Club (Argentina). Between April 9 and 21, Argentina entered a first round of confidential negotiations with creditors and developed restructuring guidelines (Apr 9). Argentina made a debt-restructuring offer, establishing a dialogue with creditors to ensure Argentina’s long-term sustainability. The offer included a 3-year grace period, a 5.5% reduction on the bonds’ principal, and a 62% reduction of interest payments. It left creditors with an average bond coupon of 2.3%, instead of 7% (Guzmán).

On May 3, Minister Guzmán published a piece in the Financial Times titled “Argentina cannot afford to pay creditors more” (FT). On May 4, three groups of creditors rejected the government’s proposal to restructure the debt. Argentina garnered support from economists such as World Bank chief economist Carmen Reinhart, and Nobel Laureates Joseph Stiglitz and Edmund Phelps, who on May 6 published a letter co-signed by over 100 economists in support of Argentina’s debt restructuring proposal. More than 150 Argentine economists also supported the proposal. However, on May 15, creditors filed three counter offers, which did not take into account the IMF analysis of Argentina’s debt sustainability (Argentina).

On May 22, as negotiations did not reach an agreement, Argentina entered into default after the 30-day grace period expired for interest payments on $65 billion in dollar-denominated bonds with maturities of 2021, 2026, and 2046 (Bloomberg).

Argentina submitted a revised debt-restructuring proposal on May 28, after a second round of negotiations (May 28, Argentina). The offer contained a two-year moratorium, instead of three. Bonds rallied after the announcement (Bloomberg). Minister Guzmán said that regardless of the outcome of the negotiations with private creditors, Argentina expected to sign a new IMF program in 2020 (BA). Days later, the IMF staff released a technical statement concluding that Argentina’s revised proposal was consistent with long-term debt sustainability. It said there was “limited scope” for improvements (Jun 1).

Private creditors rejected the offer, however, leading to a third round of negotiations. Argentina submitted a third offer on June 17, seeking to meet investors’ requests. Argentina also proposed a Value Recovery Instrument (IRV) based on exports (Argentina). Argentina’s revised fourth and “final” offer on July 6 included an average recovery of 53 cents on the dollar and interest payments starting in 2021, a year earlier than the last offer (July 5, Fernández, Bloomberg, FT).

Finally, after months of tense negotiations, on August 4 Argentina and private creditors announced they had reached an agreement (Aug 4). The debt-restructuring agreement lowered interest payments from 7% to 3% and gave investors about 55 cents on the dollar. It will give the country $37.7 billion in debt relief over the next 10 years (Argentina, BA, Hitos).

Argentina has pursued other creditors separately. The country’s public debt includes a $44 billion loan from the IMF. In 2018, the IMF had granted Argentina, under former President Mauricio Macri, a record $57.1 billion loan over three years—the largest IMF loan to a single country (IMF, CRS). By the end of Macri’s term in late 2019, the IMF had disbursed $44
billion. President Fernández, who defeated Macri in the 2019 elections, declined the remaining tranche of the IMF loan.

On August 27, Argentina notified the IMF of a request for a new IMF-supported program (Argentina, IMF). President Fernández expects a debt-restructuring agreement on the $44 billion debt “as soon as possible” in order to “clear up any doubts” (Oct 5). IMF Managing Director Kristalina Georgieva said the IMF had “no intention of putting pressure on Argentina” as the IMF team arrived in the country to start negotiations (Oct 7).

Currently, the IMF forecasts an 11.8% economic contraction for Argentina in 2020 and 4.9% growth in 2021. In response to COVID-19, the country has received over $6 billion in financing through multilateral development banks including the World Bank, IDB, CAF and FONPLATA (see YPFS blog posts on overall efforts by multinational organizations and also on multilateral development banks in Latin America and the Caribbean).

Argentina’s debt-restructuring experience might serve as an example for other countries that due to the current COVID-19 crisis might need to restructure debt owed to private creditors.

Table 1: Timeline of Argentina’s Sovereign Debt Crisis

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018</td>
<td>The IMF approved a record $57.1 billion loan over three years to Argentina—the largest IMF loan to a single country (IMF, CRS). The IMF disbursed a total of $44 billion under that commitment.</td>
</tr>
<tr>
<td>Dec. 10</td>
<td>President Alberto Fernández came into office after defeating President Mauricio Macri in the elections. Fernández refused to take the remaining tranche of the IMF loan and promised to restructure Argentina’s debt. Fernández appointed Martín Guzmán as Minister of the Economy.</td>
</tr>
<tr>
<td>Jan. 31</td>
<td>Pope Francis promised President Fernández to help Argentina in its debt crisis (Jan. 31). A week later, the Vatican held the conference “New Forms of Solidarity: Towards Fraternal Inclusion, Integration and Innovation,” with the participation of the IMF’s Managing Director, Finance Ministers, and leading economists.</td>
</tr>
<tr>
<td>Feb. 19</td>
<td>IMF staff assessed Argentina’s debt to be unsustainable. It noted that since July 2019, the Argentinian peso depreciated by over 40%, sovereign spreads increased by 1100 basis points, international reserves declined by $20 billion, and real GDP contracted more than expected. As a result, gross public debt rose to nearly 90% of GDP at end-2019 (Feb. 19).</td>
</tr>
</tbody>
</table>
Mar. 20

At the request of Argentina, IMF staff prepared a technical note on debt relief that could underpin a debt restructuring consistent with restoring debt sustainability with high probability (Technical Note, Summary).

Apr. 7

Argentina formally requested the rescheduling of its debt with the Paris Club (Argentina).

Apr. 9-21

A first round of private negotiations occurred between Argentina and private creditors. Argentina developed its restructuring guidelines.

Argentina made a debt offer, establishing a dialogue with creditors to ensure that Argentina’s long-term sustainability path. It included a 3-year grace period, a 5.5% reduction on the bonds’ principal, and a 62% reduction of interest payments. It left creditors with an average bond coupon of 2.3%, instead of 7% (Guzmán).

May 3

Minister Guzmán published a piece in the Financial Times titled “Argentina cannot afford to pay creditors more” (FT).

May 4

Three groups of creditors rejected the government’s proposal to restructure the debt.

Economists Carmen Reinhart, Joseph Stiglitz, and Edmund Phelps publish a letter co-signed by over 100 economists in support of Argentina’s debt restructuring proposal. In addition, more than 150 Argentine economists signed a letter supporting the debt restructuring proposal.

May 10

Argentina pushed back its deadline to accept the offer to May 22 (Bloomberg).

May 15

Creditors filed three counter offers.

Argentina entered in default after a 30-day grace period expired for interest payments on $65 billion in dollar-denominated bonds with maturities of 2021, 2026 and 2046 (Bloomberg).

May 22-28

A second round of negotiations occurred. Argentina submitted a revised debt restructuring proposal while ensuring the debt remained sustainable with an economy aimed at long-term growth (May 28, Argentina). The offer contained a two-year moratorium, instead of three. Bonds rallied (Bloomberg). Minister Guzman said Argentina expected to sign a new IMF program in 2020 (BA).
IMF’s staff technical statement on Argentina’s revised proposal stated the offer to be consistent with restoring debt sustainability with high probability. It further suggested that there was “limited scope” for improvements (Jun 1).

A third round of negotiations occurred. Argentina improved its offer to meet investors’ request for a return value at identifier 50 with a 10% discount factor, a measure often invoked by creditors. Argentina also proposed a Value Recovery Instrument (IRV) based on exports (Argentina).

Two bondholder groups submitted an offer accepting losses on a net-present value basis around 44%-46%. Argentina rejected the offer (Bloomberg).

Argentina submitted a revised fourth and “final” offer. The terms included an average recovery of 53 cents on the dollar and interest payments starting in 2021, a year earlier than the last offer.

Two bondholder groups rejected the offer. Argentina extended the deadline for talks until August 4 (July 5, Fernández, Bloomberg, FT).

The three largest creditor groups jointly submit a new offer. Argentina said bondholders “misunderstand” the country’s restructuring. Greylock Capital Management supported the government’s offer (Bloomberg).

Argentina and private creditors announced they reached an agreement (Aug 4). The debt restructuring agreement decreased the interest payments from 7% to 3% and gave investors about 55 cents on the dollar. It will give the country $37.7 billion in debt relief over the next 10 years (Argentina, BA, Hitos).

Argentina notified the IMF of a request for a new IMF-supported program (Argentina, IMF).

President Fernández expects an agreement with the IMF “as soon as possible” in order to “clear up any doubts” (Oct 5).

IMF Managing Director Kristalina Georgieva said the IMF had “no intention of putting pressure on Argentina” as the IMF team arrived in the country to start negotiations. (Oct 7).

Source: Argentina’s Timeline and Bloomberg.
Chile’s Central Bank Injects Liquidity in Financial Markets

By Manuel Leon Hoyos

Original post [here](#).

In March, the central bank of Chile (CBC) cut interest rates twice from 1.75% to 0.5% and unveiled a series of liquidity measures to “ensure the normal functioning of credit markets and the effective transmission of the increased monetary stimulus.” The CBC expanded its exceptional measures in June by an additional 10% of GDP. The current CBC liquidity injection represents 20% of GDP.

Chile’s monetary policy rate has remained at 0.5%, its “technical minimum,” and is expected to remain there over much of “the two-year monetary policy horizon.” The CBC said it will also maintain the unconventional measures. The CBC has stated that “in case the evolution of the economy so requires, it will continue to assess other options to intensify such impulse and provide support to financial stability, using unconventional instruments” (July 15, October statement and minutes).

Chile, Latin America’s fifth largest economy and the world’s top copper producer, has been hit hard by COVID-19. It recently surpassed 15,000 deaths. Beginning in March, Chile experienced shortages in foreign exchange liquidity and a sharp fall in prices of copper and other export commodities, although prices have since improved. The country’s monthly index of economic activity contracted 14.1% in April, 15.3% in May, and 12.4% in June compared to the same months in 2019. In its September Monetary Policy Report ([IPoM](#)), the CBC raised its expectations. It now estimates that GDP will fall between 4.5% and 5.5% (from the 5.5% to 7.5% estimates in June). The IMF expects a 6% contraction in 2020 (see YPFS blog posts on liquidity measures by the central banks of [Brazil](#) and [Mexico](#)).

The CBC liquidity measures include the repo operations and the foreign exchange (FX) swap program, foreign currency sales, relaxation of liquidity regulations and reserve requirements, cash purchases and forward sale (CC-VP), and purchase of term deposits. The CBC also uses unconventional measures that include credit lines for banks to encourage lending to households and firms, bank bond-purchase programs, and the CBC bond-repurchase program ([FSR 1](#), Exceptional Measures).

The CBC’s Facility of Credit Conditional on Lending Increase (FCIC) and the Liquidity Credit Line (LCL) make resources available to commercial banks to “maintain financing and refinancing loans to households and companies, especially SMEs that do not have access to capital markets” ([Exceptional Measures](#)). Banks can access up to $24 billion through the FCIC, the LCL, or a combination of both. There are two lines available: a first line of $4.8 billion and an additional line of $19.2 billion. The FCIC is capped at 15% for each bank’s baseline portfolio, which is the sum of commercial and consumer loans as of February 29, 2020. An initial 3% is available immediately to banks through the first line. The remaining 12% is offered through an additional...
line whose availability depends on the growth of the baseline portfolio and lending to SMEs. The LCL is limited by the average cash reserves in Chilean currency of each bank.

The FCIC and the LCL are similar to a repo with the difference that the FCIC has a term of 4 years and the LCL has a term of 2 years. Eligible collateral includes government bonds, bank and corporate bonds, and high-quality commercial loans. On May 6, 2020, eligible collateral for the FCIC was expanded to include highly-rated commercial loans (A1 to A3). The CBC has extended the facilities beyond the initial term of six months. They are priced at the monetary policy rate (0.5%). The first line started operations on March 30 and the additional line on April 16 (Exceptional Measures, FSR 1, Oct 15).

Since the announcement of the FCIC, loans in the baseline portfolio have increased significantly and come exclusively from commercial loans, in particular an expansion of credit lines (see Figure 2). By May, the majority of banks have accessed almost all of their allocated funds in the additional line (FSR 1, see Figure 1).

Figure 1: FCIC amounts (USD millions)

Source: Central Bank of Chile (Exceptional Measures)

Figure 2: Credit growth and SME ratio (percentage)

Source: Central Bank of Chile (Exceptional Measures)
In June, the CBC expanded the use of non-conventional measures for an additional 10% of GDP to bring the total liquidity injection to 20% of GDP (Sep 16). These included phase 2 of the FCIC line (FCIC-2) and an $8 billion special asset purchase program over six months (June 16).

The FCIC-2 line included an additional $16 billion for eight months and strengthened incentives to lend to SMEs and non-bank credit providers (June 16). In the view of a CBC Board member, “implementing a new phase of the FCIC … would consider the role of non-bank credit intermediaries that depend themselves on bank financing. This can be complemented by a financial asset purchase program. This mechanism would allow, in principle, to reduce certain risk premiums in the capital market, facilitate portfolio rebalancing towards riskier assets, and directly provide liquidity to non-banking institutions, which nevertheless are important mobilizers of private savings” (June Minutes). As of November 5, the FCIC-2 line reached usage of $5.1 billion (Exceptional Measures).

The special asset purchase program allows the acquisition of bonds from eligible issuers to reactivate the bond market and reduce long-term borrowing costs (June Minutes). As of November 5, the program reached cumulative purchases of $3.1 billion (Exceptional Measures).

The CBC also established in March a program to purchase bank bonds to reduce the cost of long-term funding. The program is not limited to Open Market Operations System (SOMA) participants and can be used by other market agents such as pension fund managers, mutual funds, and life insurance companies (FSR 1). Initially, the CBC limited the program to $4 billion. It extended the program a couple of weeks later to $8 billion and eliminated the maturity constraints of the eligible instruments (March 31). As of November 5, the bank bond purchase program reached cumulative purchases of $3.8 billion (Exceptional Measures).
On August 6, Chile’s Congress approved a law to allow the CBC to buy bonds issued by Chile’s Treasury in the secondary market. As of September 16, the measure had not been used. It was considered a source of additional liquidity if necessary (Sep 16).

To increase liquidity of local markets in domestic and foreign currency, the CBC reactivated foreign exchange interventions for up to $20 billion, split between repo operations (REPO) and the foreign exchange (FX) swap program (CBC March). Last year, the CBC had launched these programs and sold $7 billion in U.S. dollars between December 2019 and January 2020 to help boost the exchange rate (Sep 16). However, the currency fell in January and the CBC stopped the program. Due to the COVID-19 crisis, the CBC reactivated it in March until January 2021 (CBC FX). The CBC also extended a foreign currency sales program through January 2021. It includes longer maturities for Chilean peso and U.S. dollar liquidity programs (FSR 1).

The CBC has signed international financing lines with the IMF, the U.S. Federal Reserve (Fed), and the People’s Bank of China to strengthen its liquidity position in foreign currency and to allow it to handle potential capital outflows in the event of a severe shock. In May, the IMF approved a $23.9 billion Flexible Credit Line (FCL) to Chile. The IMF stated that “Chile qualifies for the FCL by virtue of its very strong fundamentals, institutional policy frameworks, track record of economic performance and policy implementation and commitment to maintain such policies in the future” and that Chile intends “to treat the arrangement as precautionary financing” (May 29). In June, the CBC received access to the U.S. Fed’s Temporary Foreign and International Monetary Authorities (FIMA) Repo Facility. The line allows the CBC to have

Source: Central Bank of Chile (Exceptional Measures, Sep. 3 presentation)
flexibility in conducting currency swaps. In July, the CBC increased its bilateral renminbi/Chilean peso currency swap with the central bank of China from 22,000 million renminbi to 50,000 million renminbi ($7.1 billion). The agreement was originally signed in 2015 and renewed in 2018.

On July 8, Chile’s Congress approved the withdrawal by individuals of 10% of their pension funds. The CBC later said that the resulting change in pension fund portfolios might increase market volatility. It said it would intensify its monitoring of local money and fixed-income markets and consider activating special operations if necessary (July 23).

The CBC implemented two additional measures on July 8. First, it introduced the cash purchase of bank bonds with joint and simultaneous sale (CC-VP) for up to $10 billion. Through the CC-VP, the CBC carries out direct cash purchase of bank bonds, and jointly and simultaneously, sells instruments of the same type at a term of one or three months to the same counterparty. Second, it introduced the direct purchase through the window of bank deposits for up to $8 billion. As of November 5, The CC-VP program held cumulative purchases of $5.5 billion and an outstanding amount of $1.8 billion. The purchase of bank deposits has been low at about $250 million (Exceptional Measures).

In September, the CBC indicated that it was achieving the intended objectives of these programs. The CC-VP and the purchase of bank bonds with a premium succeeded in keeping financial markets stable, despite enormous portfolio changes and large asset liquidations by pension funds. The CBC argued that low interest rates, combined with the exceptional measures to provide liquidity, have been a significant driver of credit growth (September Minutes). The CBC said it will continue with the asset-purchase program (October Minutes).

The CBC said in its Financial Stability Report released on November 11, that “notwithstanding the contribution of the policy measures mitigating the effects of the pandemic, the maneuvering margins have tightened.” And “although an increase in lending has been essential to face the immediate impact of the pandemic, the higher leverage and lower capital margins make firms and lenders more vulnerable under more stressed scenarios” (FSR 2). CBC’s President Mario Marcel stated that the measures have been effective and that the worst was avoided. However, the emergency is not over and there is still a long period of recovery in which there are significant risks to financial stability (Nov 13).

The following Figure 5 and 6 summarizes information on the CBC’s extraordinary liquidity measures to date.

Figure 5: Usage of Central Bank of Chile Extraordinary Measures (USD millions)

<table>
<thead>
<tr>
<th>Purpose</th>
<th>Program</th>
<th>Amount</th>
<th>Total amount since announcement</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### FX Intervention

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>FX Spot</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>NDF (Non-deliverable Forward)</td>
<td>10,000</td>
<td>36,090</td>
</tr>
<tr>
<td>FX Swap</td>
<td>4,000</td>
<td>2,493</td>
</tr>
</tbody>
</table>

### Foreign Exchange Liquidity

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>REPO</td>
<td>6,611</td>
</tr>
<tr>
<td>CBC Debt Buyback</td>
<td>8,514</td>
</tr>
<tr>
<td>Bank Bonds Purchases</td>
<td>8,000</td>
</tr>
<tr>
<td>(Start date March 20, 2020)</td>
<td></td>
</tr>
<tr>
<td>Special Assets Purchases</td>
<td>8,000</td>
</tr>
<tr>
<td>(Start date June 22, 2020)</td>
<td></td>
</tr>
</tbody>
</table>

### Domestic Currency Liquidity

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>CC-VP Cash purchase of bank bonds with joint and simultaneous sale (Aug 3, 200)</td>
<td>10,000</td>
<td>5,552</td>
</tr>
<tr>
<td>Deposits Purchases (Aug 7, 2020)</td>
<td>8,000</td>
<td>250</td>
</tr>
</tbody>
</table>

### Domestic Currency Liquidity with Credit Expansion Incentives

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Facility of Credit Conditional on Lending Increase (FCIC 1) - Liquidity Credit Line (LCL) (Start date March 30th, 2020)</td>
<td>24,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial Line 3%</td>
<td>4,800</td>
</tr>
<tr>
<td>FCIC usage</td>
<td>1,697</td>
</tr>
<tr>
<td>LCL usage</td>
<td>3,337</td>
</tr>
<tr>
<td>Additional Line 12%</td>
<td>19,200</td>
</tr>
<tr>
<td>FCIC usage</td>
<td>15,368</td>
</tr>
<tr>
<td>LCL usage</td>
<td>3,600</td>
</tr>
</tbody>
</table>
Source: Central Bank of Chile (Exceptional Measures, Sep 16)

Figure 6: Timeline of Chile’s central bank liquidity measures

<table>
<thead>
<tr>
<th>Date</th>
<th>Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mar. 12</td>
<td>The central bank of Chile (CBC) foreign exchange interventions were reactivated until January 2021, for up to $20 billion split between the REPO and FX Swap program (CBC FX).</td>
</tr>
<tr>
<td></td>
<td>The CBC in a special monetary policy meeting cut the monetary policy rate (MPR) from 1.75% to 1% (Mar 16).</td>
</tr>
<tr>
<td>Mar. 16</td>
<td>The CBC announced exceptional measures in the order of 10% of GDP:</td>
</tr>
<tr>
<td></td>
<td>The Facility of Credit Conditional on Lending Increase (FCIC) and the Liquidity Credit Line (LCL) were established for commercial banks to encourage lending to households and SMEs. The FCIC and the LCL are similar to a repo, with terms of 4 years and 2 years, respectively. Banks can access up to $24 billion through the FCIC, the LCL or a combination of both. The FCIC is capped at 15% for each bank’s baseline portfolio which is the sum of commercial and consumer loans. The LCL is limited by the average cash reserves in Chilean currency of each bank. The required provision of eligible collateral included government bonds, bank and corporate bonds, and high-quality commercial loans.</td>
</tr>
<tr>
<td></td>
<td>The Bank bonds purchase program was established for Open Market Operations System (SOMA) participants for up to $4 billion.</td>
</tr>
<tr>
<td>Mar. 31</td>
<td>The CBC cut the MPR from 1% to 0.5%, its “technical minimum.”</td>
</tr>
<tr>
<td></td>
<td>The Bank bonds purchase program for Open Market Operations System (SOMA) participants of up to $4 billion was expanded to $8 billion and maturity constraints of eligible instruments were eliminated (Mar 31).</td>
</tr>
<tr>
<td>Apr. 28</td>
<td>The Small Business Guarantee Fund (FOGAPE) was expanded with additional contributions of up to $3 billion (1.2% of GDP) to enable the provision of credit guarantees of up to $24 billion (10% of GDP). This allows banks to lend to companies with annual sales of up to $33.5 million (Apr/28).</td>
</tr>
<tr>
<td>May 6</td>
<td>Eligible collaterals for the FCIC were expanded to include high-quality commercial loans—A1 to A3 buckets (Exceptional Measures).</td>
</tr>
</tbody>
</table>
May 29  The IMF approved a $23.9 billion Flexible Credit Line (FCL) to Chile, which Chile intends “to treat the arrangement as precautionary financing” (May 29).

The CBC stated that “it will maintain a high monetary impulse for a prolonged period of time. It kept the MPR at 0.5% and said that “it will keep the MPR at its technical minimum over the entire projection horizon.”

The use of non-conventional instruments was expanded for an additional 10% of GDP to bring the total liquidity injection to 20% of GDP.

Phase 2 of the FCIC contemplates an additional $16 billion for 8 months. It strengthened incentives to lend to SMEs and to non-banking credit providers.

The $8 billion special asset purchase program launched for a period of six months allows the acquisition of bonds from eligible issuers to reactivate the bond market and reduce long-term borrowing costs.

The CBC stated that “if economic developments so require, it will continue to explore options to intensify the impulse and support financial stability, using unconventional instruments (June 16).

June 16

The CBC received access to the U.S. Federal Reserve’s Temporary Foreign and International Monetary Authorities (FIMA) Repo Facility. This facility allows the CBC to have flexibility in conducting currency swaps.

The CBC increased its bilateral renminbi/Chilean peso currency swap with the central bank of China from 22,000 million renminbi to 50,000 million renminbi ($7.1 billion).

August 8  Chile’s Congress approved a law to allow the CBC to buy bonds issued by Chile’s Treasury in the second market (Sep 16).

The CBC maintained its MPR at 0.50% and specified that “it expects the MPR to remain at its minimum level over much of the two-year monetary policy horizon and will maintain the unconventional measures now in place” (Sep 1).

The CBC’s September Monetary Policy Report (IPoM) improved previous estimations and now expects GDP to fall between 4.5% and 5.5% in 2020.

October 15  The CBC maintained its MPR at 0.50% and exceptional measures in place (Oct 15).
Small and Medium Enterprises (SMEs)

The majority of workers in many economies are employed by SMEs, and these firms account for more than 90% of total businesses worldwide. Due to the COVID-19 pandemic, many SMEs were forced to shut-down. Government programs in response to the COVID-19 pandemic vary with some focused on providing access to finance, supporting employee wages, providing grants to cover various expenses, among others. In many cases, especially in emerging markets, governments are also providing support to informal economy workers and firms.
Credit Guarantee Programs for Small and Medium-Sized Enterprises
By Christian McNamara with Research Support from Mallory Dreyer and Kaleb Nygaard

Original post here.

With the economic fallout from the coronavirus pandemic likely to have a particularly significant impact on small and medium-sized enterprises (SMEs), countries around the world have adopted or are considering measures intended to support such businesses. One common tool for doing so, even in non-crisis times, is an SME credit guarantee, a program pursuant to which governments encourage banks to lend to SMEs by at least partially guaranteeing those loans. While evaluations of these programs are somewhat limited and the evidence mixed, when an event like the Asian Financial Crisis or the Global Financial Crisis occurs, countries often expand existing SME credit guarantee programs to make them more responsive to crisis conditions and/or develop new programs specifically targeted to the crisis.

When designing an SME credit guarantee program, the following four categories of design decisions are of particular importance to policymakers:

1. Underwriting - who will be responsible for approving the guaranteed loans?
2. Risk sharing - how much of the loans will be guaranteed?
3. Fees - how much will borrowers have to pay in guarantee fees?
4. Eligibility - what borrowers will be eligible to participate and what type of loans will they be able to receive?

Below is a summary of how policymakers have approached these questions in the past.

Underwriting

Typically, the decision to extend particular loans has been made by the banks themselves, often with the rationale that they are better positioned to engage in credit analysis than the government. This decision is closely tied to how risk sharing is structured. If the banks are determining which borrowers get loans, fully guaranteed loans could give rise to a moral hazard problem because the banks won’t suffer any losses from non-performing loans.

Less frequently, governments have decided which loans to extend. Japan’s Special Credit Guarantee Program (SCGP), adopted in 1998 during its banking crisis, involved the government making underwriting decisions (while also providing a full guarantee). In its screening process for borrowers, it relied on a short list of negative characteristics such as tax delinquencies and previous bank loan defaults. The SCGP typically accepted any borrower not
possessing one of the listed characteristics, with the result that the approval rate was very high. However, this limited credit analysis has been criticized as having contributed to misuse by borrowers. Government involvement in underwriting may also result in high program administrative costs, as appears to have been the case with South Korea’s Credit Guarantee Fund.

**Risk Sharing**

As noted above, the question of how much of a loan should be guaranteed introduces the issue of moral hazard. For that reason, SME credit guarantee programs have typically provided partial guarantees (often in the range of 70%-80%). This leaves banks with some of the loss associated with a non-performing loan and therefore offers better incentives to conduct effective credit analysis. The portion guaranteed is not always fixed. In the Czech Republic, the Czech-Moravian Guarantee and Development Bank provides a gradual guarantee whose percentage increases over the duration of the loan up to a cap of 80%.

Some countries have sought to preserve these incentives while still fully guaranteeing loans, particularly in times of crisis. In Thailand, the Thai Credit Guarantee Corporation established during the Global Financial Crisis provided a full guarantee, but only if a participating bank’s portfolio of guaranteed loans did not have non-performing loans that exceeded 16% of the total.

Chile’s FOGAPE takes a unique approach to risk sharing, determining the percentage of a loan to be guaranteed pursuant to an auction in which banks bid for the right to provide a certain amount of guaranteed loans. Bids with the lowest guarantee percentages are selected first until the total amount of guarantee rights has been allocated. Such an approach may be consistent with research by Yoshino and Taghizadeh-Hesary (2016) arguing that guarantee percentages should vary by bank based on soundness (and based on macroeconomic conditions).

**Fees**

In determining the guarantee fees to be charged in connection with an SME credit guarantee program, countries typically seek to balance the desire to fund the programs with the need to avoid pricing out participants. Flat fees of approximately 1% to 2% of loan amounts seem common. A reduction in such fees is often a way that existing programs are adapted in the face of crisis.

**Eligibility**

SME credit guarantee programs can either be broadly available or, less commonly, limited to borrowers meeting specific criteria. In the UK, the Enterprise Finance Guarantee adopted during the Global Financial Crisis required borrowers to demonstrate that they had first been denied a loan outside of the program. Programs in the US, Brazil, and Turkey had similar features. The Greek Credit Guarantee Fund of Small and Very Small Enterprises (TEMPME SA) limited participation to firms that had been profitable over the previous three years. In Italy and Chile,
rather than acting directly, programs have provided guarantees to mutual guarantee associations that in turn provide guarantees to their SME members.

What types of loans will be eligible is also an important consideration. To ensure that guaranteed loans are not used to refinance existing non-guaranteed loans, many programs contain a prohibition on this practice. Programs often specifically include shorter-term working capital loans. In Canada, a Global Financial Crisis-era initiative called the Canada Small Business Financing Program excluded working capital loans despite a subsequent survey that showed over half of all SMEs intended to use debt financing for that purpose. This exclusion was seen as limiting the program’s effectiveness.

Loan Guarantee Programs May Include Nonbanks

By Mallory Dreyer

Original post here.

Loan guarantee programs that involve nonbank lenders may be more effective than bank-only programs at getting credit quickly to small businesses that need it during the coronavirus crisis.

Small and medium-sized enterprises (SMEs) play a major role in the world economy, representing roughly 90% of businesses and 50% of employment worldwide. Many countries operate credit guarantee programs to encourage lending to SMEs. These programs are typically limited to bank loans. For example, the UK launched a Coronavirus Business Interruption Loan Scheme this week, taking advantage of existing programs, but the program is limited to forty previously accredited bank lenders.

This may limit its value. Since the Global Financial Crisis, other types of financing beyond traditional bank lending--such as online sources of alternative lending and short-term loans from non-financial corporations--have become increasingly important for SMEs. Expanding the scope of eligible lenders for guarantee programs could be a valuable tool for credit guarantee programs developed or expanded during times of crisis.

Some guarantee programs involve nonbanks already. The Netherlands expanded the BMKB program in 2012 and GO facility in 2013 to include other types of financial institutions, such as credit unions, SME funds, and crowdfunding as eligible lenders. The Growth Facility offers banks or private equity firms a 50% guarantee on newly issued equity or mezzanine loans. Mezzanine loans are a hybrid instrument, which gives the right to convert debt to equity if the loan is not paid back.
Making SME Credit Guarantee Programs Affordable: Subsidized Interest Payments for an Initial Period

By Mallory Dreyer

Original post here.

The coronavirus pandemic has severely affected small businesses across the world and forced many to close temporarily. Several countries have provided relief to help them cover their fixed costs until social conditions return to normal. Government-guaranteed loans can help, but a small business may hesitate to take on new debt that only adds to its monthly fixed costs.

For that reason, the U.K. government’s new temporary Coronavirus Business Interruption Loan Scheme, announced on March 17, 2020, includes a full government subsidy of the first 6 months of interest payments on guaranteed loans. This feature appears designed to address the issue of providing liquidity to small and medium-sized enterprises, while removing the immediate burden of interest payments, allowing for viable SMEs to survive until macroeconomic conditions improve.

In our March 19, 2020 post, Credit Guarantee Programs for Small and Medium-Sized Enterprises, we highlighted key considerations in the design of SME credit guarantee programs, especially how these programs have been modified in response to crises. Literature suggests that crisis-focused guarantee programs can help solve immediate liquidity problems, although their effectiveness ultimately relies on improving macroeconomic conditions.

A prior example of interest payment relief can be found in the Greek response to the Global Financial Crisis, during which it established the Credit Guarantee Fund of Small and Very Small Enterprises (TEMPME S.A.). The interest costs on guaranteed loans under the first phase of the program, between December 2008 and April 2009, were fully covered by the government. In the second phase of the program, the interest rate for guaranteed loans was set at a fixed privileged rate, based on negotiations between TEMPME S.A. and the banking sector, which was lower than the going market rate.

In 2008-2009, some programs also temporarily decreased or suspended guarantee fees, including programs such as those in Hungary, Finland, and other EU countries, as well as the US Small Business Administration (SBA). Other programs, such as Malaysia’s SME Assistance Guarantee Scheme, did not charge a guarantee fee at all. Decreasing or eliminating the cost of the guarantee can also relieve the immediate financial burden on SMEs.
Large-Scale Assistance Programs for Small Businesses

By Mallory Dreyer, Christian McNamara, Alexander Nye, Kaleb Nygaard, and Priya Sankar

Original post here.

With the economic effects of the coronavirus pandemic likely to be particularly devastating for small and medium-sized enterprises (SMEs), countries around the globe are faced with the task of determining how best to support such businesses. A number of potential intervention types exist and are already being deployed, many of which have also been used in response to earlier financial crises. This post begins by describing the fundamental challenge: to provide SME assistance quickly and on a large scale. It next examines each of the primary tools governments can use to extend assistance to SMEs on such a scale. In so doing, it provides examples of the use of these tools drawn from the current situation and previous crises. The post then presents a detailed analysis of the framework for SME assistance established in the United States by the recently adopted CARES Act as one example of how interventions can be combined to support SMEs. It concludes by offering some takeaways about why certain SME assistance interventions may be preferable to others in given contexts.

Statement of the Challenge

Confronted with a crisis that threatens to result in widespread failure of SMEs, governments have an interest in keeping such businesses afloat, even if their activities are temporarily suspended. While failed companies can restart post-crisis, costs can arise from the need to rehire employees and reestablish business relationships. Some of these costs could be avoided if companies can remain in business in a suspended state. Government assistance to SMEs may be justified to avoid these costs.

Governments may have the funds available to provide assistance. The fundamental challenge is to get those funds into the hands of SMEs quickly and on a large scale. But there is a tradeoff between speed of distribution and the amount of due diligence that can be done on potential recipients. Governments generally lack the capacity to engage in due diligence at scale. For that reason, they often turn to private financial institutions to perform this role, given such institutions’ expertise and existing relationships with SMEs.

Thus, key questions that must be answered in designing an approach to SME assistance include:

*What is the right balance between speed of distribution and due diligence on potential recipients?*

*To what extent should private financial institutions be utilized to help achieve the right balance?*

*If private financial institutions are to be utilized, how should the SME assistance be structured so as to provide them with adequate incentives to actually perform their intended role?*

**Types of Large-Scale SME Assistance**
1. Grants - government payments to or on behalf of SMEs
2. Forgivable Loans - loans extended to SMEs that they do not have to repay under certain circumstances
3. Direct Lending - government loans to SMEs
4. Credit Guarantees - government guarantees to induce private firms to lend to SMEs
5. Funding for Lending - funding for private lenders to induce them to lend to SMEs
6. Payment Forbearance - delays on amounts SMEs owe to creditors
7. Tax Policy Changes - waivers of/revisions to the tax code to reduce or delay taxes owed

Grants

Arguably the most direct way to assist SMEs is by providing them with funds they do not have to repay. Other tools such as loans and payment delays are provided in the expectation that SMEs’ ability to service loans and meet other obligations will improve over the duration of the intervention. If this does not occur, SMEs will be saddled with loans that they cannot repay and payments they cannot make. Given the severity of the pandemic’s effect on SMEs and its uncertain duration, it is perhaps not surprising that grants play a key role in many countries’ approach to SME assistance, despite their cost.

In Denmark, for example, the government established a program that pays a portion of the fixed costs of eligible businesses for up to three months. Businesses that expect to lose at least 25% of their revenues will see the government pay at least 40% (and up to 100% for businesses that lose all revenue) of fixed costs, including payroll and rent. The program’s initial three months are expected to cost 40 billion Danish crowns ($5.8 billion or about 1.6% of GDP). In Australia, the government is providing grants of up to AUD $100,000 ($59,960) based on a business’s employment tax withholdings. It is distributing these grants via the system businesses use to make their withholdings.

Other grant-based programs have focused on providing fixed, relatively small amounts of money to SMEs quickly while more substantial support is pending. The United States has appropriated $10 billion so that applicants for coronavirus economic disaster loans can receive advances of up to $10,000 per potential borrower while loan applications are pending. Recipients do not have to repay the advances, even if a loan application is ultimately rejected. In Austria, the government established a €1 billion hardship fund to provide immediate payments of up to €1,000, with the possibility of monthly payments of up to €2,000 for three months following an application process. A German program provides €50 billion in grants to support SMEs and self-employed individuals in all sectors. SMEs with the equivalent of up to five full-time employees will receive €9,000 over the course of three months, while SMEs with the equivalent of up to 10 full-time employees will receive €15,000 over three months.
Many governments are using grants to subsidize wages. For example, businesses and nonprofits that have lost 30% or more in revenue due to COVID-19 are eligible for the Canada Emergency Wage Subsidy. It supports 75% of the first CAD $58,700 of each employee’s salary for three months. Similarly, Australia’s wage subsidy provides SMEs that have lost 30% of revenue relative to 2019 a fixed grant of AUD $1,500 per employee every two weeks for up to six months. Large businesses are also eligible for this grant, administered through the JobKeeper program, which is expected to cost the government AUD $130 billion (approximately 7% of GDP). Singapore’s Job Support Scheme (JSS) co-funds different amounts of employee salaries in different industries for a period of nine months: 25% of the first SGD $4,600 ($3,200) of monthly wages for all employees, 50% for food service workers, and 75% for aviation and tourism workers. A notable feature of the Singapore program is that employers do not need to apply; the government will calculate the subsidy based on their tax withholdings and dispense it in three installments that are estimated to cost SGD $15.1 billion total (approximately 3% of GDP).

In some programs, only furloughed or laid-off employees qualify. For example, the United Kingdom’s Coronavirus Job Retention Scheme explicitly prohibits employees receiving the subsidy from undertaking work for their employers. Programs with these types of restrictions operate more like a form of unemployment insurance than direct assistance to the businesses themselves. The primary benefit to SMEs appears to be continued ties to an idled workforce that can be quickly reactivated once conditions improve. Germany’s existing kurzarbeit policy allows employers to furlough workers in periods of economic hardship; during that time, the government pays 60% of their pre-crisis salary or 67% of their pre-crisis salary if they have children. Germany recently expanded eligibility for this program to companies with at least 10% (previously 30%) of their workers under furlough. Estonia and Belgium, among others, also have similar temporary unemployment programs.

Forgivable Loans

Other types of support can function like a grant. The cornerstone of the United States’ assistance for SMEs is a $349 billion program that guarantees loans that can be forgiven in an amount equal to eight weeks of the borrowers’ key expenses, including payroll, mortgage interest, rent, and utilities. Following forgiveness, borrowers will have received a grant covering these expenses similar to that provided by Denmark’s program. Austria has developed a program with a similar structure -- a €15 billion ($16.2 billion) “corona crisis fund” that provides loans, of which the portion used for a borrower’s operating costs, such as energy costs, insurance or rent, can be 75%-forgiven. Under the Canada Emergency Business Account program established in response to the pandemic, SMEs can borrow up to CAD $40,000 ($28,000), of which CAD $10,000 will be forgiven, conditioned upon timely repayment of the remaining balance.

Direct Lending

Some countries lend directly to SMEs through public institutions such as state or development banks. An example of direct lending to SMEs is the Business Development Bank of
Canada (BDC). The BDC serves a counter-cyclical role, as its lending activities increase during periods of economic instability. During the Global Financial Crisis, BDC lending was a key component of the Canadian government’s approach to providing assistance to SMEs, as the government provided additional funding for new or existing programs. Through the Business Credit Availability Program (BCAP), the government allocated additional funds to the BDC for working capital loans, term lending, and loan guarantees. In 2010, the BDC expanded its offerings with the Emergency Recovery Loans Program, which provided 3,700 businesses with pre-approved financing for working capital needs up to CAD $100,000.

Ireland is using an existing institution to lend directly to a specific subgroup of SMEs. The Irish government established MicroFinance Ireland in 2012 to provide liquidity support to microenterprises that do not meet the lending criteria of private banks. This year, MicroFinance Ireland launched an emergency lending program for microenterprises negatively impacted by the pandemic. In order to be eligible for the program, applicants must demonstrate through financial projections that the pandemic is expected to decrease turnover by 15%. The loans are interest-free with a payment moratorium for the first six months, which eases the initial debt burden on microenterprises during the period of economic uncertainty.

Countries such as Spain (Instituto de Crédito Oficial), France (OSEO), and Japan (Japan Finance Corporation) also have institutions that lend directly to SMEs. But direct lending programs for SMEs are rare in comparison to other interventions, likely because direct lending programs require the government to utilize an existing vehicle or create a new vehicle from scratch during a crisis.

Credit Guarantees

Rather than providing loans to SMEs directly, governments can encourage private lenders to do so by at least partially guaranteeing those loans. Some governments use credit guarantee programs to promote SMEs’ access to credit even during non-crisis times. But they often expand these programs or develop new ones during crises. That has happened in the current pandemic and also during earlier events such as the Global Financial Crisis and the Asian Financial Crisis.

Typically such programs involve the government guaranteeing loans approved by private lenders, often with the rationale that such lenders are better positioned to engage in credit analysis than the government. Less commonly, governments themselves have been responsible for the loan underwriting process. In Japan’s Special Credit Guarantee Program, adopted in 1998 during its banking crisis, the government made underwriting decisions based on a short list of negative characteristics such as tax delinquencies and previous bank loan default. But the program has been criticized as having contributed to misuse by borrowers. Government involvement in underwriting may also result in high program administrative costs, as appears to have been the case with South Korea’s Credit Guarantee Fund.

SME credit guarantee programs have typically provided partial guarantees, often in the range of 70%-80%, to leave banks with some of the loss associated with a non-performing loan to
incentivise effective credit analysis. Some countries have sought to preserve these incentives while still fully guaranteeing loans, particularly in times of crisis. In Thailand, the Thai Credit Guarantee Corporation, established during the Global Financial Crisis, provided a full guarantee, but only if a participating bank’s portfolio of guaranteed loans did not have non-performing loans that exceeded 16% of the total. Chile’s FOGAPE takes a unique approach to risk-sharing, determining the percentage of a loan to be guaranteed pursuant to an auction in which banks bid for the right to provide a certain amount of guaranteed loans and bids with the lowest guarantee percentages are selected first, until the total amount of guarantee rights has been allocated.

Borrowers typically pay a fee for the guarantee. Flat fees of 1% to 2% of loan amounts are common. A reduction in such fees is often a way that existing programs are adapted in a crisis.

SME credit guarantee programs can either be broadly available or, less commonly, limited to borrowers meeting specific criteria, such as those who can demonstrate that they have been denied a loan outside of the program or those with a history of profitability. What types of loans will be eligible is also an important consideration. Programs often specifically include shorter-term working capital loans. In Canada, a Global Financial Crisis-era initiative called the Canada Small Business Financing Program excluded working capital loans, an omission that was seen as limiting its effectiveness.

For more information about Credit Guarantee Programs for SMEs, please see YPFS’s analysis of this topic.

Funding for Lending

An additional means for encouraging lending by private banks to SMEs involves providing banks with the funding to do so. Under such funding-for-lending programs, the government, frequently via the central bank, provides low-interest-rate funds to the banking system, while requiring or incentivizing banks to use the money to support SMEs. In response to the COVID-19 pandemic, the Bank of England (BoE) and the Reserve Bank of Australia (RBA) are each conducting funding-for-lending programs. To incentivise banks to lend to SMEs, both central banks offer two tranches of money to eligible banks. All eligible banks have access to the first tranche, but banks can only access the second tranche if they use the first tranche to increase their loans to SMEs. The BoE ran a similar program in 2012, and although the multi-tranche structure was not included in the initial phase, it was added when the program was extended in 2013.

The BoE set no upper limit on the overall size of either the 2012 or the current program. Banks borrowed £42 billion (roughly $67 billion, 2.5% of the UK GDP in 2012) through the original program between June 2012 and April 2013. Other central banks have announced a maximum size for their funding-for-lending programs. The RBA set its program at AUD $90 billion ($52 billion, or 4.8% of GDP); Hungary’s 2013 program, HUF 750 billion ($3 billion, or 2.2% of GDP); Saudi Arabia, SAR 13.2 billion ($3.5 billion, or 2.5% of GDP); and Taiwan, NT 200
billion ($6.6 billion, or 1.1% of GDP). Still, the amount of funds available to each bank depends on the size of its loan portfolio.

Typically, only companies with prior access to a central bank’s discount window are eligible to participate in funding-for-lending programs due at least in part to the pre-existing technical and operational capacity of institutions already in the central bank system. Central banks are finding ways to expand eligibility, however. For example, the RBA said in announcing its program that it had developed a complementary program for nonbank lenders.

To encourage banks to begin lending to SMEs as soon as possible, funding-for-lending programs can reward banks for the lending they had extended to SMEs even before the central bank had made the funding available. This is accomplished by using a date before the crisis began as the date by which the central bank will begin counting new lending. For example, in the current crisis, the BoE used December 31, 2019 and RBA used January 31, 2020. This ensures that banks can benefit appropriately if they were already lending to SMEs before the central bank announced its program but after the crisis began.

Funding-for-lending programs are not exclusively conducted by central banks. For example, South Korea, Saudi Arabia, Ireland, and the EU (via the European Investment Fund) have each established funding-for-lending programs where the fiscal authority provides the funds to banks and sets similar stipulations and/or incentives for banks to lend to SMEs at favorable rates.

For more information about Funding for Lending for SMEs, please see YPFS’s analysis of this topic.

Payment Forbearance

Assistance to SMEs focused on increasing the funds coming into a business can be complemented by programs aimed at delaying or reducing outflows. Payment forbearance allows businesses to simply delay paying amounts owed. Creditors sometimes implement these programs during normal times, especially when the institution in question thinks a business is suffering but is viable as a going concern. During economic downturns, governments are more likely to step into the picture and create their own programs by incentivizing or outright requiring forbearance.

Which creditors should offer forbearance and for which types of obligations is a critical question. SMEs can have payment obligations to entities in the public sector, financial private sector, and nonfinancial sector. Public-sector payment obligations can include government-owned utilities and other services, government-sponsored entities, and, of course, taxes (discussed in more detail below). It may be relatively easy for a government to waive such payments for a short period. On March 18, for example, Dubai and Abu Dhabi reduced 15 different customs fees, taxes, and other costs for businesses.
In the financial sector, banks typically have procedures for working with borrowers who are experiencing temporary financial stress. In the current crisis, some of the largest banks voluntarily created forbearance programs. A broad, government-initiated moratorium on loan payments to banks and other financial institutions could offer relief to small businesses during a crisis. On March 17, Italy adopted such a plan as part of the “Cura Italia Decree”. Under this plan, amounts owed by Italian SMEs with no non-performing exposures on financings to banks, financial intermediaries, and other entities authorized to carry out lending activity in Italy are suspended until September 30.

SMEs also may have obligations to creditors in the nonfinancial private sector, such as landlords and suppliers. A French program adopted in response to the current crisis allows SMEs to apply to defer rent and utility payments.

Which businesses will receive forbearance must also be considered. On March 19, Korea’s Financial Services Commission (FSC) announced a forbearance program that appears to offer blanket eligibility. Under the program, SMEs can access a six-month minimum extension on existing loans and guarantees from both banks and nonbanks. Blanket eligibility may be the most efficient policy in a pervasive crisis such as the current one, in which the sheer number of affected SMEs is so large as to challenge systematic efforts to distinguish the truly needy. However, blanket eligibility, as seen in some of India’s farm loan waiver programs, can also be susceptible to abuse due to moral hazard. Recent small-business programs in Europe have tended to limit eligibility to borrowers that meet certain criteria related to the impact of the coronavirus on their businesses.

Governments can negotiate forbearance programs with creditor associations for institutions like banks and non-banks, then bind them to the program. The Central Bank of Ireland announced one such agreement in response to the COVID-19 pandemic. Authorities can also outright require forbearance. In some cases, governments pass laws that require creditors to restructure SMEs loans. The Japanese government passed such a law during the Global Financial Crisis.

Typically, payment forbearance programs operate for a short and specified time period tied to the nature of the crisis. In cases of natural disasters, these programs can last for just a few months, as affected regions return to normalcy. Financial crises can be different. Governments that introduce temporary programs can end up extending them under political pressure or simply because the economic stress has continued longer than expected. During the Global Financial Crisis, for example, the Italian government, in collaboration with a creditor association, imposed a loan forbearance program for SMEs in August 2009 that Italy continued to extend and modify through at least 2014.

A challenge associated with forbearance programs is that they have the potential to negatively affect the creditors who were to have received the payments that are now being delayed. For this reason, forbearance programs are sometimes paired with measures intended to support affected creditors. Under the Italian debt moratorium discussed above, lenders are entitled to a
government guarantee equal to 33% of suspended payments if 18 months after the end of the moratorium a debtor remains unable to pay. In Saudi Arabia, a program delaying SME payments to banks and financing companies for six months also includes financing from the Saudia Arabrian Monetary Authority for such banks and financing companies.

For more information about Payment Forbearance for SMEs, please see YPFS’s analysis of this topic.

Tax Policy Changes

Some governments choose to lessen SMEs’ tax burdens as a way to provide them with relief during a crisis. Unlike some of the other tools for assisting SMEs, governments may change tax policies to benefit SMEs just as frequently during normal times as during crises. These programs have a tremendous range, but all tend to alter the corporate tax code. They can encompass everything from delays on employers’ social contributions to tax cuts and changes in how tax deductions work.

One of the most common tax policy tools, regardless of whether times are good or bad, is altering tax deductions for SMEs. Governments usually deploy these kinds of tax policies to encourage or discourage different kinds of investment by SMEs. In 2005, while the United States economy was still in expansion, the government passed the Gulf Opportunity Zone Act of 2005. This law contained a provision that increased the size of the deduction small businesses could take on property expenditures, which encouraged businesses to improve their properties. One Australian response to the COVID-19 pandemic operates on a similar logic. Australia’s Backing Business Investment (BBI) program allows businesses with turnover of less than AUD $500 million to deduct 50% of the cost of a business’s investment in a new asset. Programs like this provide cash flow relief and incentivize increased capital expenditures during the COVID-19 crisis.

Another common tool, especially during a recession, is cutting or delaying taxes for SMEs. The most common variant of this tool, which in some ways is similar to payment suspension, is the VAT (value-added tax) or sales tax deferral, in which payment of the VAT is merely delayed for a specified period of time. One can find a recent example of this policy in the Republic of Korea, which suspended the VAT for companies earning 60 million won or less per annum. Vietnam announced a five-month VAT deferral, during which businesses would not be punished for late payments.

Given the circumstances in which tax policy changes are being introduced, it is important that they be on taxes that are “profit insensitive” (i.e. taxes that are paid regardless of whether the SME is profitable). A break on a tax that a business pays only when it is making a profit is unlikely to be of much use during a crisis.

CARES Act
On March 27, 2020, the United States passed the Coronavirus Aid, Relief, and Economic Security (CARES) Act, which establishes a number of measures to combat the economic impact of the COVID-19 pandemic, including aid to SMEs.

Forgivable Loans and Grants

Section 1102 of the CARES Act allocates $349 billion to the Paycheck Protection Program, which guarantees Small Business Administration (SBA) sponsored loans made by financial institutions of up to 250% of an employer’s pre-pandemic average monthly payroll (up to a maximum loan value of $10 million each) to businesses with up to 500 employees. The CARES Act also expands eligibility to sole proprietors, independent contractors, eligible self-employed individuals, certain nonprofits, and certain tribal business organizations. Borrowers can use the proceeds of the guaranteed loans to fund payroll costs, employee benefits, mortgage interest payments, rent, utilities, and interest on existing debt, in addition to other allowable SBA uses. SBA fees typically associated with such loans are waived, and the interest rate lenders can charge is capped at 4% with a minimum payment deferment of six months. The Treasury has set this rate at 1%. The CARES Act also waives requirements borrowers must typically meet to receive an SBA loan, including providing a personal guarantee and/or collateral and demonstrating an inability to obtain credit elsewhere. Any loan not entirely forgiven as described below can have a maximum maturity of 10 years from the forgiveness application date.

Under Section 1106, guaranteed loans provided pursuant to Section 1102 will be forgiven in an amount equal to the borrower’s spending on payroll (including salaries, wages, and benefits), mortgage interest, rent, and utilities in the eight weeks after the origination of the loan. This forgiveness amount is subject to reduction (a) in proportion to the reduction in the number of employees during this eight week period as compared with pre-pandemic periods and (b) based on the amount salaries and wages are reduced beyond 25% during this eight week period as compared with pre-pandemic periods. Rehire provisions incentivize businesses to bring back staff and restore salaries and wages by enabling borrowers to avoid loan forgiveness reductions if certain previously adopted job or pay cuts are reversed.

The CARES Act also expands other loan opportunities for SMEs. Section 1102 increases the maximum amount of the SBA’s Express Loans to $1 million from $350,000. Section 1110 expands eligibility and loosens requirements for the SBA’s Economic Injury Disaster Loans (EIDL) program and establishes emergency grants in amounts up to $10,000 per potential borrower to be paid while loan applications are pending, with no repayment required even if a loan application is ultimately rejected. Section 1112 provides for six months of payment subsidies on existing SBA loans.

Funding for Lending

SMEs may also benefit from the $500 billion in loans, loan guarantees, and other investments the CARES Act makes available to assist businesses, states, and municipalities under Section 4003. Section 4003 requires the Treasury Secretary to “endeavor to seek” to establish a
program providing financing to lenders who make loans to eligible businesses with between 500 and 10,000 employees on favorable terms including a maximum annual interest rate of 2% and at least six months of deferred payments. Section 4003 also allows for the creation of a “Main Street Lending Program” aimed at small and mid-sized businesses that are too big for SBA lending but not big enough for capital markets. On March 23, 2020, the Federal Reserve announced that it would soon establish a Main Street Business Lending Program, which would provide support to SMEs and complement SBA lending. Further information about this potential program is not yet available.

On April 6, the Federal Reserve announced that it would establish a new lending facility to offer term financing backed by loans in the Paycheck Protection Program. Further information about this program is not yet available.

Tax Policy Changes

SMEs may also benefit from a number of the tax provisions contained in the CARES Act. Section 2301 establishes an employee retention tax credit for businesses fully or partially suspended as a result of a government order stemming from the coronavirus or that otherwise suffer a more than 50% decline in revenue. Eligible businesses will receive a refundable credit against employment taxes equal to 50% of qualified employee wages (up to $10,000 in wages per employee). For businesses with more than 100 employees, only wages paid to employees not performing services due to coronavirus suspensions are included. Section 2302, meanwhile, allows businesses (although not those who have received the loan forgiveness provided by Section 1106 described above) to delay payment of 2020 employment taxes until December 31, 2021 (50% due) and December 31, 2022 (the remaining 50% due). There are also provisions for relaxing restrictions on net operating losses, providing corporate alternative minimum tax credits, and business interest expense deductibility.

Key Takeaways

Evaluations of SME assistance interventions are limited and/or mixed. Nonetheless, it is possible to identify several key takeaways associated with their use.

*In order for assistance to be effective, SMEs must receive it in time*

Speed is often essential when seeking to support SMEs during a crisis because of SMEs’ limited reserves and reduced access to other forms of financing. Which intervention type or types will enable a country to respond most quickly can depend on what resources, programs, infrastructure, etc. it had in place heading into the crisis. Many countries expand existing SME support programs in response to crisis conditions. An intervention like direct lending seems difficult to introduce during a crisis absent such a pre-existing program given the resources and infrastructure it requires, but where institutions like state banks exist, they may be able to provide lending on favorable terms more readily than the private banking system.
Grants, while costly, can be relatively easy to implement, particularly where there is an existing mechanism like the withholding system that can be used for their distribution. Even relatively small grants given quickly may afford countries adequate time to adopt interventions that are more difficult to implement.

Funding for lending can potentially be implemented under existing central bank authority, meaning that no legislative or executive action would be required. Tax policy changes and payment suspensions involving government-controlled creditors, meanwhile, can be accomplished without the involvement of third parties such as private banks and private creditors.

In the developing world, credit guarantee programs may be the intervention type most easily adopted because they leverage the expertise of private banks in a context of limited government capabilities. Guarantee programs have the added benefit of not requiring a large upfront expenditure, as costs are incurred only after loan defaults.

**Due diligence on potential recipients is also an important consideration**

While speed of distribution would be improved by conducting no due diligence on potential recipients of SME assistance, such an approach runs the risk of widespread waste, fraud, and losses to the government. Governments generally lack the capacity to engage in this sort of diligence. The experience and existing relationships theoretically possessed by private financial institutions may make them well-suited for this role. However, the extent of the diligence must still be balanced with the desire for speed, and the incentives of private financial institutions to perform the role must be addressed.

**Assistance to financial institutions does not automatically result in greater lending to SMEs absent the right incentives**

The experience of past crises suggests that merely providing assistance to the banking sector doesn’t ensure that such assistance will be used to increase lending to SMEs. During the Global Financial Crisis, capital injections for banks did not necessarily improve SMEs’ access to bank credit. Even guarantees on SME lending may not result in such lending where banks are reluctant to take them up. The Paycheck Protection Program under the CARES Act in the US is an example. It may be similar to a grant for borrowers whose loans are forgiven, but the role of banks as intermediaries means that the government can’t control how much lending actually occurs. Elected officials followed the announcement of the program with strong language urging banks to participate. Additional tools such as credit mediators, timely reporting of SME lending, and SME lending codes of conduct may be necessary.

**Actual sources of SME credit must be considered**

SMEs are increasingly obtaining financing from outside the traditional banking sector. Programs that operate solely through this sector (e.g., a guarantee program available only on bank lending or a funding-for-lending program targeted at just those institutions with
discount window access) may be insufficiently broad. Some programs are being tailored with this new reality in mind by including non-bank lenders alongside traditional banks.

**Interventions may have effects on other parts of the system that must be considered**

Payment forbearance programs can be attractive as they provide immediate relief to SMEs without any government outlay. However, the suspension of payments to creditors may have a negative impact on those creditors who themselves in turn may require government intervention.

**Ultimately macroeconomic conditions will need to improve relatively quickly for most intervention types to be successful**

Programs that provide SMEs with loans or that delay payments otherwise owed can meet the short-run liquidity needs of businesses. However, absent an improvement in macroeconomic conditions they may only postpone insolvency.
Lessons Learned in Designing and Implementing Support for Small Businesses

By Mallory Dreyer and Kaleb Nygaard

Original post here.

One month into the biggest global bailout of small businesses in history, countries have started to adjust their initial programs to make them more effective. Small and medium sized enterprises (SMEs) account for 90 percent of businesses and a majority of employment opportunities across the world. Even during non-crisis times, many SMEs face constraints in accessing financing. Governments are working to provide exceptional support during the COVID-19 pandemic in order to prevent bankruptcies, unemployment, and a deeper recession.

All countries face the same challenge: how to quickly get funds to the businesses that need them. In response to the challenge, governments have adopted a variety of interventions (see the YPFS blog here). In this post, we evaluate interventions designed to support SMEs and present nine lessons learned.

Lessons Learned

1. Demand has far exceeded most programs’ initial budgets
2. Aligning incentives can encourage more private-sector lender participation
3. Leveraging existing agencies can get money to SMEs faster
4. Including both bank and nonbank lenders can account for multiple sources of SME financing
5. Targeting assistance too narrowly can slow down the provision of support
6. Streamlining the application process can speed up distribution of funds
7. Small businesses may face challenges meeting fixed costs that programs don’t cover
8. Some programs inherently require, or benefit from, additional programs
9. Businesses will likely need further government support

1. Demand has far exceeded most programs’ initial budgets

In many countries, demand from SMEs for assistance has outstripped the amount governments initially made available. In response, governments have increased the overall allocation of funds to these support programs. In some instances they have also increased the amount available to individual SMEs.

Overall allocation
Italy, a country that suffered particularly early and deeply from COVID-19 has dramatically increased the amount of funds available for loan guarantees. On March 17, the Italian government announced a EUR 100 billion ($109 billion) loan guarantee program. On April 14, the EC approved a four fold increase (up to EUR 500 billion) of the original program and announced a new program for the self employed and smaller companies with an unspecified allocation.

In less than two weeks, on April 16, the United States expended the full $349 billion Paycheck Protection Program (PPP). On April 22, congressional leaders reached a deal with the administration to infuse the PPP with an additional $310 billion.

Switzerland doubled its initial loan guarantee program allocation from CHF 20 billion ($21 billion) to CHF 40 billion. Spain increased its original EUR 100 billion SME support program by EUR 20 billion.

Participation limit

Many countries have increased not only the amount of total funding available in a support program, but also the individual business participation limit. For example, the government of Singapore increased the maximum loan amount available under its Temporary Bridging Loan Program from SGD 1 million ($700,000) to SGD 5 million. When Italy added a new program specifically targeting smaller companies and the self-employed it increased the size of loans eligible for a 100% state guarantee from EUR 25,000 under the previous program to EUR 800,000 in the new one.

2. Aligning incentives can encourage more private-sector lender participation

When the government channels funds through the financial system, it has to ensure that the lenders are properly incentivized to lend the funds to the SMEs.

Guarantee Percentage

Many countries have had to increase the government guarantee rate on the loans they are asking the banks to offer to SMEs. When Germany expanded its loan guarantee program, it increased the guarantee rate from between 80% and 90% up to 100% after banks were reluctant to take on new risks in the current economic environment. Singapore increased guarantee rates on a variety of its programs from 80% to 90%. Colombia increased its guarantee rates from 60% to 90%.

Interest Rate Ceiling

Many governments set interest rate ceilings on the loans that banks offer to SMEs under credit guarantee programs. However, setting this rate ceiling too low can make banks unwilling to participate. The US’s PPP initially set the interest rate at 0.5% but later had to increase the rate to 1.0%.

Waiver for Individual Bank Participation
Wells Fargo had been lending under the PPP, but it was constrained by an outstanding restriction on balance sheet growth due to previous misconduct. The Federal Reserve temporarily waived the growth restriction on Wells Fargo to allow Wells to issue more loans under the PPP. Because Wells Fargo is an important lending channel for small businesses, this waiver incentivizes it to continue to participate, which will help its small business customers that need funding receive it.

3. Leveraging existing agencies can get money to SMEs faster

Some governments avoid the challenge of structuring programs to appropriately incentivize private sector banks by leveraging pre-existing government agencies that provide loans directly to small businesses without needing to use the banking system as an intermediary. This can lead to quicker delivery of emergency funds.

In response to the COVID-19 crisis some of these countries have increased funding to these agencies to allow them to provide substantially more loans directly to small businesses. For example the Business Development Bank of Canada announced a CAD 10 billion program that will provide up to CAD 2 million working capital loans with flexible repayment terms to small businesses. MicroFinance Ireland initiated a new program that provides loans to businesses with less than 10 employees if they have been rejected for financing by a bank. The European Investment Bank, the lending arm of the European Union, has announced a EUR 25 billion credit guarantee program, part of which will be distributed by European countries’ development banks.

The US tasked its Small Business Administration (SBA) agency with the administration of much of its support programs. This includes the PPP as well as direct grants and loans under the SBA’s Economic Injury Disaster Loan program. The SBA deployed more than $350 billion in support to SMEs in two weeks and is expected to deploy a similar amount in the coming days.

4. Including both bank and nonbank lenders can account for multiple sources of SME financing

Because many SMEs do not have existing loans, credit lines, or relationships with traditional banks, some programs include lenders beyond traditional commercial banks or target lenders with expertise to lend to small businesses.

For example, many SMEs in Switzerland do not have bank loans and only bank with PostFinance, the financial services subsidiary of the national postal service, which does not traditionally lend. The Swiss government is temporarily allowing PostFinance to issue loans under its credit guarantee program.

In the PPP, the Small Business Administration (SBA) provides the guarantees, but the financial system issues the loans. Eligible lenders of SBA loans now include non-bank-entities like PayPal, Square, and Intuit. In the proposed emergency legislation, which appropriates an additional $310 billion for the PPP, $60 billion is earmarked for small, midsize, and community lenders, as
these lenders typically reach more of the smaller businesses compared to the large national lenders.

On April 17, the British Business Bank (BBB), which administers the United Kingdom’s Coronavirus Business Interruption Loan Scheme (CBILS), announced that a new lender was accredited to lend under the scheme. The new lender, Funding Circle, is the first newly accredited marketplace lending platform in CBILS and is the largest online small business loan provider in the UK. The BBB has accredited additional lenders since the launch of CBILS and will continue to accept applications from new lenders in order to expand the funding options for SMEs.

5. Targeting assistance too narrowly can slow down the provision of support

Policymakers face a trade off between specificity and efficiency in providing support to SMEs. In general, programs that target specific types of firms require more administrative processes. For example in the United Kingdom, the CBILS was initially limited to borrowers who had failed to secure standard commercial financing. This not only limited the scope of the support but also added administrative burden for lenders and prolonged the process. Some firms complained that banks were offering standard financing with high interest rates instead of loans under the scheme. In the first two weeks of the program, 130,000 inquiries were received but only 983 loans were approved. The amendment to CBILS eliminated the requirement, thus expanding the eligibility criteria. The UK also announced a credit guarantee scheme for larger companies when the CBILS program was amended, in order to fill the financing gap for companies that could not participate in CBILS or access the Covid Corporate Financing Facility (CCFF).

Many countries limit programs to firms up to a certain size or maximum turnover. For example, the Paycheck Protection Program in the US restricts usage to employers with 500 or fewer employees. However, the SBA released additional guidance regarding eligibility to clarify that firms that meet the statutory and regulatory definition of a “small business concern” with more than 500 employees are eligible. The US program has faced backlash after some larger companies were reported to have received loans under the program, and Financial Times analysis shows that eighty publicly-traded companies, with ability to raise capital elsewhere, received aid.

6. Streamlining the application process can speed up distribution of funds

By eliminating complexity from the application process, programs can distribute funds to small businesses quickly.

In the United States, small businesses apply directly to their lender. These institutions are responsible for the application process and can utilize their existing interface and online systems though the SBA provides a template application. Thus, borrowers approach the lender, and lenders then submit information to the SBA. However, speed will depend on existing bank infrastructure, system, and staff. In the US where the PPP operates on a “first-come-first-serve”
basis, the speed at which an individual lender can process applications influences which small businesses receive aid.

In Switzerland, the government provides a standardized application online which applicants fill out and then take to the lender. The government anticipates that the application should take approximately 10 minutes to complete. In some cases, applicants have reported receiving funds less than an hour after completing the application. Because credit risk assessments are waived, the Swiss government announced actions to prevent fraud on April 3. The Swiss guarantee organizations confirm that the loan agreements comply with the requirements and cancel loans that are duplicates or wrongly applied. The loans are also checked systematically by linking VAT and other data to the information provided by companies.

In contrast to the 10 minute application in Switzerland, some countries require more detailed documentation in applications and feature more complex processes. Applications vary across lenders, but in programs with less than a 100% guarantee, lenders bear a portion of the risk. Because of this, credit and risk assessments are often required, but these processes are more time consuming. In Italy, this is cited as a reason why funds are not flowing quickly. Thus, the application process can be a bottleneck to distributing funds

7. Small businesses may face challenges meeting fixed costs that programs don’t cover

Some countries establish criteria and restrictions on how funds can be used, which can leave some small businesses with the challenge of finding financing to cover the gap. In the United States, the Treasury requires that at least 75% of the value of a forgivable loan issued under the PPP will be used for payroll expenses. Some firms worry that this support does not go far enough, especially for firms with high rent costs. Employee compensation is capped at an annualized $100,000 per employee under the PPP. Other countries developed or expanded wage subsidy programs which are specifically designed to cover payroll costs.

In Denmark, the government announced a program to cover a certain percentage of fixed costs of companies that have been impacted by the COVID-19 pandemic. The government will cover between 25 to 100% of fixed costs. Denmark also announced a wage subsidy program for firms forced to decrease work hours of employees or temporarily lay them off. By providing support for fixed costs in addition to payroll expenses, Denmark addresses a gap faced by other programs.

8. Some programs inherently require, or benefit from, additional programs

Providing support to one type of business or one sector of the economy sometimes disadvantages a different business or sector. Governments have had to introduce a number of complementary programs in tandem or introduce new programs in response to outcomes from previously announced programs.

Funding for Lending and Guarantees
A number of countries have paired credit guarantee programs with funding for lending programs. These programs are designed to increase the incentives to lenders to issue the guaranteed loans. In general these programs work by accepting loans to small businesses (often the very ones issued under the credit guarantee programs) as collateral for funds from the central bank or ministry of finance.

In the US, the Federal Reserve has two sets of programs that serve this purpose: the Paycheck Protection Program Lending Facility and the Main Street Lending Program. The Bank of England introduced the Term Funding Scheme. The Australian government introduced two such programs, one administered by the Reserve Bank of Australia for depository institutions and another administered by the Office of Financial Management for non-bank lenders.

Debt Moratoriums and Guarantees

By introducing debt moratoriums, the government effectively shifts the risk from the SME to the lender, who in turn often requires assistance. In Italy, the government paired its six month debt moratorium with a government guarantee equal to 33% of suspended payments if 18 months after the end of the moratorium a debtor remains unable to pay.

**9. Businesses will likely need additional government support**

To a larger degree than seen in past crises, many countries are providing direct grants for businesses in response to the COVID-19 crisis. Recent research from the Federal Reserve Bank of New York shows that fewer than 1 in 5 small businesses in the US can continue normal operations with their cash reserves if they experience a two-month revenue loss. Credit guarantee programs and additional lending can assist businesses with immediate cash flow needs, but the programs will only be effective if underlying macroeconomic conditions improve quickly; otherwise, they only delay insolvency. Beyond increased adoption of grants, credit guarantee programs are more generous, with the EU allowing 100% credit guarantees and multiple countries waiving risk assessments. Generous loan guarantee programs have similar characteristics to grants in terms of limited diligence but still increase the overall debt burden for firms, which some firms may not be inclined to accept given the uncertainty of long-term economic conditions and future revenues.
Countries Provide Support to Workers in the Informal Economy

By Kaleb Nygaard and Mallory Dreyer

Original post here.

In response to the COVID-19 crisis, countries have begun to help informal sector workers through safety-net programs, cash transfers, and public-works programs.

Workers in the informal economy are especially vulnerable to negative impacts from the COVID-19 pandemic. Informal workers are those in jobs without social insurance in sectors of the economy that are neither taxed nor regulated. The International Labor Organization (ILO) estimates that 1.6 billion of the approximately 2 billion informal economy workers globally will be significantly impacted by the COVID-19 pandemic, with workers experiencing an average earnings decline of 60%. Without an alternative income source, the ILO estimates that the proportion of informal economy workers in low-income countries living in relative poverty will increase from 18% to 74%. Informal workers are already twice as likely as formal workers to belong to poor households.

In general, informal economy workers have higher exposure to occupational health and safety risks. COVID-19 increases risks for workers, and many who become infected do not have a source of income security or healthcare coverage. Policies targeting informal economy workers are thus an important component of the government policy response to COVID-19, but policymakers face additional challenges in designing policies. Informal workers are not officially registered, making them harder to reach, and the informal economy varies widely across countries and regions.

In response to the COVID-19 pandemic, countries have implemented support programs for informal sector workers using the following:

- Existing unemployment insurance or social safety net programs
- New direct cash or in-kind transfers
- Public works programs
- Support to micro, small and medium-sized enterprises (including informal businesses)

Existing unemployment insurance or social safety net programs

Many countries have existing social safety net programs, such as cash and in-kind transfer, social pension, and school meal programs. In response to the COVID-19 pandemic, these programs can be expanded or enhanced to include more vulnerable and high-risk individuals. By utilizing existing programs, policymakers can quickly respond to the urgent needs of informal workers.

In the United States, the Pandemic Unemployment Assistance (PUA) provision of the CARES Act expands unemployment insurance eligibility to include self-employed individuals or those
who may otherwise be excluded. Though low-income countries have higher proportions of the workforce in informal jobs, industrialized countries, including the US, also have an informal labor force. The share of workers in informal jobs in the US has steadily increased in the past decade, and the ILO estimated that informal employment accounted for 30 million jobs in 2018, or 19% of the total labor force. States are permitted to provide unemployment benefits to self-employed, gig economy, or other informal workers through PUA for 39 weeks. The benefits include what the state provides and $600 through the Federal Pandemic Unemployment Compensation (FPUC) program under the CARES Act.

North Macedonia expanded its existing unemployment insurance system to include informal sector workers, with an additional 20,000 households expected to benefit. These informal workers can receive 7,000 denars (USD 125) in April and May. Lesotho, Kazakhstan, and Vietnam have also expanded social protection programs to include informal sector workers.

New direct transfers or grants

Other countries have introduced new cash transfers for informal workers in response to the COVID-19 pandemic. Identifying eligible individuals can be a challenge, as many informal workers are not registered, and policymakers also face the challenge of providing access to benefits quickly.

On March 25, Thailand introduced a cash transfer of 5,000 baht (USD 153) per month for three months for informal workers. The government initially committed to support 3 million workers, but demand far exceeded the commitment size. The Thai government has since announced that 14.5 million individuals are eligible to receive support. Individuals are required to submit applications online to claim the benefits. The website to submit applications opened on March 28, and despite a system crash, 8.5 million individuals were able to submit applications on the first day. However, not all individuals are approved automatically, and some applicants are asked to provide additional information, such as a picture of their workplace, and others have been rejected.

In Egypt, workers in the informal sector are eligible to receive a one-time payment of LE 500 (USD 32) to recoup some lost income due to the COVID-19 shutdowns. This one-time payment was initially expected to go to 400,000 individuals. Like Thailand, the actual demand exceeded the announced size, as 1.2 million people applied for the grant in the first week. These benefits will be provided to individuals who are registered in government workforce databases and distributed through post offices.

Identifying informal workers can be a major challenge, as these workers may not have formal employment contracts or be officially registered. In Guatemala, the government determines eligibility based on electricity consumption to provide the emergency cash grant of GTQ 1,000 (USD 130) to informal and self-employed workers. Individuals receive emergency grant payments electronically, either through smartphones or ATM withdrawals. Similarly, in El Salvador, the government’s new cash transfer program targeted households using electricity.
Households with usage between 0-250 kilowatts/hour received the transfers. In Ecuador, informal workers who earn less than USD 400 per month are required to register to receive the emergency cash benefit. After registering for the benefit, individuals receive a text message with information regarding nearby payment locations where the USD 60 benefit can be collected. In Brazil, informal workers, including domestic workers, can receive an emergency cash transfer of USD 115 per month for three months. The government identifies beneficiaries through the social registry, but individuals who are not registered can apply online.

In addition to cash transfers for vulnerable individuals, some countries have launched programs that provide training support to informal workers. Indonesia’s Kartu Pra-Kerja (pre-employment card) program provides vouchers for training and re-skilling to unemployed workers in addition to unemployment benefits. The program is estimated to benefit 5.6 million informal workers impacted by COVID-19, and eligible recipients receive benefits through bank transfers or through e-wallet platforms.

Public-works programs

Many governments have announced programs that provide financial aid to unemployed workers, some of whom come from the informal economy, in exchange for participation in a public-works program. Government-sponsored public-works programs have traditionally consisted of infrastructure projects. The US’s Public Works Administration is often cited as an important part of the government’s response to the Great Depression in the 1930s. To varying degrees, many countries are also hiring people to do COVID-19 testing or sanitation.

Many countries have increased funding to existing public-works programs. In Nepal, the Prime Minister’s Employment Program was originally introduced in early 2019 and guaranteed 100 days of work per year to work on infrastructure projects. In April the government extended the program; it also announced that informal sector workers who had lost their jobs due to the crisis would receive 25% of a local daily wage if they chose not to participate in the public-works projects. The Philippines added an additional sub-program to its broader TUPAD public-works program that provides between 10 and 30 days of work to displaced, underemployed, or seasonal workers. In Kenya, the government introduced a new program, Kazi Mtaani, focusing on unemployed workers in informal settlements in poor countries.

Other countries have provided public-works projects in health and hygiene. For example, South Africa’s program provides work in essential services and waste collection but also includes a new initiative to hire 20,000 people to support the distribution of sanitizers and hygiene education as well as to work in disinfection and sanitization. Kenya’s program includes street cleaning, garbage collection, bush clearance and drainage unclogging services, as well as fumigation and disinfection. The emergency expansion of the existing Philippines program provided 10 days of employment in sanitation and disinfection activities to eligible workers.

Beyond infrastructure and sanitation, governments have looked to hire many contact tracers. These contact tracers “work with patients to help them recall everyone with whom they have had
close contact during the time-frame while they may have been infectious, then contact the
individuals to let them know of their potential exposure.” In the US, according to one survey,
state governments plan to hire at least 36,000 people to work in contact tracing. Similarly,
the UK will hire 18,000 contact tracers. Though some countries have leveraged existing
surveillance technologies or mobile apps, there is likely going to be a high demand in other
countries for contact tracers, which a government could fill using a public works program.

Support to micro SMEs and informal businesses

The ILO predicts that the informal economy will grow as workers are pushed out of small
businesses that close, in some cases permanently, due to economic shut-down measures taken by
governments to help prevent the spread of the disease. Some countries have introduced measures
to support these micro SMEs and informal businesses.

The government in Burkina Faso has suspended fees charged on informal sector operators for
rent, security, and parking. In Gabon, the government has a lending mechanism with
approximately USD 375 million in funding to facilitate access to commercial bank financing for
both formal and informal companies. In Malaysia, the government introduced a special, one-
time MYR 3,000 (USD 690) grant program for micro SMEs with less than 5 employees
(excluding the owner) and less than MYR 300,000 in turnover. Support to micro SMEs and
informal businesses will be important as governments begin to lift stay-at-home orders and
restrictions.
Governments Provide SMEs with Relief for Non-Wage Fixed Costs

By Mallory Dreyer and Kaleb Nygaard

Original post here.

As countries adopt measures to respond to the ongoing COVID-19 crisis, many are providing support to businesses for fixed costs. Fixed costs are those that do not change with the amount of product or services a firm provides. Though a small business may be able to decrease variable costs in response to diminished demand or a government-mandated suspension of operations, small and medium-sized enterprises (SMEs) still face the ongoing burden of fixed costs.

Instruments vary across countries, with some countries providing waivers, grants, deferrals, moratoriums, loans, or even negotiation tools and eviction protection. Most fall in one of the following categories:

1. Multiple fixed costs
2. Rent
3. Property taxes
4. Utilities

We have covered programs that support wages, salaries, and other personnel costs earlier. See our posts on the Paycheck Protection Program, small business support in the United States, and short-time work schemes.

Programs Covering Multiple Fixed Costs

The Netherlands, Austria, and Denmark have all announced fixed-cost subsidy programs to cover a specified amount of fixed costs for companies. Unlike programs that cover specific fixed costs, these programs cover multiple fixed costs.

In the Netherlands, the government announced a EUR 1.4 billion (USD 1.6 billion) support package for fixed costs of SMEs on May 20. On May 28, the government expanded the maximum amount of support and extended the time frame. The program will provide up to EUR 50,000 per company for reimbursement of fixed costs for four months. The size of the grant depends on the size of the company, level of fixed costs, and amount of the revenue loss. Eligible companies are those with at least a 30% decrease in revenue. Wage costs are not eligible under the program, but rent, insurance premiums, lease, and maintenance costs are.

The Austrian government has allocated EUR 8 billion in funding for its fixed-cost subsidy program, which reimburses up to 75% of a company’s fixed costs for up to three months. Eligible costs include rent, insurance premiums, financing costs for leases, utility costs, spoiled goods that have lost at least 50% of their value due to the crisis, and interest expenses; including interest expenses as eligible for reimbursement appears to be unique to the Austrian program.
Support is provided in the form of direct grants to companies that experience at least a 40% decline in turnover compared to the same quarter in 2019.
Rent

One significant fixed expense many SMEs face is rent payments. In response to COVID-19, governments at all levels have provided direct support to SMEs in the form of rent waivers, deferrals, and subsidies, as well as eviction protection.

Government as landlord

For some SMEs, their landlord is the government. In these cases, governments have been able to provide rent payment relief quickly and efficiently. St. Lucia, for example, waived rental payments for six months for all small entities renting properties from the government. Bahrain and Burkina Faso instituted similar waivers. Other countries have waived rent payments owed to the government from certain sectors, like tourism-related businesses in Bhutan. In Malaysia, the government’s rent waiver extends to government-linked companies such as the state-owned oil and gas company (Petronas), highway construction company (Plus), and urban-development company (UDA), among others.

The Russian government introduced a support program that waives three months of rent owed to the federal government for SMEs in affected sectors. The measure also defers all rent payments to all levels of government in the country through the rest of 2020.

Private landlord

Governments also provide support for SMEs whose landlord is not the government. These programs are more challenging to implement and often shift the burden from small businesses to landlords; however, many more SMEs rent from private landlords and therefore the impacts of these programs can be significant. These support programs come in two broad categories: (1) moratoriums and payment deferrals and (2) government subsidies of all or part of payments.

Government-mandated payment moratoriums have ranged in duration from a few months (e.g. Albania, Oman, and Slovak Republic) to six months (e.g. Qatar) to even a full year (e.g. Vietnam).

The government of Singapore passed a SGD 2 billion program (USD 1.4 billion) offering grants to SMEs to use for rent payments. For SME tenants of commercial properties, the program will cover two months of rent, and for SME tenants of industrial and office properties, the program will cover one month of rent.

Other programs seek to distribute the costs between the landlord, tenant, and government. The governments of Lithuania and the Czech Republic have each introduced programs whereby landlords of properties with small-business tenants will waive 30% of the rent, the tenant will pay 20%, and the government will pay the landlord the remaining 50%.

Lease negotiation and eviction protection

Many governments have passed laws restricting the actions of property owners in dealing with small business tenants who do not pay rent. In Russia, SMEs may simply terminate their lease
without penalty. Spain introduced a mechanism whereby small businesses can renegotiate leases. In the Netherlands and the Democratic Republic of the Congo (DRC), the governments have prohibited eviction during the COVID-19 pandemic (the DRC explicitly defined this period as March through June).

Support through property owners

Rather than provide support directly to SMEs for rent expenses, some governments channel support indirectly through landlords and property owners.

The Canada Emergency Commercial Rent Assistance (CECRA) program provides support to property owners. The support comes in the form of unsecured, forgivable loans. The loans to eligible property owners are forgivable if they reduce rent for small business tenants by at least 75% for the months of April, May, and June. Small businesses eligible for the reduction include those who pay less than CAD 50,000 (USD 37,000) gross rent per location, generate no more than CAD 20 million in gross revenue, and have experienced at least a 70% decline in pre-COVID-19 revenue.

Many governments offer tax breaks to incentivize property owners to reduce rent expenses. For example, Mongolia and Malaysia offer tax rebates or reductions equal to the amount by which rent was reduced. In Russia, the government offers tax deferrals to property owners that defer rent payments.

Property Taxes

Some governments provide property-tax relief to SMEs and other companies through deferrals, penalty waivers, and discounts.

In the Czech Republic, the government is waiving penalties for companies that do not file and pay property taxes on time. This provides an extended window for repayment, but it does not impact the total amount owed. Similarly, Chile provided a property-tax deferral of the first quarter payment to companies with less than UF 350,000 (USD 12 million) in sales. The government is not charging interest on the deferred amount and requires the amount to be repaid with the remaining quarterly payments.

Some countries are targeting specific sectors and industries through property-tax relief. Georgia is providing a property-tax holiday for hotels through November 1. Egypt is providing companies in the industrial and tourism sectors with a three-month extension on tax payments.

Israel has allocated NIS 2.8 billion (USD 806 million) for property-tax discounts for businesses. Businesses will be eligible for a 25% discount on the property-tax bill. Because local government authorities are impacted by a decline in property taxes, the federal government is transferring funds to local governments to make up for the lost revenues. In other countries, local governments have deferred the payment of property taxes, but not always with a federal backstop.
Japan has also reduced property taxes for SMEs. The measure impacts the property-tax bill for 2021, unlike measures in other countries which typically decrease or defer the 2020 amount. SMEs can benefit from a 50% decrease in the tax due if their gross income falls between 30% and 50% for a three-month period between February and October, 2020; SMEs whose gross income declines more than 50% will be exempt from paying property taxes during that period.

Utilities

Some countries are also providing relief for utility payments to SMEs. Relief varies across countries and can take different forms.

In Romania, some SMEs are eligible for utility-payment extensions, which include electricity, gas, water, phone, and internet services. Guinea, Brunei, and Israel provide temporary deferrals for companies that are most impacted by the COVID-19 crisis.

In some countries, state and local governments provide direct support to SMEs for utility payments. For example, San Francisco suspended shutoffs of water and power for 60 days for residential and business tenants and waived interest and fees on late payments. South Carolina, Kentucky, and Massachusetts have also temporarily stopped shut-offs for small businesses during the crisis.
Governments Encourage SMEs to Adopt New Technology

By Mallory Dreyer and Kaleb Nygaard

Original post here.

In response to the COVID-19 pandemic, governments around the world are adopting measures to encourage small and medium-sized enterprises (SMEs) to implement new technology.

Mandatory stay-at-home orders significantly impact foot traffic and revenue for many small businesses. Governments are encouraging firms to use new technologies to promote objectives such as establishing e-commerce sales channels, enabling employees to work remotely, increasing internet access, and moving to cashless payment systems.

Instruments to encourage digitalization vary across countries but include the following:

1. Grants
2. Loans
3. Free online platforms
4. Consulting and advisory services

Grants

Some governments are providing direct financial support in the form of grants or subsidies to small businesses to encourage the adoption of technologies to enable remote working, online sales, or cashless payments. The design of such grant programs vary, with some programs targeting firms of specific sizes or stipulating specific usage while other programs have a broader range of eligible uses.

In Ireland, eligible SMEs can receive grants of up to EUR 2,500 (USD 2,827) to develop an e-commerce platform or online trading platform. The Trading Online Voucher is available to SMEs with up to 10 employees and annual revenue of less than EUR 2 million. Firms are required to cofund 10% of the cost of the new technology. A firm could be eligible for a second voucher of up to EUR 2,500 if upgrades are required.

Japan is offering multiple subsidies to firms as a part of the SME Productivity Revolution Promotion Project. These include a sustainability subsidy, a manufacturing subsidy, and an IT introduction subsidy. Specifically, the IT Introduction Subsidy provides grants to small businesses for projects to improve labor productivity by at least 3% after one year and 9% after three years. Size requirements vary across sectors, with manufacturing companies eligible if they have less than 300 million yen in capital and less than 300 full-time employees while retail companies are eligible if they have less than 50 million yen in capital and less than 50 full-time employees. Firms can receive up to 4.5 million yen (USD 42,118), which in addition to supporting new technology adoption, can retroactively cover the costs of leasing computers and other hardware to April 7.
Singapore’s Ministry of Finance announced total measures of SGD 500 million (USD 359 million) to support businesses in digital transformation. These measures target firms of different sizes. The first measure, which targets sole traders and microenterprises, provides SGD 300 per month for five months to stall holders in “hawker centres, wet markets, coffee shops, and industrial canteens” to adopt e-payment platforms and avoid handling cash. The second measure expands an existing support program for SMEs, the SMEs Go Digital program, which assists SMEs in the adoption of new technology. The government is augmenting this program with a Digital Resilience Bonus of up to SGD 5,000. The bonus is available to firms that adopt electronic payment and invoicing solutions, in addition to business process and e-commerce solutions. Furthermore, food and beverage and retail firms that have already adopted such technologies can be eligible for SGD 5,000 if they adopt advanced solutions. The government also has announced a package that covers 80% of the value of remote working equipment, such as laptops, under the SMEs Go Digital Program.

South Korea is also encouraging small businesses to go online. Under the government’s proposed “Digital New Deal” package, it will provide 160,000 SMEs with 4-million won (USD 3,315) vouchers for accessing remote work platforms, such as videoconferencing.

Loans

Rather than providing direct grants to small businesses, some governments have announced lending programs for SMEs, with the requirement that firms use the loans exclusively for the adoption of new technologies.

Bank Negara Malaysia, Malaysia’s central bank, announced multiple credit facilities for SMEs, one of which is the RM 300 million (USD 70.6 million) Automation and Digitalization Facility to improve productivity and efficiency. Eligible SMEs can obtain up to RM 3 million in financing at a 4% interest rate with a maximum term of 10 years. These funds are to be used exclusively for the purchase of equipment, machinery, hardware, software, and IT solutions and services. The facility is available through the end of 2020.

Spain’s government announced the SMB Accelerate Plan which is a package designed to incentivize small businesses to adopt new technologies. One component of the plan is a EUR 200 million credit line through the Official Credit Institute (ICO) to lend to SMEs for the purchase and leasing of equipment and services for digitalization. Specifically, the government encourages companies to use the funding to purchase equipment and services for remote work.

Other countries have similarly established lending facilities to encourage technology adoption. South Korea announced that it would increase total funding for small business loans to 1 trillion won, with 200 billion specifically allocated to encourage businesses to go online. Argentina also announced a 7.2 billion credit line for SMEs, with funds to be used exclusively for the purchase or lease of remote working technologies or products.

Free online platforms
To help SMEs navigate government support programs, shift to remote working, and improve general business management or technical skills, many countries offer free online training courses and materials. In some cases, the governments themselves provide the training, and in other cases the training is provided by private companies (often technology companies) and facilitated by the government. Such platforms can assist SMEs in making the transition to new technologies, in order to resume operations, expand sales channels, or provide safer working conditions for employees.

Ireland’s eILearn platform provides learning resources and hosts training programs, workshops, and networking events online for SMEs affected by the crisis. The platform is operated by Enterprise Ireland, a government organization responsible for development and growth of Irish enterprises. Another Irish government agency, Skillnet, brings together private businesses and provides training support to SMEs.

The governments of Italy and Austria both provide subsidized use of remote working technologies like videoconferencing, collaboration tools, internet access, and cloud computing. Austria also announced the creation of a virtual department store that would allow retailers to become more visible to existing digital stores like Amazon and Google. Spain’s SMB Accelerate Plan provides similar resources through its online portal.

In Greece, the government announced a digital solidarity platform where large technology companies provide free online marketing and account management training to SMEs. The government also announced an initiative to help SMEs establish an online presence.

The government of New Zealand created an online calculator tool that helps small businesses forecast their cash flow in the COVID-19 context.

Consulting and advisory services

A question that many SMEs face in response to the COVID-19 pandemic is how to adjust their business models for the short and long-term. Many governments have introduced programs that supplement, or fully pay for, advisory services for SMEs.

On April 3, the German government announced an assistance program that would cover up to EUR 4,000 in consultancy services to help SMEs find solutions for coping with the crisis and economic shutdown. SMEs quickly drew down the full amount allocated to the program and the government agency running the program announced that the program had closed sooner than anticipated.

Korea included significant support for consulting services as part of its recently announced Digital New Deal. One measure of the plan is to provide 25,000 SMEs with free security testing and consulting services. The plan also includes funding for consulting services for companies looking to introduce remote working.

In Spain, the government expanded its Digital Transformation Office program and improved its personalized advisory services. As part of a March 20 announcement, the government
of Finland indicated that it would dedicate EUR 500,000 to subsidizing counselling and support services for entrepreneurs. The government of Costa Rica announced support for business development services to help companies navigate returning to economic activity once the crisis is over.
Countries Continue to Adopt and Update Credit Guarantee Schemes for Small Business Lending

By Mallory Dreyer and Kaleb Nygaard

For prior analysis, see Credit Guarantee Programs for Small and Medium-Sized Enterprises and Lessons Learned in Designing and Implementing Support for Small Businesses. The SME Credit Guarantee Resource Guide catalogs features of past and present guarantee schemes and provides evaluation and general resources.

In response to the COVID-19 pandemic, many countries quickly announced credit guarantee schemes to support lending to small and medium-sized enterprises (SMEs). Under a credit guarantee scheme, the government fully or partially guarantees the value of a loan to an SME, which minimizes the risk to the lender, incentivizing the lender to provide credit. According to recent data from the World Bank, 41 countries have launched 57 credit guarantee schemes for SMEs this year.

Under normal economic conditions, SMEs are more constrained than larger firms in accessing finance. In the context of the COVID-19 pandemic these constraints are exacerbated and they face severe liquidity shortages. Without support, many SMEs could begin to face a solvency crisis.

Credit guarantee schemes are one tool available to governments to support SME liquidity, but they are not without design and implementation challenges. Guarantees can encourage banks to lend to riskier borrowers by limiting the downside risk, but guarantees will not be as helpful when lenders are limited by balance sheet constraints. Similarly, many SMEs are in a position where any new debt, even inexpensive, fully guaranteed debt, isn’t financially feasible. Guarantee programs leverage existing lender-borrower relationships, but the total amount of lending will be influenced by the coverage ratio - the percentage of the loan being guaranteed. If a ratio is set too low, banks may not lend to riskier, high-need borrowers, and the program will not support those it is intended to aid. However, if the coverage ratio is 100% and a program fully protects banks against default risk, banks may lower their lending standards. Other design considerations include size, loan terms, eligible firms and lenders, and duration.

In response to the Global Financial Crisis in 2008-2009, many countries adopted credit guarantee schemes that were never closed. Countries and the responsible authorities that maintained such programs could quickly respond in the face of the pandemic. However, initial responses were often inadequate and have since been expanded. Many other countries have since adopted new programs.
In this post, we provide an update on credit guarantee schemes in response to the COVID-19 crisis. Specifically, we review how governments continue to adapt and expand existing schemes and create new schemes, and how program utilization and demand compare across countries.

**Updating and Expanding Existing Credit Guarantee Schemes**

Many countries have announced changes to their initial credit guarantee schemes, most of which were introduced in the second half of March and early April.

**Coverage Ratio**

The coverage ratio is one feature of credit guarantee schemes that can be changed in response to changing economic conditions and demand. Since the beginning of the COVID-19 pandemic, 100% guarantees have increased in prevalence; our initial analysis of credit guarantees for SMEs noted that only Japan, South Korea, and Hong Kong provided 100% guarantees. Initially, the European Union’s Temporary Framework for State Aid permitted Member States to provide a guarantee on up to a maximum of 90% of a loan. In an April 3 update to the Temporary Framework, the limit was loosened, and Member States can now provide a 100% credit guarantee. Italy initially announced a tiered credit guarantee system, with decreasing coverage ratios based on loan and company size, but later announced a 100% guarantee. Other countries have increased the coverage ratio to a higher level, though not to a full 100% guarantee. The Netherlands increased the coverage ratio for SMEs from 50% to 90%, and Finland increased its coverage ratio from 80% to 90%.

**Total Funding**

Depending on fiscal availability, countries can increase total funding for guarantee schemes. Often, increases in total funding are multiple times the size of the initial scheme, as evidenced by Israel, which increased funding for its guarantee scheme on several occasions, from NIS 4 billion initially up to 22 billion (USD 6.4 billion or 1.7% of 2018 GDP) in the latest version. On June 17, the European Commission (EC) approved amendments to Italian credit guarantee scheme. The changes include an increase to the budget of the scheme to EUR 25 billion (USD 28.1 billion or 1.2% of 2019 GDP) from EUR 1.7 billion. Other countries have similarly increased total funding for credit guarantee schemes, including Romania, South Korea, and Tunisia, among others.

**Maximum Guarantee Amount**

Increasing the maximum guarantee amount per beneficiary is another step governments have taken to expand access and increase usage. In Italy, the June 17 amendment increased the maximum guarantee amount for SMEs from EUR 25,000 to EUR 30,000. The Peruvian government amended the Reactiva Peru Program, a tiered guarantee system, to provide a 98% guarantee on loans up to S / 90,000 from S / 30,000.

**Duration**
Extending the duration of the credit guarantee scheme is another way countries have updated their programs. Countries have both amended the length of the guarantee period and extended the application period. Under the June 17 changes to the Italian guarantee scheme, the loan term is now 10 years, up from the previous 6 years. Norway has extended its guarantee scheme to include loans made after June 1. New Zealand extended the term of its Business Finance Guarantee Scheme from 90 to 180 days.

**Eligibility**

Other countries have expanded eligibility for credit guarantee schemes. For example, Bpifrance, the French national investment bank, modified eligibility criteria on May 7 to include some companies that were previously excluded. Significantly, it now allows companies that were in bankruptcy proceedings since January 1, 2020, to benefit from the guarantee, and includes some property companies. Peru expanded eligibility for the MYPE Business Support Fund, which specifically targets microenterprises, to include companies in any sector; the modification also lowered required credit ratings to ensure that more firms would be covered by the scheme.

**Phased Approach**

Spain has taken a step-by-step approach to its credit guarantee scheme; by releasing funding over an extended duration, it adapts to changes in the macroeconomic conditions in order to better target assistance. The EUR 100 billion guarantee fund is activated in tranches, and the fifth and final tranche was released on June 16. Of the EUR 15.5 billion of the final tranche, EUR 7.5 billion is allocated for SMEs and the self-employed, EUR 2.5 million for SMEs in the tourism industry, and EUR 500 million for the automotive industry, with the remaining funding open to all firms.

**Creating New Credit Guarantee Schemes**

The total number of credit guarantee schemes has grown since the start of the pandemic. The growth can be attributed to countries without such programs announcing the creation of a new scheme and to countries that had schemes but created new, supplementary schemes with different eligibility or a higher coverage ratio.

**Eligibility**

Switzerland's initial 100% guarantee scheme for SMEs, the “COVID-19 credit” program, served as a model for other countries. However, many startups were ineligible for aid, so the Swiss government created the “Guarantee Scheme for Startups.” The new scheme leveraged the existing process and infrastructure from the initial program, but the terms of the startup scheme are different. The federal government provides 65% of the guarantee while 35% is provided by the canton to jointly guarantee 100% of the loan up to CHF 1 million (USD 1.1 million). The scheme will guarantee up to CHF 154 million total, whereas the COVID-19 credit program can guarantee up to CHF 40 billion (approximately 5.8% of 2019 GDP).
Similarly in South Korea, the government recently announced a smaller, more targeted credit guarantee scheme, the “Win-Win Special Guarantee to Support Auto Parts Industry.” This new, 420 billion won (USD 348 million or 0.02% of 2018 GDP) credit guarantee scheme specifically targets SMEs in the automotive industry. The scheme is partially funded by the government, which is investing 29.5 billion won, while large automotive companies, such as Hyundai and GM Korea, are together contributing 24 billion won. Beneficiaries are determined based on performance, technological capabilities, and supplier availability, rather than credit rating. The scheme is administered by the national Technology Guarantee Fund.

**Coverage Ratio**

Other countries have announced new credit guarantee schemes with more favorable terms than their initial schemes. For example, Germany, Italy, and the UK all announced 100% credit guarantee schemes, after initially launching credit guarantee schemes with lower coverage ratios. The creation of new schemes, rather than the modification of an existing scheme, could be due to multiple factors such as the complexity of updating guarantees already made, new eligibility criteria, streamlined application processes, or different infrastructure. Brazil announced a 100% credit guarantee scheme, the Operations Guarantee Fund, on June 10 to guarantee loans for microenterprises and SMEs. Eligible companies must make a commitment to preserve the number of employees at least 2 months after it receives the last instalment.

**Demand and Utilization Across Countries**

Demand for and utilization of loan guarantees have varied across countries. With many countries increasing funding for guarantee schemes, demand from eligible firms appears to be high. For example, Switzerland doubled the funding for the “COVID-19 credit” program from CHF 20 billion to CHF 40 billion. Despite the increase in funding, the total value of loans guaranteed as of June 18 was CHF 15.2 billion. Of this, CHF 13.3 billion was lent under a 100% guarantee on a loan of less than CHF 500,000. Switzerland’s program also allows for guarantees on loans greater than CHF 500,000, but the government only guarantees 85% of the value while the bank retains the remaining 15% risk.

Media reports indicate that Spain is considering a EUR 50 billion increase to its current EUR 100 billion credit guarantee program (approximately 8% of 2019 GDP). As described above, the Instituto de Credito Oficial (ICO) designed the program to release the money in five tranches. The SME loans carry an 80% guarantee and the larger corporation loans carry a 70% guarantee. As of June 17, the ICO had released all five tranches and had made EUR 84.5 billion in guaranteed loans, EUR 60 billion of which had gone to the self-employed and SMEs.

On March 17, the Italian government announced a EUR 100 billion credit guarantee program. It was exhausted within a few weeks and the European Commission approved a significant increase of EUR 400 billion in the second week of April. However, media reports indicate that a small portion of the EUR 400 billion has actually been lent to SMEs. The reports point to bureaucratic infighting, low staff levels at the responsible agencies due to the pandemic, and
concerns by banks about receiving timely reimbursements as causes for the low utilization of the new credit guarantee funds.

The United Kingdom releases weekly data regarding the utilization of its credit guarantee schemes. Under the Coronavirus Business Interruption Loan Scheme (CBILS), which provides an 80% guarantee, the government has supported 50,482 small businesses with GBP 10.5 billion (USD 13 billion) as of June 21. The Bounce Back Loans Scheme (BBLS) provides a 100% guarantee on loans up to GBP 50,000. This program was launched on April 27 and has guaranteed 921,229 loans worth a total of GBP 28 billion. Applications for the BBLS exceed 1 million while applications for the CBILS are less than 100,000. A recent industry taskforce report includes a projection that one-third of debt under government guarantee schemes will be unsustainable by March 2021. It should be noted that credit guarantee schemes are not without risk to the government, and losses are inevitable, especially given the uncertainty of the duration of the COVID-19 crisis. Credit guarantee schemes and other government-supported lending programs that do not have borrowers that default are likely too narrow. Guarantees are intended to encourage lending to borrowers that are higher-risk, and even during normal economic conditions, borrowers can and will default.

To date in France, approximately one third of the EUR 300 billion (USD 336 billion or 10.7% of 2018 GDP) in guarantees for companies of all sizes have been used. Most of the guaranteed loans have been made to firms with less than 250 employees and less than EUR 50 million in revenue. It is likely that more firms will benefit from the facility as the crisis continues. Bpifrance, which administers the guarantee, has recommended that firms do not borrow the total entitled amount at once.

Utilization of credit guarantees varies across countries and depends on multiple factors. Utilization is one measure of the success of a credit guarantee scheme, but other measures, such as the increase in lending to borrowers that were unable to access market finance, the default rate, and others should also be used to evaluate if the credit guarantee scheme met the objective of ensuring SMEs had access to finance. Credit guarantee schemes are dependent on broader macroeconomic conditions as well, and if the economy enters another decline or if the recovery is prolonged, governments will face higher losses due to defaults.
Governments Support Businesses through Equity Investments

By Mallory Dreyer and Kaleb Nygaard

Original post here.

In response to the economic shutdown caused by COVID-19, many countries have announced plans to take equity stakes in private businesses. Germany and Poland have announced large-scale programs focused on relatively large companies that the government determines are systemically important. Other countries, like the U.S., have announced equity programs that target critical industries, which we cover in a separate survey. Several countries -- including the U.K., France, and Germany -- have also announced much smaller programs dedicating small sums to startups or small and medium-sized enterprises, as part of broader efforts to support small businesses.

In this post we outline some of the key design features of equity-support programs.

- Purpose of the Program
- Capital Characteristics
- Eligibility
- Use of Private Investors
- Existing Program or New
- Size
- Funding
- Individual Participation Limits
- Other Considerations

Purpose of the Program

All of the programs evaluated are designed to support companies facing difficulties due to the COVID-19 pandemic, though different programs target different types of companies. In Germany, the government can recapitalize large nonfinancial companies that are considered critical to the economy through the Economic Stabilization Fund. The government modelled the fund on the Financial Market Stabilization Fund that Germany created in 2008 to support financial companies during the global financial crisis of 2007-09 (see the YPFS case study here). The Polish Financial Shield includes measures to recapitalize or lend directly to large companies, while smaller companies are eligible for forgivable loans.
Other programs are designed to support smaller companies, specifically startups or innovative firms. The UK and France have such programs, and Germany also has a EUR 2 billion program to support startups.

Capital Characteristics

The type of capital provided through an equity program varies across countries. The UK, Belgium, and France provide support through convertible loans. The UK’s Future Fund scheme issues convertible loans with a value between GBP 125,000 and 5 million. The loans automatically convert to equity at a minimum conversion discount of 20% to the price of the next qualifying funding round, which is the discount rate. To qualify, the amount of equity capital raised must be at least the size of the convertible loan. At maturity, the loans must either be repaid or convert into equity at a discount of at least 20% to the price in the most recent funding round. In the case of a sale or initial public offering (IPO), the loan either converts to equity at the discount rate or is repaid at a premium of 100% of the principal. Only the principal will convert at the discount rate, while the accrued interest will convert without the discount rate. Loans convert into the most senior class of shares in the company.

In Germany, the Economic Stabilization Fund can acquire subordinated debt, hybrid bonds, profit participation rights, silent participations, or convertible bonds. Poland’s Capital Shield for Large Companies allows the Polish Fund for the Development of Capital Instruments to provide support through shares, subscription warrants, bonds, or convertible loans.

In Mauritius, the State Investment Corporation launched the Equity Participation Scheme, which provides financing through redeemable preference shares. Redeemable preference shares receive a fixed dividend distribution and the repayment period is predetermined.

The EU’s ESCALAR Program provides investments into venture capital funds, thus providing funding for equity indirectly, as the investment does not go directly to companies. New Zealand relaxed its rules to allow companies to raise more new capital without shareholder approval, thus enabling companies to more easily access financing.

Eligibility

In order to channel the funding to the targeted companies or sectors, governments establish eligibility criteria, often based on size, revenue, or previous capital raises.

In the UK, the Future Fund scheme is available to unlisted, registered UK companies that have previously raised at least GBP 250,000 in equity (USD 310,000). In Poland, the equity program is available to companies with at least 250 employees and PLN 50 million in turnover or at least 150 employees and PLN 100 million in turnover. Companies could not be in arrears as of December 31, 2019 and must have had a 25% decline in business due to COVID-19.

In Germany, recapitalization under the Economic Stabilization Fund is available to companies that meet at least two of the following size requirements:
• At least EUR 43 million in total assets
• At least EUR 50 million in turnover
• More than 249 employees on average

Germany allows exceptions for smaller companies if they are determined to be critical infrastructure or essential to economic or national security. In addition, companies with a valuation of at least EUR 50 million since January 1, 2017, can be recapitalized through the Economic Stabilization Fund. Germany also has a EUR 2 billion package to support smaller startup companies through equity investments.

In Mauritius, the State Investment Corporation’s program is available to companies with annual turnover of at least Rs 250 million (USD 6.3 million). A separate Equity Financing Program through the SME Equity Fund is available to companies with annual turnover of less than Rs 250 million.

Use of Private Investors

How the government partners with private investors is another consideration. Some programs do not require private financing; in other programs, the government will provide up to a certain percent of the support.

In Germany, support through the Economic Stabilization Fund is available to companies that cannot access other financing; thus, there is no required private investor match. However, support to startups through the EUR 2 billion package allows public venture capital funds to provide up to 70% of the financing while private investors take at least 30%. In both the UK and France, the government will match investments from third-party investors one-to-one.

Existing Program or New

In many cases, government equity programs utilize existing programs or infrastructure. In Germany, public venture capital firms and the investment arm of the national development bank, KfW Capital, can provide financing through the support package for startups. Other countries, including Angola, Denmark, Mauritius, France, and Belgium, utilize existing public investment companies or funds. The EU’s ESCALAR program, a new program in its pilot phase, partners with existing funds and new funds that focus on financing startups. In the UK, the newly established Future Fund will be delivered in partnership with the British Business Bank, the state-owned development bank.

Size

In most countries, the equity-support programs represent a very small portion of the government’s economic support to businesses.

In Germany, the government allocated EUR 600 billion in funding for the Economic Stabilization Fund, of which EUR 100 billion is earmarked for recapitalization purposes. The
government also allocated **EUR 2 billion** in funding for startups. Other countries have allocated much less to equity programs. The UK’s Future Fund has GBP 250 million in funding, less than 0.1% of the more than **GBP 330 billion** the government provided in credit guarantees and other support. France has made EUR 80 million in funding for equity available through the public investment bank, Bpifrance, out of more than **EUR 110 billion**.

**Funding**

Most governments we reviewed did not specify a unique funding source for these equity programs, but rather structured the programs to pull from the general fiscal budget. However, the Solomon Islands issued a special COVID-19 Domestic Development Bond for SBD 120 million (USD 14.5 million), from which the funds for its equity program were to be pulled.

**Individual Participation Limits**

In the **UK**, the government has defined the limits of the equity investments at between GBP 125,000 and GBP 5 million. Similarly, **France** set the limits at between EUR 100,000 and EUR 5 million. In both of these countries the actual size of the government’s investment is determined by the amount of funds invested from private investors. In **Mauritius**, the government will invest an amount that will keep the government’s ownership at 49% or below the business’s total equity capital.

**Other Considerations**

Details from the **UK’s** Future Fund program provide insight into two additional design features of equity-support programs.

*Restrictions on use of funds*

Businesses that receive equity investments under the Futures Fund cannot use the money to “pay off previous debts or make dividends or bonus payments to staff, management, shareholders, or consultants.” The funds cannot be used to repay existing debt.

*Government voting rights*

The government indicated that it would have “limited corporate governance rights during the term of the loan and as a shareholder after conversion.”
78% of US Small Businesses Negatively Impacted by the COVID-19 Pandemic

By Mallory Dreyer

Original post here.

On August 20, the U.S. Census released updated data for its Small Business Pulse Survey. This release marks the beginning of the second phase of the survey and covers the week between August 9 and 15.

The first phase of the survey launched at the end of April and lasted nine weeks, covering the period between April 26 and June 27. After pausing the survey, the Census launched the second phase on August 9 and will continue to release new weekly Phase 2 data in the coming weeks. The survey seeks to determine the impact of the COVID-19 pandemic on small businesses in the U.S. and their participation in federal relief programs. It covers nonfarm, single-location businesses with between 1 and 499 employees and receipts of $1,000 or more in all 50 states, the District of Columbia, and Puerto Rico.

Nationally, 78.7% of surveyed small businesses responded that the COVID-19 pandemic has had a negative impact on their business. 34.2% of businesses responded that impact has been large while 44.5% of businesses responded that the impact has been moderate. The remaining businesses responded that the pandemic either had little or no effect, a moderate positive effect, or a large positive effect. Based on the questionnaire, it appears that each business is open to interpret the difference between a large and moderate impact, as there is no specific threshold or measure to differentiate between large and moderate.

During the week of August 9 to 15, 6.7% of firms reported increasing the number of paid employees while 10.9% of firms decreased the number of paid employees. 5.7% rehired employees that had been furloughed while 38.9% did not rehire furloughed or laid off employees.

The Census also surveyed businesses on their future needs. Over the next 6 months, businesses reported the following:

<table>
<thead>
<tr>
<th>In the next 6 months, the business will need to:</th>
<th>% of Survey Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obtain financial assistance or additional capital</td>
<td>26.8%</td>
</tr>
<tr>
<td>Identify new supply chain options</td>
<td>14.1%</td>
</tr>
<tr>
<td>Develop online sales or websites</td>
<td>13.9%</td>
</tr>
</tbody>
</table>
Increase marketing or sales 32.8%

Learn how to better provide for the safety of customers and employees 19.3%

Identify and hire new employees 23.4%

Permanently close the business 5.5%

None of the above 32.7%

With the Paycheck Protection Program (PPP) closed as of August 8, the 26.8% of firms that expect to need additional financial support will likely watch the government closely to understand what additional financial support may become available.

The survey also provides a picture of how the pandemic has had a disproportionate impact on firms in certain industries and sectors. For example, 47.3% of surveyed businesses in the accommodation and food services industry reported that they would need to obtain financial assistance or increase capital, compared to the national average of 26.8%. 12.2% reported that they may need to permanently close in the next 6 months, compared to the national average of 5.5%. Accommodation and food services firms are more likely to report missing a loan payment since March 13, with 10.1% reporting compared to the national average of 3.5%.

The Census was not collecting survey responses when the PPP closed, nor was it collecting responses when the Federal Reserve’s Main Street Lending Program (MSLP) became fully operational. As of August 13, the MSLP had $226 million in loan participations, but the program has been criticized for its slower start.

In addition to the recent data from the Census, Facebook, the World Bank, and the OECD released the Wave II survey report for their Global State of Small Business Survey. Wave II responses were collected between June 24 and 30 and covered over 25,000 businesses across 50 countries. The updated report focuses on small businesses’ access to finance. The survey finds that fewer small businesses globally received financial assistance during Wave II, which could be due decreased need for financial support as businesses reopen or because financial assistance may no longer be available. However, the report notes that policies related to increasing access to finance and covering expenses continue to be the most-needed policies cited by small businesses.

Both the Census survey and the Facebook survey seek to provide near real-time information about how the COVID-19 pandemic is impacting small businesses in order to better inform policy making and support programs. The Census Small Business Pulse Survey will be updated weekly and Facebook, the World Bank, and the OECD will publish monthly reports.
Case Studies and Policy Changes

MicroFinance Ireland: Targeted Lending for Microenterprises Impacted by COVID-19
By Mallory Dreyer

Original post here.

Ireland is expanding an existing direct lending program to help small businesses deal with declining revenues during the coronavirus crisis.

The coronavirus pandemic is projected to have a large and detrimental impact on small and medium-sized enterprises (SMEs). Many countries have established government credit guarantee programs to ensure that SMEs can access liquidity. Some countries, like Ireland, have programs for direct government lending to SMEs in addition to or in lieu of guarantees.

MicroFinance Ireland was established in 2012 by the Microenterprise Loan Fund Act. Its lending activities are limited to microenterprises with no more than 10 employees and less than €2 million in revenue that do not meet the risk criteria of private banks. Applicants are required to prove that they have been refused financing by a bank before their applications are considered. Thus, the fund was designed so that it does not replace traditional bank lending.

In response to Covid-19, MicroFinance Ireland has launched an emergency lending program. Microenterprises must demonstrate that they are facing a negative impact on their business from the coronavirus pandemic, with a minimum expected impact of 15% in lost profits or revenue. Applicants submit financial projections in a template showing expected monthly cashflows for six months.

The lending limit for loans under the emergency program is €50,000, an increase from the normal €25,000, with a maximum three-year term limit. Microenterprises that apply directly to MicroFinance Ireland will be charged a 7.8% interest rate while those that apply to a local enterprise office will be charged a 6.8% interest rate. A key feature of the loans is that for the first six months they will be interest-free and have a payment moratorium, which is designed to address cash flow uncertainty due to the coronavirus pandemic.

Because MicroFinance Ireland has been operational since 2012, it is already equipped to offer emergency lending to microenterprises impacted by Covid-19. The program could serve as a crisis-response model for other countries with institutions similar to MicroFinance Ireland, although it could be difficult for countries without similar institutions to replicate given the need for an urgent response.
Canada has reintroduced a program from the Global Financial Crisis of 2007-09 to provide government loans directly to small businesses to help them deal with the economic consequences of the COVID-19 pandemic.

Countries across the world are adopting measures to support small and medium-sized enterprises (SMEs) during the COVID-19 crisis. They often use credit guarantees to facilitate lending to SMEs by guaranteeing their bank loans. This post discusses a less common tool, direct governmental lending to SMEs, illustrated by Canada’s programs both during the Global Financial Crisis, and today.

**Direct Lending to SMEs**

Some countries have implemented programs for direct lending to SMEs in both the Global Financial Crisis and the COVID-19 crisis, though it remains a less common tool, and one often paired with credit guarantees for SMEs. Often these direct loans are made through a bureaucratic agency focusing on small businesses or a government bank focused on development of specific industries. Several countries have created loan programs for SMEs funding innovation or new technology. A partial list of countries adopting these interventions during the Global Financial Crisis can be found on page 20 of the OECD report found [here](#).

**Canada’s COVID-19 SME Lending Program**

On [March 13, 2020](#), the Canadian government re-established the Business Credit Availability Program (BCAP), allowing the Business Development Bank of Canada (BDC) and Export Development Canada (EDC) to provide CAD 10 billion to businesses. As of [March 16, 2020](#), the BDC will now offer small business loans of up to CAD 100,000 that can be obtained in as little as 48 hours from the time of approval. It will also offer flexible working capital loans of up to CAD 2 million, with potential payment postponements for six months, to bridge cash flow gaps and support daily operations. The BDC will also provide purchase order financing to increase flexibility in fulfilling domestic or international orders.

SMEs seeking to access the BCAP will first contact their financial institutions. The financial institutions will then assess SMEs with liquidity needs beyond what the private sector can meet, and refer them to the BDC or EDC. Thus, although Canada will be engaged in direct lending to SMEs, it will do so in consultation with those SMEs’ existing financial institutions. The BDC and EDC are paying particular attention to sectors that are heavily impacted by the crisis, like oil and gas, and tourism. Farm Credit Canada is also increasing short-term credit available to farmers and the agri-food industry.
Canada’s GFC SME Lending Program

Prior to the Global Financial Crisis, the BDC, EDC, and the Canada Small Business Financing Program provided direct loans and guaranteed loans to SMEs.

The BCAP was first established in response to the GFC. It allowed the BDC and EDC to work with private lenders to finance viable businesses. It disbursed over CAD 10.1 billion in 2009 and 2010, of which CAD 3.44 billion went to SMEs with under CAD 25 million in annual revenue. The BCAP’s Economic Recovery Loans Initiative, established in early 2010, made small working capital loans of up to CAD 100,000, and constituted much of BCAP’s 2010 activity, despite expiring in October of that year.

Feedback on the BCAP’s countercyclical activity during the GFC was positive. The Conference Board of Canada commended the BDC and EDC on their role in providing credit support during a crisis, and credited them with speeding up the healing of the Canadian financial system.
Federal Reserve Announces Main Street Lending Program

By Mallory Dreyer

Original post [here](#).

On April 9, the Federal Reserve announced the details of its new Main Street Lending Program to purchase up to $600 billion in small business loans.

The program consists of the Main Street New Loan Facility (MSNLF) and the Main Street Expanded Loan Facility (MSELF). The Fed established the facilities under its emergency lending authority under [Section 13(3) of the Federal Reserve Act](#) and approved by the Treasury Secretary. In support of these facilities, the Treasury will make a $75 billion equity investment in a special purpose vehicle (SPV) using funds appropriated to the Exchange Stabilization Fund under the [CARES Act](#). The Fed will in turn provide recourse loans to the SPV. The SPV will purchase a 95% participation in eligible loans while lenders retain the remaining 5%. The SPV will purchase up to $600 billion in loans.

Eligible lenders include United States insured depository institutions, bank holding companies, and saving and loan holding companies. Lenders may originate new loans (MSNLF) or expand the size of existing loans to eligible businesses (MSELF). Both facilities have a minimum loan size of $1 million.

Under the MSNLF, the maximum size is the lesser of either $25 million or the amount that does not bring the borrower’s total existing debt to four times its 2019 EBITDA (EBITDA measures a company’s earnings before interest, tax, depreciation, and amortization). Under the MSELF, the maximum loan size is equal to the lesser of $150 million, 30% of the borrower’s existing outstanding and committed but undrawn debt, or the amount that does not bring the borrower’s total existing debt to six times its 2019 EBITDA.

Lenders can set loan interest rates at the Secured Overnight Financing Rate (SOFR) plus 250-400 basis points. Loans will have a maturity of four years. Principal and interest payments can be deferred for one year. Loans purchased pursuant to the MSNLF must be unsecured, while those purchased under the MSELF may be collateralized.

Businesses with up to 10,000 employees or up to $2.5 billion of revenue in 2019 are eligible for loans under the program. Eligible businesses must be organized in the United States with significant operations and a majority of their employees in the country. Businesses eligible to receive forgivable loans under the Paycheck Protection Program through the Small Business Administration (SBA) can also participate. A borrower cannot participate in both the program and the Primary Market Corporate Credit Facility (PMCCF). Borrowers also cannot utilize both the MSNLF and the MSELF.

Eligible borrowers must commit to making “reasonable efforts” to maintain payroll and retain employees over the life of the loan. Borrowers must follow compensation, stock repurchase, and
dividend restrictions set forth in the CARES Act for direct loan programs. Businesses with conflicts of interest, as defined in Section 4019(b) of the CARES Act, cannot participate. Borrowing under the program cannot be used to pay off existing debt, including pre-existing portions of eligible loans that are extended under the MSELF.

The Federal Reserve defines fees for participating in the facility, as well as origination and servicing. Under the MSNLF, eligible lenders will pay the SPV a facility fee of 100 basis points of the principal amount of the loan participation purchased by the SPV, though the lender can require the borrower to pay. Borrowers pay an origination fee of 100 basis points of the principal for loans under the MSNLF. Under the MSELF, borrowers will pay a fee of 100 basis points on the increase in principal under the expanded loan. The SPV will pay lenders 25 basis points of its participation in the principal amount per year for loan servicing under both facilities.

The program is set to purchase loans through September 30, though Chair Jerome Powell, in an interview, said that the end date is tentative and will be extended if necessary, depending on the state of the economy. The Federal Reserve Board of Governors and the Treasury Department will be required to approve a proposed extension.
Federal Reserve Introduces Paycheck Protection Program Liquidity Facility

By Kaleb Nygaard

Original post [here](#).

On April 9, the Federal Reserve released the details of its new Paycheck Protection Program Liquidity Facility (PPPLF), through which financial institutions can use eligible loans made to small businesses as collateral when borrowing from the Fed. The purpose of the program, authorized under [Section 13(3) of the Federal Reserve Act](#), is to facilitate such lending to small businesses.

The [CARES Act](#) rescue package, signed into law in the United States on March 27, includes in Section 1102 the establishment of the Paycheck Protection Program (PPP). The PPP allocates $349 billion of taxpayer funds to guarantee Small Business Administration (SBA) loans made by financial institutions to certain small businesses with up to 500 employees. The Fed had made a brief announcement on April 6 indicating that it was developing a program to provide term financing backed by PPP loans.

Under the PPP, financial institutions originate loans to eligible businesses. The SBA fully guarantees these loans. By accessing the PPPLF, the financial institutions can now use these PPP loans as collateral for loans at their regional Federal Reserve Bank. Such loans will be made on a non-recourse basis, meaning that the Fed is limited to recovery of collateral in the event loans are unpaid.

The PPPLF is available to all depository institutions that originate PPP loans. Under section 1102 of the CARES Act, a PPP Loan will be assigned a risk weight of zero percent under the risk-based capital rules that apply to depository institutions. The Fed has indicated that it will work to expand eligibility to other PPP lenders in the near future.

The Fed will not apply a haircut to the principal value of the PPP loan, which means it will accept the collateral at face value. The Fed will charge an interest rate of 35 basis points, but there is no participation fee. The maturity of the Fed’s loan to the financial institution is set to match the maturity of the financial institution’s loan to the small business, subject to acceleration in the event the underlying PPP loan defaults or is forgiven under the terms of the PPP.

The Fed announced that it will not extend new credit via the PPPLF after September 30. However, in an [interview](#), Fed Chair Jerome Powell said, “we will be in no hurry to pull back...on these programs. They are tentatively scheduled to stop lending on September 30. If they have to go longer, then of course they will. We’ll be looking to make sure the economy really is on a solid footing before pulling back. And then, as we start pulling back, we will do so very gradually.”
Germany Launches New Support Program After Partial Guarantee Insufficient to Promote Lending to Small Businesses

By Mallory Dreyer

Original post here.

On April 6, Germany introduced a fully guaranteed loan program to support small businesses after an earlier partial government guarantee did not achieve its intended results. The Quick Loan Program will provide fully-guaranteed “instant” loans of up to EUR 800,000 to eligible businesses.

The earlier KfW 2020 Special Program (KfW-Sonderprogramm 2020), launched on March 23, provides 80% or 90% credit guarantees to companies experiencing financing difficulties due to the COVID-19 pandemic. It is available to companies of all sizes, and features lower interest rates. However, as Bloomberg reported on April 1, banks were reluctant to take on new risk given the economic circumstances, and private lenders requested full government guarantees on lending.

The new Quick Loan Program (KfW-Schnellkredit 2020) provides SMEs with loans that are fully government guaranteed. KfW, the state-owned development bank, will provide banks with 100% liability waivers backed by the government. Firms are eligible for the loans if they have been active since at least January 1, 2019, were profitable in 2019, and have more than 10 employees. Firms can receive loans for up to three months of 2019 revenue. Loans are capped at EUR 800,000 for firms with 50 or more employees and EUR 500,000 for those with between 10 and 50 employees. Loans will carry 3% interest for terms of 10 years and include two years of payment deferral. In order to expedite approval, applications will be approved without risk assessment by banks or by KfW. Applications will be available starting April 15.

The European Commission (EC) approved the program on April 11, as it aligns with the EU’s amended Temporary Framework for state aid. The amended framework allows Member States to provide zero-interest loans or guarantees on loans covering 100% of the risk for loans up to EUR 800,000 per company.

Support to SMEs in Germany in response to the COVID-19 crisis is not limited to the Quick Loan Program and the new KfW 2020 Special Program. Small and mid-sized businesses, the Mittelstand, make up 99.5% of firms, generate 35% of total revenue, and employ approximately 60% of workers in Germany. Thus, according to the Economic Affairs Minister, Peter Altmaier, the government is working to “safeguard this unique, broad-based cornerstone of [the] economy.”

On March 23, Germany announced a EUR 50 billion package, the Immediate Assistance Program, to provide direct cash assistance to small firms, including self-employed individuals and freelancers. The program provides taxable grants, not loans, to small businesses in all sectors.
of the economy with up to 10 employees. One-time payments of up to EUR 9,000, to cover a period of three months, are available to firms with up to 5 employees while firms with up to 10 employees can receive one-time payments of up to EUR 15,000. Firms must be facing financial distress due to the COVID-19 pandemic and declare in the application that their business is at risk of collapse or experiencing liquidity shortages. The program is financed by the federal government, but the state (Länder) level handles the granting of aid. On March 29, the German Länder and the federal government announced that an agreement was reached to begin implementing the program. The program processed approximately 140,000 applications in a handful of days and has paid out approximately EUR 1.3 billion. Some firms received the money within 24 hours.

Two additional measures to provide support to SMEs include expanded export-credit insurance guarantees and a package to provide venture capital financing to startups. On March 30, the government announced an expanded scope for export-credit guarantees. This allows the federal government to issue export guarantees for transactions with short-term payment obligations within EU and OECD countries. Germany announced a EUR 2 billion package on April 1 to support venture capital financing for startups, technology companies and small businesses during the Covid-19 crisis.
Federal Reserve Waives Restriction on Wells Fargo to Allow Lending to Small Businesses

By Kaleb Nygaard

Original post here.

On April 8, the Federal Reserve temporarily waived a growth restriction on Wells Fargo & Co. so that it can provide additional lending to small businesses.

The growth restriction is part of an enforcement action that the Fed originally issued on February 2, 2018. It forbids Wells Fargo from expanding its balance sheet. It also removed a third of the company’s board of directors.

The enforcement action outlined widespread consumer abuses, including opening millions of unauthorized customer accounts, forcing people to buy unnecessary auto insurance, and overcharging members of the military for their mortgages. The enforcement action is still in effect and will be “until [Wells Fargo] sufficiently improves its governance and controls.”

Wells Fargo, the nation’s fourth-largest bank holding company by assets, announced on April 5 that it had committed $10 billion to lend under the Paycheck Protection Program (PPP). It said this amount was the upper limit of what it believed it could lend without exceeding the growth restriction. Some have argued that Wells Fargo could have reduced lending in other areas to make funds available to issue additional PPP loans.

Congress created the PPP in the CARES Act to provide small businesses with access to inexpensive, fully-guaranteed, forgivable loans to help replace cash flow and pay expenses during this period of social-distancing-caused closures. Section 1102 of the CARES Act allocates $349 billion to the program. For comparison, on April 7, Bank of America indicated that it had received applications for $40 billion in PPP loans.

The Fed’s April 8 announcement stated that the waiver will be narrow. Loans issued under the PPP or the Main Street Lending Program (another support program that is available to a wider range of businesses) will not count against the growth cap. The Fed also required that economic benefits from the PPP and the Main Street Lending Program be transferred “to the U.S. Treasury or to non-profit organizations approved by the Federal Reserve that support small businesses.” These benefits include processing fees that other banks are allowed to keep as part of the loan origination process under these emergency lending programs.

Shortly after the waiver was issued, Wells Fargo committed to expanding its participation in the PPP. However, media reports have indicated that it has not been able to process the large quantity of applications. The company sent a letter to small business customers who had applied but had not yet received funds indicating that they may want to apply elsewhere.

The waiver will last for the duration of the PPP and Main Street Lending Program.
Italy Expands and Updates its Credit Guarantee Programs
By Kaleb Nygaard

Original Program and its Expansion

Amount of total committed funds

On March 17, the Italian government set aside EUR 100 billion for loan guarantees. This amount proved insufficient to meet the demand, so in two communications on April 9 and April 10, the EC approved an increase in the amount of funds available for the guarantees of EUR 400 billion. It indicated that the guarantees would be administered by two groups within the state lender Cassa Depositi e Prestiti. The state SME-guarantee-fund Fondo di garanzia per le PMI would administer 60%, targeting domestic companies, and the state export agency Servizi Assicurativi del Commercio Estero (SACE) would administer the remaining 40%, targeting companies working in international markets.

Guarantee structure and credit analysis

In both the initial allotment as well as the addition, the government created a tiered system of guarantee ratios based on company size. This complex structure (outlined below) allows the government to more narrowly target the support, but some market participants say it has also increased the loan origination time and burden for the banks.

- 100% for loans up to EUR 25,000
- 90% for companies with less than 5,000 employees and turnover less than EUR 1.5 billion
- 80% for companies with more than 5,000 employees and between EUR 1.5 billion and EUR 5 billion in turnover
- 70% for companies with turnover of more than EUR 5 billion

The cost of the guarantee also changes based on the size of the company, reaching as high as 2% for larger companies.

Although state agencies administer the guarantees, the banking system ultimately is responsible for making lending decisions for new and refinanced loans. Since a large portion of the loans are not 100% guaranteed, banks take on a portion of the credit risk and therefore conduct extensive due diligence reviews before issuing the loans.

New Program for Small Businesses

Although the programs outlined above are open to companies of all sizes, on April 14, the EC approved an additional, much more generous, Italian credit guarantee program specifically targeting the self employed and small businesses with up to 500 employees. This program
includes grants in the form of waivers on the guaranteed loan application fees. For loans up to EUR 800,000 the program guarantees 100%, for loans larger than this amount the program guarantees 90%. The program’s EUR 800,000 threshold for a full guarantee is significantly higher than the previous EUR 25,000. Italy now has three major guarantee programs: (1) for entrepreneurs and small businesses, (2) for medium and large businesses in domestic markets, (3) for medium and large businesses in international markets.

Usefulness of Loans

Many businesses simply cannot afford to take on debt, even inexpensive debt. For them, revenue lost during the economic shutdown may never be recovered and new revenue generated after the economy is reopened may not be enough to cover regular expenses and additional debt repayments. One Italian restaurant owner’s open letter to the prime minister explaining this dilemma has received a lot of attention. Other countries provide direct cash grants to small businesses instead of or in conjunction with credit guarantees.
UK Expands Support for Small Businesses After Limited Impact of Initial Program
By Mallory Dreyer

Original post here.

The UK is no longer requiring would-be borrowers in its crisis-lending program to confirm that they tried and failed to find funding from a commercial bank. This requirement slowed loan approvals during the first two weeks of the program.

On April 3, the United Kingdom announced updates to the Coronavirus Business Interruption Loan Scheme (CBILS) for small and medium-sized enterprises (SMEs) after the initial program failed to provide widespread liquidity support. On the date of the announced updates, over 130,000 inquiries had been submitted, but only 983 loans had been granted. The updated scheme became operational on April 6.

The amendment opens the scheme to more borrowers. Initially, the program was limited to small businesses that were unable to receive standard commercial financing. The guarantee was designed to incentivize lenders to provide financing to these small businesses. As originally designed, firms that met a lender’s requirements to receive standard commercial financing were unable to participate in CBILS, but the government eliminated this requirement as part of the update, expanding the number of borrowers who can benefit. This appears to alleviate some of the administrative burden on lenders, as banks considered the process of determining eligibility to be difficult.

UK based firms with annual turnover less than GBP 45 million are eligible for CBILS. The program excludes banks, insurers and reinsurers, public sector bodies, grant-funded educational institutions, and state-funded primary and secondary schools. Firms must certify that they have been adversely impacted by COVID-19 and have a borrowing proposal that the lender would consider viable during normal times.

The British Business Bank (BBB), a government-owned business development bank, operates CBILS through more than 40 accredited lenders. These include traditional banks, but also asset-based lenders, challenger banks (small, recently-created banks competing with longer-established institutions), and smaller specialist local lenders. On April 11, the BBB announced the addition of four new lenders under the program. It will continue to review applications to accredit more lenders under CBILS.

CBILS provides 80% guarantees on credit facilities up to GBP 5 million. Lending can be in the form of term loans, overdrafts, invoice finance, and asset finance. Loans can have terms of up to 6 years.

The government made other changes. First, the amendment prohibits lenders from taking personal guarantees on loans less than GBP 250,000. For loans greater than GBP 250,000,
personal guarantees are permitted based on the lender’s discretion but are capped at a maximum of 20% of the facility after applying the proceeds of the business assets. Principal private residences cannot be taken as security for the facility. Second, lenders are to retroactively apply the updates to firms that received CBILS facilities prior to April 6. The government also requested that lenders bring non-CBILS facilities offered since March 23 onto CBILS when possible.

The government will make a Business Interruption Payment to cover the first 12 months of interest payments and any lender fees. However, this does not include principal repayments. In addition, the Treasury has not capped the interest that banks can charge. For some SMEs, specifically those that have been forced to temporarily close, a loan increases the debt burden at a time when no revenue is collected.

By April 15, more than GBP 1.1 billion was lent to approximately 6,000 small businesses under CBILS. UK Finance reported that state backed lending to SMEs had risen by GBP 700 million (150% increase) and loan approvals doubled in the week leading up to April 15.

Despite the updates and increase in lending, some remain concerned that the scale and speed of the rollout are not sufficient, given delays, administrative complexity, and demand for liquidity.

In addition to updating CBILS, the government announced the creation of a new credit guarantee scheme for larger businesses, the Coronavirus Large Business Interruption Loan Scheme (CLBILS) on April 3. Under CLBILS, the government provides an 80% guarantee to banks for lending to firms with an annual turnover between GBP 45 million and 500 million. Loans will be capped at GBP 25 million and offered at commercial interest rates. However, this program remains limited to borrowers that are unable to secure regular commercial financing. The Treasury announced that the program will begin lending on April 20.

In addition to credit guarantee schemes, the Bank of England (BOE) announced on April 6 that the Term Funding Scheme with additional incentives for Small and Medium-sized Enterprises (TFSME) would begin operations on April 15, which is earlier than anticipated. As of the BOE’s April 15 Weekly Report, no lending under the facility had been recorded on the bank’s balance sheet. The TFSME allows eligible banks and building societies to access four-year funding at rates very close to the bank rate to incentivize credit provision to businesses and households. For more information on the TFSME, see Central Banks Launch Funding for Lending Programs.
Switzerland Programs Serve as Model for Quick Support to Small Businesses

By Mallory Dreyer

Original post here.

In response to the COVID-19 crisis, the Swiss government quickly established a program to provide small businesses with rapid access to funds. Some countries, including Italy, are looking to Switzerland as a model for how to provide immediate relief to small businesses.

The Federal Council of Switzerland approved an emergency package to provide support to small and medium-sized enterprises (SMEs) on March 25, and the program became operational on March 26. The package provides SMEs with fast access to guaranteed loans to bridge liquidity shortages caused by the COVID-19 pandemic. The application process is streamlined, as the government provides a standardized loan application online, which firms submit to their bank, and requires minimal documentation. Loans of up to CHF 500,000 carry a 100% government guarantee, and lenders are not required to perform credit risk assessments for these smaller loans. Borrowers must attest that turnover has been impacted by the COVID-19 pandemic, unlike other countries which require a level of expected or actual losses.

Between March 26 and April 2, 76,034 credit agreements worth an estimated CHF 14.3 billion ($14.8 billion) were approved under the program. Based on the total amount of aid and the number of agreements, it appears that smaller loans are more common. Given the high demand, the Federal Council approved increasing the funding for guarantees from CHF 20 billion to CHF 40 billion on April 3.

Loans are limited to 10% of annual turnover and capped at CHF 20 million. Loans have a 5 year term but can be repaid as soon as the firm returns to profitability. Loans that are less than CHF 500,000 carry zero interest and are fully guaranteed by the government while loans that exceed CHF 500,000 have an 85% government guarantee. These larger loans require more rigorous credit assessments, and the interest rate is currently set at 0.5%. Firms with more than CHF 500 million in turnover are not eligible.

Implementation of the program appears to align with the government's objectives of minimum bureaucracy and rapid access to liquidity. The Financial Times reports that the Swiss “were able to roll out the scheme almost overnight” as it leveraged existing infrastructure and bank-client relationships. 121 banks in Switzerland are participating lenders, and the largest, UBS, processed 10,000 applications in the first two days.

The scheme also temporarily allows PostFinance, the banking arm of the country’s postal service, to provide eligible SME business clients with access to credit up to CHF 500,000. This ensures broad accessibility of the program for financially constrained SMEs, as many SMEs in
Switzerland do not have bank loans and only have a bank account with PostFinance, which is otherwise banned from providing credit facilities based on current law.

While other countries elected to provide grants or forgivable loans to SMEs, Switzerland opted to provide support through guaranteed loans. The Federal Council believes that the program will aid SMEs during the COVID-19 pandemic without requiring non-repayable advances.
On April 23, the U.S. Congress passed emergency legislation to appropriate an additional $310 billion for the Paycheck Protection Program (PPP), $50 billion for Economic Injury Disaster Loans (EIDL), and $10 billion for EIDL Emergency Advances. Congress created the PPP and EIDL Emergency Advance programs on March 27 in the CARES Act.

The PPP began operating on April 3 and exhausted its initial $349 billion in funding by April 16. The emergency legislation brings its total funding to $659 billion. Despite the increased funding, lenders are calling for more as they anticipate that the new appropriations will be exhausted in a matter of days.

Unlike the original CARES Act, the new legislation earmarks a portion of the funds for smaller financial institutions. It sets aside $30 billion for depository institutions and credit unions with between $10 billion and $50 billion in consolidated assets and $30 billion for those with less than $10 billion in consolidated assets. It appears that the $60 billion for community, small, and mid-sized banks is designed to target smaller businesses that do not have pre-existing relationships with larger commercial lenders.

Under the PPP, lenders extend forgivable loans to small businesses. They may use the funds to cover eight weeks of payroll expenses and other eligible expenses, such as mortgage interest, utilities, and rent. The Treasury has not changed its guidance on the use of the loans. The government will forgive the loan on the condition that a business uses at least 75% for payroll expenses.

Between April 3 and 16, the SBA guaranteed approximately one million loans. The overall average loan size was $206,000. Many small business owners have complained that lenders prioritized larger borrowers and their existing customers. All but two of the top 15 lenders had average loan sizes greater than the overall program average, and the largest lender by total approved dollars had an average loan size of $515,000. Still, 74% of the loans made to date were $150,000 or less.

The EIDL program offers loans of up to $2 million to small businesses affected by COVID-19. Payments on the loans are deferred for one year. As of April 20, the SBA had approved nearly 27,000 loan applications worth a total of $5.6 billion. Media reports indicate approximately 4 million businesses have applied. The SBA has stopped accepting new applications and said they were processing the applications already submitted on a first-come, first-served basis. The April 23 bill appropriated an additional $50 billion to the loan program. The bill also expanded eligibility to agricultural enterprises, which had previously been eligible for PPP but not EIDL funds.
SMEs that apply for EIDLs are also eligible to receive additional support in the form of an Emergency Advance of up to $10,000. The initial March 27 law allocated $10 billion for these advances that effectively serve as grants and do not need to be paid back even if the loan application is not approved. However, if the SME receives a PPP loan, the amount of the loan that is forgiven will be reduced by the amount of the advance. On April 23, Congress extended the program by $10 billion. As of April 20, the program had made over 750,000 grants worth a total $3.3 billion.

The bill also makes an additional $2.1 billion available for SBA salaries and expenses until September 30, 2021, to be used for COVID-19 related activities. For comparison, the SBA’s most recent budget request, issued before the crisis, was for $819 million.
Germany Provides Public Funding for Recapitalization and Startup Equity

By Mallory Dreyer

Original post [here](#).

In response to the COVID-19 pandemic, Germany has announced two programs that would use public funds to purchase equity in domestic companies. EUR 100 billion is available for recapitalization of companies impacted by COVID-19 and EUR 2 billion is available for startups.

A central component of the German fiscal response is the Economic Stabilization Fund (Wirtschaftsstabilisierungsfonds or “WSF”), which the Bundesrat (the German federal council) approved on March 27. The WSF has EUR 600 billion in funding, of which EUR 100 billion is earmarked for recapitalization of nonfinancial companies, EUR 400 billion is for loan guarantees, and EUR 100 billion is for direct lending. The new legislation amends a 2008 law that authorized the government to recapitalize financial institutions.

The Federal Ministry of Finance and the Federal Ministry of Economic Affairs and Energy will decide measures for companies that apply for support under the WSF. The agencies will consider the importance of the company in the German economy, the urgency, and the impact on the labor market and competition.

Using the EUR 100 billion earmarked for recapitalization, the WSF can acquire subordinated debt, hybrid bonds, profit participation rights, silent participations or convertible bonds. The WSF can also acquire shares or other components of equity. Recapitalization measures can be implemented until December 31, 2021, and will be based on market terms. The recapitalization measures must ensure that the company is a going concern after the pandemic.

In order to benefit from recapitalization under the WSF, a company must require financial support because of the COVID-19 pandemic and could not be considered in difficulty (per the EU’s definition) as of December 31, 2019. Eligible companies must be unable to access other sources of finance in order to benefit from the WSF funds. Eligible companies must also meet two of the following size requirements:

- At least EUR 43 million in total assets
- At least EUR 50 million in turnover
- More than 249 employees on average

However, exceptions can be made for smaller companies, on the condition that they are important for critical infrastructure or economic and national security. Companies that have been valued at minimum of EUR 50 million in a financing round since January 1, 2017, can also receive support.
On **April 1**, Germany announced a EUR 2 billion package to support startups during the COVID-19 pandemic. The package is designed for companies that are unable to receive assistance from the other government support measures. The package has three elements which will be implemented gradually and will leverage existing programs.

**First**, a portion of the EUR 2 billion in funding will be available for public venture capital investors. These include KfW Capital, the investment arm of the national development bank; the European Investment Fund (EIF); the High-Tech Startup Fund (High-Tech Gründerfonds); and **Coparion**, a co-investment fund established by KfW and Federal Ministry for Economic Affairs and Energy. These state-owned venture capital investors can co-invest alongside private investors in financing startups. The public funding cannot exceed 70% of the total co-investment. KfW Capital and the EIF will receive additional public funding in order to take over the stakes of funds that pull out. Also, venture capital financing and equity replacement financing will be facilitated for small businesses and new startups that do not have existing venture capitalist shareholders.

The government will also continue to work on a **EUR 10 billion** “future fund” for startups. Additional information about this fund is not yet available.

During non-crisis times, Germany provides various financing instruments to support startups, as they are less likely to secure traditional bank financing. The **Federal Ministry for Economic Affairs and Energy** provides grants, equity investment, promotional loans, and guarantees to startups. The German Micro-Mezzanine Fund (Mikromezzaninfonds Deutschland) and the High-tech Startup Fund (High-Tech Gründerfonds) are sources of direct investment, while other programs offer incentives for private investors to provide equity to startups, such as the INVEST Grant for Venture Capital.
ECB Considers Adopting EU Bad Bank

By Mallory Dreyer

Original post here.

On April 19, the Financial Times reported that the European Central Bank (ECB) had discussed the creation of a bad bank, or asset management company (AMC), for the eurozone with European Commission (EC) leaders.

Bad banks acquire and manage distressed assets, including non-performing loans, from financial institutions in order to remove toxic assets from a lender’s balance sheet to allow them to provide new loans. The idea faces opposition within the EC, and the Financial Times reported that the discussions have stopped. However, officials did not rule out future discussions later in the COVID-19 pandemic.

During the Global Financial Crisis, many governments established bad banks, including some European countries such as Ireland, Spain, and Germany. However, the Bank Recovery and Resolution Directive (BRRD), adopted in 2014, restricts EU Member States from creating bad banks unless it is part of the official process to resolve a failing bank. In 2017, a European Banking Authority official, who is now chair of the ECB supervisory board, proposed a eurozone bad bank, but it was met with similar resistance by EU officials.

For more information and the working drafts of detailed case studies on previous AMCs, see the YPFS Resource Library.
UK Announces Support to Innovative Firms

By Kaleb Nygaard

Original post here.

On April 20, the United Kingdom (UK) announced a GBP 1.2 billion ($1.49 billion) support package for “innovative firms.” The government, in partnership with private investors in some instances, will deploy the money through a new program called the Future Fund and the expansion of an existing program called Innovate UK.

Future Fund

The package allocates GBP 250 million to the Future Fund, a new partnership between Her Majesty’s Treasury and the British Business Bank, a wholly-government-owned development bank. Only unlisted UK businesses that have raised at least GBP 250,000 in aggregate from third-party investors in previous funding rounds in the last five years may participate. The government will partner with third-party investors to issue the convertible loans to eligible businesses. The government’s portion of the loan will consist of between GBP 125,000 and GBP 5 million. The third-party investors will match at least one-to-one the government’s investment. The government will have limited corporate governance rights during the term of the loan and as a shareholder after conversion.

The loans convert at a minimum conversion discount rate of 20% on the next funding round. If the business is sold or goes public, the loan must be repaid at a premium of 100% of the principal or converted to equity at the discount rate, whichever is higher for the lenders. The program forbids businesses from using the money to pay off previous debts or make dividend or bonus payments to staff, management, shareholders, or consultants.

The initial phase of the program is expected to launch in May and accept applications through September. The government left open the option to extend the timing beyond September and to increase the total allocation.

Innovate UK

The GBP 750 million commitment to the government’s innovation, Innovate UK, will target support to research and development intensive small and medium size firms through Innovate UK grants and loans.

The announcement indicated that GBP 550 million will be made available to businesses with existing loans or grants with Innovate UK. The program will also provide 1,200 businesses without a current relationship with Innovate UK with up to GBP 175,000 each. Innovate UK expects to deliver the first payments in mid-May. In addition to the newly allocated money, the government will accelerate delivery of GBP 200 million in grants and loans already approved for
2,500 businesses with existing relationships with Innovate UK. Participation in the acceleration of delivery of funds will be optional to the eligible businesses.

Other measures

Before the COVID-19 pandemic, the government had a number of programs designed to support innovative and high growth businesses as part of an initiative to double overall public investment in research and development from GBP 11 billion to GBP 22 billion by 2025. The programs include the GBP 2.5 billion government venture capital fund British Patient Capital and other measures from the British Business Bank, like the GBP 600 million Life Sciences Investment Programme.
Federal Reserve Announces Changes to Main Street Lending Program

By Mallory Dreyer and Kaleb Nygaard

Original post here.

On April 30, the Federal Reserve Board announced updates to the Main Street Lending Program, after receiving more than 2,200 comments from individuals, businesses, and nonprofits on the initial terms of the program announced on April 9. Major changes include creating a third facility that accepts riskier borrowers, lowering the minimum loan size, lowering the interest rate, and expanding the pool of eligible borrowers.

The Main Street Lending Program is an attempt to encourage lending to small and medium-sized enterprises (SMEs) by having the Fed purchase up to $600 billion in such loans. Initially, the program consisted of two facilities: the Main Street New Loan Facility (MSNLF) and the Main Street Expanded Loan Facility (MSELF).

The newly-announced Main Street Priority Loan Facility (MSPLF) is for new lending, like the MSNLF; MSELF is for increased lending under existing loans or revolving credit facilities. MSPLF requires that lenders retain 15% of the loan, compared to 5% under MSNLF and MSELF. This higher-risk sharing ratio is for borrowers that may be more highly leveraged, as the maximum loan size under the MSPLF is six times 2019 adjusted EBITDA (earnings before income, tax, depreciation, and amortization) compared to four times 2019 adjusted EBITDA for MSNLF.

The earlier term sheets for the Main Street facilities referred only to EBITDA. The reference to “adjusted” EBITDA represents a significant concession to the industry. It allows a lender to calculate EBITDA under the same methodology it used previously for the borrower or similarly situated borrowers. In recent years, lenders have inflated EBITDA by as much as a third by adding back transaction costs and expected savings that are often not realized.

Businesses with up to 15,000 employees or up to $5 billion in annual revenue are now eligible for all three facilities, compared to the prior limit of 10,000 employees or $2.5 billion in revenue. The new MSPLF has a minimum loan size of $500,000. The Fed also lowered the minimum loan size from $1 million to $500,000 for the MSNLF. This change opens the program to smaller businesses that were unable to participate under the initial terms.

The Board raised the minimum loan size for MSELF to $10 million from $1 million. The maximum is now the lesser of $200 million, 35% of the borrower’s outstanding and undrawn available debt, or six times the 2019 adjusted EBITDA. The program originally had a maximum of $150 million or 30% of the borrower’s outstanding and undrawn available debt. The limit of six times 2019 EBITDA remains the same. Similar to the reduced minimum loan size under MSNLF and MSPLF, the increased maximum loan size under MSELF expands the pool of eligible borrowers.
The Main Street Lending Program is broad-based and does not target specific industries. Industry groups responded during the window for comments to lobby for access to the program. Retail and hospitality groups expressed concerns regarding the debt requirements, and investment professionals sought guidance surrounding EBITDA calculations. Oil and gas groups also lobbied for changes such as allowing companies with higher debt to borrow under the program and permitting companies to use the funds to pay down existing debt.

All three facilities have the same eligible lender criteria, which now includes US branches of foreign banks, and the same borrower eligibility criteria. Loans all have the same 4-year maturity and the same interest rate. Initially, the interest rate was set at the Secured Overnight Financing Rate (SOFR) plus 250 to 400 basis points. The new guidance sets the interest rate for eligible loans at LIBOR (1 or 3 month) plus 300 basis points. All loans also have a deferral of principal and interest for a year and no penalty for early repayment. For MSNLF loans, one-third of the principal will be due at the end of each year. Loans under MPSLF and MSELF will have 15% of principal due at the end of the second and third years with the remaining 70% due at the end of the fourth year.

Borrowers under the program are also permitted to borrow under the Paycheck Protection Program (PPP), provided that the borrowers meet the eligibility criteria of the PPP. All borrowers must make “commercially reasonable efforts” to retain employees and maintain payroll in order to borrow under the program. In contrast to PPP lending, these loans are not forgivable.

The Board has not yet announced the start date for the program. The program end date is currently set for September 30, 2020. The Federal Reserve Bank of Boston will administer the program and will establish and operate the Main Street Special Purpose Vehicle (Main Street SPV). The Department of the Treasury will make a $75 billion equity investment in the Main Street SPV, which will be used to purchase up to $600 billion of participations in eligible loans under the three facilities. These facilities are established under the Federal Reserve’s authority under Section 13(3) of the Federal Reserve Act.

Once operational, the Board will disclose information regarding the operations of all three facilities including the names of lenders and borrowers, amounts borrowed, interest rates charged, overall costs, revenues, and other fees. Aggregated values of balances under each facility will be published weekly. One year after terminating the program, the Board will disclose more details about participation in the program, including the name and identifying details of each borrower, the amount borrowed, and information about their collateral or pledged assets.

The Board is evaluating a separate program for nonprofits. They are currently ineligible.
## Comparison of Main Street Lending Program Facilities

<table>
<thead>
<tr>
<th>Loan Details</th>
<th>MSNLF</th>
<th>MSPLF</th>
<th>MSELF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Term</td>
<td>4 years</td>
<td>4 years</td>
<td>4 years</td>
</tr>
<tr>
<td>Minimum Loan Size</td>
<td>$500,000</td>
<td>$500,000</td>
<td>$10M</td>
</tr>
<tr>
<td>Maximum Size</td>
<td>Lesser of $25M or 4X 2019 adjusted EBITDA</td>
<td>Lesser of $25M or 6X 2019 adjusted EBITDA</td>
<td>Lesser of $200M, 35% of outstanding and undrawn available debt, or 6x 2019 adjusted EBITDA</td>
</tr>
<tr>
<td>Lender Risk Sharing</td>
<td>5%</td>
<td>15%</td>
<td>5%</td>
</tr>
<tr>
<td>Repayment</td>
<td>Year 1: 0%</td>
<td>Year 1: 0%</td>
<td>Year 1: 0%</td>
</tr>
<tr>
<td></td>
<td>Year 2: 33.33%</td>
<td>Year 2: 15%</td>
<td>Year 2: 15%</td>
</tr>
<tr>
<td></td>
<td>Year 3: 33.33%</td>
<td>Year 3: 15%</td>
<td>Year 3: 15%</td>
</tr>
<tr>
<td></td>
<td>Year 4: 33.33%</td>
<td>Year 4: 70%</td>
<td>Year 4: 70%</td>
</tr>
<tr>
<td>Rate</td>
<td>LIBOR + 300 bps</td>
<td>LIBOR + 300 bps</td>
<td>LIBOR + 300 bps</td>
</tr>
</tbody>
</table>

Source: [Federal Reserve](https://www.federalreserve.gov)
UK Announces New 100% Loan Guarantee Program Targeted at Smallest Businesses

By Kaleb Nygaard

Original post here.

On April 27, the United Kingdom (UK) announced a new loan guarantee program called the Bounce Back Loans Scheme targeted at the smallest of small businesses. In contrast to the 80% coverage offered in the UK’s existing credit guarantee program, the government will guarantee 100% of Bounce Back Loans.

The new program widens eligibility to any UK-based business that has been affected by the COVID-19 pandemic and was not an “undertaking in difficulty” on December 31, 2019. Businesses can apply for guaranteed loans between GBP 2,000 and up to 25% of turnover with a limit of GBP 50,000 ($62,948). The term of the loans will be up to six years. In the first year, no payments will be required, and the government will cover any fees and interest. The government also indicated it will work with lenders to agree on a low rate of interest for the loans. The government did not announce a maximum number of loans or the total amount of money that would be available in the program.

A business cannot access the Bounce Back Loans Scheme if it already has a loan under the earlier loan guarantee program called the Coronavirus Business Interruption Loan Scheme (CBILS). The government guarantees 80% of CBILS loans. If a business already took out a CBILS loan that is less than GBP 50,000, it can work with the lender to convert the CBILS loan to a Bounce Back Loan. Businesses have until November 4 to make this conversion.

Accredited lenders will issue the loans, though the list of lenders has not been released yet. Similar to a loan guarantee program in Switzerland, the government has created a short, simplified, standard online application that businesses will fill out and take to the lenders. The government expects businesses to have access within days, often within 24 hours.

The government indicated that the Bounce Back Loans Scheme would be open and operational on May 4.
Federal Reserve Expands Access to Paycheck Protection Program Lending Facility to Non-Depository Institution Lenders

By Kaleb Nygaard

Original post here.

On April 30, the Federal Reserve (Fed) announced that it had expanded access to its Paycheck Protection Program Lending Facility (PPPLF) to allow non-depository institution lenders to participate.

The Fed’s PPPLF compliments the Small Business Administration’s (SBA) Paycheck Protection Program (PPP), which guarantees loans made by financial institutions to small businesses with less than 500 employees. Eligible lenders can use the PPP loans as collateral to borrow from the Fed. On April 23, Congress expanded the size of the PPP to $659 billion.

The SBA had approved non-bank lenders like Paypal, Square, and Intuit to issue PPP loans, but the PPPLF was originally only open to depository institutions. In its first PPPLF term sheet, effective April 9, the Fed indicated that it was working to expand access to other lenders. With the expansion, the PPPLF is now open to all lenders that are eligible to issue PPP loans. Beyond financial technology companies, new lenders also include Community Development Financial Institutions, members of the Farm Credit System, and SBA-licensed small business lending companies.

Whereas the PPPLF originally only accepted PPP loans that lenders had originated as collateral, it will now accept PPP loans that the lender either originated or purchased.

The Fed also updated, as outlined in the table below, the Reserve Bank through which the newly eligible lenders will access the program.

<table>
<thead>
<tr>
<th>Eligible Borrower Type</th>
<th>Reserve Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depository institution or credit union</td>
<td>The Reserve Bank in whose District the eligible depository institution is located (see Regulation D, 12 CFR 204.3(g)(1)–(2), for determining location)</td>
</tr>
<tr>
<td>Community development financial institution as defined in 12 U.S.C. § 4702 and certified by the U.S. Treasury (that is not a depository institution or credit union)</td>
<td>Federal Reserve Bank of Cleveland</td>
</tr>
<tr>
<td>Member of the Farm Credit System (that is not a depository institution or credit union)</td>
<td>Federal Reserve Bank of Minneapolis</td>
</tr>
</tbody>
</table>
PPP Rules Changed to Better Target Funds

By Mallory Dreyer and Kaleb Nygaard

Original post here.

The Paycheck Protection Program (PPP) has undergone multiple revisions and updates since its launch at the beginning of April in order to better target funds to high-need small businesses and clarify program eligibility and operations.

The PPP is a key component of the US response to the COVID-19 crisis and provides forgivable loans for eight weeks of payroll and other expenses to eligible small businesses that retain or rehire employees. The program launched on April 3 and expended the initial $349 billion in funding by April 16. Congress appropriated an additional $310 billion in funding to the program, and the Small Business Administration (SBA) began accepting applications for the second round on April 27.

Rule changes and updates issued during the second round of the program include guidance to target small businesses through smaller lenders, exclude larger companies, manage application volumes, and clarify program requirements.

Targeting Small Businesses Through Lender Eligibility

On April 26, the day before it began accepting applications again, the SBA announced that it would cap the total amount that a single bank could lend at $60 billion (approximately 10% of the total). According to the SBA, no lender accounted for more than 5% of the total in the first round. The SBA also announced on April 26 that it would allow lenders to submit applications in bulk, with a 15,000 loan minimum. The SBA lowered this to 5,000 on April 27.

The SBA also expanded a previous interim final rule which allowed non-bank lenders and non-insured depository institutions to lend under the PPP if they originated, maintained and serviced at least $50 million in commercial loans for at least a 12-month period in the past three years. Lenders who perform only one of the origination, maintenance or servicing activities, subject to the same volume and time period requirements, are now eligible. Lenders that have originated, maintained and serviced at least $10 million in commercial loans are eligible to lend under the PPP if it is a community development financial institution (other than federally insured banks or credit unions) or if its lending portfolio includes a majority of businesses that are women, minority, or veteran/military-owned.
On April 29, the SBA announced that it would only accept loans from lending institutions with asset sizes less than $1 billion between 4:00 p.m. and 11:59 p.m. ET. These lenders can also submit applications during normal operations. This eight-hour period was designed to ensure that the smallest lenders and their customers have access to the program.

Excluding Larger Companies and Types of Firms

On April 28, the Treasury and SBA announced that all PPP loans greater than $2 million will be reviewed by the SBA in order to verify that the businesses receiving such loans need the funds to continue operations. In order to receive a PPP loan, a borrower is required to make a good faith certification that the loan is necessary for the business to continue operating. The loans are subject to review prior to the amount being forgiven. In an interim final rule on April 24, the SBA clarified that borrowers that certified that they needed the funds due to economic uncertainty but then fully repaid the loan prior to May 7 would be considered to have made the certification in good faith. According to press coverage, multiple larger companies, including Shake Shack, received funding under the PPP but have announced plans to repay their loans. On May 1, Treasury Secretary Steven Mnuchin tweeted that some private K-12 schools with large endowments received loans under the PPP, and he argued that they should return the funding, although he did not take any formal action against these schools.

On April 28 the Treasury also explicitly prohibited hedge funds and private equity firms from accessing PPP loans. No reporting had indicated that they had accessed the funds.

On April 30, the SBA and Treasury released an interim final rule which limited the maximum loan size for a single corporate group to $20 million. The limit became effective immediately. A business is considered a part of a corporate group if it is majority owned, either directly or indirectly, by a common parent. The maximum loan size for a single beneficiary remains $10 million. Previously the SBA had not set a limit on corporate groups.

Managing the Application Process and Volume

The SBA began accepting applications again on April 27 at 10:30 a.m. ET. In order to manage the expected load on the online system, the SBA informed lenders that it would pace the submission of applications into the system at 350 loans per bank per hour. Despite the limit, lenders reported issues with accessing the system. In response to the burden on the online system, the SBA informed lenders on April 28 that they could no longer use robotic processing automation (RPA) to submit PPP loans. The SBA claimed that this would allow the processing system to become more reliable and equitable for small businesses.

Adding Lender Requirements for Disbursement and Processing Fees

The Treasury and SBA also released an interim final rule on disbursements on April 28. This rule requires lenders to distribute the loan funds within 10 days of approval in a single disbursement. Multiple disbursements are not permitted. The rule also formalizes the process through which the SBA will refund lenders’ processing fees. To receive the refund, the lenders will be required
to upload a SBA Form 1502 to report on PPP loans. Once the SBA makes the form available, lenders will be required to submit the form within 20 calendar days of loan approval and upload the form for loans made prior to the form becoming available by May 18.

**Calculating Seasonal Employment Payroll**

The SBA released an interim final rule on April 27 allowing seasonal employers to use an alternate method to calculate the maximum loan amount. Because these employers have seasonal variation in their total employment and payroll expenses, the SBA guidance allows the borrower to elect a prior 12-week period between March 1, 2019 and June 30, 2019.

**Lending to Date**

By April 29, the SBA had approved 960,000 new loans amounting to $90 billion. Of these loans, lenders with assets less than $10 billion made 587,000 loans totalling $43 billion; lenders with assets between $10 and $50 billion made 206,000 loans totalling more than $20 billion; and lenders with total assets more than $50 billion made 167,000 loans for more than $25 billion.

**Denmark Extends Duration of COVID-19 Support Programs and Introduces New Measures**

By Mallory Dreyer

*Original post [here](#).*

On April 18, Denmark announced two new credit facilities to support small businesses and extended previously announced temporary support programs which will increase total spending by DKK 100 billion (US$15 billion).

**Introduction of New Measures for Lending Based on VAT and Payroll Taxes**

The government announced a new credit facility for businesses based on value-added tax (VAT) payments. Companies with fewer than 250 employees can apply to the government for a zero-interest loan based on the amount of VAT paid in 2019. Companies with revenue less than DKK 5 million can receive a loan based on VAT paid in the second half of 2019, while companies with revenue between DKK 5 million and DKK 50 million can receive a loan based on the VAT paid in the fourth quarter of 2019. These loans must be repaid by April 1, 2021, or interest will be charged.

The government also made a lending facility available to small businesses that are exempt from VAT based on their payroll taxes. This is open to businesses including dentists, doctors, and taxis. These firms can access a loan with a value of the payroll tax paid for the first quarter of
2020 and a quarter of the payroll tax paid in 2019. Similar to the loans based on VAT payments, these loans will carry no interest and must be repaid by April 1, 2021.

**Extension of Wage Subsidy Program**

The announcement also extended existing temporary support measures, including the wage subsidy program. It will be available through *July 8*, a month longer than initially planned. The wage subsidy program provides 75% of total salary expenses or 90% of total wages for non-salaried employees to companies, with a maximum of DKK 30,000 per employee per month. Under the wage subsidy program, **95% of the companies** that applied for the program as of May 1 received support, with more than DKK 6 billion paid.

**Extension and Modification of Fixed Cost Compensation Scheme**

The fixed cost compensation scheme will also be available through July 8. In addition to extending the program, the government modified terms and criteria. Companies can now receive **compensation** of 25% of fixed costs if revenue falls between 35-60%, compared to the prior requirement of 40-60%. The government lowered the minimum fixed cost criteria so that companies with fixed costs of DKK 12,500 over a three-month period are eligible, compared to the prior DKK 25,000 requirement. The government raised the limit on support to DKK 110 million per company, up from DKK 60 million.

The **government also introduced** a new eligibility condition for the fixed cost compensation scheme that prohibits companies that receive more than DKK 60 million from the scheme from paying dividends or buying back shares in 2020 and 2021. A company that intends to either buy back shares or pay dividends in 2020 or 2021 must repay funds in excess of DKK 60 million.

**Extension and Modification of Compensation Scheme for Self-Employed**

The government also extended the compensation scheme for the self-employed and freelancers and increased the compensation rate **from 75%** to 90% of lost income or revenue. For those who are unable to open due to the government ban, the compensation rate is 100%.
FHFA Allows Federal Home Loan Banks to Take PPP Loans as Collateral

By Vaasavi Unnava

Original post here.

On April 23, the FHFA announced that Federal Home Loan Banks (FHLBs) could take Paycheck Protection Program (PPP) loans guaranteed by the Small Business Administration as collateral for their advances providing some financial institutions two channels through which to finance such loans.

The FHFA (the Federal Housing Finance Agency) implements this new policy through its supervisory responsibilities over the 11 regional FHLBs that make up the FHLB system. The FHLBs are each separately chartered, member-owned institutions. The system as a whole has over 6,000 financial institutions as members. Most members are banks and credit unions, but the membership also includes 60 community development financial institutions and nearly 500 insurance companies.

The FHLB system provides liquidity to its members to promote housing finance. It acted extensively as a “lender of next-to-last resort” during the Global Financial Crisis. A YPFS blog noted, based on discount note and bond utilization rates, that the system is stepping into a similar, though smaller, role now during the COVID-19 crisis.

The PPP, authorized by the Coronavirus Aid, Relief, and Economic Security (CARES) Act, was originally established as a $349 million program pursuant to which the SBA guaranteed loans to small businesses whose operating expenses were affected by COVID-19 due to social distancing guidelines. The principal of the loans may be forgiven if certain criteria are met, e.g., if borrowers maintain payrolls for employees. The U.S. government recently expanded the PPP with an additional $310 million allocation.

On April 9, the Federal Reserve established the Paycheck Protection Program Lending Facility (PPPLF), meant to provide liquidity to depository institutions that originated PPP loans by permitting the use of such loans as collateral when borrowing from the Fed. In the PPPLF term sheet, the Fed stated that it was working to expand the group of eligible borrowers. On April 30, the Fed announced that nondepository institutions originating PPP loans would also be eligible to participate in the PPPLF providing two channels for such lenders wishing to finance their PPP loans.

FHLBs’ PPP collateral terms differ from the Fed’s PPPLF terms. FHLB members seeking advances from an FHLB by pledging collateral must have at least a CAMELS rating of 3 or higher or a credit rating in the top 60% of all members; the lower rating of the two is used to determine eligibility. (Bank examiners use CAMELS to rate banks’ condition). In comparison, all originators of PPP loans may borrow from the PPPLF.
Bank regulators said they will not require banks to hold capital against PPPLF loans. The FHFA did not mention capital forbearance in announcing its PPP policy.

While the Fed doesn’t require any haircuts on collateral, FHLBs must apply at least a 10 percent haircut on any unpaid balances of PPP loans pledged as collateral (a rate lower than the FHLBs apply to other collateral). However, the haircut increases should a member lose eligibility. If an FHLB member loses eligibility to use PPP loans as collateral by either receiving a CAMELS rating of 4 or falling into the bottom 20–40% of members by credit rating, the lending FHLB must apply an 80 percent haircut to the collateral. If an FHLB member receives a below 5 CAMELS rating or falls into the bottom 20% of members by credit rating, the lending FHLB must apply a 90 percent haircut to the collateral.

PPP loans may only constitute 20% of a member’s collateral with its FHLB, and a member may not pledge more than $5 billion of PPP loans as collateral.

As FHLB banks may accept agency securities as collateral for FHLB advances, FHFA interpreted PPP loans as agency securities, given that the Small Business Administration (SBA) guarantees the principle on all unpaid balances of PPP loans. The SBA published an interim final rule clarifying that lenders could pledge their PPP loans to the Fed or an FHLB as collateral, without the SBA’s prior consent. The FHFA determined that, in the event of default, FHLBs could sell any PPP loans received as collateral to another SBA lender, with the SBA’s consent, preserving the benefit of the SBA guarantee.

Non-depository institutions originally ineligible for the PPPLF may utilize the FHLB system to finance PPP loans and improve liquidity. However, with the PPPLF’s new expansion of eligibility, such institutions have two channels to choose between in financing PPP loans, with the PPPLF’s terms being less restrictive, as shown in the table:

<table>
<thead>
<tr>
<th></th>
<th>PPPLF</th>
<th>FHLB System</th>
</tr>
</thead>
<tbody>
<tr>
<td>Haircut</td>
<td>0%</td>
<td>10%</td>
</tr>
<tr>
<td>Eligibility</td>
<td>All institutions originating PPP loans</td>
<td>All FHLB Members originating PPP loans</td>
</tr>
<tr>
<td>Required Supervisory Rating (banks)</td>
<td>CAMELS Rating &lt; 5</td>
<td>CAMELS Rating ≤ 3</td>
</tr>
<tr>
<td>Rate</td>
<td>35 bps</td>
<td>Determined by FHLB Banks</td>
</tr>
<tr>
<td>Limit</td>
<td>N/A</td>
<td>$5 billion</td>
</tr>
<tr>
<td>Capital Risk Weighting (banks)</td>
<td>0%</td>
<td>N/A</td>
</tr>
</tbody>
</table>

In explaining the new policy, FHFA said that “accepting PPP loans will provide additional liquidity for small and community banks to borrow from their FHLBank to support the small businesses in their communities.” The FHFA earlier relaxed standards for mortgage servicers facing liquidity constraints. By permitting the FHLBs to take PPP loans as collateral,
FHFA can increase liquidity for small community financial institutions, providing additional support to small businesses.
US Businesses Navigate Multiple Government Support Programs

By Mallory Dreyer

Original post here.

In response to the COVID-19 pandemic, the United States has adopted multiple programs providing support to businesses, specifically targeting job retention, while at the same time expanding unemployment insurance benefits and eligibility. Programs to support businesses vary across types of benefit and eligibility criteria. This post summarizes government support options available to businesses in the United States and some potential considerations for employers and employees.

Available programs include the following; however, the list is non-exhaustive, as state and local governments have also announced programs:

- Paycheck Protection Program
- Employee Retention Tax Credit
- EIDL Loans and Grants
- Short-time Compensation
- Main Street Lending Program
- Unemployment Insurance

In determining how to respond to the COVID-19 pandemic, firms may evaluate the following:

- What support is the firm eligible to receive?
- When will the business receive support and how easily can it be accessed?
- How do wages compare to unemployment insurance benefits?
- What are the restrictions on using the support?
- When will the business be able to reopen and how will operations change upon reopening?

Available Programs

Paycheck Protection Program

On March 27, Congress passed the CARES Act which established the Paycheck Protection Program (PPP). Under the program, small businesses apply for SBA-guaranteed loans from eligible lenders, and the government forgives up to 100% of the value of the loan if it is used primarily for payroll expenses. The PPP will cover up to $100,000 in annualized salary or wages per employee, and the maximum loan amount is $10 million.
The program incentivises small businesses to maintain their payroll, as a decrease in the payroll numbers proportionally decreases the amount of the loan that can be forgiven. If an employer rehires an employee it laid off earlier, the payroll expenses can be forgiven. If an employer attempts to rehire an employee and the employee declines, the amount of forgiveness will not be reduced.

The SBA exhausted the $349 billion in appropriations by April 16, but Congress allocated an additional $310 billion in funding through emergency legislation on April 23. The SBA began accepting applications again on April 27. The Small Business Administration and Treasury have released multiple interim final rules, clarifying eligibility criteria and operations.

**Employee Retention Tax Credit**

The Employee Retention Tax Credit (ERTC) is a refundable tax credit to employers that are required to fully or partially suspend operations in 2020 (during any calendar quarter) due to a government mandate or that experience a 50% decline in gross receipts compared to the same quarter in 2019. The credit amount is determined based on the number of employees. For firms with more than 100 full-time employees, only the wages paid to employees who are not working are considered qualified wages. For firms with fewer than 100 employees, all employee wages are considered qualified wages. Only wages paid between March 13 and December 31, 2020 are eligible. Employers will receive a fully refundable tax credit of 50% of up to $10,000 in qualified wages per employee. Firms borrowing under the PPP cannot claim the ERTC.

**EIDL Loans and Grants**

The SBA has another lending program for small businesses, the Economic Injury Disaster Loan program (EIDL), which provides grants of up to $10,000 and loans on favorable terms. Similar to the PPP, initial appropriations were expended in mid-April, but the emergency legislation made additional funds available. The SBA announced on May 4 that EIDL loans and grants would only be available to eligible agricultural businesses going forward. Applications that were submitted prior to the temporary suspension of application submissions will be processed in the order received.

**Short-time Compensation**

The CARES Act also provides federal funding for short-time compensation (STC) programs. States with new or existing short-time compensation programs will receive 100% federal funding for payments under these programs through December 31. Short-time compensation is a program within the unemployment insurance system that provides benefits to workers whose hours are reduced. Employers can reduce hours of work for employees rather than laying off some employees, and those whose hours are reduced will be able to collect a percentage of unemployment compensation benefits to replace some of their lost wages.
Twenty-six states currently have operational programs, but there is variation across state administration and requirements. For example, Connecticut allows for a 10-60% reduction in work hours, while Michigan allows for a 15-45% reduction.

In order to receive support, an employer must submit the work plan to the responsible state agency and obtain approval. Employers are required to maintain health, retirement and other benefits for employees in the program. During the covered period, an employer cannot lay off employees who are receiving short-time compensation.

Short-time work schemes are common in Europe, and the European Commission announced a temporary initiative to support short-time work schemes in Member States.

**Main Street Lending Program**

The Federal Reserve Board announced the Main Street Lending Program on April 9 and updated terms on April 30. Under the program, the Federal Reserve will purchase participations (either 85 or 95%) in eligible loans to companies with up to 15,000 employees or less than $5 billion in revenue.

Unlike the PPP, these loans are not forgivable and will carry a higher interest rate. Borrowers must make “commercially reasonable efforts” to maintain payroll and retain employees. However, the program only requires borrowers to undertake “good-faith efforts” and allows firms that have already laid off or furloughed workers to apply for Main Street loans. The Federal Reserve Board has not yet announced the start date of the program.

**Unemployment Insurance**

Some employers are laying off or furloughing workers in response to COVID-19. The CARES Act expanded unemployment insurance in the United States through three components.

- The **Pandemic Unemployment Assistance (PUA)** makes benefits available to individuals who are self-employed, seeking part-time employment, or who otherwise do not qualify for unemployment insurance benefits under state or federal law.

- The **Federal Pandemic Unemployment Compensation** (FPUC) program provides an additional $600 in unemployment benefits per week to eligible individuals through July 31, 2020.

- The **Pandemic Emergency Unemployment Compensation** (PEUC) program allows individuals to receive 13 additional weeks of benefits.

The Bureau of Labor Statistics reported in the April employment report that the unemployment rate increased by 10.3 percentage points to 14.7%. Temporary layoffs accounted for 18.1 million of the 20.5 million job losses in April.

**Potential Considerations For Employers and Employees**

What support is the firm eligible to receive?
Eligibility criteria differ across programs. The PPP targets small businesses, though it has received heightened press coverage and criticism as some larger companies have received aid. The SBA and Treasury have released interim final rules regarding eligibility to attempt to limit larger companies with access to public financing from accessing the program. Private equity firms and hedge funds are explicitly excluded from the program.

The Main Street Lending Program is available to companies with up to 15,000 employees or $5 billion in revenues, making it available to companies of larger sizes, though nonprofits are not eligible.

The ERTC does not have a size restriction, though companies with more than 100 employees can only claim the tax credit for employees who are paid but not working in the quarters it is applied. The ERTC is available to companies that experience a 50% decline in gross receipts compared to the same quarter of 2019, thus targeting firms that have experienced a significant decline in revenue.

The EIDL program is only available to agricultural businesses as of May 4.

**When will the business receive support and how easily can it be accessed?**

For many small businesses, containment measures have led to an urgent need for support.

According to a recent survey of small businesses, approximately 25% of firms surveyed did not have enough cash to cover more than one month of expenses. Approximately 50% had enough cash to cover between one and two months of expenses. Recent Federal Reserve Bank of New York research found that less than 20% small businesses in the US can continue normal operations with their cash reserves if they experience a two-month revenue loss. Thus, the speed at which a program provides support to businesses is an important consideration.

A week after announcing the PPP, the SBA began administering the program. Businesses that are able to submit applications through their lenders and receive approval can quickly receive funds. However, in the first phase of the program, many borrowers were not able to receive funds due to the first-come-first-serve nature. The SBA has not yet announced details regarding the process for loan forgiveness.

For businesses that need immediate support, the Main Street Lending Program may not provide quick relief, as the Federal Reserve Board has not yet announced the start date.

The ERTC provides support through a tax credit, which can provide immediate benefits. Employers report the total qualified wages for the ERTC in quarterly federal employment tax returns. These employers can fund the qualified wages by accessing withheld federal employment taxes or requesting an advance for the credit from the IRS. Short-time compensation programs vary across states but an employer’s plan requires approval from the responsible state agency.

**How do wages compare to unemployment insurance benefits?**
According to another recent survey of small businesses, many firms surveyed had already laid off workers in response to the economic shock of COVID-19. Reducing payroll can provide immediate relief to firms, and individuals who are laid off can apply for unemployment insurance, which is augmented by an additional $600 per week from the federal government.

Some have noted that unemployment benefits exceed the prior earnings of some individuals, as the $600 addition averages to $15 per hour for a 40-hour work week, which is above state minimum wages. It is important to note that employees generally cannot quit a job in an attempt to receive unemployment benefits. The Department of Labor released recent guidance that workers who quit a job without good cause in an attempt to receive UI will have committed fraud. Additionally, some employers and employees may find that reduced hours as opposed to layoffs may be preferable to unemployment as relationships remain intact. Workers in job-protected leave or in partial unemployment status may be able to retain healthcare coverage or other benefits.

The CARES Act also waives the one-week waiting period for unemployment benefits, which is standard in many states. The speed at which individuals are able to receive unemployment benefits depends on the state unemployment system and infrastructure. Many systems are overburdened in response to the more than 33 million new claims since the start of the COVID-19 pandemic.

What are the restrictions on using the support?

Some programs place restrictions on how the funds can be used. For example, 75% of PPP forgivable loans have to be used on payroll expenses. This has been criticized by firms with high non-payroll expenses, such as rent. PPP loan forgiveness also decreases in proportion with reductions in the number of employees, which is designed to incentivize employee retention. Some firms are awaiting clarification on loan forgiveness from the Treasury and SBA.

The Main Street Lending Program is not targeted at microenterprises, as the minimum loan size is $500,000. Under the Main Street Lending Program, payroll retention is encouraged but not required explicitly, as borrowers must make a good faith certification that they will attempt to retain employees.

PPP participants cannot claim the ERTC. Businesses that meet criteria for both the Main Street Lending Program and the PPP are able to use both. STC programs supplement an employee’s wages through the unemployment insurance system, thus directly providing support to the individual.

When will the business be able to reopen and how will operations change upon reopening?

Uncertainty regarding the timeframe for reopening remains. The PPP provides eight weeks of payroll support, which some worry may not be adequate if current containment measures
remain. Other countries, such as Denmark, have already announced extensions of programs to support businesses and individuals.

UI benefits are available for an additional 13 weeks, but during the Global Financial Crisis, the eligibility period was extended multiple times so that individuals could receive up to 99 weeks of UI benefits.

As the economy reopens, some argue that the increased unemployment benefits will make it challenging for businesses to rehire workers that are collecting more in unemployment insurance benefits than they would be working. However, workers that refuse a work offer generally will not be able to continue to collect unemployment insurance benefits.

Some companies may not be willing to take on debt given the economic uncertainty; thus programs that operate as grants may be more appealing. Given the likelihood of a long period of economic recovery, businesses that reopen may not see an immediate return to pre-COVID-19 operations. This may impact an employer’s ability to rehire all employees and may make borrowing unattractive.

STC programs may be attractive to employers who want to adjust operations in response to the COVID-19 pandemic while retaining employees and maintaining relationships. Businesses will also need to take safety precautions and modify operations in order to account for government guidance related to testing, sanitation, and physical distance.

The Philippines Provides Support to Workers in the Informal Economy

By Mallory Dreyer and Kaleb Nygaard

Original post here.

The Philippines government has included a temporary short-term work program that aims to employ close to 1 million workers in the informal sector in its COVID-19 response package. The TUPAD #BKBK program provides temporary employment opportunities to workers in the informal sector, as these workers are particularly vulnerable to economic hardship due to the COVID-19 pandemic.

Informal sector workers are those who do not have secure employment contracts and generally do not have benefits or access to a social safety net. According to the International Labour Organization, the informal economy in the Philippines consists of independent, self-employed small scale producers and distributors of goods and services. Nearly 40% of the workforce in the Philippines is considered employed in a “vulnerable” source of employment, which is a proxy measure for the informal economy.

The Department of Labor and Employment (DOLE) manages the TUPAD #BKBK program (Tulong Panghanapbuhay sa Ating Disadvantaged/Displaced Workers, Barangay Ko, Bahay
The TUPAD #BKBK program provides the minimum wage to unemployed informal sector workers to perform disinfection and sanitation work of their dwellings and the surrounding areas for 10 days. Individuals will also undergo an orientation on safety and health and be enrolled in group micro-insurance (insurance policies specifically targeted to disadvantaged individuals).

The TUPAD program is an existing DOLE program that provides short-term employment opportunities to displaced, underemployed or seasonal workers for a minimum of 10 days and a maximum of 30 days. Individuals work on infrastructure projects such as repair or maintenance of public facilities or bridges, and agro-forestry projects such as reforestation. The TUPAD #BKBK program is an emergency measure specifically designed to support individuals during the COVID-19 pandemic. Funding for the TUPAD #BKBK program comes from the DOLE’s 2020 budget, with more than PHP 1 billion spent as of April 29.

As of May 10, 337,000 workers received benefits from the TUPAD #BKBK program, with a total of 540,000 expected to benefit from the TUPAD #BKBK program and a total of 962,000 expected to benefit from all TUPAD measures.

The DOLE is expanding the emergency program to allow local government units to provide short-time employment for delivery of essential goods and services, including PPE. Local governments can also hire workers for the packaging of support equipment, transportation of front-line workers, and sanitation and disinfection of communities.

At the end of April, the DOLE announced that it planned to continue to leverage the TUPAD program during the COVID-19 recovery phase. The post-COVID TUPAD program, which has PHP 4 billion in funding, is set to operate in May and June in regions under the general community quarantine.

Providing short-term public employment appears to be a relatively uncommon emergency measure to support informal sector workers. However, the Philippines is also providing financial assistance in the form of cash grants to individuals, including those in the informal sector. The Emergency Subsidy Program is a PHP 205 billion emergency subsidy program for 18 million low-income families. Families with low incomes, including those who work in informal sector jobs, are eligible. Families receive between PHP 5,000 and 8,000 for two months. By May 2, PHP 60.6 billion had been distributed to 11.3 million beneficiaries, and the government added an additional 5 million families on May 4. The Department of Social Welfare and Development will also provide Livelihood Assistance Grants (LAGs) to beneficiaries of the existing Sustainable Livelihood Program, who have at least one family member who works in the informal sector who is displaced by the lockdown measures. LAGs will be granted after the quarantine ends.
EU Expands Temporary Framework For State Aid to Allow Recapitalization

By Mallory Dreyer

Original post here.

On May 8, the European Commission (EC) approved new measures under the Temporary Framework for State Aid, which allow Member States to purchase equity and subordinated debt from non financial companies. The EC will allow recapitalization measures through June 30, 2021, a time period six months longer than other measures under the Temporary Framework.

The European Commission adopted the Temporary Framework for State aid on March 19. The initial framework allows Member States to provide direct grants, selective tax advantages, and advance payments to companies, in addition to allowing public guarantees on loans and subsidized public loans to companies.

The EC adopted the first amendment to the framework on April 3. The first amendment allows Member States to grant aid for coronavirus-related research; or provide support for construction of testing facilities or production of supplies related to the COVID-19 outbreak. Member States can provide targeted support to companies through tax or social security contribution deferrals and wage subsidies.

The second amendment allows Member States to provide public support to companies in the form of equity or hybrid capital instruments. Recapitalization can be in the form of equity or hybrid capital instruments. This includes new common or preferred shares, profit participation rights, silent participations, and convertible secured or unsecured bonds.

Under the Treaty on the Functioning of the European Union (TFEU), Member States that take equity stakes in strategic companies by buying existing shares at market price, or invest pari passu with private shareholders, are not considered to have provided State aid.

The EC established a set of conditions for the use of recapitalization measures related to appropriateness, remuneration, exit strategy, governance, and cross-subsidization or acquisition of competitors.

**Appropriateness**

Recapitalization should only be used if there is no other appropriate solution and should only be used to ensure the viability of the company. In order to be eligible for recapitalization aid, a beneficiary must not be able to find affordable financing on the market. Aid should not go beyond restoring the company’s pre-COVID-19 capital structure, and companies that were considered in difficulty as of December 31, 2019, are not eligible.

**Remuneration**
Member States must be sufficiently remunerated for the risks assumed through recapitalization.

**Equity Instruments**

For equity instruments, the price paid by the Member State cannot exceed the average share price of the beneficiary over the 15 days prior to the request for assistance. If the company is not publicly traded, the price will be based on an estimate of the market value established by an independent expert.

Recapitalization measures should include a step-up mechanism to increase the remuneration of the State to incentivize a beneficiary to buy back the State’s equity investment. The step-up mechanism can be in the form of additional shares or other mechanisms. The step-up mechanism will be activated if the State has not sold at least 40% of its participation after four years for publicly-listed companies or five years for private companies. If the State has not sold its participation in full after six years for publicly-listed companies or seven years for private companies, the step-up mechanism will be activated again. The step-up mechanism will increase the State’s share by at least 10%. For example, if the State’s stake is 40% after four years, the participation will increase by at least 4 percentage points. Hybrid capital instruments converted to equity will also be subject to the step-up mechanism.

**Hybrid Capital Instruments**

Remuneration for hybrid capital instruments must take into account the level of subordination, risk, payment modalities, incentives to exit, and an appropriate benchmark interest rate. Hybrid capital instruments must pay a minimum of the 1-year interbank offered rate (IBOR) plus the rate from the following table:

<table>
<thead>
<tr>
<th>Recipient Type</th>
<th>Year 1</th>
<th>Years 2-3</th>
<th>Years 4-5</th>
<th>Years 6-7</th>
<th>Year 8 and after</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small and medium-sized enterprises</td>
<td>225 bps</td>
<td>325 bps</td>
<td>450 bps</td>
<td>600 bps</td>
<td>800 bps</td>
</tr>
<tr>
<td>Large Companies</td>
<td>250 bps</td>
<td>350 bps</td>
<td>500 bps</td>
<td>700 bps</td>
<td>900 bps</td>
</tr>
</tbody>
</table>

Hybrid capital instruments can be converted to equity.

**Governance**

Companies are banned from share buybacks and dividends for as long as the Member State has an equity share. In addition, companies must adhere to a strict limitation on management compensation, including a ban on bonus payments, as long as 75% of the recapitalization is outstanding. Companies are also banned from...

Member states will be required to report the identity of the beneficiaries of recapitalization measures within three months. The EC encourages but does not require Member States to
incorporate a focus on green or digital transformation in recapitalization measures. However, large companies will be required to annually report on how the aid is used, specifically related to the EU objectives of green and digital transformation.

**Preventing Distortion of Competition**

If recapitalization of a single beneficiary with significant market power exceeds EUR 250 million, the Member State will be required to take additional action to preserve competition in the market. In addition, large companies receiving recapitalization support are not permitted to acquire more than a 10% stake in competitors, companies in the same line of business, or upstream and downstream suppliers, as long the State retains at least 75% of its stake.

**Exit Strategy**

A Member State can sell its equity stake at market prices to buyers other than the beneficiary at any time after the initial investment.

Large companies that receive recapitalization equal to at least a 25% equity stake must develop and submit an exit plan for the participation of the State unless the State’s stake is reduced to less than 25% after one year. The exit plans must include a planned payment schedule for the remuneration and the redemption of State investment. Beneficiaries are required to submit plans within 12 months of receiving aid, and the Member State is required to approve the plan.

If the Member State’s stake is 15% or greater after six years for a publicly-listed company or seven years for all other companies, the EC will require a restructuring plan for the beneficiary.

**Subordinated Debt**

The second measure in the amended Temporary Framework allows Member States to buy subordinated debt. In such cases, the State’s position is subordinated to that of ordinary senior creditors in insolvency proceedings. Subordinated debt provided to companies above the established limits for aid to a beneficiary will be subject to the conditions for recapitalization. For large companies, aid in excess of two-thirds of the annual wage bill or 8.4% of the total turnover in 2019 will be subject to the recapitalization conditions. For small and medium-sized enterprises, the limit is either the full annual wage bill or 12.5% of the total turnover in 2019. Subordinated debt cannot be converted to equity while a company is a going concern.

The following table provides a summary of the measures of the Temporary Framework for State Aid, which was adopted on March 19 and amended on April 3 and May 8.
<table>
<thead>
<tr>
<th>Date</th>
<th>Included Measures</th>
</tr>
</thead>
</table>
| **March 19** | 1. Direct grants, selective tax advantages and advance payments up to EUR 800,000  
|            | 2. State guarantees for loans taken by companies from banks  
|            | 3. Subsidized public loans with favorable interest rates to companies  
|            | 4. Safeguards for banks that channel State aid to the real economy  
|            | 5. Short-time export credit insurance  
| **April 3** | 1. Support for COVID-19 related research and development  
|            | 2. Support for the construction and upscaling of testing facilities  
|            | 3. Support for the production of products relevant to the COVID-19 outbreak  
|            | 4. Targeted support in the form of deferral of tax payments or social security contributions  
|            | 5. Targeted support in the form of wage subsidies for employees  
|            | 6. Expands the provisions in the initial temporary framework, allowing companies to receive up to EUR 800,000 in aid through zero-interest loans, 100% guarantees  
| **May 8**   | 1. Recapitalization of nonfinancial companies through equity and hybrid equity instruments  
|            | 2. Support to companies through subordinated debt at favorable terms |
Nepal Expands Public-Works Program

By Kaleb Nygaard and Mallory Dreyer

The Nepali government introduced the public-works program, called the Prime Minister Employment Program, in early 2019, “to create job opportunities within Nepal and end Nepal youth dependency on jobs abroad.” Unemployed persons between the ages of 18 and 51 are eligible to apply. They are assigned jobs based on their qualifications and interest areas, and receive vocational and skill-oriented training.

The jobs include traditional infrastructure projects like tree planting, public toilet construction, road construction and improvements, drainage repair, playground improvements, soil irrigation, drinking water and irrigation projects, and trekking trail building.

Originally, the program guaranteed a minimum of 100 days of work along with a subsistence allowance; however, due to a relatively slow start, the guarantee was reduced to 30 days. For the first year, the government allocated NPR 3.1 billion (USD 25.6 million) for the program, NPR 100 million of which was to be spent on administration. Each project, administered at the local level, could receive up to NPR 500,000. The program faced accusations of malpractice and fraud. Government statistics show that 175,909 were hired for these public-works projects but only for an average of 13 days per person.

On December 30, 2019, the Nepali government announced an expansion of the Prime Minister Employment Program. The government allocated an additional NPR 5.01 billion for the fiscal year. The larger total was made possible by a loan from the World Bank worth NPR 2.62 billion. This year’s program saw a number of amendments. Localities now must submit their project proposals first before funds will be given; local units must spend at least 70% of the allocated budget on payment for work to the registered citizens; and projects like rearing stray animals and gardening are no longer allowed.

In addition to the employment program, on April 26 Nepal announced that informal sector workers who had lost their jobs due to the crisis would receive 25% of a local daily wage if they chose not to participate in the public-works projects.
Bank of Japan Introduces New Facility to Support Bank Lending to Small and Medium-Sized Firms

By Mallory Dreyer and Kaleb Nygaard

Original post here.

On May 22, the Bank of Japan (BOJ) announced a new, 30 trillion yen ($279 billion) facility to support bank lending to small and medium-sized enterprises (SMEs).

The Japanese government announced an emergency program to support lending to SMEs in early March. Under this program, small businesses can take out zero-interest, unsecured loans of up to 30 million yen from financial institutions, including the Japan Finance Corporation, Shoko Chukin Bank, local banks, shinkin banks, and credit unions. The terms allow banks to defer principal payments for up to five years.

Through the new facility, the BOJ will offer loans for up to one year at a 0% interest rate to financial institutions. However, the BOJ will also pay financial institutions 0.1% interest on the amount of loans made under the new facility. Thus, the loans effectively carry a negative 0.1% interest rate, which is the same rate the BOJ pays (charges) on excess reserves. As collateral for the loans, the financial institutions may post loans, or pools of loans, made under the emergency government programs or loans with similar terms and counterparties.

The BOJ will begin extending loans under this new facility in June, taking into account loans made by financial institutions as of end-May. The new facility will operate through March 31, 2021.

The BOJ’s new facility is similar to the Federal Reserve’s Paycheck Protection Program Liquidity Facility (PPPLF). Under the PPPLF, eligible lenders can use PPP loans made to small businesses as collateral when borrowing from the Fed.

Prior to the May 22 announcement, the BOJ announced separate facilities to support lending to corporations through commercial paper or corporate bonds. This facility has 45 trillion yen in funding, which brings the BOJ’s total support for lending to businesses to 75 trillion yen.
Poland’s Financial Shield Provides Support to Businesses

By Mallory Dreyer

In response to the COVID-19 pandemic, on March 31, the Polish government announced its “Anti-Crisis Shield,” which includes the “Financial Shield” to support microenterprises, small and medium-sized enterprises, and large companies. The Financial Shield has PLN 100 billion (USD 24.8 billion or approximately 4.5% of 2019 GDP) in total funding. The Polish Development Fund (PFR), a state-owned financial group, is responsible for the administration of the Financial Shield.

As of June 1, more than 222,000 companies (both microenterprises and SMES) with 2.1 million employees benefited from the Financial Shield, and the PFR has paid out more than PLN 42 billion (USD 10.7 billion). Support to microenterprises and SMEs is in the form of a repayable advance with partial forgiveness.

Support to large companies will be in the form of liquidity financing, preferential financing, or equity financing. The European Commission (EC) approved the liquidity financing component of the Financial Shield targeting large companies on May 26. The equity and preferential financing components are under EC review and awaiting approval. After receiving approval, the PFR will begin administering the support measures for large companies.

Financial Shield for Microenterprises and SMEs

Support to microenterprises and SMEs will be in the form of repayable advances, which are similar to forgivable loans. These advances carry the possibility of redemption (forgiveness) of up to 75% after 12 months, contingent upon the firm maintaining employment and business operations. Eligible microenterprises have 1 to 9 employees and eligible SMEs have 10 to 249 employees. These firms must have been in operation as of December 31, 2019.

Under the Financial Shield, PLN 25 billion (USD 6.2 billion) is allocated for repayable advances to microenterprises, and PLN 50 billion is allocated for repayable advances to SMEs. To be eligible, firms must report a revenue decline of at least 25% compared to the same month of 2019. The scheme explicitly requires beneficiaries to have a tax residence in the European Economic Area, and firms cannot have a tax residence in a “tax haven” as defined by the EU. Funds granted to firms under the measure are not taxable.

On April 27, the European Commission approved the Financial Shield measures for microenterprises and SMEs. The PFR began accepting applications from eligible firms on April 29. Repayable advances to microenterprises and SMEs are channeled through commercial banks, but banks cannot charge fees or commissions to beneficiaries or to the PFR. Commercial banks are not responsible for the lending decisions or eligibility conditions, as the PFR carries those decisions in relation to the firms’ eligibility.
responsibilities. Participation in the program is voluntary, and more than 15 banks have registered.

Aid to microenterprises and SMEs can be granted through July 31; the government may extend the scheme through December 31. Funds are granted to firms based on the order in which applications are received.

**Microenterprise Advance Size and Forgiveness**

The amount of the advance for a microenterprise is determined by the amount of revenue lost and the number of employees. The amount per employee ranges from PLN 12,000 to PLN 36,000, depending on the revenue lost, and advances are capped at PLN 324,000 per firm.

The amount a firm is required to repay is dependent on its continued operations and employee retention. A firm will be required to fully repay the advance if it suspends business activity, begins a restructuring process, or undergoes liquidation. If the firm maintains the business activity over the 12 months following the advance, it will be required to repay the first 25% of the advance. The remaining 75% of the advance can be forgiven based on the number of employees maintained; firms that maintain full employment will be forgiven the full 75%.

**SME Advance Size and Forgiveness**

The size of the repayable advance for an SME is determined by the firm's revenue in 2019 and its revenue decline. The advance size, which is dependent on the scale of the revenue decline, ranges from 4% to 8% of 2019 revenue. The maximum advance amount, regardless of the revenue lost, is PLN 3.5 million.

Similar to the scheme for microenterprises, an SME will be required to fully repay the advance if it suspends business activities, liquidates, or begins restructuring activities. All other SMEs will be required to repay the first 25% of the advance. The next 25% will be decreased by the total cash loss during the year after the advance was received. Thus, if the cash loss exceeds 25% of the size of the advance, the SME will not be required to repay the next 25% of the advance. The remaining 50% of the advance will be forgiven based on employee retention; firms that maintain the same employment numbers will be forgiven the full 50%.

**Financial Shield for Large Corporations**

**Support for large corporations** can be through liquidity financing, preferential lending, or equity financing. The government has allocated PLN 25 billion in total funding to support larger corporations, with PLN 10 billion for liquidity financing and PLN 7.5 billion each for preferential financing and equity financing.

<table>
<thead>
<tr>
<th></th>
<th>Liquidity Financing</th>
<th>Preferential Financing</th>
<th>Equity Financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Funding</td>
<td>PLN 10 billion</td>
<td>PLN 7.5 billion</td>
<td>PLN 7.5 billion</td>
</tr>
<tr>
<td>Instruments</td>
<td>Loans, bonds, purchase of receivables, or warranties</td>
<td>Partially forgivable loans (up to 75%)</td>
<td>Shares, subscription warrants, or convertible loans</td>
</tr>
<tr>
<td>-----------------------------------</td>
<td>-----------------------------------------------------</td>
<td>---------------------------------------</td>
<td>--------------------------------------------------</td>
</tr>
<tr>
<td>Maturity</td>
<td>2 years with option to extend for 1 year</td>
<td>3 years with option to extend for 1 year</td>
<td>N/A</td>
</tr>
<tr>
<td>Maximum Amount per Firm</td>
<td>PLN 1 billion</td>
<td>PLN 750 million</td>
<td>Capped at either 50% of shares or the amount of loss due to COVID-19</td>
</tr>
</tbody>
</table>

The liquidity financing instruments contain a “cash sweep” mechanism to accelerate repayments if the company’s financial situation improves.

Firms receiving preferential financing are prohibited from using the funds to make payments to the owner or acquire shares. Additionally, firms cannot use the funds for mergers or acquisitions, or for the refinancing or early repayment of existing debt.

The measures are available to firms with at least 250 employees, turnover of at least EUR 50 million (USD 55 million), or a consolidated balance sheet of at least EUR 43 million. However, the government has also established criteria to allow some SMEs to participate in the scheme. Eligible SMEs have at least 150 employees and annual turnover of at least EUR 100 million. To participate, SMEs must either be in a specific sector affected by COVID-19, such as medicine or personal protective equipment production; or project a funding gap that exceeds PLN 3.5 million.

Beyond size criteria, large companies must either operate in a specific industry or meet at least one criteria related to inability to operate or access financing, revenue decline, or nonreceipt of payments. Similar to the support to microenterprises and SMEs, eligible companies must have a residence in the European Economic Area and cannot be registered in a “tax haven.”

The PFR is accepting initial applications from eligible companies prior to EC approval of all three financing options. After receiving a decision from the EC, the PFR will begin operations.
Bank of Mauritius Granted Permission to Make Equity Investments in Companies

By Kaleb Nygaard

Original post here.

On May 16, in response to the economic downturn caused by COVID-19, the government of Mauritius passed a law granting permission to the Bank of Mauritius (BOM), the country’s central bank, to make equity investments in companies.

As announced by the BOM on May 22, it will establish a special purpose vehicle called the Mauritius Investment Corporation (MIC) to make the capital investments. The announcement indicated the purpose was to “mitigate contagion of the ongoing economic downturn to the banking sector, thus limiting macro-economic and financial risks.”

The MIC will operate independently and be governed by a board of directors consisting of the first vice-governor and the second vice-governor of the BOM as well as three other independent members chosen from the private sector. A committee of professionals and advisors from the private sector will conduct in-depth analysis on the funding requests from companies and then submit their recommendations to the board of directors, who will have the final say on investments made by the MIC.

The MIC will make investments through a range of equity and quasi-equity instruments. The funds will be directed to “domestic systemic economic operators.” The announcement said this would help preserve jobs. In a press interview, the BOM Governor expanded, “by helping the economic operators who have a systemic importance, the MIC intends to avoid these companies from being in an irreversible financial situation and to provoke a shock wave which will affect the banking system and, by extension, the whole economy.”

The law allowing the BOM to initiate these new equity investments indicated that funding for the MIC would come from the BOM’s foreign reserves. As of April, the BOM held MUR 280 billion (USD 7 billion), roughly half of the country’s GDP. No additional details are available at this time.

The same law that allowed BOM to establish the MIC also allowed BOM to make a one-time grant of MUR 60 billion to the government to be used “to assist it in its fiscal measures to stabilise the economy of Mauritius.” The grant was issued on May 22.
United States Congress Passes Amendments to Paycheck Protection Program

By Kaleb Nygaard

Original post here.

On June 3, the United States Congress passed the Paycheck Protection Program (PPP) Flexibility Act of 2020. The update includes three significant changes to the PPP.

First, Congress reduced to 60% the portion of a government-backed loan that a company must spend on payroll to be eligible for forgiveness. Under the original law, Congress listed a number of expenses that a small or medium size enterprise (SME) could cover with a loan from the PPP. These expenses included payroll costs, payments of interest on any covered mortgage obligation, payments on any covered rent obligation, and covered utility payments. The Treasury later stipulated that 75% of the funds must be spent on payroll expenses for the government to forgive the loan. In the PPP Flexibility Act, Congress added a paragraph to the law that explicitly defines the portion of the loan that must be spent on payroll to be eligible for forgiveness at 60%. This was in response to many complaints noting that SMEs face significant other fixed expenses beyond payroll and that supporting the employees will only be useful if the company is able survive the downturn.

Second, the PPP Flexibility Act extends, from 8 weeks to 24 weeks, the timeframe within which the SMEs must use the funds to be eligible for forgiveness. Reports indicate that lawmakers made this change because the COVID-19 pandemic and economic shutdown have lasted longer than originally anticipated. This change highlights the importance of not underestimating the potential duration of a crisis. Doing so can result in relief efforts that are designed to handle short-term disruptions, but that leave limited ability to respond if the disruptions become longer-term.

Third, the law moved the last day on which a SME can use PPP funds to hire back employees previously laid-off from June 30 to December 31. Congress passed the original PPP law a few weeks into the COVID-19 pandemic and by that time many SMEs had already been forced to lay-off employees.

Congress outlined the PPP in section 1102 and 1106 of the CARES Act, which was signed into law on March 27. The law originally allocated $349 billion (expanded to $659 billion on April 23) for the forgivable, government guaranteed loans to SMEs with up to 500 employees.

As of June 3, 4.5 million loans had been approved worth $511 billion.
SBA and Treasury Issue Guidance on PPP Loan Forgiveness

By Mallory Dreyer and Kaleb Nygaard

Original post here.

On June 8, the Treasury and Small Business Administration (SBA) announced greater flexibility for loan forgiveness in a joint press statement on the Paycheck Protection Flexibility Act.

Prior to the passage of the Paycheck Protection Flexibility Act on June 3, Treasury guidance required borrowers to spend at least 75% of the loan amount on payroll expenses in order for their loan to be eligible for forgiveness from the federal government. In the Act, Congress set that level at 60%.

Even after Congress passed the Act, potential borrowers expressed concerns about the “60% cliff” effect: borrowers who spent less than 60% of their loan amount for payroll expenses would receive no forgiveness.

In the June 8 joint press release, the Treasury and SBA loosened the loan forgiveness requirements so that borrowers who use less than 60% of their loan amount on payroll expenses can now receive partial loan forgiveness. Their forgiveness will be calculated such that 60% of the forgiven amount has been used for payroll expenses.

For borrowers that use less than 60% of the loan for eligible payroll expenses, the formula to calculate the total amount eligible for forgiveness is the amount of the loan spent on payroll multiplied by $\frac{2}{3}$.

The following table provides two example scenarios based on a $100,000 loan, one which is eligible for full forgiveness and the other which is eligible for partial forgiveness:

<table>
<thead>
<tr>
<th></th>
<th>Partial Forgiveness (Less than 60% on payroll)</th>
<th>Full Forgiveness (60% or more on payroll)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total loan amount</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Amount spent on payroll</td>
<td>$50,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>Amount spent on other eligible expenses</td>
<td>$50,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Total amount forgiven</td>
<td>$83,350 (Calculation: $50,000 x $\frac{2}{3}$)</td>
<td>$100,000</td>
</tr>
</tbody>
</table>
Other eligible expenses include payments of interest on any covered mortgage obligation, payments on any covered rent obligation, and covered utility payments.

The following chart shows the portion of the loan eligible for forgiveness based on the portion spent on eligible payroll expenses.
On June 8, the Federal Reserve announced significant changes to the Main Street Lending Program, a new facility designed to support lending to small and medium-sized businesses. The changes include decreasing the minimum loan amount for some loans, increasing the maximum loan amount, amending the loan repayment schedule, and extending the loan term.

Through the Main Street Lending Program, the Fed will purchase up to $600 billion of participations in loans to so-called “main street” businesses, which are firms with up to 15,000 employees or $5 billion in annual revenue. The Fed has not yet launched the program.

The Main Street Lending Program has three facilities: the Main Street New Loan Facility (MSNLF) and Main Street Priority Loan Facility (MSPLF) are for new loans while the Main Street Extended Loan Facility (MSELF) is for increases to existing loans or credit facilities. The Fed will purchase a 95% participation in all loans under the program; previously, it had announced that it would purchase a 95% participation in loans under both the MSNLF and MSELF and an 85% participation in loans under the MSPLF.

The June 8 announcement increased the term of each loan option to five years, up from the previous term of four years. The announcement also delays the principal repayment for two years, up from the prior one-year deferral.

The table below summarizes the three different loan facilities with previous guidance in parentheses.

With the changes announced on June 8, the MSPLF and MSNLF have very similar terms, despite the MSPLF being designed for more highly leveraged borrowers. The Fed retained a measure to mitigate risk for MSPLF lending by requiring these loans to be secured if the borrower has other secured debt. A secured MSPLF loan must have a collateral coverage ratio of at least 200%; if not, then a loan’s collateral coverage ratio must be not less than the aggregate collateral coverage ratio for the borrower’s other secured loans, excluding mortgage debt. However, the Fed does not prohibit borrowers from using MSPLF loans to refinance existing debt to other lenders, unlike MSNLF loans, which cannot be used for refinancing.

Unlike the Paycheck Protection Program (PPP), loans made under the Main Street Lending Program are not forgivable. Businesses cannot participate in more than one of the three Main Street facilities and are also prohibited from accessing the Primary Market Corporate Credit Facility (an emergency facility to purchase corporate bonds). However, PPP borrowers can also borrow under the Main Street Lending Program if they meet the eligibility criteria.
The Main Street Lending Program appears to be the only Federal Reserve program under the CARES Act that is subject to the full set of restrictions on share buybacks, executive compensation, and dividend payments outlined in the CARES Act. Other programs appear to have received waivers from the Treasury Secretary under 4003 (c)(3)(a)(iii) (p. 519).

On May 27, the Federal Reserve Bank of Boston (FRBB), which will administer the program, released additional documentation for borrowers and lenders. These include the lender registration documents, loan participation and servicing agreements, and borrower covenants. The Fed also updated the FAQs to provide more information about program

<table>
<thead>
<tr>
<th>Purpose</th>
<th>MSNL (New Loans)</th>
<th>MSPLF (Priority Loans)</th>
<th>MSELF (Extended Loans)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial facility for new loans to borrowers</td>
<td>Announced on April 30 for new loans to highly leveraged borrowers</td>
<td>Increased lending (upsized tranche) to existing borrowers</td>
<td></td>
</tr>
<tr>
<td>Term</td>
<td>5 years (previously 4 years)</td>
<td>5 years (previously 4 years)</td>
<td>5 years (previously 4 years)</td>
</tr>
<tr>
<td>Minimum Loan Size</td>
<td>$250,000 (previously $500,000)</td>
<td>$250,000 (previously $500,000)</td>
<td>$10M</td>
</tr>
<tr>
<td>Maximum Loan Size</td>
<td>The lesser of $35M, or an amount that, when added to outstanding and undrawn available debt, does not exceed 4.0x adjusted EBITDA (previously $25M)</td>
<td>The lesser of $50M, or an amount that, when added to outstanding or undrawn available debt, does not exceed 6.0x adjusted EBITDA (previously $25M)</td>
<td>The lesser of $300M, or an amount that, when added to outstanding or undrawn available debt, does not exceed 6.0x adjusted EBITDA (previously $200M)</td>
</tr>
<tr>
<td>Participation</td>
<td>95%</td>
<td>95% (previously 85%)</td>
<td>95%</td>
</tr>
<tr>
<td>Principal Repayment</td>
<td>Year 1-2: Deferred</td>
<td>Year 1-2: Deferred</td>
<td>Year 1-2: Deferred</td>
</tr>
<tr>
<td></td>
<td>Year 3: 15%</td>
<td>Year 3: 15%</td>
<td>Year 3: 15%</td>
</tr>
<tr>
<td></td>
<td>Year 4: 15%</td>
<td>Year 4: 15%</td>
<td>Year 4: 15%</td>
</tr>
<tr>
<td></td>
<td>Year 5: 70%</td>
<td>Year 5: 70%</td>
<td>Year 5: 70%</td>
</tr>
<tr>
<td></td>
<td>(Previously deferred for year 1, 33.33% due in years 2-4)</td>
<td>(Previously deferred for year 1, 15% for year 2, 15% for year 3, 70% for year 4)</td>
<td>(Previously deferred for year 1, 15% for year 2, 15% for year 3, 70% for year 4)</td>
</tr>
<tr>
<td>Interest Payments</td>
<td>Deferred for 1 year</td>
<td>Deferred for 1 year</td>
<td>Deferred for 1 year</td>
</tr>
<tr>
<td>Interest Rate</td>
<td>LIBOR + 300bps</td>
<td>LIBOR + 300bps</td>
<td>LIBOR + 300bps</td>
</tr>
</tbody>
</table>
requirements. Changes made on May 27 include rules about affiliation, foreign subsidiaries, documentation, and specific updates to each facility related to security and subordination, among others.

The Fed has faced criticism for the amount of time it has taken to establish the Main Street Lending Program and begin operations. Others consider the program to be “heading for trouble before it even gets under way” as some potential borrowers view the interest rates as too high. Others considered the previous four-year term too short. In a webinar on May 29, Federal Reserve Chair Jerome Powell called the Main Street Lending Program “far and away the biggest challenge of any of the 11 facilities” the Fed set up in response to the COVID-19 pandemic. The Fed “expects that Main Street program” to be open for lender registration soon and to be actively buying loans shortly afterwards.”

The FRBB chose State Street Bank and Trust as the third-party vendor custodian and accounting administrator for the Main Street Lending Program.

The Fed announced the Main Street Lending Program on April 9 and accepted comments through April 16. Following the 2,200 plus comments, the Fed announced modifications to the program on April 30. The Fed will operate the program until September 30, unless the Federal Reserve Board and Treasury Department decide to extend its operations.
Germany Introduces Fixed Cost Support for SMEs

By Mallory Dreyer and Kaleb Nygaard

Original post here.

On June 12, the German government’s executive cabinet provided new details on the EUR 130 billion (USD 146 billion) round of fiscal stimulus measures meant to support the economy during the COVID-19 pandemic. The measures include a EUR 25 billion fixed-cost subsidy scheme for small and medium-sized enterprises (SMEs).

The fixed-cost subsidy scheme is available to businesses that experience a sales decline of at least 60% in April and May of 2020 compared to the same period in 2019. Non-public companies across all sectors are eligible, including nonprofit organizations.

The aid is provided in the form of a grant that is available for a maximum of three months. The grants reimburse a portion of fixed costs that a company incurs between June and August. These grants will be required to be repaid if the company ceases operations before August 2020. Companies can apply for aid through August 31.

Funding can be used on a broad range of fixed costs. These include rent and lease costs, interest expense on loans, financing costs for leases, utility expenses, maintenance costs for fixed assets, property taxes, insurance, licensing fees, training expenses, tax consultant or auditor fees for aid applications, and other personnel expenses that are not covered by short-time compensation, or Kurzarbeit.

The maximum funding available to a firm is EUR 150,000. Reimbursement rates are based on the percent decline in revenue:

- 80% reimbursement of eligible fixed costs for firms with a decline of 70% or more
- 50% reimbursement of eligible fixed costs for firms with a decline between 50% and 70%
- 40% reimbursement of eligible fixed costs for firms with a decline between 40% and 50%

Companies with up to five employees can receive up to EUR 9,000 for three months, and those with up to ten employees can receive up to EUR 15,000 for three months. The maximum reimbursement for firms with up to five or ten employees can be exceeded only in exceptional cases, such as when the total eligible reimbursable fixed costs are more than two times the maximum reimbursement amount.

Companies are required to prove the revenue decline and fixed cost expenses in a two-stage process. The first stage, or the application stage, requires the company to provide a forecast or estimate of the sales decline based on the sales decline in April and May of 2020. In addition, the
company is required to provide an estimate of the fixed costs over the period it is requesting aid. This first stage of the process is required to be completed by a tax advisor or consultant and submitted to the government application system. The second stage of the process is the verification process in which the actual sales decline is compared to the forecasted decline. If the sales decline is less than forecasted, and thus a company receives more in subsidies than it was eligible for, it will be required to repay the excess. If too little was paid because the forecasted decline in sales was too low, the subsidy will be increased.

The government also included other, smaller support measures in the stimulus package. For example, it committed to facilitating an electromobility fleet exchange program for electric utility vehicles for craftsmen and other SMEs.

The measures are based on the June 3 Coalition Committee’s comprehensive stimulus package. The measures will go through the parliamentary legislative process before becoming law. This new stimulus package follows a previous one from March worth EUR 750 billion.
Main Street Lending Program Opens for Lenders

By Mallory Dreyer and Kaleb Nygaard

Original post here.

On June 15, the Federal Reserve Bank of Boston (FRBB) announced that lender registration for the Main Street Lending Program is now open.

The Main Street Lending Program is designed to support lending to small- and medium-sized enterprises (SMEs). Through a special purpose vehicle (SPV) established by the FRBB, the Fed will purchase a 95% participation in loans made by eligible lenders to eligible borrowers with up to 15,000 employees or $5 billion in annual revenue. The Treasury injected $75 billion in capital into the SPV, allowing the SPV to purchase up to $600 billion in loan participations.

To register for the program, lenders must complete the required registration certifications and covenants. These documents must be signed by the principal executive officer and principal financial officer. Lenders must also register through the FRBB’s lender portal. The FRBB estimates that the lender registration process could take several business days.

Once the program is operational, eligible borrowers can apply for loans through an eligible lender.

For more information about the Main Street Lending Program, see previous YPFS blog posts:

- Federal Reserve Amends Main Street Lending Program
- Federal Reserve Announces Changes to Main Street Lending Program
- Federal Reserve Announces Main Street Lending Program
Small Business Administration Announces Updates to Small Business Support Programs
By Mallory Dreyer and Kaleb Nygaard

Original post here.

The Small Business Administration (SBA) and Treasury recently released guidance related to the Paycheck Protection Program (PPP) to clarify that they will forgive loans to employers that are unable to rehire or maintain employment levels. The agencies also released a simplified forgiveness application.

At the same time, the SBA and Treasury removed a restriction on Economic Injury Disaster Loans (EIDL) and Advances to allow all small businesses, not just agricultural businesses, to benefit.

Clarifying forgiveness rules for business owners that cannot rehire employees

On June 16, the SBA released an amended interim final rule on the PPP that clarifies that borrowers that demonstrate an inability to rehire employees will not face a proportionate decline in the amount of the loan forgiven. This clarification is based on the PPP Flexibility Act, which was signed into law on June 5. Congress indicated that if an employer is unable to rehire employees or individuals that are similarly qualified due to compliance with requirements or guidance issued by health authorities, then the employer will not be penalized by a reduction in the proportion of the loan amount forgiven. This loosens a key requirement of the program, as the program was designed to incentivize employers to maintain employment levels and salaries.

As of June 17, the SBA had approved 4.6 million PPP loans worth a total $513 billion.

Changes to simplify the PPP forgiveness application forms

On June 17, the SBA and Treasury released a new, streamlined loan forgiveness application form for borrowers under the PPP.

For eligible loans under the PPP, borrowers can benefit from full or partial forgiveness of the borrowed amount. The new forgiveness application, the “EZ” application, is available to borrowers that meet one of the following criteria:

- Borrowers that are self-employed with no employees
- Borrowers that did not reduce employee salaries or wages by more than 25% and did not reduce the number of hours of the employees
- Borrowers that experienced a reduction in business activity as a result of government health directives that did not reduce employee salaries or wages by more than 25%
This application requires less documentation from borrowers than the standard full forgiveness application. The application is three pages and requires fewer calculations than the standard, five-page application.

The SBA also modified the standard application, which was initially released on May 15.

Both applications now give borrowers the option of using the 8-week covered period or the 24-week covered period, as amended by the Paycheck Protection Program Flexibility Act (PPPFA) on June 5. The extension of the covered period under the PPPFA allows borrowers to use the loan proceeds to cover eligible expenses over a longer period of time. For borrowers that elect the 8-week covered period, the maximum payroll covered per employee is $15,385, which is equivalent to 8 weeks of pay under a $100,000 salary. Under a 24-week covered period, the maximum amount per employee is $20,833, which is equivalent to approximately 24 weeks of pay under a $45,000 salary.

**Reopening of EIDL Loans and Advances and to all small businesses**

The CARES Act, signed into law on March 27, included an expansion of the SBA’s EIDL programs. Qualified small and medium-sized enterprises (SMEs) could apply for loans on favorable terms and grants of up to $10,000. Within a few weeks of launching, the SBA announced that it had exhausted the programs’ funds. On April 24, Congress allocated additional funding for the EIDL programs in the law that expanded the PPP.

On June 15, the SBA reversed a prior decision to limit the EIDL loans and advances to agricultural businesses. It announced that it would begin to accept applications for EIDL loans and advances from small businesses and agricultural businesses.

On May 4, the SBA and Treasury had restricted the EIDL support to agricultural businesses. The same May 4 announcement also clarified that non-agricultural businesses that had submitted applications by April 15 (the day the SBA stopped accepting new applications under the initial funding allotment) would continue to be processed, but other non-agricultural firms could not apply for the EIDL loans and advances.

As of June 12, the SBA had issued 3.2 million advances worth $10.7 billion and 1.3 million loans worth $90.9 billion.

According to the US Census Small Business Pulse Survey, as of June 11, 74% of surveyed businesses had requested support from the PPP and 28% had requested support under the EIDL program. 71% of respondents had received support from the PPP by June 11 while 18% had received support under the EIDL programs. Overall, 24% of respondents had received no financial assistance from the federal government since March 13, 2020, with 18% of respondents not requesting any financial assistance.
On June 19, the US Treasury and Small Business Administration (SBA) announced that certain recipients of Paycheck Protection Program aid will be disclosed to the public.

For each business that receives a loan of $150,000 or more, the SBA will disclose the business name, address, industry, zip code, business type, demographic data, non-profit information, and jobs supported by the PPP funding. The SBA will not disclose the exact size of the loan; rather, it will report the loan amount based on the following ranges:

- $150,000 to $350,000
- $350,000 to $1 million
- $1 million to $2 million
- $2 million to $5 million
- $5 million to $10 million

Given the reported ranges above, it is not clear how the SBA will report a loan of exactly $350,000, $1 million, $2 million or $5 million.

Loans of $150,000 or more account for approximately 75% of approved funding; however, nearly 86% of the total number of borrowers took out a loan worth less than $150,000. For loans below $150,000, the SBA will release totals aggregated by zip code, industry, business type, and demographic categories. The Treasury and SBA have not yet announced the specific demographic data that will be released in the public reports.

To date, PPP recipients have been identified through voluntary information sharing or through SEC filings.

The Treasury and SBA have not yet provided timing regarding the public reporting, including when the first report will be made public and the frequency of disclosure.

Prior to the announcement, the Treasury Secretary, Steven Mnuchin, had indicated that the administration would not release names of borrowers or loan-level information. Disclosure had received full support from Democrats in both houses of Congress and had received some Republican support. In late May, a bill in the House called the TRUTH Act received support from all Democratic members and 38 Republican members. The bill would have required the SBA to publish recipients, the number of employees, the lender, and demographic data for each loan under the PPP. Because the bill was put on a fast-track approval process, it required a two-thirds majority in the House, which it did not get. On June 3, the Chairman (a Republican) and
Ranking Member (a Democrat) of the Senate’s Committee on Small Business & Entrepreneurship sent a letter to Secretary Mnuchin asking that the SBA release loan-level information, including demographic breakdowns.

As of June 19, the SBA had approved 4.7 million PPP loans worth $514.5 billion. The program, as expanded on April 23, has $659 billion in total allocated funds.
European Commission Expands Eligibility for SME Support and Increases Incentives for Private Recapitalization

By Mallory Dreyer and Kaleb Nygaard

On June 29, the European Commission (EC) announced it will extend support to SMEs that were previously ineligible for state aid and amended recapitalization measures to incentivize private investor participation.

This is the EC’s third amendment to the Temporary Framework for state aid. The EC adopted the Temporary Framework on March 19 with the first amendment approved on April 3 and the second amendment on May 8. Through the Temporary Framework, the EC defines how Member States can provide aid to companies in response to the COVID-19 pandemic while preventing competition distortion across companies in the EU.

**Support for SMEs, specifically startups**

The amendment permits Member States to provide aid to SMEs that were already financially troubled on December 31, 2019 provided they are neither insolvent nor have outstanding, non-COVID-19 related rescue aid. The Temporary Framework previously prohibited Member States from providing aid to companies whose capital had shrunk by half or more prior to the pandemic due to accumulated losses. This was because governments did not want to use COVID-19 rescue funding to help firms that were already “in difficulty” and would have been likely to go out of business in the short or medium term absent government intervention.

This amendment allows Member States to introduce support programs for small, young companies, like startups, that traditionally run losses in the first few years as they grow their businesses. It will also allow Member States like Germany and France to expand startup support programs.

Several technology trade groups had urged the EC to be more flexible in its approach to state aid. Many companies in the tech industry are classified as being “in difficulty” under the rules as they operate at a loss in order to achieve fast growth or have taken on significant debt as a result of private equity investments. These companies were unable to benefit from state aid under the rules that the EC put in place for traditional SMEs in March.

**Recapitalization Aid Measures**

In its May 8 amendment to the Temporary Framework, the EC defined the procedures and requirements for the recapitalization of nonfinancial companies through equity, hybrid equity, and subordinated debt at favorable terms. The June 29 amendment modifies the conditions to encourage private investor participation.
The May 8 amendment established restrictions on share buybacks and management compensation for companies that are recapitalized through State aid. It banned share buybacks and dividends as long as 75% of the State’s recapitalization aid was outstanding. However, if the recapitalization measures meet the new criteria under the June 29 amendment, the acquisition ban and cap on management compensation will be limited to three years. Recapitalization measures must meet the following criteria to be eligible for the three-year limit:

1) private investors contribute at least 30% of the new equity injected by the State
2) the State injects new equity under the same conditions as private investors
3) the new equity is pro rata or below to existing shareholdings.

The EC also lifted the dividend ban for the holders of new shares. The dividend ban is lifted for owners of existing shares as long as the existing shares are diluted to less than 10% of ownership. If the existing shares are not diluted to below 10%, the dividend ban applies for three years. However, any remuneration due to the State for hybrid capital and subordinated debt instruments is to be paid before any dividends are paid to shareholders.

The amendment also allows companies with existing public shareholders to raise capital from shareholders like private companies. If the State is an existing shareholder before the granting of COVID-19 recapitalization aid and the participation of private investors meets the three new criteria, the EC will not impose specific conditions on the State’s exit.

The EC expects that the amendments related to recapitalization measures will incentivize firms to seek market and State contributions for capital needs.

**Relocation**

In the June 29 amendment, the EC also clarified that States cannot provide aid to a firm on the precondition that it relocate to the State’s territory.
Table 1. Summary of Temporary Framework and Amendments

<table>
<thead>
<tr>
<th>Date</th>
<th>Included Measures</th>
</tr>
</thead>
</table>
| **March 19** | 1. Direct grants, selective tax advantages and advance payments up to EUR 800,000  
                        2. State guarantees for loans taken by companies from banks  
                        3. Subsidized public loans with favorable interest rates to companies  
                        4. Safeguards for banks that channel State aid to the real economy  
                        5. Short-time export credit insurance  |
| **April 3**  | 1. Support for COVID-19 related research and development  
                        2. Support for the construction and upscaling of testing facilities  
                        3. Support for the production of products relevant to the COVID-19 outbreak  
                        4. Targeted support in the form of deferral of tax payments or social security contributions  
                        5. Targeted support in the form of wage subsidies for employees  
                        6. Expansion of the provisions in the initial temporary framework, allowing companies to receive up to EUR 800,000 in aid through zero-interest loans, 100% guarantees |
| **May 8**    | 1. Recapitalization of nonfinancial companies through equity and hybrid equity instruments  
                        2. Support to companies through subordinated debt at favorable terms |
| **June 29**  | 1. Support for SMEs “in difficulty” under specific circumstances  
                        2. Recapitalization measures amended to encourage private investor participation  
                        3. States prohibited from conditioning aid to firms on relocation to their territory |
US Treasury Extends $700 Million Loan to YRC Worldwide Inc. under CARES Act Provision

By Mallory Dreyer and Kaleb Nygaard

On July 1, the US Treasury announced it would make a $700 million loan to YRC Worldwide Inc., a heavyweight equipment transportation company that was deemed by the US Secretary of Defense to be critical to national security. Treasury will receive a 29.6% equity stake in the company in connection with the loan.

Under the CARES Act, the Department of the Treasury is authorized to make loans, loan guarantees, or other investments in eligible businesses that are facing liquidity constraints as a result of COVID-19. Section 4003(b) of the CARES Act allocated $17 billion for businesses critical to maintaining national security.

YRC was determined to be critical to maintaining national security, as it provides 68% of the less-than-truckload transportation services for the US Department of Defense. In a statement, the company said it and its operating subsidiaries have been “significantly impacted” by the pandemic.

The loan is divided into two tranches of approximately $350 million each. The first will be used to cover short-term contractual obligations and certain other obligations including pension and healthcare payments. It will carry an interest rate of LIBOR plus 3.5%, consisting of 1.5% cash and 2.0% payment in kind. The second tranche will be used for essential capital investment in trailers and tractors and will carry an interest rate of LIBOR plus 3.5%, payable in cash. Both loan tranches mature on September 30, 2024.

The CARES Act prohibits the Treasury Department from issuing a loan to a borrower that has issued securities that are traded on a national securities exchange unless the Treasury Department receives a warrant or equity interest in the borrower.

YRC will issue to the Treasury shares of common stock that, after the issuance, will constitute approximately 29.6% of YRC’s fully diluted common stock outstanding. YRC will use a COVID-19-related exception from the NASDAQ stock exchange to issue the new shares without current stockholder approval. The Treasury will hold these shares in a voting trust that will be required to vote the shares in the same proportion as all other unaffiliated shares of YRC’s common stock are voted.

The company’s stock rose as much as 92% today on NASDAQ after the Treasury’s announcement.

The CARES Act also imposes requirements in the loan agreement. YRC will be prohibited from share buybacks and dividend payments until 12 months after the loan is no longer outstanding.
YRC has committed to maintain its employment level and cannot reduce the employment level by more than 10%. It is also subject to the executive compensation limits established in Section 4004 of the CARES Act.

Consistent with the CARES Act, the term of loan to YRC is below the maximum duration of 5 years. Under section 4003(d)(3) of the Act, the principal amount of loans made under this provision of the CARES Act cannot be forgiven.

The Treasury Department announced that it would begin accepting applications from businesses critical to national security on April 27 with a deadline of May 1; however, the application portal is still available online.

The loan to YRC appears to be the first Treasury announcement of CARES Act support to a business deemed critical to national security.

The Treasury also has the authority to lend to air carriers, as Section 4003(b) allocated up to $25 billion for passenger air carriers and $4 billion for cargo air carriers. One component of Treasury support is the Payroll Support Program for passenger air carriers which assists eligible businesses with employee wages, salaries and benefits. As of May 12, the Treasury had approved over $25 billion in response to 352 applications. The Treasury reports recipients, agreement dates, the total anticipated payroll support, anticipated principal, number of warrants, and warrant exercise price here.
US Extends Paycheck Protection Program by 5 Weeks

By Mallory Dreyer and Kaleb Nygaard

Original post here.

On July 1, the US Congress passed a bill to extend the Paycheck Protection Program (PPP) to August 8, 2020. The Small Business Administration (SBA) stopped accepting applications on June 30 with $134 billion in funding remaining.

As of June 27, nearly 4.8 million loans were made under the PPP for a total of $518.9 billion.

Beyond extending the program deadline, the new law makes no other changes to the PPP.

Senator Ben Cardin (D-MD) indicated that the August 8 date was chosen because it is the end of the Senate’s next work period, and lawmakers expect to pass the next economic stimulus package by then.

On June 23, the SBA and Treasury announced they will publicly release information about the recipients of PPP loans. Rather than disclosing the loan amount, the SBA will report loan sizes in ranges for recipients of loans of more than $150,000. Loans of $150,000 or less account for 86% of the total number of loans made and 27% of the total dollar value of lending, as of June 27.

In a June 25 letter to the Chair of the House’s Committee on Ways and Means, the Treasury and SBA indicated that the SBA would provide detailed PPP loan information, including exact loan amounts, to the relevant Congressional committees. They said that they will treat nonpublic personally identifiable information about individuals and commercially sensitive business information as confidential.
Fed Expands Main Street Lending Program to Include Nonprofits

By Mallory Dreyer and Kaleb Nygaard

Original post here.

On July 17, the Federal Reserve expanded eligibility for the Main Street Lending Program (MSLP) to include nonprofit organizations such as educational institutions, hospitals, and social service organizations. The Fed will purchase 95% participations in loans to nonprofits under terms that are similar to terms it previously announced for for-profit companies, with additional criteria tailored to non-profit organizations.

The Fed sought public comment on making this expansion in an announcement on June 15.

There are two facilities under the MSLP for nonprofit organizations: the new loan facility and the expanded loan facility. The terms of the nonprofit organization loan facilities are similar to the terms of the for-profit business loan facilities. The interest rate for nonprofit loans, like for-profit loans, is set at LIBOR plus 300 basis points. Nonprofit loans will also have a five-year term, with principal deferred for two years and interest deferred for one.

In order to be eligible for the MSLP, a nonprofit organization must be US-based and operational since at least January 1, 2015. Organizations must have more than 10 employees. An eligible organization must also have either less than 15,000 employees or have 2019 revenues of $5 billion or less. The organization’s total non-donation revenues must be equal to or greater than 60% of its expenses between 2017 and 2019. Eligible nonprofits must have an endowment of less than $3 billion. These organizations must have a ratio of adjusted 2019 earnings before interest, depreciation, and amortization (EBIDA) to unrestricted 2019 operating revenue of at least 2%. The table below provides more details regarding the terms of the loans.

The Fed announced the MSLP for for-profit businesses on April 9. The program began accepting lender registration on June 15 and the Federal Reserve Bank of Boston, which manages the program, announced that the program was fully operational on July 6.

As of July 16, the MSLP SPV had purchased its first $12 million participation in a loan through the for-profit loan facilities. This loan went entirely to 15 medical practices in Wisconsin, according to the Treasury Secretary in Congressional testimony on July 17.

The Boston Fed has updated the MSLP FAQs six times. On June 20, it clarified what actions are required of borrowers and lenders to certify that the borrower is not a covered entity, which is a firm that is more than 20% owned by government officials. The June 26 update included clarifications about calculating compensation and the financial information required from borrowers. The July 15 update clarified rules for businesses established in 2020, among other changes.
<table>
<thead>
<tr>
<th>Proposed Main Street Lending Program Nonprofit Loan Options</th>
<th>Nonprofit New Loans</th>
<th>Nonprofit Expanded Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Term</td>
<td>5 years</td>
<td></td>
</tr>
<tr>
<td>Minimum Loan Size</td>
<td>$250,000</td>
<td>$10M</td>
</tr>
<tr>
<td>Endowment Cap</td>
<td>$3 billion</td>
<td></td>
</tr>
<tr>
<td>Years in Operation</td>
<td>At least 5 years</td>
<td></td>
</tr>
<tr>
<td>Eligibility Criteria</td>
<td>• Minimum employees of 10 and less than 15,000</td>
<td>• Total non-donation revenues equal to or greater than 60% of expenses for the period from 2017 through 2019</td>
</tr>
<tr>
<td></td>
<td>• 2019 operating margin of 2% or more</td>
<td>• 2019 operating margin of 2% or more</td>
</tr>
<tr>
<td></td>
<td>• Current days cash on hand 60 days</td>
<td>• Current days cash on hand 60 days</td>
</tr>
<tr>
<td></td>
<td>• Current debt repayment capacity — ratio of cash, investments and other resources to outstanding debt and certain other liabilities — of greater than 55%</td>
<td>• Current debt repayment capacity — ratio of cash, investments and other resources to outstanding debt and certain other liabilities — of greater than 55%</td>
</tr>
<tr>
<td>Maximum Loan Size</td>
<td>The lesser of $35M, or the borrower’s average 2019 quarterly revenue</td>
<td>The lesser of $300M, or the borrower’s average 2019 quarterly revenue</td>
</tr>
<tr>
<td>Risk Retention</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>Principal Repayment</td>
<td>Principal deferred for two years; years 3-5: 15%, 15%, 70%</td>
<td></td>
</tr>
<tr>
<td>Interest Payments</td>
<td>Deferred for one year</td>
<td></td>
</tr>
<tr>
<td>Rate</td>
<td>LIBOR + 3%</td>
<td></td>
</tr>
</tbody>
</table>
Utilization of Credit Support Programs for SMEs

By Mallory Dreyer and Kaleb Nygaard

Original post here.

In response to the COVID-19 pandemic, governments have implemented a variety of programs to support small- and medium-sized enterprises (SMEs). A large portion of these programs are designed to facilitate credit access. These programs range in size, eligibility, and terms. YPFS has begun to compile usage information on 26 major programs across 16 countries. The information can be found in this spreadsheet.

According to the data compiled across the 26 programs as of July 15, the countries have committed at least USD 3 trillion\(^1\) in funding for credit support programs with a total utilization across the programs of USD 1.8 trillion, meaning nearly 40% of overall capacity is still available. Utilization varies significantly across countries, as the UK’s Future Fund and the US Paycheck Protection Program have seen 84% and 79% utilization respectively, while the US Main Street Lending Program has not purchased a single participation in a loan. With respect to credit guarantee schemes, utilization is higher in Spain and Italy while total utilization of credit guarantee schemes in New Zealand and Denmark is less than 2%.

Comparing utilization across programs in the UK shows the limited demand for the initial 80% government guarantee scheme, as the Coronavirus Business Interruption Loan Scheme (CBILS) guaranteed 54,538 loans and drew down 4.4% of the total funding available in a GBP 330 billion package of support to businesses. The UK government later announced a 100% guarantee scheme, the Bounce Back Loans Scheme (BBLS), which has guaranteed 1,047,611 loans, nearly 20x the number of loans made under CBILS. Some of the difference in demand can likely be attributed to the loan size, as the BBLS fully guarantees loans with a maximum size of GBP 50,000 while the CBILS provides an 80% guarantee on a loan with a maximum size of GBP 5 million.

The relative size of the programs varies significantly. Total funding for the UK’s CBILS and CLBILS programs combined represent nearly 15% of GDP; two of Spain’s programs combined represent nearly 12%; and France’s program represents nearly 13%. Significant programs in the US like the Paycheck Protection Program and the Main Street Lending Program are larger in absolute terms, USD 659 billion and USD 600 billion respectively, but make up a smaller percentage of GDP, approximately 3% each. Denmark’s program, which has seen relatively little utilization, is a comparatively small program as a portion of GDP, though it should be noted that credit support is only one of many Danish initiatives to support SMEs.

According to the ECB’s Bank Lending Survey, released on July 14, banks reported a net tightening of credit standards for loans to SMEs so far in 2020. During this period, borrower demand for loans and credit lines surged, highlighting the need for emergency liquidity. Banks

---

\(^1\) The amount of funding is rounded to the nearest billion.

---
reported that government guarantees on lending played a key role in maintaining favorable credit standards for overall business lending.

However, banks in different countries reported different effects of government guarantees. Banks in Germany noted that demand for government guaranteed loans was lower than they had expected. Banks in France, Spain, and Italy, where credit guarantee program utilization rates were relatively high, reported that the government guarantees were a significant factor in their ability and willingness to lend.

The SME Credit Support Programs Usage spreadsheet is one of many resources maintained by YPFS under the heading Key Program Summaries. The spreadsheet is not comprehensive, as many other countries provide credit support, and additional programs will be added as necessary. Utilization data will be periodically updated.

[1] Some programs do not have explicit sizes as they are either part of larger support packages or the respective government has not announced a size limit. This USD 3 trillion total does not include programs with an undefined size but does include total funding for support packages in which the credit support program is only one component of the overall package (UK CBILS / CLBILS and Austria).
Portugal Announces SME Debt Securitization Program

By Wyatt Wolfram

Original post here.

On June 4, the Portuguese government announced plans to create a special purpose vehicle to acquire debt issued by small- and medium-sized enterprises (SMEs) and sell debt securities on capital markets.

The program builds on an existing program, “Obrigações Turismo 2019” (OT 2019), that focuses on the tourism sector, but it will be more broadly available to SMEs across industries. The new program is part of an extensive package of economic relief policies known as the “Economic and Social Stabilization Program.”

Obrigações Turismo 2019

The existing initiative, OT 2019, is designed to diversify financing sources for SMEs in the tourism industry by making capital market financing available. The program is jointly operated by Turismo de Portugal, a state agency responsible for the promotion, enhancement, and sustainability of the tourism industry; and SPGM, the coordinating entity of the Portuguese Mutual Guarantee System, whose mission is to provide financial guarantees to the benefit of national companies.

The government guarantees 30% of the total issue amount with a maturity of seven years. OT 2019 originally intended to make available EUR 100 million in bonds to the capital markets.

All SMEs and middle-capitalization companies (mid-caps) – those companies with less than 3,000 employees – operating in the tourism industry are eligible to apply for debt issuance through OT 2019. Companies must meet specific financial requirements, including for liquidity (current assets / current liabilities > 1), profitability (EBITDA margins > 15% or return on assets > 5%), and indebtedness (financial debt / EBITDA < 5). EBITDA is earnings before interest, taxes, depreciation, and amortization.

Companies that meet these criteria may issue up to EUR 15 million in debt through the program. Approved issuers will be grouped such that the bonds obtain a minimum rating of BBB-, which takes the public guarantee into account, and all participants are subject to the same interest rate and terms. Bonds will then be shopped to institutional investors and made available to the capital markets.

New SME Program within the “Economic and Social Stabilization Program”

Details of the new program have not yet been announced. It will be based on OT 2019 and it will allow for the creation of a new special purpose vehicle to acquire SME debt, but with an expanded mandate.
A 2020 OECD Report noted that debt security issuance is an insignificant source of finance for SMEs in Portugal, as most companies rely solely on bank financing. Companies surveyed cited low liquidity in the debt market, high issuance costs, and complex regulations as the main reasons for not issuing debt. The government’s new debt purchase program aims to reduce these issues, thus opening additional financing options for Portuguese SMEs and mid-caps.

Other countries have adopted similar programs with the goal of increasing access to capital markets for SMEs. In late 2018, Australia announced the formation of the Australian Business Securitization Fund (ABSF), an AUD 2 billion fund to support the provision of finance to SMEs. The fund made its first investment in securities worth AUD 250 million in April 2020. However, at that time the Australian Office of Financial Management, which oversees the ABSF, stated that it needs to assess the currently challenging market conditions before initiating additional ABSF investment proposals. Separately, in 2016 the European Investment Fund (EIF) launched the EIF-NPI Securitization Initiative (ENSI), a cooperation and risk-sharing platform partnered with European National Promotional Institutions (NPIs). NPIs are European legal entities which are given a mandate by a member state to carry out financial, development, and promotional activities. ENSI provides funding and capital relief, defines standard procedures and minimum criteria for lending, and broadly acts as a catalyst for the development of the SME securitization market in Europe.
One-Quarter of SMEs Closed During the COVID-19 Lockdown

By Mallory Dreyer and Kaleb Nygaard

Original post here.

One-quarter of small- and medium-sized enterprises (SMEs) globally, and as many as half in countries like India and Bangladesh, closed between January and May due to the COVID-19 lockdown, according to the Global State of Small Business Report.

On July 15, Facebook, the OECD, and the World Bank released the report, which draws on the Future of Business Survey with more than 30,000 SMEs responding in more than 50 countries and regions. The survey compiles data regarding the impact of the COVID-19 pandemic on SMEs and their top policy needs to survive the pandemic, which include salary subsidies, tax deferrals, and credit guarantees.

The Future of Business Survey was launched as a biannual survey in 2016 to provide more up-to-date and global data regarding challenges and expectations of online SMEs. In response to the COVID-19 pandemic, the survey will take place monthly in order to better monitor the impact of the pandemic on SMEs. The survey covers SMEs with Facebook Business Pages in specific countries. Therefore, the data don’t reflect the state of SMEs in an entire country or region, but can provide policymakers with some key insights.

In response to the COVID-19 pandemic, SMEs have been forced to close, faced declining revenue, and reduced employment. According to the survey, 26% of SMEs reported closing between January and May of 2020, though there is significant variation across countries. South Asian countries, such as India and Bangladesh, were particularly affected as 47% and 50% of SMEs in each country closed. In both Germany and Sweden, less than 10% of SMEs reported closing.

Among the SMEs that continued to operate, 62% reported that they generated lower sales in the prior month compared to the same month in 2019. The transportation and hospitality sectors were most likely to report a decline.

One third of SMEs reported cutting staff. Employment reductions vary widely across sectors and regions. SMEs in European countries, where there are strong government support measures for employment, were less affected. Employment reductions were more severe in low- and medium-income countries.

During normal times, SMEs have limited access to financing. This challenge has been exacerbated by the pandemic. Government support programs seek to alleviate SME financing constraints, but only a quarter of businesses surveyed had received such support. The degree of support varied greatly across countries and regions, with around 50% of SMEs in countries like Australia, Belgium, and Ireland receiving government support and just 10% of SMEs in regions...
like Latin America, South Asia, and Africa receiving support. Of the total support provided, government grants represented 49% of the SME support.

SMEs said the government assistance they most desired were salary subsidies, tax deferrals, and access to loans and credit guarantees. SMEs cited other important support measures like rent and loan repayment deferrals, utility subsidies, and social security exemptions.

Of the SMEs that reported closing, 28% expected to reopen within a month and 54% expected to reopen within three months. The remaining businesses were uncertain when or if they would be able to reopen. SMEs reported that the top three near-term challenges they faced were: lack of demand (cited by 47%), cash flow constraints (cited by 37%), and repaying outstanding loans (cited by 19%). Some SMEs reported that they were adapting to the pandemic by increasing their online presence, with 41% of SMEs surveyed in Ireland and 32% in Brazil reporting such action.

The full survey data can be found here.
Paycheck Protection Program spread loans widely, if not evenly
By Corey Runkel

Original post here.

Congress charged the Paycheck Protection Program (PPP), enacted under the Coronavirus Aid, Relief, and Security (CARES) Act on March 27, with lending to small businesses stricken by the effects of COVID-19, and authorized private lenders to facilitate an unprecedented flow of Small Business Administration (SBA)-guaranteed loans. On this first objective, the program delivered, approving nearly 4.9 million loans with a total volume just north of $521 billion. But its performance, its efficacy, and its efficiency remain unsettled questions.

To address these concerns, the SBA released loan-level data comprising each approval during the PPP’s initial run from April 3 to June 30. This data offers a low-resolution picture of how the program performed against several objectives specified by the CARES Act, such as targeting rural and underserved markets, including single-person businesses, supporting hotel and restaurant franchises, and — its most important function — retaining jobs.

PPP data fall into two categories: loans smaller than $150,000; and loans at least $150,000 in value. For small loans, exact dollar figures are given, but borrower information is anonymized to the zipcode, legal structure, and 6-digit NAICS code of the business. For large loans, only ranges of loan values are given, but the borrower information is precise, with names and street addresses listed. The vast majority of applicants also reported the number of jobs that would be retained should an application be approved.

The utility of the PPP data is limited by the aggregations that the SBA has chosen to perform, which it considered necessary to keep confidential the salaries of employees in smaller businesses. The decision came after a back-and-forth between Treasury, oversight bodies, and Congress. One of the most controversial situations cropped up early, after reports that large and financially sound companies took PPP loans (though more than $38 billion has been returned). Calls are still being sounded to release the names of smaller creditors and the loan amounts given to larger creditors.

Additionally, a Bloomberg team led by Mark Niquette found that the dataset is sprinkled with errors. While no single type of error seems to be significant in the scope of 4.9 million loans, their frequency casts doubt on the precision of SBA data. But where these data are limited, we consider several studies carried out since the program’s establishment.

In short, access to loans was widely distributed across nearly 5,500 lenders. However, the pool of loan recipients looks quite similar to the pool of business owners. Though demographic data are subject to self-reporting, the available data indicate a lack of priority for women, minorities, and veterans contrary to CARES Act mandates (Fig. 2). This may have resulted from the SBA’s delay in issuing guidance prioritizing these underserved and rural markets. Rural markets,
however, seem to have fared better in spite of this delay. Rural markets were overrepresented due to the ability of small lenders to ramp up loan approvals compared to large banks with specialized loan departments, though the number of loans in an area were roughly proportional to a zipcode’s number of businesses (Fig. 5).

The PPP seems to have been effective in another feature, its explicit inclusion of nonemployers, those “sole proprietors, independent contractors, and eligible self-employed individuals” who have been traditionally excluded from stimulus. Just over one million nonemployers were approved for loans. That also means the total number of loans approved is not representative of the number of jobs retained: 37% of loans saved just one or two jobs.

The hospitality industry more often reported retaining higher numbers of jobs than any other sector (Fig. 7), despite concerns about the ability of restaurateurs and hoteliers to keep employees on during lockdowns. Changes to the design of PPP, and the belief by some that blanket loan forgiveness is on its way, have prompted concerns over its efficacy. Though research has just begun, economists estimate that the program spared less than 5% of imperiled jobs.

Figure 1.

An earlier YPFS blogpost discussed the fact that more large borrowers were approved earlier.

Helping rural markets, but not the underserved

The SBA Office of Inspector General wrote in a June report that no guidance had been issued to lenders prioritizing small business concerns run by “veterans and members of the military community, small business concerns owned and controlled by socially and economically disadvantaged individuals […], women, and businesses in operation for less than 2 years” (4). The CARES Act stipulated that the SBA issue such guidance.
As may be expected, what demographics that are available show that the pool of approved applicants closely resembles those of US business owners (Fig. 2). This finding should be taken with a grain of salt, as loan applications made demographic questions optional, resulting in only 24% of approved applicants answering in one of three fields on the application: race or ethnicity; sex; and veteran status. Information about the other groups included in those “underserved” markets was not collected during the PPP’s initial run.

Figure 2.

Approved borrowers closely resemble business owners.

A small study by the National Community Reinvestment Coalition, which has conducted several studies to investigate discrimination against Black and women loan applicants, can offer more granular information. Their method pairs white and Black small business owners with similar credit profiles applying for credit at the same banks, and compares the differences in outcomes. In line with previous studies of SBA lending, they found that PPP lenders treated white applicants better than Black applicants, and men better than women.

To address these concerns, in late May the SBA designated $10 billion of PPP funds for community development financial institutions (CDFIs). The country’s 1,129 CDFIs are certified by the Treasury, and “provide critically important capital and technical assistance to small businesses from rural, minority and other underserved communities.” According to the press
release, CDFIs had already approved $7 billion in loans during the program’s first round of funding, which was exhausted on April 16.

Though self-reported data may bias the reported statistics, CDFIs seem to have slightly increased the racial diversity of PPP borrowers, though differences in borrower gender and veteran status appear to be negligible between CDFIs and non-CDFIs. In particular, CDFIs appear to have significantly boosted loans to Black applicants. From the beginning of the program, more borrowers who applied through CDFIs reported their race as “Black or African American” than did borrowers from other lenders (Fig. 3). To some extent, the presence of CDFIs addressed the fact that, during the first round of funding, approved borrowers were more often white than in subsequent rounds.

**Figure 3.**

![Comparison of CDFIs with rest of PPP approvals.](image)

Comparison of CDFIs with rest of PPP approvals.

This “head start”, as termed by Bloomberg, may be due to the outsize impact of small lenders (Fig. 4), most of which are not CDFIs. While the four largest US banks engaged in 36% of small business lending before the PPP, they only shared 4% of loans in the first round. Smaller lenders
more often located in rural markets, which tend to be whiter — made up the difference. Without dedicated small-business lending departments, the smallest of these lenders were more able to redirect resources to loan approvals. Hence, the key to accessing rural markets may not have lay in the guidance, but in the type of lender authorized.

**Figure 4.**

![Distribution of lenders by loan volume and size](image)

236 unique lenders that processed 1,000-300,000 loans per range were omitted for readability

Many tiny lenders.

Research using first-round SBA data argues this point, that, despite delayed SBA guidance, the wide diffusion of loans among lenders meant that more loans went to small banks and rural areas. But the paper questions the value of early relief to rural markets. In retrospect, it is clear that urban areas faced much more severe outbreaks earlier than did rural areas. The authors write that the first-round “funds flowed to areas less hard hit” by the coronavirus, a relationship which held when both the value and number of loans were considered. This research does not evaluate the PPP’s rural-markets mandate per se, but it illustrates how such guidance may not have allocated aid where it was most needed. And in general, it illustrates how speedy and equally-distributed lending (Fig. 5) may not have made for efficient allocations.
Loan approvals were roughly proportional to the number of businesses.

Different sectors also varied in their usage of the PPP. Restaurants and hotels have reported retaining comparatively more jobs than other sectors (Fig. 8). Subsections 1102(a)(2)(36)(D)(iii-iv) targeted franchisees classified under NAICS as Accommodation and Food Services to apply for PPP loans by temporarily exempting them from federal regulations prohibiting certain affiliations between businesses. Hotels and restaurants were approved for the sixth-most loans among all industries, but the most jobs retained per loan (Table 1).

Academic research on restaurants and hotels have yet to be published, but the PPP received criticism early on for strict loan terms. The original terms required borrowers to spend funds within eight weeks to retain or rehire workers in order for the loan to be forgiven; this proved difficult for many restaurants that were closed or limited in the service they could offer due to government restrictions. Others waited until the term lengthened to 24 weeks before reopening, forestalling employment gains.
Restaurants and hotels report flatter job retention curves.

Nonemployers score big

Sole proprietorships, independent contractors, and self-employed individuals constitute an unknown amount of the US workforce. The conservative estimate, based on the Census Bureau's Nonemployer Statistics series, put the number north of 25 million in 2017. However, these people have traditionally been excluded from stimulus measures since their numbers are difficult to track and their political power largely unorganized. The self-employed have traditionally been left out of the mix by US relief programs, and are usually not eligible to collect unemployment benefits. Nonemployers responded to the PPP inclusion by borrowing $15.5 billion across more than 1 million loans.
Table 1. Loans made, jobs retained, and jobs per loan by industry.

<table>
<thead>
<tr>
<th>Industry</th>
<th>Loans</th>
<th>Jobs retained</th>
<th>Jobs per loan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Professional services, research, &amp; IT</td>
<td>528,391</td>
<td>4,558,974</td>
<td>8.6</td>
</tr>
<tr>
<td>Other</td>
<td>497,728</td>
<td>4,425,858</td>
<td>8.9</td>
</tr>
<tr>
<td>Healthcare</td>
<td>422,974</td>
<td>7,052,331</td>
<td>16.7</td>
</tr>
<tr>
<td>Construction</td>
<td>387,810</td>
<td>4,777,952</td>
<td>12.3</td>
</tr>
<tr>
<td>Retail</td>
<td>381,133</td>
<td>4,466,217</td>
<td>11.7</td>
</tr>
<tr>
<td>Restaurants &amp; hospitality</td>
<td>311,805</td>
<td>7,133,099</td>
<td>22.9</td>
</tr>
<tr>
<td>Real estate</td>
<td>204,003</td>
<td>1,379,370</td>
<td>6.8</td>
</tr>
<tr>
<td>Administrative support</td>
<td>198,557</td>
<td>2,851,569</td>
<td>14.4</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>195,958</td>
<td>4,316,136</td>
<td>22.0</td>
</tr>
<tr>
<td>Logistics</td>
<td>150,690</td>
<td>1,561,370</td>
<td>10.4</td>
</tr>
<tr>
<td>Wholesale trade</td>
<td>141,282</td>
<td>2,200,202</td>
<td>15.6</td>
</tr>
<tr>
<td>Finance &amp; insurance</td>
<td>139,727</td>
<td>935,968</td>
<td>6.7</td>
</tr>
<tr>
<td>Agriculture</td>
<td>120,658</td>
<td>982,294</td>
<td>8.1</td>
</tr>
<tr>
<td>NA</td>
<td>100,882</td>
<td>791,337</td>
<td>7.8</td>
</tr>
<tr>
<td>Entertainment &amp; recreation</td>
<td>95,425</td>
<td>1,244,052</td>
<td>13.0</td>
</tr>
</tbody>
</table>

This level of uptake skews the distribution of loans heavily toward smaller amounts. But this distribution does not drop off exponentially, as the distribution of lenders does (Fig. 4). Rather, almost 177,000 loans fall between $20,800 and $20,833 — while only 3,000 approvals fall in the next $33 of loan amounts (Fig. 6). This phenomenon is sharpest for sole proprietors, contractors, and the self-employed, and reflects the maximum forgivable value of net profits. This measure is how nonemployers typically compensate owners, and is what owners of such businesses report as taxable income. Owner-operator businesses may also be approved for sums above $20,833 to cover costs such as rent and utility, so long as 60% is spent replacing owner compensation.

Due to the impact of nonemployer borrowers, many loans saved a single job. This distribution attenuates the PPP’s headline performance. Disentangling the nonemployer loans from loans to employers (such as restaurants) yields a more useful picture of the PPP. Focusing just on nonemployers exposes the tradeoff many owner-operators face between applying for the PPP and
taking unemployment insurance, as individuals cannot seek both. For nonemployers with small overhead costs, that decision comes down to pre-pandemic income and state of residence. Unlike loans to businesses that face high fixed non-payroll costs, PPP loans to many nonemployers more closely resemble supports for individuals, which helped the personal savings rate touch 33% in April before dropping somewhat in May.

Figure 6.

Note that the Nonemployer Statistics series reports large numbers of S-Corporations and Partnerships as non-employers; the SBA data are unable to discriminate between nonemployers within business structures.

Overall, job retention appears low, but is consistent with loan approvals

Likely the most valuable study in terms of data quality to be released thus far is a preliminary paper published on July 22 by researchers from MIT, the Federal Reserve, and payroll software company ADP. Using several million pairs of employee-employer payroll data from ADP, authors evaluate employment levels just below and above the 500-employee general small business cutoff used by the SBA. They control for tempestuous business conditions brought by changing health regulations, as well as for variance among states. Like the above study conducted on the PPP’s first round, the authors find that the number of jobs saved is less than the number of loans made, a far cry from the 51 million jobs claimed on loan applications.
This finding would also run contrary to expectations that, at minimum, each loan saved at least one job. But that first study questioned whether the PPP had any positive employment effects at all. In contrast, this second paper estimates gains of 1.4 to 3.2 million jobs. The speed of the program was hampered in some cases by its terms, described above for restaurant owners, but applicable to many consumer-facing businesses. And, the ADP analysis cannot capture the gains of tiny firms, since it limits its analysis to 50-employee firms and larger. 96% of reporting borrowers listed fewer than 50 jobs retained. While a 60-employee business may choose to retain only 40 jobs, for instance, the ADP data are likely not fully representative of PPP borrowers.

What is clear is that nearly 4.9 million small businesses across the country (Fig. 9) received loans that they attested would help with the impacts of the coronavirus crisis. But the decoupling of loan amounts from job retention raises important questions about the efficiency of the Paycheck Protection Program with regards to protecting paychecks. Important to note is that the intent of the program has changed slightly. Legislation passed on June 3 altered the PPP’s loan forgiveness terms to include a larger portion of non-payroll costs, such as rent and utilities, crucial to basic operations.

In June, the Brookings Institution published an opinion along these lines, speculating that the PPP’s easing of loan terms — the very same that some inside the restaurant industry claimed were necessary — would help creditors of small businesses more than workers. However, these tensions, central to the oversight of the PPP as a crisis response measure, cannot be resolved before further research is conducted, and possibly more disclosures are made on the part of the SBA.

Figure 9.
Direct Lending to SMEs - Canada’s Business Credit Availability Program

By Priya Sankar

Original post here.

Canada has reintroduced a program from the Global Financial Crisis of 2007-09 to provide government loans directly to small businesses to help them deal with the economic consequences of the COVID-19 pandemic.

Countries across the world are adopting measures to support small and medium-sized enterprises (SMEs) during the COVID-19 crisis. They often use credit guarantees to facilitate lending to SMEs by guaranteeing their bank loans. This post discusses a less common tool, direct governmental lending to SMEs, illustrated by Canada’s programs both during the Global Financial Crisis, and today.

Direct Lending to SMEs

Some countries have implemented programs for direct lending to SMEs in both the Global Financial Crisis and the COVID-19 crisis, though it remains a less common tool, and one often paired with credit guarantees for SMEs. Often these direct loans are made through a bureaucratic agency focusing on small businesses or a government bank focused on development of specific industries. Several countries have created loan programs for SMEs funding innovation or new technology. A partial list of countries adopting these interventions during the Global Financial Crisis can be found on page 20 of the OECD report found here.

Canada’s COVID-19 SME Lending Program

On March 13, 2020, the Canadian government re-established the Business Credit Availability Program (BCAP), allowing the Business Development Bank of Canada (BDC) and Export Development Canada (EDC) to provide CAD 10 billion to businesses. As of March 16, 2020, the BDC will now offer small business loans of up to CAD 100,000 that can be obtained in as little as 48 hours from the time of approval. It will also offer flexible working capital loans of up to CAD 2 million, with potential payment postponements for six months, to bridge cash flow gaps and support daily operations. The BDC will also provide purchase order financing to increase flexibility in fulfilling domestic or international orders.

SMEs seeking to access the BCAP will first contact their financial institutions. The financial institutions will then assess SMEs with liquidity needs beyond what the private sector can meet, and refer them to the BDC or EDC. Thus, although Canada will be engaged in direct lending to SMEs, it will do so in consultation with those SMEs’ existing financial institutions. The BDC and EDC are paying particular attention to sectors that are heavily impacted by the crisis, like oil and gas, and tourism. Farm Credit Canada is also increasing short-term credit available to farmers and the agri-food industry.
Canada’s GFC SME Lending Program

Prior to the Global Financial Crisis, the BDC, EDC, and the Canada Small Business Financing Program provided direct loans and guaranteed loans to SMEs.

The BCAP was first established in response to the GFC. It allowed the BDC and EDC to work with private lenders to finance viable businesses. It disbursed over CAD 10.1 billion in 2009 and 2010, of which CAD 3.44 billion went to SMEs with under CAD 25 million in annual revenue. The BCAP’s Economic Recovery Loans Initiative, established in early 2010, made small working capital loans of up to CAD 100,000, and constituted much of BCAP’s 2010 activity, despite expiring in October of that year.

Feedback on the BCAP’s countercyclical activity during the GFC was positive. The Conference Board of Canada commended the BDC and EDC on their role in providing credit support during a crisis, and credited them with speeding up the healing of the Canadian financial system.
Paycheck Protection Program Loan Forgiveness Rules Eased for Smallest Borrowers

By Mallory Dreyer

Original post here.

On October 8, the Small Business Administration (SBA) and Treasury released an interim final rule easing the process for loan forgiveness on Paycheck Protection Program (PPP) loans of $50,000 or less. The new rule exempts small businesses with such loans from reductions in loan forgiveness if they have cut wages or laid off employees. The previous rule required PPP borrowers to maintain employment and wages at pre-COVID levels in order to be fully eligible for loan forgiveness.

The United States implemented the PPP to provide support to small businesses in response to the COVID-19 pandemic. The PPP provided full guarantees on loans that banks or nonbanks extended to small businesses. These loans are eligible for full forgiveness if the borrower meets requirements on how funds are spent.

The eased loan-forgiveness rules appear to respond to borrower and lender complaints about the length and complexity of the forgiveness process. The SBA has received nearly 100,000 applications since it launched the forgiveness portal in August, but it had approved none as of October 1.

The interim final rule exempts borrowers that received a loan of $50,000 or less from the requirement to retain or rehire employees to return to pre-Covid employment levels. These borrowers are also exempt from the prohibition on reducing employee wages. The SBA estimates that PPP loans eligible for this treatment account for $49 billion, or 9%, of the total outstanding PPP lending.

The SBA also introduced a new loan forgiveness application for PPP loans of $50,000 or less, Form 3508S. This forgiveness application is shorter than the existing “EZ” application, which the SBA released on June 17.

Since the PPP launched, it has been subject to complaints from borrowers and lenders, leading to evolution of the program (see this timeline for more information). Public scrutiny of the $659 billion program is high. Small businesses account for nearly 48% of US employment, and many are concerned about the equity of distribution. Congress initially allocated $349 billion to the PPP, but after the initial funding ran dry, it approved an additional $310 billion in funding. The PPP closed for applications on August 8, with total lending of $525 billion and a total loan count of 5.2 million.

Unused PPP funds total $134 billion. Although Congress has considered proposals to provide additional support to small businesses, it has not yet come to an agreement on how to do that.
As Need for Additional Small Business Aid Intensifies, Preliminary Evaluations of the PPP Suggest It Improved Business Survival

By Mallory Dreyer

Original post here.

A central component of the initial fiscal response to the Covid-19 pandemic, the Paycheck Protection Program (PPP) was designed to support small businesses in the United States. It launched on April 3 after Congress signed the Coronavirus Aid, Relief, and Economic Security (CARES) Act into law on March 27, initially allocating $349 billion for the forgivable loan program. Congress later increased funding by $310 billion, bringing total funding to $659 billion. When the PPP closed for applications on August 8, it had provided $525 billion in support through more than 5.2 million loans.

This post begins with an overview of key design features of the PPP followed by a summary of preliminary research on the effectiveness of the PPP. Though it is too early to determine the long-term impact of the PPP, it appears that the PPP improved short-term business survival, while evidence of its impact on employment is mixed.

It is important to note that the evaluations do not take into account the program’s expiration and the continued impact of the pandemic on small businesses. According to recent Yelp data, business closures have risen since July, with 60% of all business closures becoming permanent. Despite apparent bipartisan support for additional small business aid, Congress has not agreed on how to allocate the remaining $134 billion.

Key Features of the Paycheck Protection Program

The PPP is the largest forgivable loan program adopted in response to the Covid-19 pandemic. Forgivable loans are essentially grants, but loan forgiveness depends on whether borrowers meet certain requirements and criteria.

The Small Business Administration (SBA) operates the PPP with support from the Treasury Department. PPP loans are fully guaranteed by the SBA, carry a 1% interest rate, and have a six-month repayment deferral. Loans issued before June 5 have a two-year term while loans issued after June 5 have a five-year term. The maximum PPP loan size was equal to 8 weeks of the firm’s average annual payroll costs, capped at $10 million. Small businesses with less than 500 employees were eligible to apply for a PPP loan through one of the more than 5,000 participating financial institutions.

To incentivize small businesses to retain their employees, the SBA initially required borrowers to spend at least 75% of the loan on payroll expenses to receive full forgiveness. In June, the SBA modified this requirement, decreasing it to 60% and allowing for partial forgiveness. Borrowers were required to retain or rehire employees to maintain the pre-Covid employment level, and firms could not cut salaries or wages. Initially, borrowers could use the PPP loan for eight weeks’
of eligible payroll and business expenses, but this covered period was extended to 24 weeks as part of the Paycheck Protection Program Flexibility Act in June.

The PPP continues to evolve: on October 8, the SBA and Treasury released new guidance for borrowers with loans of $50,000 or less, exempting them from the employee retention and payroll maintenance requirements.

**Preliminary Evaluation**

Despite the ongoing evolution of the PPP, there is a growing body of economic analysis on the effectiveness of the program. To date, the literature evaluates the short-term impact of the PPP on employment and business survival, in addition to analyzing whether the program effectively targeted funding.

**Impact on employment**

Evidence of the PPP’s impact on employment is mixed. Hubbard and Strain (2020) find that the PPP had a significant positive effect on employment between April and June for the businesses in their sample, which included only recipients of PPP loans of more than $150,000.

Others have found that the PPP had a slight positive effect on employment, though the benefits came at a high cost per job saved. For example, Chetty, Friedman, Hendren, Stepner, and the Opportunity Insights Team (2020) estimate that PPP loans increased employment at small businesses with 45 employees or more by 3 percent, implying a cost of $290,000 per job saved. Similarly, Autor et al. (2020) estimate that the PPP increased employment by 2 to 4.5 percent, implying a cost of $224,000 per job saved.

Bartik, Cullen, Glaeser, Luca, Stanton and Sunderam (2020) focus on the first phase of the PPP and find that PPP approval had positive but imprecise effects on employment at recipient firms. Granja, Makridis, Yannelis, and Zwick (2020) analyze the impact of the first phase of the PPP on the local economy of recipients. They find no evidence that the PPP had a substantial effect on local economic outcomes, including unemployment insurance claims.

**Impact on small business survival**

In addition to the PPP’s objective to preserve employment during the Covid-19 pandemic, the program was designed to improve a small business’s likelihood of surviving the pandemic. Preliminary evaluations show that the survival effects of the PPP are positive. For example, Bartik et al. (2020) find that PPP loans led to a 14 to 30 percentage point increase in a business’s expected survival during the early months of the program. Hubbard and Strain (2020) also find evidence that the PPP increased the survival of small businesses and improved their financial health. They find that the impact of the PPP increased over time, as there were larger effects in June than in April and May. In June, PPP rules were relaxed, allowing businesses to spend up to 40% of the loan on non-payroll expenses such as rent.
Bartlett and Morse (2020) analyze the impact of the PPP at a local level, focusing on firm survival in Oakland, California. Their findings are firm-size specific: they conclude that PPP funding increased the medium-run survival probability by 20.5 percent only for businesses with 1-5 employees. They find no impact on medium-term survival for businesses with between 6 and 50 employees.

Effectiveness of targeting

The PPP was not restricted to certain industries, sectors, or severely impacted regions; rather, it was broadly available with eligibility restricted by size. Some analyses focused on whether the PPP funding was directed to the firms that most needed support. Granja et al. (2020) find that the funds did not flow to the hardest hit regions and also conclude that the PPP did not have significant positive effects on local economic outcomes.

In the first few weeks of the PPP, there was significant public outrage regarding publicly owned firms that received PPP loans. In response, Cororaton and Rosen (2020) focus their analysis on publicly owned firms that received PPP loans. They find that 424 such firms were granted $1.4 billion in PPP loans through July 15, accounting for only 0.2% of allocated funds. They conclude that nearly half of all publicly owned firms were eligible for the PPP based on SBA criteria. They find that 22% of the eligible publicly owned firms received PPP loans, but these firms tended to be smaller in size and have fewer employees on average.

Humphries, Neilson, and Ulyssea (2020) find that PPP’s “first-come, first-served” model meant that funding was more readily available to larger firms with established banking relationships. They find that the smallest businesses were both less aware of the PPP and less likely to apply for the program. According to their analysis, information frictions, which includes the lack of awareness and uncertainty about the application process, forgiveness, and eligibility, prevented the smallest businesses from accessing the funding. They also attribute widespread uncertainty regarding eligibility and forgiveness to the lower likelihood that the smallest business would apply for the program. The fact that small businesses were less aware of and less likely to apply for the PPP is a concern, as Bartlett and Morse (2020) find that the PPP’s impact was positive for only the smallest businesses.

A recent House report from the Select Subcommittee on the Coronavirus Crisis presents preliminary findings that the SBA and Treasury encouraged banks to limit their PPP lending to existing customers. The report also notes that the administration failed to issue guidance to prioritize underserved markets.

Other Impacts

Other research has focused on access to credit for small businesses and how nonbank lenders participated in the PPP. Chodorow-Reich, Darmouni, Luck, and Plosser (2020) focus on access to credit during the pandemic and find that the increase in bank credit in the first two quarters of 2020 was primarily due to large firm drawdowns of pre-committed lines of credit. They also investigate whether PPP recipients reduced other borrowing, finding that PPP borrowers
reduced their non-PPP bank borrowing by between 53 and 125 percent of the amount of their PPP loan. They conclude that their results suggest that government-sponsored liquidity can overcome private credit constraints.

Erel and Liebersohn (2020) examine how fintech lenders responded to the introduction of the PPP. They find that fintech firms lend disproportionately more in zip codes with fewer bank branches, lower household incomes, and a larger minority population. They also investigate whether fintech lenders filled a finance gap or if borrowers were switching from traditional banks to fintech lenders. They find that businesses were more likely to borrow from a fintech lender in zip codes where local banks were unlikely to make PPP loans.

Evaluation of the PPP will continue as new data become available. It is still too early to reach a conclusion on the effectiveness or long-term success of the PPP. However, preliminary evaluations are informative and valuable for policymakers, especially given the continued demand for additional small business support.
Support for Individuals

Support for individuals includes all policies implemented to reduce the economic impact of a downturn on households. These measures support households by offsetting the decline in disposable income they face as a result of adverse economic conditions. Policies implemented to achieve this include direct payments, expanded unemployment benefits, or income tax cuts.
Analysis

Government Support to Individuals and Households During Crises
By Kaleb Nygaard, Pascal Ungerboeck, Mallory Dreyer, Rosalind Z. Wiggins, and Greg Feldberg

Original post here.

Many countries are adopting programs to provide support to individuals in response to the COVID-19 pandemic, which has entailed unprecedented government-directed curtailment of economic activity. These programs are designed to provide cashflow support for individuals and households who may be struggling due to economic uncertainty and hardship. Measures to support individuals vary and either enhance cashflows or decrease required expenses. In the former category, countries have adopted measures to provide enhanced income support to the unemployed, direct payments to individuals, and favorable access to retirement savings. Tax cuts and filing extensions are examples of the latter.

This post begins by describing the challenges facing policymakers in designing support for individuals, provides an overview of options to support individuals, outlines a few examples of countries implementing a mix of these policies, and concludes by offering some key takeaways about why certain interventions to support individuals may be preferable in different scenarios.

Statement of the Challenge

Governments must determine how to structure and implement effective, targeted support to individuals. With businesses shuttering in response to the COVID-19 pandemic, millions of individuals across the world are losing jobs and sources of income. Though the shock from the pandemic is expected to be temporary, many face immediate financial hardship with limited savings. Governments face the task of determining which tools to use to quickly provide large-scale, targeted support to individuals.

Policymakers must consider who will be eligible for support. Some tools are broad by nature, while others provide support to a specific subgroup. Eligibility can be complicated by immigrant and resident status. Funding for individual support is generally fiscal in nature, either through unemployment insurance, direct payments, tax measures, or housing relief, but the mechanism for funding is important. Some support programs require large, upfront expenditures, such as increased unemployment support or direct payments to individuals, while tax deadline extensions and tax cuts impact the timing or amount of revenue the government ultimately collects. Some programs, such as increased unemployment support, rely on existing systems, while others require that new processes be established.

In order to design policies to optimally target individuals, governments must consider the following:
1. How quickly will individuals receive aid under the program?
2. How much support should be provided?
3. Who will receive support?
4. How long should support be provided?
5. How will the government fund the program?
6. How should the tools be combined in the policy mix?

Options to Support Individuals

1. Unemployment Insurance and Wage Subsidies
2. Direct Payments
3. Income Tax Cuts
4. Other Tax Cuts
5. Deadline Extensions and Penalty Waivers
6. Access to Retirement Savings
7. Housing Relief

Unemployment Insurance and Wage Subsidies

Many countries provide support to employees who lose their jobs or who are at risk of losing their jobs. Two common approaches are unemployment insurance and short-time work schemes or wage subsidies. Unemployment insurance replaces some of an individual's lost income through direct benefits. Short-time work schemes and wage subsidies provide income support to individuals who are temporarily laid off or working reduced hours. Governments can utilize these systems to address individual hardships during times of economic downturn by increasing the amount of the usual support, lengthening the term of the support, or broadening the group of individuals who are eligible for the support.

Under unemployment insurance, governments provide direct benefits to individuals who meet qualifying criteria. During crises, countries can expand or provide additional support through their existing unemployment insurance system. The United States CARES Act temporarily increases the weekly unemployment benefit by $600 (about 50% of GDP/capita, annualized), prolongs the covered period, and expands eligibility criteria. During the 2007-09 Global Financial Crisis (GFC), the United States extended the entitlement period multiple times, with unemployed workers eligible to receive up to 99 weeks of benefits. The Coronavirus Supplement in Australia provides an additional AUD 550 in unemployment benefits to eligible individuals every two weeks, on top of the JobSeeker Program. Greece will provide EUR 800
(58% of GDP/capita, annualized) to individuals who lose jobs due to the economic impact of COVID-19, while Belgium provides additional daily allowances to individuals whose job loss is due to a “force majeure” such as the COVID-19 pandemic.

Under short-time work schemes or wage subsidy schemes, an employer that is experiencing economic difficulties may temporarily reduce the hours worked by employees or temporarily furlough them, while paying employees some portion of their wages that is subsidized by income support from the government. These schemes help employers retain employees rather than lay them off, helping to keep unemployment levels down and presumably fuelling a quicker recovery.

Short-time work schemes are common in many European countries, and many are expanding short-time work schemes in response to the COVID-19 pandemic. The duration of Germany’s program has been expanded to provide support for up to 12 months. Since the onset of the pandemic, 650,000 German employers have notified the government that they intend to use the country’s Kurzarbeit scheme. The French system has seen dramatic increases since the onset of the crisis and is so far covering a third of the country’s private-sector workers, at an expected cost of EUR 24 billion over the next three months. The United Kingdom has announced a new scheme under which it promises to pay employers 80% of workers’ pay, as long as they don’t lay them off. The EU recently approved an initiative, the Support to Mitigate Unemployment Risks in an Emergency (SURE), to lend up to EUR 100 billion to Member States to support increased public spending on short-time work schemes.

During the GFC, usage of short-time work schemes increased. The German Kurzarbeit supported 1.4 million individuals. The Czech Republic, Hungary, the Netherlands and several other countries adopted new schemes. Other countries extended the duration of short-time work scheme support or increased the benefit amount.

Governments must determine what percentage of lost income to provide in benefits. This can be a flat rate amount. For example, the JobKeeper wage subsidy program in Australia provides AUD 1,500 (49% of GDP/capita, annualized) every other week; the New Zealand wage subsidy provides NZD 585 (47% of GDP/capita, annualized) per week for full-time workers and NZD 350 for part-time workers. Other countries provide benefits based on a percentage of each individual’s average earnings, with a cap on the benefit amount. The percentage of lost income covered, or the replacement rate, is typically 60% to 80%. For example, Belgium reimburses 70% of lost wages up to EUR 2,750 per month (82% of GDP/capita, annualized); Canada’s wage subsidy covers 75% lost wages, up to CAD 847 per week (73% of GDP/capita, annualized).

Governments may also choose to expand unemployment or wage support benefits to individuals not usually covered by such programs. and many have expanded the scope of programs in response to the COVID-19 pandemic. The CARES Act provides benefits to self-employed individuals and sole proprietors through the existing state-administered system, although such individuals would not normally be eligible. Unlike the existing program, which is state-funded,
this coverage is fully-funded by the federal government. The government estimates it will cost $250 billion. Other countries are similarly expanding coverage. The Austrian program now includes apprentices, and temporary workers are eligible in Germany. The EU SURE initiative permits funds to be used for short-time work or similar schemes for the self-employed.

Similarly, during the GFC, some countries expanded eligibility to part-time workers or fixed contract workers. The Netherlands and Slovenia required that participants undergo training during the hours not worked in order to receive benefits. Other countries incentivized participation in training programs by providing greater income support.

In the European short-time work and wage subsidy programs, benefits are typically provided through the employer. In such cases, the business must meet a set of criteria; many COVID-19 related programs are available only to businesses in hard-hit sectors or that have experienced large declines in sales or workforce. In Australia, companies with more than AUD 1 billion in revenue are eligible for the JobKeeper wage subsidy program if revenue decreases by 50%; smaller companies are eligible if revenue decreases by 30%. In the United Kingdom, the wage subsidy program is available to furloughed workers who do not provide revenue-generating services for their employer. Some countries, such as Estonia, require employers to contribute a certain amount of employee wages, while other countries request, but do not require, employers to try to cover the difference between the subsidy and the employee's standard wages.

Some countries are waiving criteria and application materials in order to expedite the approval and payment process. In France, the government must make a decision on an employer’s wage subsidy application in two days; otherwise, it will be automatically granted. Other countries, such as Australia, are waiving application materials for individuals applying for unemployment insurance.

For more specific information about Unemployment Insurance and Wage Subsidy programs, see Support to Individuals through Unemployment Insurance and Short-Time Work Schemes Direct Payments

To address financial distress and cash-flow issues, some governments send money directly to residents. The US and Hong Kong have the largest and broadest of such programs. The US will send $1,200 (approximately 1.9% of GDP/capita) to adult residents and $500 per child. The Hong Kong government has announced that it will send a similar amount of HKD10,000 ($1,290; approximately 2.7% of GDP/capita) to all adult permanent residents. For comparison, the US conducted a direct payment program in 2001 and 2008 with maximum payments to adults of $300 and $600, respectively. In March of this year, the Australian government introduced a program that provides up to two payments of AUD750 ($482; approximately 0.8% GDP/capita) to approximately 6.5 million Australians described as all welfare recipients and concession card holders, including all pensioners.

In the current US program, for those who filed taxes previously and included bank account information, the Internal Revenue System (IRS) will directly deposit the stimulus funds. The
IRS is working on a website portal where eligible individuals will be able to provide bank account information. If no bank account information is available and where physical address information is available, the IRS will mail checks. By sending payments via direct deposit, the quickest distribution seems assured for most recipients; the government estimates that the first monies will arrive within three weeks.

The choice of administrative process affects the timing of the payment and thus how effective it is in implementing the intended policy. Eligible Australians were groups that already received government welfare payments and began receiving the COVID payments within three weeks.

Hong Kong and Singapore announced direct payment plans, in February and March, respectively, but the payments are not expected to be distributed until summer. The reasons for the delay in the Hong Kong payment include approval of the budget, legal and technical issues, and the requirement that residents register for the benefit. Distribution is expected to begin in August. In contrast, Singapore, subsequently announced that it would distribute part of the payments as early as April using known resident information and direct deposits in a manner similar to the US.

Direct payments programs often, though not exclusively, target those at lower income levels. Australia’s program is designed with this objective. Funds are targeted at groups who need the funds and would spend them, thus assisting the individuals and the economy. A number of other countries announced direct payments to lower income groups as follows: “1,500 vulnerable families” in Barbados, “12 million low-and modest-income families” in Canada, and “3 million of the poorest” in both Iran and Thailand.

The US and Canadian direct payment programs target a significant portion of the population. The payments begin to taper as income increases above a specified threshold, eventually reaching zero. The $1,200 payment for a single adult in the United States begins to taper as income rises above $75,000 (approximately 120% median income) and reaches zero at $99,000. In a similar program in Canada, the taper begins at around $20,000 (approximately 80% of median income). Hong Kong is unique in offering stimulus payments to all adult permanent residents regardless of income level.

In some countries, including the US and Canada, parents of dependent children are eligible for additional funds, $500 and CAD300 per child, respectively. The 2001 US program did not include additional funds for children, but the 2008 US program in response to the GFC included an additional $300 per child. Australia conducted a direct payment program in 2008 that included AUD1,000 per child.

As of the time of this writing, most programs announced have been single payments; however, Thailand and Barbados offer monthly direct payments. The program in Thailand is expected to last three months, and Barbados did not announce an end date to its program. Australia’s current direct payment program has two installments; the second is available to fewer residents than the
first. Recurring payments provide additional flexibility and scalability that one-time payments do not.

For more specific information about Direct Payments programs, see Support to Individuals through Direct Payments and Tax Cuts

Income Tax Cuts

Some governments are providing stimulus funds to individuals via general income tax cuts. However, it is important to note that income tax cuts only allot funds to those who still have jobs, and therefore income. (However, sometimes individuals have to pay income tax on unemployment insurance payments).

Indonesia and Kenya have passed some of the largest income tax cuts. Indonesia’s program decreases the income tax rate by 30% for workers in most sectors, and cuts the rate to 0% at certain low-income levels. Kenya’s program cuts the tax rate to 0%. Hong Kong has taken a different tactic and exempted the first HK$20,000 of income from tax for all workers. The cost to the government of such programs is less clear, as it represents a loss of future income as opposed to an increase in immediate expenses. The US cut income taxes during the 2001 recession.

Although income tax cuts also increase household disposable income, the increase is often not as perceptible as direct payments. Surveys of past tax cuts have shown that they often go unnoticed by the beneficiaries. However, this may be a more viable method for countries with limited resources with which to fund direct payments or augment unemployment support.

Other Tax Cuts

Governments can also lower taxes on certain goods and services so that households experience a relative increase in purchasing power. By cutting taxes other than income taxes, more individuals potentially benefit, whether or not they have income. For example, decreasing sales taxes benefits consumers across the country. But governments can also target tax cuts to certain hard-hit sectors. There are three broad categories of taxes that have been cut in response to the COVID-19 crisis:

1. Sector specific: many countries cut taxes on goods and services related to the tourism and travel industry, which has been hit particularly hard by the virus, including: El Salvador, Indonesia, Norway, and Turkey.

2. Basic food items: countries cut taxes on basic food items, including El Salvador and Gibraltar.

3. Healthcare and medical related items: many countries cut taxes on goods and services related to the medical, emergency, and hygiene industries, including: Colombia, Curacao, and Greece.
This type of specific, targeted tax cut appears to be a relatively new policy option in response to the current COVID-19 pandemic. Note that our resource guide focuses almost exclusively on national programs and therefore does not capture actions related to taxes below the national level.

Deadline Extensions and Penalty Waivers

In response to the COVID-19 crisis, many countries have extended the filing deadline for income taxes, or waived the fees, penalties, and interest associated with late payments, even if they have not decreased their tax rate. Both measures allow households to temporarily delay their tax obligations and thus, may provide liquidity support to a significant portion of households in a country. While more countries have adopted explicit deadline extensions, both measures have seen widespread application. Deadline extensions have been used for short horizons, some as short as two weeks, as in Egypt, but most have been for between one and three months. The US extended the deadline to file and pay personal income taxes by three months. Penalty waivers have been used to provide longer-term relief. Switzerland implemented a penalty waiver for any federal taxes due between March and December 2020, providing up to nine months of relief. On average, these programs provide taxpayers with an additional three months to meet their income tax obligations.

Deadline extensions can be implemented on a targeted or universal basis. While many countries, like the US, chose to extend the deadline for all taxpayers, other countries offer relief on the basis of need with defined eligibility criteria. This is the case in Germany, where taxpayers have to be “directly and not insignificantly affected” by current conditions to defer their tax payment. In such cases, targeted programs require taxpayers to submit an application to the tax authority to establish eligibility. Such application systems have also been implemented in Belgium, Singapore, and El Salvador. Singapore follows the German approach and targets taxpayers who are experiencing financial difficulties. El Salvador provides relief to all taxpayers who owe less than USD 10,000 in taxes. For taxpayers employed in the tourism industry, this cap is increased to USD 25,000. In general, tax authorities can grant penalty waivers to eligible taxpayers without requiring an application.

These programs provide relief to taxpayers by allowing postponement of tax payments while the government bears a cost in the form of delayed fiscal revenue. To find a balance, some countries permit taxpayers to opt into installment plans to spread the tax burden over time, instead of simply delaying payment. Portugal, Singapore, El Salvador, and Belgium have implemented such programs.

Extending filing tax deadlines (and the related penalty relief) provides an easy-to-implement and readily available tool to provide liquidity support to taxpayers. The actual benefit for an individual, however, varies and may be limited, especially in countries where taxes are collected throughout the year through payroll deductions. The benefit would be the greatest for individuals who have under-withheld or who are required to make direct installment payments to the revenue agent. By making extended deadlines optional, taxpayers entitled to refunds
would still be able to file earlier in order to secure them. Also, it should be noted, there may be
taxes, other than income taxes, for which this type of deadline extension and penalty waiver
treatment would also apply.

For more specific information about Deadline Extensions and Penalty Waivers programs,
see Support to Individuals through Tax Deadline Extensions and Penalty Waivers

Access to Retirement Savings

Some countries - including the US, Australia, and Malaysia - have temporarily suspended the
taxes, penalties, and fees associated with early withdrawals from tax-advantaged retirement
accounts. Many programs have an explicit cap on the amount that can be withdrawn.

Retirement accounts typically offer special tax treatment and other incentives to encourage
individuals to save money for retirement. To discourage withdrawals from these accounts before
retirement, the government charges a penalty for early withdrawals. Suspending these penalties
and fees provides impacted households with improved access to liquidity. In the US, individuals
impacted by the COVID-19 crisis may withdraw up to $100,000 from a tax-deferred account
without having taxes or the 10 percent penalty withheld. Provided that the individual
contributes an amount equal to the withdrawal to the account within three years, the taxes and
penalty will be waived. To facilitate the return contribution, yearly contribution caps have also
been waived. Taxes will still be owed on any amounts not repaid within three years. A similar
eight percent penalty was waived in Malaysia. In Australia, individuals may withdraw up to AUD
10,000 without penalty.

The US did not waive the 10 percent tax on early withdrawals during the GFC. Empirical
evidence suggests that individuals still tapped into their retirement accounts to absorb income
shocks. The policy currently in place substantially lowers the cost of this option and thus makes
it viable to a wider range of liquidity-constrained households. However, the benefits of such
policies remain limited to middle- and higher-income individuals who are more likely to have
contributed to a retirement account. A 2019 Federal Reserve study found that only around 60%
of US households had a retirement account.

Housing Relief

Since housing costs are often the largest fixed costs of households, during a crisis governments
may provide targeted support for homeowners and renters through mortgage and rent
forbearance and debt restructuring. Some governments have funded mortgage purchase
programs and changed accounting rules to provide flexibility for debt restructuring in order to
provide relief for individuals. For information about government policy options targeting
homeowners and renters, see Residential Mortgage and Rent Relief During Crises.
Illustrative Examples

In a separate post, we outlined the combination of individual support measures taken to date in the United States in response to COVID-19. We briefly outline two additional countries’ policy actions to support individuals below.

Germany

Germany, like many other European countries, made use of its established welfare infrastructure to provide support. Through its short-time work scheme, Kurzarbeit, the government was able to provide rapid relief to underemployed individuals, preventing lay-offs and the associated cost of mass unemployment. As a result, Germany has not provided emergency support to individuals, which would have entailed an additional administrative burden. Use of the short-time work scheme increased in March, with nearly 650,000 businesses notifying the government that they intend to use the program.

Similar to a majority of OECD countries, the German government also offered the possibility to defer individual income-tax payments. Only households directly affected by the current crisis are eligible.

Thailand

One of the first actions the Thai government took in this crisis was to delay the deadline for income tax filings. In early February, it pushed the deadline from March to the end of June. On March 24, the government approved a direct payment of THB 5,000 ($154) per month for three months for three million of the country’s poorest residents. The Thai government also cut the income withholding tax from 3 percent to 1.5 percent for six months, from April to September.

Key Takeaways

Below we outline a number of important considerations that policymakers review in providing support to individuals and households.

How quickly will individuals receive aid under the program?

The amount of time it takes financial support to reach eligible individuals varies across programs and across countries.

Traditional unemployment insurance programs and short-time work programs are considered automatic stabilizers, as they are preexisting programs designed to support individuals through their normal operations without additional government legislation. In times of crisis, some countries expand or modify such programs to increase the speed of support or expand reach. For example, the United States waived the one-week waiting period for unemployment benefits. Many European countries with short-time or wage subsidy programs have in the current and past crises utilized existing infrastructure and thus appear to be able to quickly deliver benefits to individuals through employers.
In a crisis, countries can also increase the amount of support or provide supplemental benefits. These expansions can be implemented as quickly as funds are made available by the legislature and processed through the administrative infrastructure. Of course, a significant influx of new applications, as the US has experienced with its unemployment insurance programs during the COVID-19 crisis, may create administrative log-jams that slow the delivery of funds.

Cutting taxes, extending tax deadlines, and waiving penalties can all be implemented with relatively little administrative burden. The main challenge is to clearly communicate the decision and its terms. Therefore, the support can arrive fairly quickly. However, as noted above, the support this tool provides in terms of cash flow can be limited.

Direct payment programs may require new programs to be passed by the legislature, as in the US and Hong Kong, or may rely on augmenting an existing program, as occurred in Canada. Once approved, individuals receive support only as quickly as the government can get financial information or physical addresses for all eligible individuals. Where an existing program is used as a means of distribution, as in Canada, payments may be quicker to implement, but administrative times vary greatly. In the US, where the government is using available taxpayer information, the money is scheduled to arrive within three weeks. However, in Hong Kong, the money is not scheduled to arrive until five months after the announcement of the program, which requires that individuals register for the benefit.

How much support will be provided?

The size of individual support programs varies across countries, as economic activity and per capita GDP differ. Some variation in policy mix appears to be based on preexisting, non-crisis support programs. For example, direct payments in the US appear necessary to support individuals; in contrast, several European countries have large existing safety net programs and have not chosen to create new direct-payment programs.

Certain interventions have an explicit, predetermined size, such as direct payments, while other interventions, such as unemployment insurance, are dependent on exogenous variables such as labor market demand. For example, a country can determine how large direct payments to individuals will be and the total number of individuals eligible to receive the payments, and thus estimate the total size of the support program. For example, the direct payments in Hong Kong are estimated to benefit seven million individuals with a total cost of HKD 71 billion. However, unemployment insurance claims will vary based on the number of unemployed, which can be projected, though uncertainty about the total size of the program will remain. Certain countries, including Belgium and Australia, are providing additional benefits to individuals impacted by the Covid-19 pandemic. Countries frequently determine the size of support to individuals based on projected income loss to households.

Who will receive support?

Support to individuals can be targeted or universal. Programs such as unemployment insurance and facilitated access to liquidity from retirement accounts are targeted by design. However,
most programs discussed above can be implemented in various ways depending on the specific subgroups of the population that policymakers want to target. Even unemployment support can be broadened to cover groups not traditionally covered, as demonstrated by various short-term work schemes in Europe, such as temporary workers in Germany and apprentices in Austria. Eligibility for income tax cuts or direct payments can be assessed based on income to ensure that benefits are allocated following a need-based approach. Tax deadline extensions can be implemented on a universal basis and thus benefit all taxpayers. When implementing an individual support program, policymakers must determine how to deliver support to the segment of the population that needs it. The policy design can be adjusted to ensure benefits are allocated efficiently and match the country’s fiscal capacity.

How long will support be provided?

Support programs can be a single instance of support or can be spread out over time. In times of crisis, governments can extend the duration of unemployment insurance and wage subsidy programs. Denmark’s new wage subsidy program is available for three months, while Germany’s extended short-time work scheme, Kurzarbeit, is available for 12 months. The US CARES Act extends the unemployment entitlement period from 26 weeks to 39 weeks; in the GFC, the US ultimately expanded the entitlement period to 99 weeks.

Most direct payment programs we reviewed were one-time, with the exception of Thailand (three monthly payments), Barbados (monthly payments for an unspecified period of time), and Australia (two installments, although the second is available to a smaller subset of those eligible for the first). Tax cuts provide recurring support to the taxpayer each time they pay the tax at the lower rate. In response to COVID-19, most countries have delayed tax deadlines by a few months.

How will the government fund the program?

Most of the programs for funding to individuals come from public expenditures. Direct payments to individuals are publicly funded through fiscal stimulus measures.

For some wage subsidy programs and short-time work schemes, employers are required to chip in a certain percent of wages to the employee, in addition to what the government subsidizes, normally between 60% and 80%. During times of crisis, employers may face difficulties in meeting the required contribution; thus, not all wage subsidy programs or short-time work schemes require employer contributions.

In the United States, standard unemployment insurance benefits are typically paid from employer contributions to the federal government and to the insurance funds of the states in which they operate. However, the expansion of the US unemployment insurance system in response to COVID-19 is federally funded. Income tax cuts or changes to other taxes impact government revenue, potentially delaying or decreasing total government revenues for the year. With a direct payment, the government spends cash immediately, but with tax cuts, the government foregoes future revenue. Policymakers considering direct support to individuals
should consider how the program is funded, specifically whether direct cash spending is feasible in contrast to forgoing future tax revenue.

How can the tools be combined?

When designing a policy mix to support individuals, it is critical to identify the main policy objectives. These include desired recipients, size, and timing of the support. At the same time, policymakers need to be mindful of a country’s policy environment and fiscal capacities. The optimal mix will depend on country-specific variations in these two factors as much as on the policy objectives. For instance, expanding unemployment benefits may be an efficient channel to provide support to a large number of households in countries with a preexisting infrastructure, but may not reach individuals who are ineligible for the scheme. Direct payments may be preferred in countries with less developed or more fragmented unemployment systems or as a way to provide a benefit to the broad citizenry or targeted groups. And different benefits can be combined to deliver different assistance to different groups. For example, a direct payment can be targeted at low-income earners, while greater access to retirement savings is targeted to high-wage earners. Similarly, countries with extensive fiscal capacities can implement programs such as wage subsidies or universal payments and incur a large cost in the present. For governments facing fiscal constraints, it may be preferable to implement support programs by forgoing present revenue through tax cuts, tax deadline extension and various penalty waivers.

Given policy objectives and country-specific factors, the set of programs discussed above can be combined and tailored in many different ways to support households through a downturn.
US Supports Individuals and Households in Response to COVID-19
By Mallory Dreyer, Kaleb Nygaard, and Pascal Ungersboeck

Original post here.

The $2.2 trillion CARES Act, which the US Congress passed on March 27, 2020, provides direct payments to individuals, temporarily expands unemployment insurance, and eases restrictions on withdrawing money from retirement accounts for those affected by the coronavirus. The government also offered mortgage forbearance to certain households and extended the tax filing deadline. These policies specifically provide support to individuals and households during the COVID-19 crisis.

Direct payments

One of the most widely publicized aspects of the CARES Act is the $290 billion allocated for direct payments to eligible residents of the country. The Economic Impact Payments represent 13% of the stimulus in the Act and 1.5% of 2019 GDP. The one-time payment allots $1,200 for eligible adult tax filers and recipients of Social Security and railroad retirees who are not required to file a return.

The payments begin to taper at an adjusted gross income of $75,000 ($150,000 per couple) and reach zero at $99,000 ($198,000 per couple). The $75,000 threshold represents approximately 120% of the median US income. Parents are eligible for up to $500 extra for each dependent child under age 17. The Internal Revenue Service (IRS) will directly deposit the funds to eligible individuals for whom they have bank account information. It is developing an online system to allow individuals to provide this information outside of a tax filing. The IRS will mail checks to individuals for whom it has no bank account information, if it can locate a physical address. Individuals who did not file a return for 2018 or 2019 have until the end of the year to do so in order to receive the payment. The IRS is developing a simplified form for those who otherwise are not required to file. Social Security recipients, however, will generally not have to file as the IRS will rely on Social Security data for their information.

Unemployment Insurance

The CARES Act supplements state unemployment benefits with an additional $600 on top of the state’s weekly benefit. Based on an average 40-hour work week, this equates to an average per hour benefit of at least $15. The temporary expansion also allows individuals to claim an additional 13 weeks of benefits, on top of the standard 26 weeks.

In the US, the state and federal governments jointly fund unemployment insurance, and states administer it. The level of benefits differs across states. As of February 2020, benefits range from $215 in Mississippi to $550 in Massachusetts and average $387 per week nationally. The duration of benefits also varies, with most states offering benefits for 26 weeks. During the
Global Financial Crisis, the government extended the number of weeks individuals could claim benefits multiple times.

The Act extends coverage to those otherwise ineligible for state benefits, such as self-employed individuals and gig-economy workers. It also extends benefits to workers who left their jobs for a specific COVID-19-related reason and who can’t telework or take paid leave. These two groups are eligible for a benefit equal to the state unemployment benefit plus the $600 per week top-up. The federal government will fully fund the benefit for up to 39 weeks.

**Retirement Accounts**

For people impacted by COVID-19, the CARES Act temporarily waives the income-tax withholding requirement and temporarily waives the income-tax withholding requirement and the 10 percent tax penalty for early withdrawals from retirement accounts. Individuals who withdraw early from their retirement account savings can repay the withdrawal back into a retirement account over a period of three years or pay income taxes on the withdrawal over a period of three years. This provision allows individuals to tap into their retirement savings without penalty.

**Mortgage Forbearance**

Both individuals with single-family mortgages and landlords with multifamily mortgages are eligible for mortgage forbearance. Individuals are entitled to 180 days with a one-time extension for another 180 days. Landlords can request forbearance for 30 days and two extensions for 30 additional days each.

Mortgage servicers may not foreclose on loans during the 60-day period beginning March 18. Vacant properties are exempt from the policy. Similarly, no tenant residing in a federally-subsidized housing or in housing covered by a federally-backed mortgage loan can be evicted during the 120-day period beginning March 27.

Finally, the act provides that creditors who accommodated borrowers for making late payments must report these obligations as “current” until the later of 120 days after enactment of the CARES Act or 120 days after the end of the national emergency concerning COVID-19.

The federal government or government-sponsored entities generally bear the cost of these programs. However, given that an increasing number of mortgages are serviced by nonbank servicers, the industry has asked authorities to create a liquidity facility to finance the policies.

**Tax filing and payment extensions**

On March 18, the IRS said it will allow individuals to defer income tax payments due on April 15 until July 15. The intervention followed the President’s emergency declaration on March 13. The IRS said it considered all taxpayers with payments due on April 15 to be adversely affected by the pandemic. Under the policy, taxpayers can postpone payments of up to $1,000,000 regardless of their filing status.
The stimulus in the CARES Act is funded via deficit spending; offsets or other funding mechanisms are not included.

Programs Support Individuals through Unemployment Insurance and Wage Subsidies

By Mallory Dreyer, Rosalind Z. Wiggins, and Greg Feldberg

Original post here.

Governments are providing extraordinary relief to the unemployed during the COVID-19 pandemic. Countries are both extending existing coverage and establishing temporary new income-support programs to help individuals who have been furloughed, lost their jobs, or face an imminent layoff. Key considerations for these programs include:

1. **Channel**: What is the channel for providing the benefits?
2. **Size**: What is the monetary value of the benefits provided?
3. **Private-sector Funding**: Do employers share the cost?
4. **Eligibility**: Who is eligible to receive the benefits?
5. **Length**: What is the timeframe for the benefits?
6. **Administration**: How does the individual receive the benefits?

**Channel**

Governments can provide income support directly to individuals or through their employers. Standard unemployment insurance programs provide direct support and payments to individuals who are laid off. In response to the COVID-19 pandemic, the US CARES Act expands existing unemployment insurance benefits. Australia replaced existing unemployment insurance programs with the expanded JobSeeker Program. The Australian government also announced the Coronavirus Supplement, which provides an additional AUD $550 every other week to eligible individuals.

The other channel is through the employer, which is common in some European countries. The European Commission for example, has announced a plan based on the German Kurzarbeit, or “Short-Time Work Scheme,” which provides wage support to eligible employers who would otherwise lay off employees due to a forced suspension or reduction of work. During the Global Financial Crisis, this program supported more than 1.4 million individuals. In response to COVID-19, multiple countries are adopting or expanding temporary short-time work schemes, such as France, Austria, Australia, Denmark, New Zealand, and others. Though the support is
based on employer eligibility, the aid ultimately benefits the individual who would otherwise be unemployed.

Size

Governments may base the size of a benefit on an individual’s average earnings or pay a flat rate to everyone, regardless of their prior income. Australia’s JobKeeper program pays a flat rate of AUD 1,500 per employee every other week, which is the equivalent of 70% of the median wage in Australia. Greece will provide EUR 800 per month to all individuals who are unable to work due to the COVID-19 pandemic. The New Zealand wage subsidy program provides a weekly flat rate payment based on the employee’s average weekly hours: $585 for those working more than 20 hours per week, or full-time, and $350 for those working less than 20 hours per week.

Most European countries provide benefits based on a replacement rate, that is, a percentage of an individual’s average earnings. Replacement rates vary across countries but are typically between 60 and 80 percent. For example, Germany pays 60% of lost wages or 67% for people with children. Belgium provides direct benefits equal to 70% of an individual’s prior average earnings. In Belgium, individuals can also receive additional daily allowances if they lose work due to a “force majeure” such as the coronavirus or economic conditions. In Bahrain, a parliamentary committee passed a provision on March 30 mandating the unemployment fund to pay the full salaries of all private-sector employees for three months.

Most countries cap the benefit per individual. Belgium’s program has a monthly cap of EUR 2,755. Denmark initially capped monthly government support at DKK 23,000 for salaried employees and DKK 26,000 for hourly employees. It increased the limit to DKK 30,000, regardless of hourly or salaried status a few weeks after announcing the program. Germany and France limit monthly benefits of wage-subsidy programs to EUR 6,700 and EUR 6,927 respectively, while the monthly maximum benefit in Italy, Spain, and Ireland is less than EUR 2,000 per month.

Private-sector Funding

Some countries require employers to chip in to participate in wage-subsidy programs. The Danish government pays 75 percent of an employee’s salary and requires the employer to pay 25 percent; for hourly wage employees, the government covers 90 percent. Estonia pays 70% of salaries, but requires employers to also provide EUR 150 in wages. For employees in New Zealand whose usual wages are more than the subsidy, their employer must try to pay at least 80% of their usual wages, though employer contributions are not required.

Eligibility

Governments must determine who is eligible. Countries with existing programs already have criteria for eligibility. For example, some countries do not allow people who quit their jobs to claim unemployment benefits. However, some countries have expanded eligibility in response to the COVID-19 pandemic. Significantly, the United States and Australia now allow individuals...
who are self-employed or contractors to claim benefits, through expansions of existing programs or under new benefits. The US also includes employees who leave their job for a COVID-19-related reason, such as inability to work due to quarantine or caring for a family member with the virus.

For programs such as short-time work programs that are channeled through the employer, eligibility is based on the company, rather than the individual. In France, wage subsidies are available to employers who are forced to suspend or reduce business activity due to COVID-19. Other countries set more specific criteria. Bulgaria extends its program to employers in sectors most affected by the pandemic, such as retail, land and air transportation, and restaurants; employers forced to suspend activities because of quarantine; and employers that experienced a 20 percent decline in sales in March. Other countries do not specify sectors but limit their programs to those experiencing a certain percent decline in sales or workforce, such as Denmark and Estonia. In order for employees to receive wage subsidies in Denmark, the employer must document that it has retained employees during the covered period. Other countries, such as New Zealand, make wage subsidies available to employers who rehire employees they recently let go due to COVID-19.

Most wage-subsidy programs cover all employees, though programs differ on whether or not employees who still work can be covered under the program. In the UK, for example, employees must be placed on furlough and cannot provide work or services for the employer while receiving the wage subsidy. In Denmark, employees must take five paid vacation days to be covered under the program. Denmark’s program provides coverage for both full- and part-time employees, in addition to self-employed or sole-proprietors. Other countries provide wage subsidies for employees who work reduced hours, such as Germany and France.

Length

Unemployment insurance and wage-subsidy programs are generally limited in duration. For unemployment insurance, many countries have a maximum number of weeks that an individual is entitled to receive benefits. The US CARES Act provides an additional 13 weeks of unemployment insurance, on top of the standard 26 weeks. During the 2008-2009 crisis in the United States, the government extended the entitlement period multiple times, with unemployed workers eligible to receive up to 99 weeks of benefits. Wage-subsidy programs vary widely. Italy will provide wage subsidies for nine weeks. Denmark’s modified wage-subsidy program is available for three months. The wage subsidy in Germany’s Kurzarbeit program can be collected for up to 12 months.

Administration

Many countries will leverage existing infrastructure and systems to pay benefits. These include Germany, France, and Spain.

Some countries are also streamlining application processes to expedite support. For example, the process in Belgium occurs entirely online and requires forms from both the individual and
the employer. In New Zealand, the employer applies for support on behalf of the employees it plans to cover under the wage subsidy. In France, the government must decide within two business days whether to provide support to an employer through the short-time work scheme. If the employer receives no decision, the support will be granted automatically. Bulgaria similarly requires the government to make timely decisions.

In response to the COVID-19 pandemic, many countries are implementing and extending various policies to provide support to individuals. For an overview of different types of programs, see “Government Support for Individuals in Response to COVID-19.”
Programs Support Individuals through Direct Payments and Tax Cuts

By Kaleb Nygaard, Greg Feldberg, and Rosalind Z. Wiggins

Original post here.

During this COVID-19 crisis, many countries have provided cash directly to individuals and households through direct payments and tax cuts. Though programs differ across countries, some key considerations for these temporary income support programs include:

1. Channel: What is the channel for providing the benefits?
2. Size: What is the monetary value of the benefits provided?
3. Eligibility: Who is eligible to receive the benefits?
4. Length: What is the timeframe for the benefits?
5. Administration: How does the individual receive the benefits?

Channel

Governments are providing financial support to individuals, whether or not they’ve lost their job. One channel is via direct payments, where the government sends money to residents. A second channel is via income tax cuts, where the government decreases the amount of money withheld from paychecks or required of contractors and self-employed individuals. Both channels seek to increase the amount of disposable income available to households in need.

The United States (US) and Hong Kong are implementing sweeping direct payment programs in response to COVID-19. Indonesia and Kenya have made large cuts to their income tax rates. Many countries have implemented one or both of these types of programs; see the Resource Guide for dozens of examples.

Size

Broadly speaking, the size of a program can be measured by: (1) the amount offered to each eligible individual, and (2) the total size of the program and that total compared to the size of the country’s GDP.

The US and Hong Kong appear to have set up the largest and broadest direct payment programs. The US is sending $1,200 to eligible adults and $500 per child to eligible parents. The CARES Act, signed into law on March 27, authorizes $290 billion for this program. This represents 13% of the stimulus in the CARES Act and 1.5% of US GDP. The Hong Kong direct payment program, of similar size, would send HK$10,000 ($1,290) to eligible adults. The announcement indicated that it would reach 7 million people, providing HK$70 billion of stimulus, which represents 21% of GDP. A number of other countries have announced direct payment programs, including Canada, Thailand, and Barbados.
Indonesia and Kenya have passed some of the largest income tax cuts. Indonesia’s program decreases the income tax rate by 30% for workers in most sectors. Kenya’s program decreases the tax rate to 0%. Both programs have cut the rate to zero, up to certain income levels. The cost to the government is less clear as it represents a loss of future income as opposed to an increase in immediate expenses. Although income tax cuts also increase household disposable income, the increase is often not as perceptible as direct payments. Surveys of past tax cuts have shown that they often go unnoticed by the beneficiaries. However, this may be a more viable method for countries with limited resources with which to fund direct payments.

Eligibility

The direct payments programs often, though not always exclusively, target those at lower income levels. A number of countries announced direct payments to lower income groups as follows: “1,500 vulnerable families” in Barbados, “12 million low- and modest-income families” in Canada, and “3 million of the poorest” in both Iran and Thailand.

The US and Canadian direct payment programs target a significant portion of the population. The payments begin to taper as income increases above a set point, eventually reaching zero. The $1,200 payment for a single adult in the United States begins to taper as income rises above $75,000 (approximately 120% median income) and reaches zero at $99,000. In a similar program in Canada, the taper begins at around $20,000 (approximately 80% median income). Hong Kong is unique in offering stimulus payments to all adult residents, regardless of income level.

In some countries, including the US and Canada, parents of dependent children are eligible for additional funds, $500 and C$300 per child, respectively. The US program directly pays almost all adults with Social Security numbers. The Hong Kong program directly pays all permanent residents over the age of 18.

Income tax cuts are not a substitute for direct payments. It is important to note that income tax cuts only increase disposable income for those who pay income taxes, and thus are generally employed. This excludes a significant portion of the population that is in the most need during a recession. For this reason, governments often choose not to implement income tax cuts. In response to COVID-19, the government of Indonesia and Kenya both cut income taxes to zero, up to a certain income (KES24,000 for Kenya, which represents approximately 25% GDP per capita). Austria’s program allows taxpayers directly affected by COVID-19 to reduce their quarterly income tax, in some instances all the way to zero. Australia’s program increased the “low-income threshold” for families and individuals increasing eligibility for tax offsets that reduce the amount of tax payable.

Length

The duration of direct payment programs come in two categories: one-time payments and recurring payments. The majority of direct payment programs, including those of the US and Hong Kong, are one-offs; however, programs in Thailand and Barbados offer
monthly payments. The program in Thailand is expected to last 3 months, and the program in Barbados did not announce an end date. Recurring payments do provide some additional flexibility and scalability that one-time payments do not.

The announced duration of the 30% income tax cut in Indonesia is 6 months.

Administration

The Internal Revenue Service (IRS) of the US will administer the disbursement of funds to eligible individuals and families and expects to send the first payments by April 9. For those who filed taxes previously and included bank account information the IRS will direct-deposit the stimulus funds. The IRS is working on a website portal where eligible individuals will be able to provide bank account information. If no bank account information is available and where physical address information is available, the IRS will mail checks.

Although the Hong Kong government announced the direct payment program at the end of February, the program will not be available “until the start of summer.” And because the program will require residents to register it will take even longer to process payments.

Normally, the tax authority simply announces and then administers the tax cuts. A significant advantage to tax cuts is their relative ease of implementing and administering in comparison to direct payments.

In response to the COVID-19 pandemic, many countries are implementing and extending policies to provide support to individuals. For an overview of different types of programs, see “Government Support for Individuals in Response to COVID-19.”
Programs Support Individuals through Tax-Deadline Extensions and Penalty Waivers

By Pascal Ungersboeck, Greg Feldberg, and Rosalind Z. Wiggins

Original post here.

Several governments have extended the payment deadline for 2019 income taxes or adopted waivers for late-payment penalties as measures to support household income. Among the OECD’s 36 member countries, more than half have implemented such measures. In essence, both policies achieve the same objective which is to relieve households from the burden of a pending income tax payment while affected by the current adverse economic environment.

There are two channels through which governments have supported households by momentarily lifting the income tax burden: (a) an explicit extension of the deadline to pay 2019 income taxes, and, less commonly, (b) waivers of fees, penalties or interest payments related to late income-tax payments. The intervention is especially relevant given that in many countries the national tax deadline is scheduled in the spring. These policies extend the deadline for tax filing and payment by 3 months on average.

Both tax deadline extensions and penalty waivers have seen widespread use across the world and constitute a simple tool to provide relief for cash-strapped households effectively addressing cash-flow issues. At the same time, they provide policymakers with flexibility to extend the length of the program or target especially vulnerable households.

Key considerations in the design of a deadline extension or penalty waiver for income taxes include:

1. Channel: What is the channel for providing the benefits?
2. Eligibility: Who is eligible to receive the benefits?
3. Length: What is the timeframe for the benefits?
4. Administration: How does the individual receive the benefits?

Channel

As discussed above two different channels are available to policymakers: explicit extensions and penalty waivers. In general, the decision appears to depend on the intended length of the extension; extensions of deadlines have been used for short extensions with a large majority providing two or three month relief. Penalty waivers have been used for longer horizons.

Eligibility

Some countries’ programs require taxpayers to fulfill certain eligibility criteria to obtain the extension or waiver. These criteria ensure that the policy targets high-need households and
eliminate concerns that the policy could lead to tax non-compliance for reasons other than financial need. German taxpayers, for instance, have to be “directly and not insignificantly affected” by current conditions to defer their tax payments. The tax authority assesses eligibility based on an application that taxpayers submit. Belgium, El Salvador and Singapore implemented similar application systems. In Singapore, as in Germany, the policy targets taxpayers who are experiencing financial difficulties. El Salvador’s criteria are sector- and industry-based and ensure that only small taxpayers or those employed in particularly affected industries delay payment. The tax authority can assess eligibility for penalty waivers without requiring taxpayers to apply. The US has taken a universal approach automatically extending the filing and payment deadlines for three months for all taxpayers.

Length of the program

The length of the extension is another key feature of the policy. Horizons vary although many countries opted for a relief period between two and four months. Switzerland and Germany provide the longest relief at 9 months. On the other end of the spectrum, Egypt provides the shortest with a two week extension. The following table provides a more detailed breakdown.

Table 1. Length of the program.

<table>
<thead>
<tr>
<th>Length</th>
<th>Number of Countries</th>
<th>Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>up to 1 month</td>
<td>8</td>
<td>Egypt, Canada, El Salvador, Japan, Poland, Sweden, Taiwan, Turkey</td>
</tr>
<tr>
<td>Between 1 and 2 months</td>
<td>11</td>
<td>Norway, Algeria, Brazil, Bulgaria, Chile, Cyprus, Dominican Republic, Israel, Lithuania, Malaysia, Thailand</td>
</tr>
<tr>
<td>Between 2 and 3 months</td>
<td>12</td>
<td>Bosnia-Herzegovina, Czech Republic, India, Iran, Ireland, Montenegro, Netherlands, Peru, Portugal*, Slovakia, United States, Netherlands</td>
</tr>
<tr>
<td>Between 3 and 4 months</td>
<td>1</td>
<td>Uzbekistan</td>
</tr>
<tr>
<td>Between 4 and 5 months</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td>Between 5 and 6 months</td>
<td>3</td>
<td>Canada*, Ecuador, United Kingdom</td>
</tr>
<tr>
<td>Between 6 and 7 months</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td>Between 7 and 8 months</td>
<td>1</td>
<td>El Salvador</td>
</tr>
<tr>
<td>9 months</td>
<td>2</td>
<td>Germany*, Switzerland*</td>
</tr>
</tbody>
</table>
*denotes countries that implemented a penalty waiver

Administration

In most cases, the program’s direct benefit is an ability to postpone tax payments. However, some countries offer an intermediate solution by allowing taxpayers to opt into installment plans to spread the tax burden over time, instead of simply delaying payment. Singapore, El Salvador and Belgium have implemented such programs. In each case, taxpayers have to submit an application and fulfill their respective country’s eligibility criteria.

In response to the COVID-19 pandemic, many countries are implementing and extending policies to provide support to individuals. For an overview of different types of programs, see “Government Support for Individuals in Response to COVID-19.”
Unemployment Insurance and Short-Time Compensation in the US and abroad

By Pascal Ungersboeck

Original post here.

To address the COVID-19 pandemic, governments around the world recently placed restrictions on business activities, in many cases ordering non-essential businesses to close and workers to stay at home. In many countries this led to a rapid decline in labor demand. In the US the Bureau of Labor Statistics (BLS) reported the highest unemployment rate since the Great Depression in April with a national rate of 14.7, an 11 percentage point increase from the historical low of 3.5 percent reported two months before. Nevada reported the highest rate in the country at 28.2 percent, up from 6.3 percent in March, while the lowest rate was reported in Connecticut at 7.9 percent, still more than a twofold increase from 3.7 percent reported in March. In May, the labor market began to show the first signs of recovery as some states reopened their economies; the unemployment rate dropped to 13.3 percent.

Initial jobless claims across the nation peaked at 6.8 million during the week ending March 28, ten times higher than the numbers reported at the height of the 2007-2009 global financial crisis (GFC). Between March 1 and April 30, a total of 28.5 million new claims for unemployment insurance payments were filed. Unemployment insurance provides workers who involuntarily lose their jobs with replacement income based on previous earnings; amounts and terms of benefits vary across states, which fund the benefit. In many states, mass layoffs due to the lockdown resulted in overwhelmed unemployment systems and significant delays in payments. The CARES Act sought to address some of these shortcomings by expanding state unemployment benefits and adding a weekly payment of $600.

At the same time, many European countries did not experience a similar surge in unemployment as a result of their lockdown. In May, Germany’s unemployment rate stood at just 6.1 percent, up from 5.1 percent one month earlier, a stark contrast to the US numbers as shown in the chart below. The country has avoided mass layoffs by relying on its Kurzarbeit or short-time work scheme to maintain workers employed through the downturn. Kurzarbeit allows employers to reduce employees’ hours and compensation while maintaining them on payroll; employees then receive government benefits to compensate for the wage reduction. Since March, the German federal labor agency has received applications to participate in the program from over 750,000 employers, potentially covering 10 million workers. Similar work-share programs exist in other European countries and are also being heavily used during the current downturn.
Note: The unemployment rate in Germany is reported by the Federal Labor Agency (Bundesagentur für Arbeit). The agency does not follow international guidelines defined by the International Labor Organization (ILO) and typically produces estimates above ILO levels. The most recent estimate available rate using ILO standards is 3.1 percent, reported in December 2019.

Short-time compensation (STC) programs that operate similar to Germany’s Kurzarbeit are in place in 26 states and the District of Columbia in the US. However, these programs have not encountered nearly as much utilization as abroad, with American employers resorting to layoffs and furloughs instead. This post discusses different unemployment systems and their use during economic downturns. The discussion is structured in 4 parts:

1. An overview of STC policies implemented in the US and abroad
2. A discussion of the benefits of STC during economic downturns
3. An overview of STC in recent legislation in the US
4. A discussion of the use of STC in the US

1. STC policies in Germany and the US

STC allows employers to keep their employees on payroll in times of low demand. Under the program employers decrease an employee’s hours by a certain percentage and provide wages in proportion to the hours worked; employees then receive government benefits to offset a portion of lost wages. Different programs can be distinguished by the application process for employers,
the calculation of benefits to be paid, restrictions placed on minimum and maximum adjustments to hours worked, and the maximum duration of the program.

German employers are required to document the cause of a decline in labor demand and submit a justification to the local employment agency; over 163,000 employers did so in March, 587,000 in April. Once the reduction has been approved, companies can apply for STC benefits that replace 60 percent of lost wages for employees working fewer hours, employees with children collect 67 percent of lost income. To be eligible, at least one third of a company’s workforce needs to face a decrease of at least 10 percent of hours worked. However, there is no upper bound on the reduction, employers can decrease hours by up to 100 percent.

In response to the COVID-19 pandemic German authorities have expanded the program. In particular, the minimum reduction to be eligible for STC has been lowered to a 10 percent reduction for one tenth of the workforce, instead of one third. Additionally, the replacement rate for hours lost has been increased to 70 percent after employees received STC for three consecutive months and 80 percent after six months (77 and 87 percent for workers with children). Introduced almost a century ago, the German policy served as a model for many STC programs introduced in other European countries.

US states were first authorized to implement similar STC programs under the Tax Equity and Fiscal Responsibility Act of 1982. Currently 26 states and WDC have a STC program in place. Essentially these programs are designed to fulfill the same purpose of maintaining workers on payroll through a downturn. Employers submit an application to the state’s Department of Labor including a breakdown of the hours to be worked by each employee. If the application is approved, workers collect wages in proportion to hours worked and weekly unemployment benefits in proportion to hours lost. An employee whose hours have been decreased by 20 percent will thus collect 80 percent of his full-time wages and 20 percent of the unemployment benefit he would have been entitled to had he been laid off.

All programs impose a minimum decrease in hours worked to be eligible for the program. Most states require hours to be decreased by at least 10 percent, although some require a 20 percent decrease. Moreover, in most states, hours cannot be decreased by more than 40 percent; a few states allow decreases of up to 50 or 60 percent. In response to the COVID-19 pandemic, some states have loosened these requirements. Arizona and Michigan both recently extended the upper bound on reduced hours to 60 percent.

In the US, usage of STC programs has historically been limited. The dominant system is the unemployment insurance system under which eligibility for benefits is contingent on the loss of employment. The amount and duration of payments vary widely across the 50 states and WDC, with many maximum benefits capped at a level that would be below 100 percent of lost income for many workers.

2. STC during economic downturns
By protecting workers from layoffs STC programs can prevent an increase in unemployment in the immediate aftermath of an economic shock, as reflected in the recent unemployment data discussed above.

If successful, STC programs can alleviate many of the costs of unemployment and offer advantages to both employers and employees. The policy can prevent skill erosion for workers as they maintain part-time employment. Maintaining ties with an employer can also protect workers from psychological costs related to unemployment and prevent discouragement by eliminating the need to engage in a costly job search process following the downturn. Finally, in countries like the US, where many benefits including healthcare are tied to employment, maintaining these benefits can prove crucial for workers and their families. For employers, the policy eliminates search and training costs during recovery. STC also allows employers to flexibly increase their workforce to meet demand as the economy recovers. STC programs in most states allow employers to adjust each worker’s hours on a weekly basis.

However, the critical question policymakers must answer is whether STC can prevent job destruction in the long run, rather than just postpone layoffs. Empirical evidence collected from programs used in Switzerland, Italy and France during the GFC indicates that the answer depends on the type of shock firms are facing. STC systems implemented in these countries are similar to the German Kurzarbeit, providing employees with a certain percentage of wages lost.

Switzerland entered the GFC with strong employment and GDP growth, before facing a short V-shaped recession in the final quarter of 2008 and the first half of 2009. The downturn mostly affected exporting firms faced with a decrease in global demand, the recession was milder in domestic sectors. Under these conditions, evidence suggests that the wage subsidies paid under the STC program contributed to preventing permanent layoffs by allowing firms to maintain workers on payroll until global demand recovered.

The conclusions are different for the STC program implemented during the same period in Italy. Evidence from Italian firms indicates that the policy had a large short-term effect on employment but did not prevent layoffs in the long run because firms with low levels of productivity prior to the recession were significantly more likely to select into the program. The authors of the study also measure the policy’s effect on reallocation in the labor market. Since participating firms have the ability to hold on to workers through a downturn, the policy can limit non-participating firms’ ability to hire, preventing the correction of imbalances and potentially leading to labor market inefficiencies.

In France, researchers conclude that the policy preserved employment during the recession. However, only about 1 percent of French firms participated in the program at the height of the GFC, limiting the program to a small segment of the economy and preventing a larger effect on labor market reallocation.

Overall, the literature suggests that STC is an appropriate tool for firms forced to lay off workers due to a temporary deterioration in conditions. The policy can prevent costly layoffs for firms
experiencing a temporary decrease in demand or credit and liquidity constraints. In cases where an activity is not viable in the long run, STC can only postpone layoffs and may have the harmful effect of limiting or delaying workers’ transition to more productive sectors of the economy.

The current global downturn is a result of various lockdown policies implemented by governments to prevent the spread of COVID-19. As such, it provides a textbook example of a temporary downturn resulting from an exogenous shock, rather than an internal imbalance requiring some form of market correction. Currently European economies with a tradition of providing STC to their workers during downturns boast unemployment rates vastly below the rates reported in the US. Although these are still short-term effects, given the nature of the crisis, we can expect these policies to produce a stable labor market as countries exit the lockdown and re-open their economies.

3. STC in recent US legislation

STC has recently received renewed attention from policymakers in the US. Under the expanded unemployment protection in the CARES Act, the federal government covers all payments made to workers under an STC program until December 31, 2020. This offered a strong incentive for states to promote the use of STC over conventional unemployment insurance as these benefits are not covered under the Act. However, as the discussion below shows, this incentive had no sizable effect on participation in the program. In addition to the benefits distributed under their state’s STC program, workers are also eligible for the full $600 per week payment provided under the Federal Pandemic Unemployment Compensation (FPUC) while on STC. Under these conditions a worker’s income under STC will almost certainly be higher than their full-time compensation. The expanded benefits under the Act thus would provide more than a replacement of lost wages. In the context of STC, the FPUC can be seen as a measure to stimulate economic activity by temporarily increasing the purchasing power of individuals who receive it, similar to the $1200 direct payment made to all individuals.

The HEROES Act passed in the House and recently introduced to the Senate would extend full federal funding for STC benefits until January 31, 2020. The CARES Act also provides incentives for states without STC to roll out a program. Per the Act the Treasury will fund half of the benefits distributed under a newly implemented STC program until December 31, 2020. The HEROES Act proposes to extend this date to January 31, 2021 as well.

The Paycheck Protection Program (PPP) of the CARES Act is another program intended to replicate some of the benefits of STC for workers employed by small and medium enterprises (SMEs). Although the program excludes large firms with 500 or more employees and/or revenue above $1mn, the program has the potential to affect employment outcomes for a large sector of the economy as 49.2 percent of private-sector jobs are provided by SMEs. The program, operated by the Small Business Administration (SBA), allows SMEs to obtain loans to cover payroll and other expenses. Initially loans would be forgiven by the federal government contingent on 75 percent of the funds being spent on payroll within eight weeks of the funds being received. A recent amendment to the program updated these requirements to allow small
businesses with large fixed costs beyond payroll to be eligible for loan forgiveness. Under the amendment loans are forgiven if 60 percent of the total is spent on payroll, the timeframe within which funds have to be used was extended to 24 weeks. If not forgiven, loans have a maturity of two years at 1 percent interest.

The program has been criticized for its generous terms and inability to allocate funds to the firms that needed it the most. Given the lack of restrictions to participate, the program became widely popular and exhausted its initial funding of $350 billion less than a month after it was launched on April 3. To allow the program to continue the Senate approved an additional $310 billion for the program.

As of May 30, the program has given out more than 4 million individual loans totaling over $510 billion. While the program prevented layoffs at a large number of SMEs, it did so at a high cost for the taxpayer - compared to a program that could have allocated funds to firms most likely unable to meet payroll without support. In order to be eligible, applicants had to certify in good faith that “current economic uncertainty makes [the] loan request necessary to support the ongoing operations of the Applicant.” In guidelines issued on May 13, the SBA announced that all loan applications with principal amounts below $2 million will be deemed to have been made in good faith, covering almost 80% of the outstanding balance as of May 30 or more than $400 billion. With eligibility not being contingent on declines in cash-flows or operating profit, the program provided funds to many businesses with the understanding that a large share of the total will not be paid back, the rest was provided loans under extremely generous terms.

4. STC use in the US

Data on STC claims in the US suggests that participation is more pro-cyclical than conventional unemployment claims with large increases in participation during downturns. Note also that there are strong seasonal fluctuations in unemployment claims while STC claims appear to be less tied to seasonal variations. With over 98,000 first claims in April 2020, STC programs experienced the largest participation in the programs’ history. In absolute terms, however, STC participation remains negligible relative to the size of the labor force. Initial unemployment claims reached 16.7mn over the same period. Given the low participation rate, there are no differences in unemployment rates in states with STC programs, compared to states that don’t have a program.

In the wake of the GFC, Congress passed the Middle Class Tax Relief and Job Creation Act of 2012. The Act was intended to promote adoption of STC programs across the country by providing states with various financial incentives to implement and expand their programs. As required under the act, the Labor Department produced a report in 2016 and identified various factors that explain low participation. Factors included in the report are:

1. “antiquated IT systems that cannot support STC automation efforts
2. lack of preparation to efficiently manage the spike in STC activity during the recession

4. STC use in the US

Data on STC claims in the US suggests that participation is more pro-cyclical than conventional unemployment claims with large increases in participation during downturns. Note also that there are strong seasonal fluctuations in unemployment claims while STC claims appear to be less tied to seasonal variations. With over 98,000 first claims in April 2020, STC programs experienced the largest participation in the programs’ history. In absolute terms, however, STC participation remains negligible relative to the size of the labor force. Initial unemployment claims reached 16.7mn over the same period. Given the low participation rate, there are no differences in unemployment rates in states with STC programs, compared to states that don’t have a program.

In the wake of the GFC, Congress passed the Middle Class Tax Relief and Job Creation Act of 2012. The Act was intended to promote adoption of STC programs across the country by providing states with various financial incentives to implement and expand their programs. As required under the act, the Labor Department produced a report in 2016 and identified various factors that explain low participation. Factors included in the report are:

1. “antiquated IT systems that cannot support STC automation efforts
2. lack of preparation to efficiently manage the spike in STC activity during the recession

4. STC use in the US

Data on STC claims in the US suggests that participation is more pro-cyclical than conventional unemployment claims with large increases in participation during downturns. Note also that there are strong seasonal fluctuations in unemployment claims while STC claims appear to be less tied to seasonal variations. With over 98,000 first claims in April 2020, STC programs experienced the largest participation in the programs’ history. In absolute terms, however, STC participation remains negligible relative to the size of the labor force. Initial unemployment claims reached 16.7mn over the same period. Given the low participation rate, there are no differences in unemployment rates in states with STC programs, compared to states that don’t have a program.

In the wake of the GFC, Congress passed the Middle Class Tax Relief and Job Creation Act of 2012. The Act was intended to promote adoption of STC programs across the country by providing states with various financial incentives to implement and expand their programs. As required under the act, the Labor Department produced a report in 2016 and identified various factors that explain low participation. Factors included in the report are:

1. “antiquated IT systems that cannot support STC automation efforts
2. lack of preparation to efficiently manage the spike in STC activity during the recession

4. STC use in the US

Data on STC claims in the US suggests that participation is more pro-cyclical than conventional unemployment claims with large increases in participation during downturns. Note also that there are strong seasonal fluctuations in unemployment claims while STC claims appear to be less tied to seasonal variations. With over 98,000 first claims in April 2020, STC programs experienced the largest participation in the programs’ history. In absolute terms, however, STC participation remains negligible relative to the size of the labor force. Initial unemployment claims reached 16.7mn over the same period. Given the low participation rate, there are no differences in unemployment rates in states with STC programs, compared to states that don’t have a program.

In the wake of the GFC, Congress passed the Middle Class Tax Relief and Job Creation Act of 2012. The Act was intended to promote adoption of STC programs across the country by providing states with various financial incentives to implement and expand their programs. As required under the act, the Labor Department produced a report in 2016 and identified various factors that explain low participation. Factors included in the report are:

1. “antiquated IT systems that cannot support STC automation efforts
2. lack of preparation to efficiently manage the spike in STC activity during the recession

4. STC use in the US

Data on STC claims in the US suggests that participation is more pro-cyclical than conventional unemployment claims with large increases in participation during downturns. Note also that there are strong seasonal fluctuations in unemployment claims while STC claims appear to be less tied to seasonal variations. With over 98,000 first claims in April 2020, STC programs experienced the largest participation in the programs’ history. In absolute terms, however, STC participation remains negligible relative to the size of the labor force. Initial unemployment claims reached 16.7mn over the same period. Given the low participation rate, there are no differences in unemployment rates in states with STC programs, compared to states that don’t have a program.

In the wake of the GFC, Congress passed the Middle Class Tax Relief and Job Creation Act of 2012. The Act was intended to promote adoption of STC programs across the country by providing states with various financial incentives to implement and expand their programs. As required under the act, the Labor Department produced a report in 2016 and identified various factors that explain low participation. Factors included in the report are:

1. “antiquated IT systems that cannot support STC automation efforts
2. lack of preparation to efficiently manage the spike in STC activity during the recession

4. STC use in the US

Data on STC claims in the US suggests that participation is more pro-cyclical than conventional unemployment claims with large increases in participation during downturns. Note also that there are strong seasonal fluctuations in unemployment claims while STC claims appear to be less tied to seasonal variations. With over 98,000 first claims in April 2020, STC programs experienced the largest participation in the programs’ history. In absolute terms, however, STC participation remains negligible relative to the size of the labor force. Initial unemployment claims reached 16.7mn over the same period. Given the low participation rate, there are no differences in unemployment rates in states with STC programs, compared to states that don’t have a program.

In the wake of the GFC, Congress passed the Middle Class Tax Relief and Job Creation Act of 2012. The Act was intended to promote adoption of STC programs across the country by providing states with various financial incentives to implement and expand their programs. As required under the act, the Labor Department produced a report in 2016 and identified various factors that explain low participation. Factors included in the report are:

1. “antiquated IT systems that cannot support STC automation efforts
2. lack of preparation to efficiently manage the spike in STC activity during the recession

4. STC use in the US

Data on STC claims in the US suggests that participation is more pro-cyclical than conventional unemployment claims with large increases in participation during downturns. Note also that there are strong seasonal fluctuations in unemployment claims while STC claims appear to be less tied to seasonal variations. With over 98,000 first claims in April 2020, STC programs experienced the largest participation in the programs’ history. In absolute terms, however, STC participation remains negligible relative to the size of the labor force. Initial unemployment claims reached 16.7mn over the same period. Given the low participation rate, there are no differences in unemployment rates in states with STC programs, compared to states that don’t have a program.

In the wake of the GFC, Congress passed the Middle Class Tax Relief and Job Creation Act of 2012. The Act was intended to promote adoption of STC programs across the country by providing states with various financial incentives to implement and expand their programs. As required under the act, the Labor Department produced a report in 2016 and identified various factors that explain low participation. Factors included in the report are:

1. “antiquated IT systems that cannot support STC automation efforts
2. lack of preparation to efficiently manage the spike in STC activity during the recession
The findings suggest that both operational and communication issues prevent more participation in STC programs. Since STC claims require a weekly review of employee-level data on hours worked, programs can’t reach an appropriate scale if processes are not automated. As of 2016, some states still relied on paper systems to review claims. Combined with a shortage of staff in charge of STC claims, these shortcomings constitute obvious barriers to reaching a scale sufficient to provide the benefits European countries are currently experiencing under their programs.

Beyond operational issues, STC programs suffer from the fact that many employers are not familiar with the program. This is accentuated by the fact that STC programs do not have a nationally recognized brand as states use different names for their programs such as Shared Work or Workshare. A survey among employers in four states with STC programs shows that while around 95 percent of non-STC employers are familiar with unemployment benefits, most are not aware of their state’s STC program. In the four states surveyed, between 28 and 54 percent of employers were aware of the STC program in their state.

In May, the BLS reported a national unemployment rate of 13.3, indicating that, as restrictions on business activity are lifted, the labor market is on the road to recovery. Meanwhile European countries that made extensive use of STC over the past months appear to weather the downturn without significant layoffs, paving the way for a swift recovery. The early evidence from many countries suggests that STC policies were able to reduce the effects of the pandemic on labor
Monthly initial STC claims and unemployment rate

Source: BLS

Monthly initial UI claims and unemployment rate

Source: BLS
market outcomes. However, further analysis of STC programs during the downturn will be necessary to provide a definitive answer. In the US, the experience of the last months could encourage policymakers to renew the effort started in the wake of the GFC, to promote STC programs as an alternative to conventional unemployment benefits during economic downturns.

In May, the BLS reported a national unemployment rate of 13.3%, indicating that, as restrictions on business activity are lifted, the labor market is on the road to recovery. Meanwhile European countries that made extensive use of STC over the past months appear to weather the downturn without significant layoffs, paving the way for a swift recovery. The early evidence from many countries suggests that STC policies were able to reduce the effects of the pandemic on labor market outcomes. However, further analysis of STC programs during the downturn will be necessary to provide a definitive answer. In the US, the experience of the last months could encourage policymakers to renew the effort started in the wake of the GFC, to promote STC programs as an alternative to conventional unemployment benefits during economic downturns.

References:


Guipponi, Landais, “Building effective short-time work schemes for the COVID-19 crisis” Vox EU. April 2020


Greenwald, “Here’s Why Adding Billions More to the Second Round of PPP Won’t Fix It” Medium. April 2020

Pandemic catalyzes transition to cashless benefits

By Corey Runkel

Original post here.

Health concerns and the sudden implementation of economic shutdowns have caused many countries to expedite or expand transitions to the cashless administration of government benefits in order to make their support efforts as effective as possible. Cashless supports for individuals offer speed, security, and availability that far outperform cash in combating the COVID-19 pandemic, given its unique circumstances. In some countries, increased adoption of cashless technology is an escalation of previously-announced long-term policy goals. Other governments have expedited the transition from cash-based systems to digital payment capacities.

In this post we discuss examples of countries that have used digital payments in their responses to the Ebola epidemic in 2014 and now the COVID-19 pandemic.

Sierra Leone: Lessons from Ebola

While payment systems in most countries progress from cash to bank-cards to mobile money, many Sub-Saharan African governments have leapfrogged card-based solutions in favor of mobile interventions.

According to a World Bank survey, 27 of the 35 countries with the highest portion of mobile money account holders in 2017 were in Sub-Saharan Africa. Sierra Leone ranked 35th on the list, with 11% of adults holding mobile money accounts. The country had aggressively promoted mobile transactions. It issued its first mobile money guidelines in November 2015. At the time, only 4% of adults reported having a mobile money account, but the country had a 90% mobile phone penetration rate and 5,000 mobile-to-cash agents. This enabled the government’s campaign.

The campaign was also prompted by, and a corollary to, a successful effort undertaken a year earlier by healthcare authorities to quickly set up a decentralized mobile payments system for emergency response workers when the country suffered an Ebola outbreak in 2014 (see pp. 20-21). The effort responded to extraordinary hiring and retention needs, which were made more difficult by a payment system rife with delays and fraud.

On top of reducing contact risks, the digitized system cut payroll delivery time from a month to a week, and spared the virus response an estimated 800 lost healthcare work days due to strikes that had occurred early in the outbreak. The success of Sierra Leone’s intervention depended on prior acceptance of the new media of exchange, its easy convertibility into and out of cash, and a strong government initiative.
A UN-sponsored report concluded that the effort was very successful:

“Sierra Leone was also able to substantially improve the security, transparency, and efficiency of paying Ebola Response Workers [and] also generated major cost savings, compared to the expense of moving cash around during an extremely dangerous time in the country. The combination of these two benefits – saving lives and saving money – stands as a remarkable achievement in the humanitarian field” (p. 6).

The report concluded that Liberia and Guinea, the other two countries hardest hit by the Ebola outbreak, were less successful for various reasons: lower penetration of cell phones, underdeveloped mobile payment networks, and high fees during the conversion to and from cash (p. 21). The contrast among these neighboring countries underscores two factors important to successful digital transitions: existing communications infrastructure and well-integrated payment systems. The UN report urged countries to invest in infrastructure in normal times to be ready for a crisis.

**Responses to COVID-19**

In the COVID-19 crisis, the immediate problem governments face is to safeguard the health of benefits recipients and administrators in an environment where social contact is limited by necessity.

The pandemic has led governments to swiftly roll out payments to individuals to mitigate the effects of economic lockdowns. In many countries, lockdowns have a particularly negative impact on lower-income populations, who are less likely to be able to work remotely or rely on savings to cover essential costs. They are also less likely to have bank accounts than richer populations, which makes it difficult for governments to deliver benefits quickly without resorting to physical cash. As a result, countries have had to contend with an extra burden: those who receive government-to-person (G2P) payments are rarely at the forefront of medium-of-exchange developments.

Many governments that have been stymied by public demand for cash (Fig. 1, panel 2) are taking advantage of the crisis to aggressively improve their distribution systems. Bank Indonesia, for instance, has rolled out prepaid cash cards for food assistance programs. Meanwhile, states that had card-based systems in place are upgrading to mobile platforms. For example, some of Brazil’s G2P payments, which have been distributed by prepaid debit cards, are beginning to migrate to the Federal Revenue Service’s CPF app, which could serve as the primary contact point both for benefits and the collection of taxes (P2G).

**Indonesia: Accelerating from cash to debit**

Ineffective government administration of benefits can undermine the public-health response to the crisis. Cash distribution presents problems for countries combatting COVID-19 because recipients must travel to, and gather in, the relatively few places where government officials are
located. Cash can then change hands multiple times in the distribution chain. This problem is particularly visible in Indonesia, where 2017 World Bank data show that 36% of those receiving government payments received them in cash alone.

World Bank data suggest that the government has already had some success in changing how Indonesians deal with their money prior to COVID. From 2014 to 2017, the portion of recipients who received G2P payments into a bank account jumped from 23% to 41%, with nearly half of recipients opening their first bank account in order to collect such payments. In 2019, Bank Indonesia committed to digitizing the government’s welfare schemes to increase efficiency and transparency.

Figure 1. The Bank for International Settlements has followed the digital transition extensively, including in this June report. CPMI countries refer to members of the Committee on Payments and Market Infrastructures; its membership overlaps closely with the G20.

COVID accelerated such efforts. On April 14, 2020, the central bank announced that it would be “expediting the electronification of relevant social programs, including the Family Hope Program (PKH), Noncash Food Assistance Program (BPNT), Pre-Employment Card and Smart..."
Indonesian Card (KIP)” in order to “mitigate the COVID-19 impact.” More ambiguously, the central bank on April 14 said it was committed to “increase the uptake of non-cash instruments.” This language reflected the reality that, for card-based benefits to be successful, merchants must also accept the cards. Unless merchants adopt the cards as a medium of exchange, upgrading the G2P technology will only shift where cash is distributed rather than replace its usage. In other words, recipients will just use the cards to get cash. In 2017, only 11% of Indonesians used a debit card to make purchases, even though 31% owned a debit card (Fig. 2). These two facts suggest that Indonesians use their cards primarily to access ATMs for cash rather than as media of exchange. While cards may allow for more frequent and geographically dispersed access to funds, without widespread acceptance they may not do much for the health of recipients.

**Adoption trends in various media of exchange, 2014-2017**

![Adoption trends chart](image)

Figure 2. Popularity of various media of exchange in several countries.

**United States: Bridging a digital divide**

One recent incident in the United States demonstrates the practical implications of the challenges described above. KeyBank, as unemployment vendor to the New York State Department of Labor, provides approximately 500,000 citizens with benefits by prepaid debit card (80% of recipients receive direct deposit into bank accounts). For days in May and June, as the city was just reopening from the lockdown, lines to withdraw unemployment funds stretched a full block at New York City’s lone KeyBank ATM. Individuals chose to stand in lines for hours where social distancing was not always observed, to avoid withdrawal fees or transaction limits at more
convenient non-KeyBank machines. Some said they did not know that they could have withdrawn funds at more than 1,000 ATMs throughout the city, although such information was available on the KeyBank’s website.

The situation served as a lesson about how isolated solutions may do little to address the complexity that medium-of-exchange adoption presents. Though the US has high rates of card acceptance at businesses, World Bank data show that slightly more low-income Americans typically borrow from friends or family -- where transactions likely take place in cash -- than from a financial institution. Without more robust usage of person-to-person (P2P) payment options, transitioning G2P payments from an ultimate cash dependence will prove difficult.

So, in a country where only 56% of low-income adults accessed a financial account over the Internet in 2017, cards retain their position as medium of choice due to the speed of distribution (relative to checks) and wide acceptance (relative to mobile money).

At the federal level, the US Treasury made the vast majority of one-time Economic Impact Payments (EIPs) via direct deposit into recipients’ bank accounts. But the US Treasury also issued nearly 4 million Economic Impact Payments by prepaid debit card. The Treasury allowed recipients to choose between the cards and paper checks, which can take weeks to process and deliver. Another primary mode of delivery has been Direct Express card accounts, debit cards used for Social Security payments and a variety of benefits for current and former federal employees. (A previous YPFS blogpost covered the one-time EIP transfers to eligible tax filers, which have so far totalled $290 billion of CARES Act-approved funds.)

The IRS says that collection of bank information in the first round of stimulus will help should more payments be issued, but repeat issuances may not be the largest problem. A Center for Budget and Policy Priorities study estimated that 12 million Americans have not received a stimulus check since they did not have banking or mailing information on file, a symptom of both ineligibility for [non-pandemic] federal welfare programs and not filing taxes with the IRS. These people can receive their payments if they file a form online, providing deposit information and an email address.

But filing this form will be a barrier for many since reliable Internet access is a problem for low-income Americans, a fact illustrated by the number of New Yorkers who were unaware of the surcharge-free ATM network. As of 2018, at least 29 million Americans lacked both broadband and a smartphone, according to Pew Research survey estimates and the Social Security Administration. Digital exclusion often overlaps with the “unbanked,” which the FDIC defines as those lacking a financial institution account. The Federal Reserve estimates the unbanked comprise 14% of Americans making less than $40,000 annually. Another 21% are “underbanked” (Table 11), meaning they have an account but also use unregulated services such as payday loans. The un- and underbanked are more likely to have disabilities, lower education attainment, and are less often white or Asian-American (Table 3.3) — in other words, the same population that often qualifies for government benefits (Table 1).
To address the needs of Americans with diverse financial and technological access, these cases have shown how important it may be to use a constellation of payment systems. For those with smartphone access, mobile payments apps Venmo and Cash App announced in May that tax filers and non–tax filers alike would be able to receive CARES Act stimulus payments from the IRS through their apps. Both apps allow users to join without linking to any bank and to transfer funds instantly to another user or vendor. This change edges the US closer to Sub-Saharan governments such as Sierra Leone, which, while much less financialized, have the highest adoption rates of mobile money accounts, five times the World Bank average.

**India: Millions to provide for**

India’s national transition to digital systems began 11 years ago with the introduction of the Aadhaar national identification system. The system facilitates security by verifying the identities of those using the system, and has already saved India billions of dollars by eliminating fraudulent payments. Digital payment systems built using Aadhaar have grown during the pandemic to process 60 million transactions a day (Fig. 3), and connect more than 150 banking partners.

But, as with much of India, digital payments are a study in contrasts. The country faces administrative difficulties reaching its poorest populations. Its food ration system for internal migrant workers has traditionally operated only within one’s home state. The home-state limit caused huge problems for the estimated 10 million migrant workers, stranded across India by the country’s COVID lockdown, who had neither income nor rations. Migrant workers then sparked India’s largest exodus since the 1947 Partition to return to families and claim benefits.

On May 12, the Indian Ministry of Finance announced an aggressive expansion of its pilot cashless ration delivery service, the One Nation, One Ration card, as an attempt to distribute food to migrant workers. By August, the pilot program will allow recipients with a ration card to access grain rations in 23 states, potentially covering some 670 million recipients or 83% of the program’s beneficiaries. The program uses the Aadhaar network to verify identities at the 500,000 government-run shops that distribute rations. The expectation is that the program will be available nationwide by January 2021, ahead of its original target date. Here, cashless distribution dovetails with internal freedom of mobility under India’s continuing project of integration as the country attempts to span 36 administrative divisions and 447 languages.

The security and control over the money supply afforded by a nationally run digital payment system will be very important to India. In 2016, Prime Minister Narendra Modi attempted to suddenly demonetize the country’s currency in order to crack down on counterfeit bills. The project failed as the central bank reported 99% of value returned to the new bills in circulation, and upended innumerable transactions in cash-loving India. Digital currencies offer improved security against counterfeiting, and provide the detailed data that cash cannot. Additionally, it may allow the country to more strictly enforce taxation as incomes and revenues would be easier to track as they are linked through the Aadhaar network.
Brazil: Using the crisis to fuel adoption of other technologies

A similar story is playing out in Brazil, where mobile payments of government benefits grew 22% by volume in the first four months of 2020. The government has long used prepaid debit cards to deliver benefits (p. 13), but the verification service for such benefits remains unreliable. In April the government released the CPF app, which builds on the country’s year-old national identification framework to facilitate two-way transfers between the Federal Revenue Service and individuals and replace the face-to-face interactions aborted due to COVID.

The release takes advantage of the crisis to introduce what the Secretary says may slowly become a primary interface between the federal government and citizens, providing a platform for the government to send benefits and for citizens to send taxes. This comes ahead of the central bank’s roll out in November of its Pix instant payment platform, which has already secured participation from more than 1,000 banks and merchants.

Conclusion: a variety of problems prompt a variety of tools

Despite significant medium-of-exchange developments, government benefit distribution has remained inferior for governments that continue to rely on cash payments. The Ebola epidemic and COVID-19 pandemic highlighted these disadvantages and propelled public health concerns over the distribution of cash to the forefront of administrative concerns. Pressed by short- and long-term policy goals, governments have taken ambitious steps toward cashless benefits.
administration. They have succeeded in expanding benefits delivery options, but have yet to persuade citizens into switching voluntarily. The reasons these transitions have been difficult are the same as they have been for decades: low general acceptance of cashless media of exchange; limited access to technological advances; and a reliance on informal financial markets.

These governments’ prospects for success in providing healthier, more effective relief than hard currencies therefore depend on current levels of digital financial integration, the accessibility of such technologies to the unbanked, and levels of general financialization. While some of the interventions are card-based, several countries have used the pandemic to push for the adoption of e-commerce and mobile payment systems. (A previous YPFS blogpost surveyed how these have worked for small businesses.) Governments that have authorized private-sector partners have succeeded, but have had to build systems — public goods such as India’s Aadhaar network and Brazil’s CPF platform — that facilitate interoperability and spur adoption.

If and when governments persuade citizens to switch their means of payment, digital payment systems offer long-term benefits to countries that successfully integrate them. These come in addition to the resilience that future emergencies will require. Often, the very process of integration creates opportunities to link other, non-financial systems that can support policy goals. Singapore’s PAssion card has enabled it to target specific industries and classes of citizens. In this respect, the PAssion card is a scalpel to the Paycheck Protection Program’s knife, supporting precisely the individuals and sectors that need it most.

In monetary policy, central banks have started to seriously consider central bank digital currencies. CDBCs would be money as much as bills or coins are today, rather than just a medium of exchange. Its status as money would mean that CDBCs could be distributed virtually immediately, realizing Milton Friedman’s famous helicopter drop thought experiment.

Conversely, digital payments have also enabled funds to flow from citizens to treasuries. A 300,000 person municipality in Senegal saw sevenfold growth in their tax collections when they transitioned to digital (p. 7). Senegal’s public sector has led the private sector in its digitization efforts, and intra-government payments reached 100% digitization in 2016 (p. 4). Indirectly, these transitions can also cut the size of the informal sector, meaning that more transactions can be tracked for excise taxes (Fig. 4).

However, a significant informal sector may resist these changes. Citizens may be wary of the level of control and feedback afforded by digital payments and the identification backbones on which they operate, especially when low levels of trust exist in government. But the private sector has its own troubles in novel possibilities for fraud (§2.2) and data harvesting by private payment vendors.

The cost-benefit tradeoff to welfare recipients and governments could be worthwhile. As they work to roll out digital systems, government investment may end up leading the transition away from their own hard currencies.
Digital payments create a data trail, bringing both risks and benefits

Views on data privacy differ across and within societies.\(^1\)

The informal economy is smaller where digital payments are more widely used.\(^2\)

\(^1\) Based on a survey of 27,000 individuals across 27 countries. The exact question reads: “I would be comfortable with my main bank securely sharing my financial data with other organisations if it meant that I received better offers from other financial intermediaries”. For Belgium, the figure covers Belgium and Luxembourg. The dots visualise the percentage of respondents answering the question affirmatively. EMEA = Europe, the Middle East and Africa. \(^2\) Data as of 2017. \(^3\) Estimates of the informal (“shadow”) economy based on a multiple indicator–multiple cause approach.


© Bank for International Settlements

Figure 4. Differing views on data privacy and the significance of the informal sector may hamper digitization efforts by governments. Figure also from BIS report.
Case Studies and Policy Changes

EU Proposes Support for Short-Time Work Schemes
By Mallory Dreyer

Original post [here].

On April 2, the European Commission (EC) announced a proposal to extend loans to Member States to preserve employment. The Support to Mitigate Unemployment Risks in an Emergency (SURE) initiative would provide loans to Member States to support the creation and expansion of short-time work schemes. It is meant to act as a “second line of defence” to back up Member States’ increased public expenditures. The Council of the European Union (EU) must vote on the SURE proposal before it can take effect.

The SURE initiative would complement the European Union Solidarity Fund (EUSF). The EU established the EUSF in 2002 to aid Member States when large-scale disasters occur, and its scope was recently amended to incorporate large-scale public health emergencies such as the COVID-19 pandemic. The EUSF is a permanent facility that provides grants, while the SURE initiative would be a temporary program that provides loans. The SURE initiative joins a series of proposals under the umbrella of the Coronavirus Response Investment Initiative (CRII) which the EU announced on March 13 and implemented on April 1. The CRII allows Member States to benefit from more financial support and targeted assistance particularly in the most exposed sectors, such as healthcare, small businesses, and labour markets; and the most affected territories in Member States and their citizens.

Under the SURE proposal, the EU would extend loans to Member States to help cover costs directly related to the creation or extension of national short-time work schemes and similar measures for the self-employed. Short-time work schemes allow companies experiencing economic difficulties to temporarily reduce hours of, or lay off, employees while the employees receive income support from the government for hours not worked. The SURE initiative would make up to EUR 100 billion in loans available and would be backed by EUR 25 billion in voluntary guarantees from EU Member States. The EC would be authorized to borrow on the capital markets or with financial institutions on behalf of the EU to fund the program. The United Kingdom will not participate in the SURE initiative as it has left the EU.

The German short-time work scheme, Kurzarbeit, is one of the oldest such programs in Europe, with roots back to 1910. Short-time work schemes gained popularity and widespread adoption in response to the Global Financial Crisis (GFC), as countries, including the Czech Republic, Hungary, Mexico, the Netherlands, New Zealand, Poland and the Slovak Republic, created new short-time work schemes. Other countries, such as Denmark, France, Italy, Japan, and Spain, operated short-time work schemes prior to the GFC. In Germany during the GFC,
more than 1.4 million individuals received income support. The OECD credits the German program with preventing unemployment for nearly 500,000 individuals.

Evidence suggests that short-time work schemes prevent layoffs and enable employers to adjust workers’ hours in response to an economic downturn. Short-time work schemes can promote equity in the labor market, as the burden of adjustment is shared more equally across the workforce. Short-time work schemes also promote labor market efficiency, as they prevent temporary downturns from destroying efficient labor market allocation. These programs allow employers to retain valuable staff and maintain relationships during the downturn. An OECD analysis concludes that short-time work programs used in response to the GFC had significant positive effects, and that countries without such programs could benefit from their introduction.

However, some note that short-time work schemes could lead to labor market distortions and inefficient allocation of labor in the long run. If such programs remain in place indefinitely, workers may not have an incentive to move to more productive firms. During the COVID-19 crisis, when many companies have been forced to close due to exogenous circumstances, there is less concern about inefficient allocation of labor.

In response to the COVID-19 crisis, countries with existing short-time work schemes are seeing an increase in uptake. Between March 1 and March 27, 2020, 470,000 companies applied for the program in Germany, under which the government covers 60% of lost wages and 67% for those with children. Denmark announced a wage subsidy program on March 14, 2020, and over 11,000 companies applied by March 30, 2020. Only employees who do not work are eligible for the Danish program, which covers 75% of wages for salaried employees and 90% of wages for hourly employees, up to DKK 30,000. In Sweden, employees will receive 90% of their wages. The chômage partiel (partial unemployment) program in France, reimburses 84% of net earnings for employees of companies who reduce or stop operations due to exceptional circumstances. As of April 1, 2020, the Labour Minister in France said that 1 of every 5 employees is on chômage partiel due to the COVID-19 crisis.

Despite increased usage of short-time work schemes, features vary, including eligible reductions in work hours, percent coverage of lost wages, and duration. Many programs protect employees from dismissal, requiring employers to retain the employees while receiving the benefit and for a set period after.

If the SURE proposal is approved, Member States will be able to request financial assistance from the European Commission to support short-time work schemes and assistance for the self-employed.
Korea Announces New Deal Budget Proposal Aimed at Developing its Post-COVID Economy

By Pascal Ungersboeck

Original post here.

The Korean government recently released a new proposal to increase the 2020 budget to promote recovery following the economic shock caused by the COVID-19 pandemic. The proposal intends to promote economic growth and employment over the next few years. Total support is valued at KRW 35.3 trillion ($29 billion), funded through debt issuance (67 percent), restructuring spending and prioritizing the measures outlined in the bill above other government expenses (29 percent) and borrowing from social security funds (4 percent).

The current proposal is the third request for increased support submitted by the Korean government since the onset of the COVID-19 crisis. The first stimulus package of KRW 11.7 trillion was unveiled on March 4, followed by a second proposal for KRW 7.6 trillion on April 16. The first two bills were passed within 15 and 20 days of their respective proposal. As of June 22, the current proposal has not officially passed.

While the first two packages were meant to support “disease control efforts, as well as to help businesses and local economies affected [by the pandemic]”, the current proposal is focused on recovery. It is one of the first country post-pandemic plans to be announced. President Moon Jae-in placed the proposal in the context of an ongoing effort to strengthen the Korean post-recovery economy by creating 550,000 new jobs and spending KRW 31 trillion through 2022 when he leaves office. The plan is to spend an additional KRW 45 by 2025 for total support of KRW 76 trillion ($62 billion) through 2025. The government has said that it will provide more details in July.

The current proposal includes KRW 23.9 trillion in new spending towards this effort. The funds will serve to support workers, businesses and promote further development of the Korean COVID-19 response model as a global standard. In addition, the proposal provides for a KRW 11.4 trillion revenue adjustment. This post discusses the use of the KRW 23.9 trillion of new spending allocated under the proposal:

- KRW 5 trillion to marginal firms and promote job retention
- KRW 9.4 trillion to improve job security and expand social safety nets
- KRW 3.7 trillion to boost consumption, exports and local economies
- KRW 5.1 trillion for the Korean New Deal
- KRW 2.5 trillion to further develop and promote the Korean Covid-19 response model
(The bill states that there will be KRW 23.9 trillion in new spending, however, the stated itemized parts amount to KRW 25.7 trillion.)

Although, unlike many countries, Korea did not experience a large increase in unemployment during the pandemic, support for workers in the proposal includes measures designed to fight unemployment, including funding for job retention programs, improved job security and expanded social safety nets. In May, the unemployment rate stood at 4.5 percent, up from 3.3 percent in February. The shock to the labor market was contained to a small sector of the Korean economy as the government did not implement a general lockdown policy to contain the spread of the virus.

Under the new budget proposal, job retention efforts are focused on the provision of emergency funds for businesses with a special focus on small and medium-sized enterprises (SMEs), an approach similar to the Paycheck Protection Program implemented in the US. This includes KRW 1.9 trillion to finance the KRW 40 trillion emergency fund for SMEs established in March. The fund, which provides government guarantees of loans to SMEs, had also been included in the two previous funding bills. Other support for workers includes KRW 8.9 trillion to “expand wage support to help businesses retain jobs and create over 550,000 jobs,... including remote jobs and digital jobs for young adults.” Some critics have suggested that many of these positions will be temporary and called for the creation of more sustainable jobs. Finally, the proposal provides KRW 500 billion to expand “social safety nets, such as by increasing household emergency reliefs, microcredit and affordable housing.” These measures also include plans to support workers left out of the employment insurance system by expanding job safety to all workers.

Businesses will benefit from the proposal through increased investment. The proposal provides KRW 3.1 trillion to an emergency fund for key businesses in the “airline, automobile, shipbuilding, maritime shipping, machinery, power and communications” industries. Additional funds are provided to support corporate bond purchase programs established previously. The government also allocated a share of the funds for direct investment in domestic firms, specifically reshoring incentives and support to Korean exporters.

The proposal also provides for KRW 5.1 trillion for the Korean New Deal, including a Digital New Deal, Green New Deal, and various employment protection measures discussed above.

The Digital New Deal focuses on supporting the implementation of a 5G network throughout the country and promoting the use of artificial intelligence by businesses. The government also intends to increase investments in digital infrastructure, including “[setting] up high-speed internet in remote villages and WiFi in public facilities” as well as “[improving] public administration networks with 5G and cloud computing.” Digitizing all public schools and creating 100,000 new AI and software jobs are also part of the plan, which has at its core digitizing the provision of services and facilitating working remotely. COVID has provided the opportunity to jump-start these initiatives, which dovetail with previously announced projects.

Finally, the government expects to spend KRW 2.5 trillion “on further developing the [Korean] COVID-19 response model.” Specifically, officials wish to establish the country’s test, trace and treat formula, known as the 3T COVID-19 response model, as a global standard. The country’s methods, which relied heavily on wide-spread testing, contract tracing, emergency text messaging and face coverings, succeeded in helping it flatten its curve quickly and avoid the broad-based economic lockdowns that other countries implemented. To date, South Korea has recorded only 12,400 cases and 280 deaths — far less than most other developed countries of any size.
Debate over new stimulus plan continues as unemployment benefits near expiration

By Natalie Leonard

Original post here.

On July 20, the Senate reconvened after a two-week hiatus and one topic is “front and center:” extending the COVID-19 stimulus.

Many provisions of the CARES Act, signed on March 25, are set to expire July 25. With their expiration will go a number of costly but impactful economic stimulus programs, including the $600-per-week federal addition to state-provided unemployment benefits for laid-off workers. With more than 32 million Americans on unemployment, new daily coronavirus cases reaching new heights, and 32% of renters missing July rent payments, America’s second wave of COVID-19 is likely to stall re-opening plans and deepen the economic effects of the pandemic.

What won’t expire?

While the July 25 expiration date will impact a number of economic programs, a few programs will persist. This includes the CARES Act expansion of unemployment insurance (UI) benefits to typically excluded groups, including part-time workers and sole proprietors. Additionally, CARES act provision that extends the length of UI benefits, from the typical period of 13 weeks to at least 39 weeks, will continue for all workers laid off during 2020. All states but South Dakota have also enacted Extended Benefits (EB) that add an additional 13 weeks to UI when the unemployment rate exceeds 5.9%. Between typical state UI programs, the federal add-on, and Extended Benefits, all states have benefits lasting at least 30 weeks, and many states’ programs exceed 50 weeks.

The CARES Act also paused payments for student loans, setting interest rates to 0%. This moratorium on interest accrual and loan repayment is set to expire on September 30.

What are House Democrats pushing for?

The House, led by Democrats, passed its own extension bill on May 15, titled the HEROES Act. The $3 trillion stimulus bill expands on the CARES Act. Highlights include:

- $1 trillion set aside for local and state governments;
- One-time stimulus check of $1,200 per person earning less than $75,000 or $2,400 for a couple filing jointly earning less than $150,000, and an additional $1,200 per dependent (up to 3 dependents);
- Extended federal unemployment add-on of $600 through January 2021;
- $200 billion for hazard pay for front-line workers;
• $100 billion for rental assistance, and $75 billion for mortgage assistance, on top of a year long foreclosure and eviction moratorium;

• Modifications to remaining PPP funds, requiring 25% be reserved for small businesses with fewer than 10 employees. It will also relax the requirement that 60% of funds be used for payroll purposes;

• Extension of student loan suspension for another year through September 30, 2021.

Senator Mitch McConnell dismissed the House bill as a “liberal wish-list.” This YPFS blog further discusses the HEROES Act.

What will Senate Republicans propose?

While the Senate hasn’t reconvened yet, there is some information circulating about what Republicans will likely include in their counter-proposal coming from Senator McConnell, Economic Advisor Larry Kudlow, and Secretary Steve Mnuchin.

• Cost

The GOP proposal will likely have a much smaller price tag, somewhere around $1 trillion, with smaller benefits.

• Expanded UI benefit

According to various news reports, GOP senators are pitching a $200 to $300 weekly UI enhanced benefit, capped at 100% of a recipient’s previous wage in order to avoid any disincentive to return to work. The expanded unemployment benefit has long been controversial for GOP senators. A University of Chicago paper found that “two-thirds of UI eligible workers can receive benefits which exceed lost earnings and one-fifth can receive benefits at least double lost earnings.” The new bill might also include a back-to-work bonus to offset work disincentives of increased unemployment benefits.

Detractors of the enhanced UI benefits estimate that “the U.S. economy has lost 1 million to 2 million jobs” from work disincentives, while supporters argue that the suspension of the benefits, which constitute four percent of GDP on an annualized basis, would stunt the already sluggish economic recovery. A group of top former policymakers and economists, including former Treasury Secretary Timothy Geithner, supports a reduction in the weekly federal subsidy from $600 to $400.

• One-time stimulus checks

The GOP bill will likely include a one-time stimulus check, but with a reduced amount and a strict income cap of $40,000.

• Liability protection
Senator McConnell has promised that COVID-19-related liability protection for nurses, businesses, colleges, and K-12 schools will “be in any bill that passes the senate.” The current proposal involves retroactive protection for these entities from 2019 to 2024. The 2024 date may be a sticking point.

- Payroll tax reduction

President Trump has long been demanding a payroll tax reduction, telling GOP senators that he will not sign any bill that does not have the provision. Neither party has supported the President’s proposal on this.

- State and local funding

Funding for state and local governments, which are facing severe budget shortfalls due to the effects of COVID-19, will likely be included in the GOP’s proposal. However, sources indicate that federal dollars might be tied to schools reopening this fall, a point the President has pushed for.

**What can we expect from the new bill?**

At this point, it’s uncertain what a new stimulus bill will contain. However, with COVID-19 cases surging, Republican leaders in the Senate have acknowledged the need for an extensive stimulus package. Reports indicate that it is likely a final bill will include direct payment to individuals below a strict income line, support for local and state governments, and some expanded unemployment benefits program.
Cross-country Comparison of Economic Outcomes and Policy Responses to Support Individuals in June

By Pascal Ungersboeck

Original post here.

Since March, countries around the globe have implemented policies to support individuals and households through the downturn that has resulted from the global COVID-19 pandemic. Over the last five months countries have implemented different economic policies in response to various stages of the pandemic. Based on the YPFS four-phase model of the economic consequences of the pandemic, Run-Rescue-Recession-Recovery, this blogpost discusses different policy trajectories and economic outcomes for countries at different stages of the pandemic, with a focus on support to individuals.

The first part of this post discusses countries, such as Austria, South Korea, Germany, and Hong Kong, that have been able to rapidly reduce the rate of infection and control the spread of the virus. As they lift many of the public health measures that were put in place, these countries currently aim to transition to the final phase, recovery, by implementing measures to boost aggregate demand and stimulate the economy. Policymakers in these countries currently face the challenge of returning the economy to pre-crisis levels of productivity while balancing public health objectives and avoiding a new wave of infections.

The second part of this post focuses on two South American countries experiencing significant pandemic activity, Chile and Peru. In both countries, the rate of infection has recently peaked and most public health measures remain in place, shuttering much non-essential activity. These countries are in the recession phase and policies are currently focused on extending previously implemented measures to offer support to individuals in order to stabilize the economies as the pandemic persists and economies are not yet ready to fully reopen.

Finally, the post provides a brief discussion of next steps for policy in the US. As the rate of infection in the country continues to rise and support measures implemented in the CARES Act expire in July, the country faces increasing pressure to extend support beyond the measures implemented in March.

Recovery in Asia and Europe

Korea and Hong Kong were among the first countries affected by the virus and the first countries to contain the rate of infection. New infections peaked in early March in Korea and late March in Hong Kong. Both countries managed to control the spread of the disease without the costly lockdown measures implemented in other countries.

Despite the absence of explicit lockdown measures, however, their economies suffered from depressed demand as a result of social-distancing requirements. For both, this translated into the highest levels of unemployment in a decade. Although unemployment rates in both countries
remained low compared to other countries, the policy responses in Hong Kong and Korea included a set of measures to promote employment protection, job creation, and support to vulnerable workers and households.

Korea’s most recent support program, announced in early June and adopted on July 3, was the country’s third budget increase in response to the pandemic, valued at KRW 35.3tn ($29.4bn and 1.8 percent of GDP). The first package was passed on March 17 and offered funding for disease control measures while also providing support to vulnerable households through direct payments and expanded unemployment support. Direct support was provided through vouchers and gift certificates issued to low-income households while unemployment support focused on job retention through wage subsidies. The second bill, passed on April 30, included funding for emergency support to households in lower income brackets. The three packages together amount to KRW 54.6tn ($45.4bn and 3.4 percent of GDP).

The June recovery package, labelled the Korean New Deal, focuses on boosting the labor market and promoting recovery. It contains a broad range of measures to promote job retention through wage support and funding for small and medium-sized enterprises. Unlike previous bills, the most recent package also includes funding to promote job creation (see the YPFS blog post). Although short, the shock to the Korean labor market was severe, with 467,000 jobs lost in April, the largest monthly decline since the Asian Financial Crisis. Unemployment in Korea stood at 4.5 percent in May.

Similarly, beginning in March, Hong Kong implemented a number of measures to support the most affected households and boost the depressed labor market. At 5.9 percent for the period between March and May, the unemployment rate in the country was at its highest level since March 2005, when the country was recovering from the 2003 SARS crisis. By comparison, unemployment in Hong Kong peaked at 5.5 percent during the Great Recession.

In Hong Kong the government has provided three support packages. Two packages were extended through the country’s Anti Epidemic Fund (AEF). The first support package (HKD 30 billion), which created the country’s Anti Epidemic Fund (AEF), was passed on February 21; a second round of funding (HKD 137.5 billion) passed on April 18. Other measures aimed at addressing the impacts of the virus were included in a broad-based HKD 120 billion relief package announced by the government on February 26 as part of the new budget. All three packages together amount to HKD 287.5 billion ($37 billion, 10.2 percent of GDP).

The first round of funding offered through the AEF focused on disease control measures and subsidies for businesses; about HKD 2 billion were offered to support families and students. The second round of AEF funding focused on job retention and job creation, with a set of measures valued at HKD 89 billion. A dominant part of this funding was the Employment Support Scheme (ESS), which was designed to provide HKD 81 billion in wage subsidies to workers in Hong Kong, an approach similar to the short-time compensation (STC) programs implemented in some European countries. Finally, the HKD 120 billion relief package, which passed in May, includes two additional measures for households: a direct payment of HKD 10,000 to
permanent residents aged 18 or above (HKD 71 billion) and an income tax cut with a ceiling of HKD 20,000, expected to benefit 1.95 million taxpayers.

Although public health policies were implemented rapidly, economic support measures for households announced during the early stages of the pandemic were delayed pending legislative approval and suffered from administrative delays. Online registration for the direct payout program only opened on June 21, with the first payments made July 8. The legislation allowing income tax reduction was passed on June 19 and the ESS started accepting applications from employers on May 25. Given the long implementation time, support in Hong Kong acted more as a boost to aggregate demand as the country recovered from the virus than a stabilizer during earlier stages. However, the case of Hong Kong also underlines the uncertainty surrounding countries’ ability to transition towards recovery while the virus remains a threat.

Recently, Hong Kong has experienced a new wave of infections as daily case reports rose above their peak in March. The numbers remain low compared to other countries discussed below, with 67 new cases (9 cases per million) reported at the new peak on July 16. Authorities responded with a new set of public health measures on July 13. The measures include mandatory masks in public transportation and a ban on public gatherings of more than four people.

As the number of COVID-19 cases in parts of Asia began declining in March, rates of infection began increasing in Europe. Germany and Austria were among the countries that were able to rapidly control the spread of the virus. Both countries saw a decline in the rate of infection by early April. Their early support policies focused on expanding public funding of STC programs that European employers traditionally use heavily during downturns. Although unemployment increased, it remained low compared to other parts of the world. In May, the rate peaked in Germany at 6.2 percent and in Austria at 6 percent.

In May, following effective public health measures to contain the virus, Austria began lifting restrictions on economic activity and in June it announced a second wave of support intended to boost recovery. The total value of the new measures is estimated at €12 billion (2.6 percent of GDP). This support comes in addition to €38 billion provided previously for a total of €50 billion, or 10.9 percent of GDP.
Korea
Covid-19 timeline

Hong Kong
Covid-19 timeline
While previous support measures for households had largely focussed on stabilizing the labor market by funding the country’s unemployment insurance and STC program (Kurzarbeit), the June policy package focuses on families and provides direct support for households in four ways:

- Reduction of the marginal income tax rate in the lowest bracket (€ 11,000 to € 18,000) from 25 percent to 20 percent – a maximum decrease in taxes due of €350
- One-time payment of €100 for taxpayers with annual income below €11,000
- One-time payment of €360 per child for families, and
- One-time payment of €450 for unemployed workers.

In a press conference, Chancellor Kurz noted that the support would amount to a payout of €1,000 for an average household, an amount smaller than the expected payout under direct support programs in the US or Hong Kong (both over $1,000 per taxpayer).

Similarly, Germany relied on STC as a stabilizer during the early stages of the crisis. The German government announced its recovery package on June 3. The package is valued at €130 billion (3.7 percent of GDP). New measures to support individuals and households largely focus on families with three main measures:

- One-time payment of €300 per child
- Increase from €1,908 to €4,008 of the income tax credit for single parents, and
- VAT lowered from 19 to 16 percent (and from 7 to 5 percent for goods and services that are taxed at a lower rate; including food, public transport and some medical expenses).
Extended support in South America
COVID-19 infections in South America began to increase in April. Peru and Chile were two of the hardest hit countries and are among the ten countries with the highest number of confirmed infections per million inhabitants—and are higher than in the US. However, rates of infection in both countries have recently declined and Peru has relaxed its lockdown; Chile never had a formal lockdown. Both countries first implemented measures to support households in March and April and are currently expanding previously announced programs, given the continued severity of the pandemic.

Peru reported 1,000 confirmed cases in late March, about the same time as new infections peaked in Europe. The government reacted at the onset of the pandemic with the announcement of a large economic stimulus package totaling PEN 90 billion (USD 26 billion or 12 percent of GDP) to provide support to households and critical sectors of the economy as the country entered a strict national lockdown. Decades of conservative fiscal management put Peru in a position where it was able to respond to the pandemic with one of the world’s largest fiscal packages relative to the size of its economy. Peru entered the lockdown with one of the lowest debt-to-GDP ratios and highest sovereign bond rating (BBB) in the region. Its government debt-to-GDP ratio currently stands at 27 percent.

The support package included a number of direct support measures for individuals:

- Economic Benefit for Emergency Social Protection: an unemployment program that provides monthly payments of PEN 760 ($219) to workers who are unable to work due to the lockdown. Only workers with gross wages below PEN 2,400 are eligible for support. The support was also initially limited to companies that employ less than 10 workers
- A series of measures meant to provide PEN 760 monthly payment to vulnerable individuals including families, independents workers, rural populations, and
- Employees are allowed to withdraw up to PEN 2,400 from compensation-for-time-of-service (CTS) accounts. CTS accounts collect employee contributions over time to provide payouts when workers are terminated or migrate to a new job, since the Peruvian government does not provide unemployment benefits in normal times.

Peru is currently in the recession phase of the pandemic’s economic cycle. Since the lockdown was announced in March, the unemployment rate in Peru has constantly increased. It reached 16.3 percent in June, more than doubling since January, when it stood at 6.3 percent. The government responded to worsening labor market conditions in June by extending the unemployment support provided under the Economic Benefit for Emergency Social Protection program to companies that employ less than 100 workers, making the support available to a much larger share of the labor force. Additionally, the government provided PEN 700 million ($200 million) to Trabajo Perù (Work Peru), an initiative of the labor ministry launched in 2011 to promote the creation of jobs for low-income Peruvians through public infrastructure projects. The latest funds aim to provide 226,000 temporary jobs.
The progression of the virus in Chile parallels the developments in Peru, with new infections peaking in June. As of July 18, both countries had over 300,000 confirmed cases. The Chilean government initially reacted with a $11.75 billion support package (4.2 percent of GDP) announced in March.

Measures to support individuals and households included the following:

- $2 billion for the national solidarity fund to insure sufficient funds for unemployment support to those workers whose individual severance accounts are insufficient to cover payments. The Chilean unemployment system uses a combination of individual accounts (like Peru) and a solidarity fund.

- Extension of unemployment benefits to workers who are furloughed due to the pandemic. This allows workers to maintain ties to an employer who continues to pay the worker’s healthcare and pension contributions. The replacement rate depends on whether funds are drawn from an individual account or the solidarity fund. The rate decreases monthly until it reaches the floor of 30 percent.

- Monthly payments of CLP 50,000 ($63) for each member of households who are eligible to receive support under the government’s family subsidy program (Family Income Support Bonus).

- Three monthly payments for vulnerable households and households (Emergency Family Income - EFI) that do not have a formal income earner. The amount depends on the size of the household. Households of up to four members receive CLP 65,000 ($82) each. Payments to larger households are smaller.

The unemployment rate in Chile has also followed a trajectory similar to its neighbor's over the course of the year. The 3-month average rate peaked at 11.2 percent in May, up from 7.4 percent in January. Given the continued severity of the crisis, Chile remains in the recession phase of the crisis. In response, authorities announced a second round of support of $12 billion on June 14, more than doubling the total support provided (8.4 percent of GDP combined). The second wave of support increases to CLP 100,000 the support each member of a household can expect under the EFI payout. The package also provides a replacement rate floor at 55 percent for unemployed workers until August.

Support to expire soon in the US

The number of new reported COVID-19 cases in the US increased rapidly in March before slowly declining during the first weeks of April. However, new infections began increasing in June and July as many states began to reopen but at a more rapid rate. The rate of infection has continually increased since early June and the US remains the country with the highest number of confirmed cases globally; it ranks 12th on a per capita basis.

To combat the effects of managing the virus, the US government reacted with the largest economic stimulus bill in the country's history. The CARES Act passed on March 27 provided
total support of $2.3 trillion (11.2 percent of GDP), including a set of measures to support individuals.

- One-time payments of $1,200 to eligible individuals. Individuals with an annual income above $75,000 received a fraction of the total payment.

- $600 weekly payment to unemployed workers (Federal Pandemic Unemployment Compensation, FPUC). Individuals receive these payments in addition to state unemployment benefits. This measure expires on July 31.

(See our previous YPFS blog post for a more detailed review).
The two main measures for households included:

The country entered its first recession since the Global Financial Crisis and reported the highest unemployment rates since the Great Depression. The US began the year with an unemployment rate of 3.5 percent in January, the lowest in decades. Unemployment began increasing in March and peaked at 14.7 percent in April as a result of widespread lockdown measures. The June unemployment rate was 11.1 percent. Efforts to augment previous support to individuals, including the $3 trillion HEROES Act passed by the House on May 15, have so far failed to gain approval in the Senate. (Notably, the Payroll Protection Plan, a program of forgivable loans for small business was reauthorized and extended.) However, Senate majority leader Mitch McConnell has recently mentioned the possibility of a bill containing a second stimulus payment and there remains debate around a potential extension of the controversial $600 per week unemployment supplement.
Concluding remarks

The discussion above highlights the fact that effective public health measures are essential to allow countries to transition from the recession to the recovery phase of the pandemic economic cycle. It also shows that support to individuals and households is a key component of policy responses at both stages.

During the recession phase, some countries successfully implemented measures intended to prevent job destruction and made payments to support vulnerable households through the downturn. The first wave of support in Austria and Germany achieved this by relying on wage subsidies to facilitate partial employment and prevent layoffs. Korea limited the shock to the labor market by gaining rapid control over the rate of infection through proactive public health measures while also providing income support to vulnerable households. This allowed it to avoid shutting down its economy, thus limiting negative economic effects. and

Chile and Peru remain in the third phase of the cycle, recession, as the rate of infection recently decreased - although not yet enough to allow policy to transition to recovery. In response, both countries extended measures implemented previously to support households through the downturn. Their policy mix focuses on support for vulnerable households and unemployed workers as well as preventing further job destruction.

Countries that were able to successfully manage the rate of infection have recently shifted their policy to measures that promote economic recovery. At this stage, support measures aim to boost
household demand and promote job creation. This is the case for the recent measures offering
direct support to families in Austria and Germany as well as the job creation measures contained
in the Korean New Deal, as well as the Hong Kong direct payments now being made. However,
economic output is expected to remain depressed until a vaccine or treatment becomes widely
available, as consumers are unable or unwilling to return to pre-crisis consumption patterns.
Additionally, the recent deterioration of the public health situation in Hong Kong highlights that
recovery prospects remain uncertain until the virus can be defeated through widespread access to
treatments or vaccination.

Similar to Peru and Chile, the US remains in the third stage of the process and any prospects to
steer policy towards recovery are compromised by the ever-increasing rate of infection in many
states across the country. Without a second wave of support, the country faces the risk of further
job destruction and a deepening recession before eventually entering the recovery phase as the
public health situation improves and stabilizes.

COVID-19 cases - data sources:

- [https://ourworldindata.org/grapher/total-daily-covid-cases-per-million](https://ourworldindata.org/grapher/total-daily-covid-cases-per-million)
With Phaseout of Wage Subsidy Scheme, UK Announces Rehiring Bonus

By Mallory Dreyer

Original post here.

On July 8, to compensate for the phaseout of its wage subsidy scheme for furloughed employees, the UK announced a Job Retention Bonus program that incentivizes firms to return those furloughed employees back to work.

In response to the COVID-19 pandemic, the United Kingdom announced the wage subsidy program, the Coronavirus Job Retention Scheme (CJRS), on March 20. Wage subsidies are designed to prevent widespread and permanent layoffs by temporarily supporting employers that face challenges paying employees with the expectation that such employers will be able to resume operations and pay employees after lockdown measures end and the economy begins to recover.

As policymakers ease lockdown measures and roll back support for companies and individuals, they face the challenge of minimizing the negative economic outcomes. If a wage support program ends and employers cannot pay employees or return to pre-COVID hours, a surge of layoffs is likely, exactly what these schemes were designed to prevent.

The United Kingdom has announced that its wage subsidy scheme will end on October 31. In order to incentivize employers to rehire employees and mitigate the risk of an increase in layoffs, it has paired the phase out of the CJRS with a rehiring bonus for employers that hire back furloughed or laid-off employees. However, this program has been met with some concern and criticism.

Coronavirus Job Retention Scheme (CJRS)

Under the CJRS, employees that are furloughed receive 80% of their salary, up to GBP 2,500 per month. Furloughed employees are those that take a temporary leave of absence and do not work, but are kept on the payroll. This wage support is channeled from the government through the employer to the employee. During the second phase of the scheme, which begins in August, employees continue to receive 80% of their salary but employer contributions increase every month while government contributions decline. The CJRS is scheduled to end on October 31.

Job Retention Bonus

On July 8, HM Treasury released “A Plan for Jobs 2020,” which includes a GBP 1,000 Job Retention Bonus to encourage firms to return furloughed workers to work. This bonus is a one-time payment for eligible UK employers that rehire furloughed workers as of November and maintain their employment through the end of January 2021.

The Job Retention Bonus is available only for employees that were furloughed under the CJRS. Such employees must earn at least GBP 520 per month on average between November 1 and January 31, 2021. Employers can claim the bonus for each eligible employee beginning in
February 2021. As there are 9.4 million individuals covered under the CJRS, the total expenditure under the Job Retention Bonus could reach GBP 9.4 billion. HM Treasury provided additional information regarding the Job Retention Bonus on July 31 and will publish full guidance in September.

Some have raised the concern that the retention bonus will not be necessary in many cases. In the days following the initial announcement, some companies pledged not to claim the bonus, as they had already planned to return employees from furlough. A top official in HM Revenue and Customs released a letter in which he acknowledged that while there is “sound policy rationale” for such a scheme there is uncertainty regarding the “value for money of this proposal.”

Others have raised concerns that the bonus amount may not provide sufficient or timely support to struggling companies to rehire workers, as the amount of the scheme and the February 2021 receipt date do not provide immediate relief for firms in hard-hit industries. According to a recent survey, 66% of UK firms view the measure as helpful for the overall economy, while only 54% view the scheme as helpful for their own business.

Seventy-five percent of firms with furloughed staff expect to claim the bonus, but only 20% of these firms expect it to influence the number of employees they rehire from furlough. Those results raise the question whether the aid could be targeted in such a way to have a greater effect on job outcomes and hiring decisions. The survey also asked businesses what further measures they would support. Fifty percent of respondents said they would like a cut in employer social insurance contributions, 31% would like an extension of the furlough scheme, and 24% would like rent support.

It is also important to note that the winding down of programs prematurely is a risk, given the uncertainty of a second wave and other negative public health outcomes. Some countries are currently facing a peak number of cases and are not yet ready to consider winding down such programs. The UK is not currently seeing an uptick in COVID-19 cases or deaths, but uncertainty regarding a second wave of the virus remains. As the bonus is dependent upon rehiring decisions in November and cannot be claimed until February 2021, the scheme may require amendment or updates based on future economic or health data.
President Trump Takes Executive Action as Further Stimulus Bill Talks Stall

By Aidan Lawson

Original post [here](#).

The first memorandum repurposed existing disaster relief funds for COVID-19 relief. The president allocated an additional $70 billion from the Disaster Relief Fund (DRF), which has been traditionally used to finance natural disaster support, to be used for COVID-19-related expenditures. President Trump also requested that states make more active use of the $80 billion in Coronavirus Relief Fund (CRF) allocations that have not yet been used. The CRF funds will be used to support expanded state unemployment programs and ensure that they will continue through the end of the year.

Of the newly appointed DRF funds, $44 billion of them will be directed to "lost wage assistance." This assistance allows state governors to provide weekly payments of $400 a week to people that have received expanded unemployment or COVID-19-related federal relief or can demonstrate that they are unemployed or underemployed due to the pandemic. The initial [release](#) said that the federal government will only contribute $300 a week, meaning cash-strapped states will have to pay the other 25% themselves. The governor of South Dakota has [declined](#) this relief, citing its improving economy as the rationale.

The Trump administration [clarified](#) later that states are not required to contribute the 25% to receive the federal aid, which could only last up to five weeks. States have also [expressed concern](#) about the administrative burden the program would place on states and that the onus is on the federal government to pass more comprehensive relief.

The second memorandum deferred payroll tax obligations from September 1 through December 31 for employees making approximately less than $4,000 (pre-tax) every two weeks, or about $104,000 a year. It is important to note that this is simply a deferral, so these taxes will need to be paid back at some point. President Trump has promised, however, that he would make the deferral permanent if re-elected (see [here](#)).

The Center on Budget and Policy Priorities (CBPP) [stated](#) that the action could potentially increase administrative and financial burdens on businesses without providing any short-run economic stimulus. There are a myriad of logistical issues - payroll tax changes are harder to make than those for income taxes, incomes of employees could vary throughout the year, and a number of firms are still waiting for exact guidance from the IRS. It is unclear if employers would even need to pass on the additional savings to their employees. The CBPP was skeptical that, even if the relief did make it to employees, they are likely to save it since the period will only be for about four months.

Most recently, the U.S. Chamber of Commerce, along with a coalition of more than 30 trade associations wrote a [letter](#) to House Speaker Nancy Pelosi, Senate Majority Leader Mitch
McConnell, and Treasury Secretary Steven Mnuchin stating that the payroll tax relief is "unworkable." The group stated that the relief could impose a significant tax liability on employees, and that many of the members of the trade associations would likely decline to offer the deferral.

The third action, and only executive order, gives general authority to provide relief to renters. The CARES Act provided a four-month eviction moratorium, but this ended on July 24 (see here, pp. 492-493). The Federal Housing Finance Agency (FHFA) also extended a separate federal eviction moratorium, but it is set to expire at the end of August (see here).

The language in the order is very vague, however. It states that the Secretary of Health and Human Services and the Director of the CDC should "consider" whether an additional eviction moratorium is necessary to curb the spread of COVID-19. It also requires the Secretary of the Treasury and the Secretary of Housing and Urban Development (HUD) to identify any additional funds that could be used for potential financial assistance to renters and homeowners that are struggling to make rental or mortgage payments. The order also directs the Secretary of HUD to and the Director of the Federal Housing Finance Agency to promote and review different ways to prevent evictions and foreclosures.

The order does not provide any concrete relief to renters or homeowners but merely encourages the heads of key agencies to explore avenues that could offer additional relief. The CBPP stated that the order would not help renters at all, given its language. Evictions are still continuing across the country and as many as 30-40 million Americans are at risk, according to a report released by a group of housing advocates and researchers.

The fourth action and final memorandum extends student loan payment relief. The administration previously provided some student loan relief on March 20 by both introducing payment forbearance and setting interest rates on federal student loans to 0% for 60 days. The CARES Act also suspended all student loan payments until September 30. This executive order suspends all interest and principal payments made on student loans through the end of the year. This relief will likely be automatic and apply to most borrowers that have public loans, but there are some areas of confusion.

Borrowers that are in the federal government's Public Service Loan Forgiveness (PSLF) program may still need to make any deferred payments, just at a later date. The PSLF forgives student loan balances for borrowers that work for the U.S. or tribal government, as well as qualifying non-profit if they make 120 qualifying payments on their loans. The CARES Act relief counts six months of non-payments afforded to borrowers towards the PSLF payment threshold. For example, if you had 120 payments left to qualify for forgiveness after the Act was passed in March, the six months of non-payments would count towards your 120 qualifying payments, meaning you would have 114 left at the end of the relief period in September even if you paid nothing. The executive order, however, does not explicitly discuss student loan forgiveness, leading many to recommend that, after the CARES Act relief expires at the end of September,
PSLF participants resume repaying their loans. The CARES Act also paused debt collection for student loans, but the executive order does not mention this, either.

Generally, the reception towards this relief seems mixed, with some believing that the president may face legal challenges, as Congress usually holds the purse strings. Congressional Democrats, however, seem to be "unlikely" to take that fight given the logistical limits of the payroll tax deferral and disaster relief reapportionment and that they believe they are "nearly unworkable."

As discussed above, there are a host of problems with each of the orders - ranging from logistical confusion, vague word choice, and heavier burdens on already-struggling state and local authorities. The administration has issued some guidance to clarify some of these concerns, but the real battle is being fought in Congress, where Democratic and Republican lawmakers continue to trade plans for more comprehensive relief back and forth with no end in sight.
Barriers to Wage Replacement Schemes

By Natalie Leonard and Corey Runkel

Original post here.

Negotiations stalled last week on more federal relief to address the coronavirus crisis. The sticking point seems to have been unemployment insurance (UI).

The Coronavirus Aid, Relief, and Economic Security (CARES) Act included a $600 weekly federal UI benefit on top of state benefits, called the Federal Pandemic Unemployment Compensation (FPUC). It gave two-thirds of claimants higher weekly earnings than their previous job paid.

For these workers, Republican lawmakers say that expanded unemployment insurance (UI) offers little incentive to return to work. Republicans have therefore called for states to implement partial wage replacement rather than the Democrats’ proposal, which would simply extend the $600 supplement for the remainder of 2020. In the GOP’s wage-replacement scheme, claimants’ benefits would be equivalent to 70% of pre-pandemic wages.

Senate Republicans included the wage-replacement scheme in the HEALS Act, a panoply of proposed bills that constitute the party’s response to the HEROES Act that the Democratic-controlled House passed in May.

Lawmakers had proposed this sort of scheme during the negotiations for the CARES Act in March. However, state unemployment administrations were not ready to implement such a program at the time due to fragmented systems, overlapping benefits, and aging information technology (IT). But some states will still struggle to implement a wage-replacement scheme by October, as the HEALS Act proposes.

Perhaps the largest problem is the federal separation of benefits administration. Unlike shared protocols such as the Uniform Commercial Code, where procedures are more or less standard across states, the United States has 52 separate UI systems -- one for each state, the District of Columbia, and Puerto Rico -- with 52 separate benefits calculations.

States also lack the earnings data that would serve as an input to such formulae. For year-round wage earners, funneling tax filings into a state’s UI system may solve the problem. But for seasonal employees or independent contractors, eligible for UI for the first time during COVID-19, determining benefit levels poses novel challenges.

UI systems nationwide have long faced disinvestment and tortuous development. Many of the computer programs used to process benefits are brittle -- some systems accept only fixed-dollar amounts, rejecting percentages -- and are written in a nearly-dead language. As a result, coders are scarce and maintenance difficult. States have reported that these technical problems alone would add up to a five-month timeframe for implementing wage-replacement formulae.
Some states began to overhaul their UI systems in response to failures during the April spike in unemployment claims and the initial federal UI supplement that the CARES Act provided. Employees in Connecticut’s Department of Labor worked 32 straight days to resolve its backlog. California’s governor appointed a “strike team” to modernize the application and distribution of UI benefits, while he prioritized communications with claimants. However, not every administration is able to marshal a timely digital response. Florida, which the New York Times reported has one of the nation’s worst UI systems, briefly reverted to paper applications.

States stand at various levels of readiness for wage-replacement schemes. Surmounting these challenges would require simultaneous (though not coordinated) action by every system. Should a third wave of federal relief mandate such a proposal, it would need to provide flexibility, additional support, or both to salvage cumbersome UI systems weighed down by millions of new and unfilled claims. However, wage-replacement features, such as those required by the HEALS Act, may end up standardizing state systems to some extent, allowing states to avoid some of the problems discussed below in future crises.

**Wage replacement proposals**

The Senate Republicans’ proposed HEALS Act would reduce the FPUC to $200 per week until October 5, when it would shift to funding a 70% wage-replacement scheme. The American Action Forum, a center-right Washington think tank, estimated that the average benefit under such a program would be $182 per week. The HEROES Act would simply continue the $600 FPUC through 2020.

The thinking behind the Republican proposal is straightforward: Why return to a job that pays less than UI would provide? As businesses seek to reopen, high unemployment benefits may depress demand for jobs at wages that can’t compete with claimants’ total benefits, which are made up of state and federal components. In contrast, the 70% scheme would aim to make pre-pandemic wages attractive enough that low-income workers will return to their jobs. As the pandemic continues to spread, many workers also may be reluctant to return to jobs that only exist outside their homes.

In the CARES Act, Congress expanded unemployment benefits. It extended support by 26 weeks and widened eligibility to include part-time and self-employed workers. More than 50 million people have filed unemployment claims this year.

Data appeared to confirm the Republicans’ argument that the CARES Act subsidy, combined with existing state unemployment benefits, exceeded many workers’ earnings. In a paper published in May, researchers at the University of Chicago estimated that “68% of unemployed workers eligible for UI will receive benefits which exceed lost earnings,” with a fifth of those eligible receiving more than twice their lost earnings. The authors hypothesized that the $600 supplement could promote compliance with stay-at-home orders, but would dampen policies that sought to reignite hiring.
However, more recent studies have added to our understanding of the FPUC’s effects. For example, the May paper only compares wages to earnings, where relatively granular data are available. The National Employment Law Project analyzed data on UI recipients to estimate that claimants’ pre-pandemic compensation was, on average, 28 percent higher than the Chicago researchers had assumed because they excluded non-wage benefits (page 4). If so, then the effects of the CARES Act subsidy on rehiring may not be as important. Early scholarship on hiring and work scheduling fits this conclusion.

By a range of measures — hours worked, applications per job vacancy, employment probabilities — researchers have shown that the employment effects of the FPUC was likely not significant. This result seems to hold both in the aggregate as well as at the individual level. The first and third papers linked leveraged the Current Population Survey, which tracks tens of thousands of households over a four-month period. In this case, following individual households allowed researchers to distinguish between new hires and rehires; they concluded that higher rates of wage replacement, on average, did not affect decisions to return to work. Rather, they suggested that decreased demand for labor is the limiting factor.

**Challenges to implementing a wage-replacement scheme**

Even before the COVID-19 crisis, UI benefits faced several challenges. First, the federal structure of UI systems means that each state has its own, idiosyncratic program. Second, the existence of overlapping state and federal systems creates diverse categories of workers, each with distinct benefits programs, funded by different sources. Third, the systems that process unemployment claims are aging and frequently underfunded.

*Problems with federalism*

Each state administers UI benefits through its own program. This leads to considerable variation among states in the length of UI benefits, the minimum and maximum benefit, the method of calculation, and the data sources. Some states use weekly wages, while some use quarterly wages or annual wages.

The length of the basis period for calculating the highest quarter varies from state to state. Most states count the first four of the last five completed calendar quarters for calculating weekly benefits, but some do not. In 40 states, more recent earnings can be counted towards the weekly benefit calculation, in some circumstances. Forty states do not pay a benefit in the first week of unemployment, while 10 states do. Below is a table of selected states to illustrate the range of formulae.

**Table 1: Sample range of formulae for UI benefit calculation**

<table>
<thead>
<tr>
<th>Method of calculation</th>
<th>Min benefit</th>
<th>Max benefit</th>
<th>Length of benefits, weeks</th>
<th>% of claims filled by June 15</th>
<th>How long does it take to decide on</th>
</tr>
</thead>
</table>

1
<table>
<thead>
<tr>
<th>State</th>
<th>Formula for Claim Calculation</th>
<th>Annualized Claim Amount</th>
<th>Claim Decision Time</th>
<th>Decision Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arizona</td>
<td>1/25 of highest quarterly wage (HQW)</td>
<td>$187 $240 8-26</td>
<td>46.85%</td>
<td>10.8%</td>
</tr>
<tr>
<td>Delaware</td>
<td>1/46 of total wages in highest two quarters</td>
<td>$20 $400 24-26</td>
<td>6.93%</td>
<td>32.6%</td>
</tr>
<tr>
<td>Nebraska</td>
<td>1/2 average weekly wage</td>
<td>$70 $440 10-26</td>
<td>51%</td>
<td>53.1%</td>
</tr>
<tr>
<td>New York</td>
<td>1/25 to 1/26 of HQW</td>
<td>$104 $504 26</td>
<td>64.93%</td>
<td>26.6%</td>
</tr>
<tr>
<td>Virginia</td>
<td>1/50 of total wages in highest two quarters</td>
<td>$60 $378 12-26</td>
<td>130.82%</td>
<td>8.6%</td>
</tr>
</tbody>
</table>

1. States in table chosen at random.
2. States chosen at random. Filings from neighboring DC and Maryland bias the Virginia claims up.

Sources: U.S. Department of Labor, Significant Provisions of State Unemployment Insurance Laws; the Century Foundation, Unemployment Insurance Data Dashboard

Problems with overlapping systems

The existence of overlapping federal and state UI programs pose unique difficulties to updating the systems and implementing a wage-replacement scheme. Combining pre-existing UI benefits systems and new pandemic-related programs, there are four different programs. The last two programs on the following list were created by the CARES Act:

1. Standard state systems
2. Extended state benefits
3. Pandemic Unemployment Assistance (PUA)
4. Pandemic Emergency Unemployment Compensation (PEUC)

Standard state systems pay benefits for at least eight and not more than 26 weeks. These benefits are funded in full by states. When a state’s unemployment rate is higher than a certain level, unemployment benefits can be extended up to 13 additional weeks. The federal government
pays 50% of extended benefits. Upon the expiration of extended benefits (EB), workers are eligible for Pandemic Emergency Unemployment Compensation (PEUC), which is funded in full by the federal government but still administered by states.

Pandemic Unemployment Assistance (PUA) adds an additional $600 per week for workers who do not typically receive state UI benefits. These include sole proprietors, gig workers, part-time employees, and those furloughed as a direct result of COVID-19. It also pays a minimum weekly benefit equal to 50% of each state’s average weekly benefit, although states are mandated to phase in fuller payments.

While state systems vary considerably, all those who qualify for pre-pandemic state-provided UI benefits submit wage records. So, in principle, states could calculate a 70% wage replacement rate for each worker under existing UI programs.

But the CARES Act does not require self-employed workers to supply wage records to state agencies to receive the minimum benefit. Therefore, a wage-replacement scheme would, at present, be impossible to implement for this category of worker.

In the week ending August 8, 831,000 people filed initial claims for state-provided UI, while 489,000 people filed initial claims for PUA.

Technical problems

Technological disinvestment and the state of information technology procurement have afflicted UI benefits programs for decades. Between 2001 and 2020, nationwide funding for UI systems declined in real terms from $3.27 billion to $2.14 billion (p. 4). And much of the remaining funds flow to failed projects: high-profile failures anchor estimates that, worldwide, only 13% of government IT projects larger than $6 million succeeded. Some states, such as Michigan, have successfully fixed broken systems, but the appropriations process that rules UI funding make iterative development—the core of modern software development—difficult to execute.

A recent report from the Century Foundation revealed that only 60% of unemployment claims filed between March 1 and June 15 were paid by the end of June. The unprecedented recent strains have laid bare fractures that have grown for years. Between 2007 and 2017, the false denial rate has more than doubled from 8% of unemployment claims to 17%. Michigan’s system offers an egregious example: after the system’s deployment in 2013, “The MiDAS system flagged more than 40,000 workers for fraud, and it was 93 percent inaccurate.”

Yet, Michigan's commitment to its system catapulted it to among the fastest states for processing unemployment claims during COVID-19. Governor Gretchen Whitmer’s executive orders early in March are part of the reason for this improvement. Following the spate of false denials that marred the system’s deployment, lawsuits and legislation mandated improvements to the state’s system. But continuous improvement is the exception, not the rule, in government-procured IT. Government contract administration discourages the testing and iterative development standard.
in the private sector. These incentives result in big-ticket procurements that fail when scaled up to millions of users.

The appropriations cycle has also exposed IT procurement to procyclical funding, which poses problems for UI systems that face, by definition, countercyclical demand. Michigan suffered, along with other states, fiscal austerity following the Global Financial Crisis and Great Recession. In that case, the revelation of massive errors in MiDAS spurred pressure to reform. States with quieter failures still languish at the bottom of the claims-processing totem pole. Florida, which neglected important reforms to its $77 million system, briefly reverted to issuing paper applications, and, as of June 30, had paid only 52% of claims filed since March.

Only 16 states have fully modernized their UI systems, according to the National Employment Law Project. Aging systems often rely on COBOL, a 70-year-old programming language used to access mainframe computers. Only 37 schools in the world offer a mainframe computing course. In April, New Jersey’s governor appealed to retirees fluent in COBOL’s syntax to help fix its system.

But, even if states could rewrite their code to define benefits in terms of prior earnings, the PUA has expanded eligibility to self-employed workers and other workers who don’t report their earnings. Depending on the level of integration between UI administrations and revenue services, the ease of importing these data will vary. But the case of Virginia shows how technological problems can compound those of federalism: because many Virginia citizens worked in DC or Maryland, the state has handled many claims originating outside its borders; to use the earnings data of these citizens, it would have to coordinate with the DC’s and Maryland’s UI systems.

Responses to proposal

Taking together the existence of 52 unique state-level unemployment programs and two major federal programs, a 70% wage replacement program is likely to take weeks or months to implement. A memo from the National Association of State Workforce Agencies (NASWA) estimates that changing FPUC to be tied to individuals wage records would take from “four to twelve weeks or more” to implement.

The debate over the next fiscal spending bill continues, and there is some indication that the final bill won’t include the Republican wage-replacement proposal. The President recently signed an executive order extending a $300 per week federal benefit through December 2020, and demanding that states cover an additional $100.

Conclusions

A number of logistical and administrative problems have plagued unemployment benefits programs for decades. State UI systems collectively faced some 33 million claims by the end of May. This strain exposed deep flaws in states’ technical capacities and reporting. The federal programs tailored to the pandemic-caused recession have imposed new standards on old,
fragmented systems, further complicating the prospects for a speedy implementation of wage replacement.
Swaps

To ensure that international trade continues during periods of financial stress, central banks establish short-term liquidity swap lines. While many states participate in swap lines, the prominence of the US dollar in global markets makes Federal Reserve swaps particularly useful. These work the same as any swap line: a foreign central bank uses their currency to purchase dollars at the market exchange rate, and agrees to use dollars to purchase back their currency at the original exchange rate, plus interest. The foreign central bank may then freely lend dollars to its domestic institutions. Because the exchange rate does not change, swaps are riskless transactions that effectively support foreign exchange liquidity.
Central Banks Use Swap Lines to Maintain the Flow of US Dollar

By Rosalind Z. Wiggins with Research Support from Pascal Ungersboeck

The Yale Program on Financial Stability has produced and will continue to update a spreadsheet to assist those contemplating swap line agreements. The spreadsheet catalogs past and current examples of crisis-focused swap line agreements, identifies interesting program features, summarizes existing evaluations of programs, and shares general resources on the topic. This spreadsheet can be accessed here. (Current version as of 3/26/2020 for those unable to access Google Sheets)

As the world responds to the COVID-19 pandemic, the US dollar funding markets have come under stress. To address this issue, the US Federal Reserve (Fed) and other major central banks have taken a series of coordinated actions to provide more global US dollar liquidity. Swap lines are a powerful and flexible tool when central bank reserves are inadequate or when normal currency markets become distressed. We discuss here: (i) the recent actions regarding the US dollar, (ii) actions relating to prior crises, and (iii) significant features that countries might consider when contemplating entering a swap line.

Under a currency swap agreement, the lending central bank, for example, the Bank of England (BoE), requests US dollars from the Fed. In exchange, the Fed receives an equivalent value of pounds calculated at the market exchange rate. The BoE then lends the dollars to banks in the UK, charging interest. For the life of the swap, the BoE has a dollar liability, which takes the form of an account at the Fed, and the Fed has a pound liability, which is an account at the BoE. When the swap is over, the BoE returns the dollars to the Fed and the Fed returns the pounds to the BoE. The BoE also pays to the Fed the interest earned on the funds lent.

The Fed bears no exchange risk on these transactions. Also, because the receiving central bank determines the banks in its country to which it lends dollars, the Fed has no contractual relationship with those institutions and therefore does not bear any credit risk related to the downstream borrowers. (See 2020 Swap Line FAQs).

The recently established Fed swap lines appear to operate similarly to the standing swaps and those used in the GFC. (See Frequently asked questions: US Dollar and Foreign Currency Liquidity Swaps, which describes earlier programs.)

2020 Actions

On March 15, the Fed and five central banks with which it has unlimited standing swap lines agreed to: (i) lower the interest rate by 25 basis points; the rate is now the overnight index swap
rate (OIS) rate plus 25 basis points; and (ii) offer loans with 84-day maturity in addition to their ongoing weekly operations, beginning on March 16. The five central banks are the Bank of Canada, Bank of England (BoE), European Central Bank (ECB), Bank of Japan (BoJ), and Swiss National Bank (SNB). (Fed webpage discussing swaps). The Fed calls these the “key banks.” The changes are to remain in place as long as appropriate to smooth the functioning of the US dollar funding markets

On March 20, the Fed and four of the five key banks also announced that, beginning March 23, they would increase the frequency of their 7-day maturity operations from weekly to daily, continuing at least through the end of April.

The Bank of Canada does not currently conduct offerings of US dollars, but agreed to the rate provisions of the March 15 announcement and also announced on March 20 that it would initiate a USD Term Repo Facility (at the new rate), should one become necessary. See the Canadian announcement here.

March 19, the Fed announced swap lines with nine more countries, bringing the total to 14. Maximum amounts currently authorized under the swaps are shown in Table 1.

Table 1. Federal Reserve US Dollar liquidity swap provisions

<table>
<thead>
<tr>
<th>Maximum amount available</th>
<th>Country/Region</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unlimited standing facility</td>
<td>Canada, United Kingdom, European Union, Japan, Switzerland</td>
</tr>
<tr>
<td>$60 billion</td>
<td>Australia, Brazil, South Korea, Mexico, Singapore, Sweden</td>
</tr>
<tr>
<td>$30 billion</td>
<td>Denmark, Norway, New Zealand</td>
</tr>
</tbody>
</table>

Source: Central Bank Swap Arrangements, Federal Reserve Bank of New York website

The US dollar is by far the most widely held and transacted international currency. Strains in dollar funding markets outside the US can disrupt financial conditions inside the US as well. If foreign entities were to experience difficulties accessing dollars to settle their transactions denominated in US dollars, the strain could further destabilize the flow of international commerce and roil US financial markets, potentially impacting businesses and households.

Lessons from the GFC and other Crises

The latest actions match the number and country distribution of swap lines that the Fed deployed during the Global Financial Crisis (GFC). Moreover, the scope of the lines established so far closely approximates those the Fed had in place at the peak of the GFC—it did not offer
uncapped capacity to the key banks until October 2008, after the failure of Lehman Brothers. (In recognition of changes to the economic situation, some lines are larger than during the GFC.) During the GFC, the Fed swaps were heavily used; by December 10, 2008, swaps outstanding had risen to more than $580 billion. (Fleming and Klaage, 2010). A BIS study considered the Fed swap lines “to be very effective in relieving stresses in US dollar liquidity stresses and stresses in foreign currency markets.” (BIS, 2010).

The Fed terminated its GFC swap lines as market conditions improved. However, the lines with the key banks were reestablished on a temporary basis in 2010 and converted to permanent standing facilities in October 2013 to act as a “prudent liquidity backstop” to problems that might arise in the availability of a currency. (Federal Reserve, Oct 2013). The standing agreements allow the Fed to quickly provide US dollars to funding markets as needed.

The Federal Reserve operates swap lines under the authority of Section 14 of the Federal Reserve Act and in compliance with authorizations, policies, and procedures established by the Federal Open Market Committee (FOMC). Most central banks have a similar authority.

During the GFC, central banks also created swap lines to address shortages in currencies besides the US dollar. The ECB entered into swaps with several countries to address strains in the availability of Euros: Sweden, Hungary, Denmark, Latvia, Poland, and the United Kingdom. (BIS, see page 30). The SNB entered into Swiss franc swaps with Poland, Hungary and the United Kingdom. (BIS, page 31). The BOJ entered into Japanese yen swaps with Korea and India. (BIS, page 32).

Central banks also introduced currency swaps after the 9/11 terrorist attacks in the US and in response to the Asian Financial Crisis. After the Asian Financial Crisis, several Asian countries entered into a multilateral swap agreement under the Chiang Mai Initiative, as well as many bilateral agreements, generally to supply US dollars or yen. (BIS, page 32). These lines were limited, in that only small amounts could be borrowed without IMF approval. These were augmented to provide for more flexibility and to make them two-way. See the YPFS Swaps Resource Guide for more information on these and other swaps.

**Key Features of Swaps**

Swap lines are an important monetary policy tool and have attributes that make them very responsive to changing circumstances. Some of the features which countries contemplating swaps consider are:

Cooperation and coordination

Swaps signal cooperation between the implementing central banks; different levels of cooperation are possible and there can also be a coordinated effort to manage the flow of a currency so as to avoid arbitrage or better meet market needs. The recent March 20 announcement from the Fed and five key banks recognizes a joint need to provide significantly more availability of one-week funding. As another example, in 2008 the ECB and BOE timed
their auctions of US dollars (provided under the swaps) to coincide with the Fed’s auctions under its Term Auction Facility. (ECB Press Release, 12/12/2007). After September 15, 2008, however, the Fed negotiated terms of bilateral arrangements, such as interest rates and timing, with other central banks individually.

Design Flexibility

Swaps usually can be implemented fairly rapidly. After the 9/11 terrorists attacks, the Fed and ECB announced a US Dollar swap line on September 13. The next day a line with the BoE was announced and augmentation of the standing line with Canada. Standing lines can be activated or expanded very quickly as circumstances change.

Eligibility

In deciding which countries to enter into swaps with, a central bank considers the extent of bilateral capital flows between the two countries and the risk the swap lines could pose. There have been instances where requests for swap line have been denied. However, in such cases, there may still be a way for a country to use a third-party swap to access the needed currency.

Most swaps are one-way or two-way bilateral agreements. One notable multilateral swap agreement is the Chiang Mai Initiative (Multilateralization) (CMIM) among Asian VVV countries to provide for US Dollar support. The CMIM replaced a prior multilateral agreement and a network of bilateral agreements but did not prohibit additional bilateral agreements, which have been maintained by several countries. Sussangkarn 2010. Chiang Mai FAQs.

Swaps enable a country to seek support for those foreign currencies in which its domestic banks have exposure and in amounts that it perceives are needed. The standing swaps that the Fed established in 2013 “constitute a network of bilateral swap lines among the six central banks” and “allow for the provision of liquidity in each jurisdiction in any of the five currencies foreign to that jurisdiction, should the two central banks in a particular bilateral swap arrangement judge that market conditions warrant such action in one of their currencies.” (Federal Reserve website). Thus far, the US Fed has not utilized its ability to request a foreign currency under these arrangements.

Notably, because of their flexible design properties, swaps can provide increased access to a third currency, such as US dollars, for countries that do not have a swap agreement with the Fed. The bilateral swap agreements established under the Chiang Mai Initiative demonstrate the range of types of agreements and their responsiveness. These agreements were established or renewed after the Asian Financial Crisis (AFC), when a lack of foreign reserves was an issue. They were a way for the countries to make their foreign currency reserves available to each other. Several of these lines have since been extended to include local currency swaps, as well as USD-for-local currency swaps.

Examples of these swaps that incorporate terms tailored to the countries’ particular situation include:
• The *(one-way)* swap line that Japan has established with Indonesia permits Indonesia to swap its local currency for US dollars as well as Japanese Yen.

• The *(two-way)* agreement between Japan and Singapore which permitted each country to swap its local currency for US dollars from the other was amended in 2018 to also permit Singapore to access Japanese Yen.

• The *(two-way)* agreement between Japan and Thailand permits both countries to swap their local currencies (i.e., the Japanese Yen and the Thai Baht, respectively) for US Dollars from the other. Thailand may also swap the Baht against the Japanese Yen.

There is also discussion of extending the basic CMIM multilateral agreement to include Yen and Yuan. *(Kyodo 2019).*

During the GFC, the ECB set up Euro swap lines with Sweden and Denmark. But it used a different arrangement with the central banks of Poland and Hungary because it did not want to accept their local currencies. Instead, the ECB entered into repo agreements under which the Poland and Hungary central banks exchanged high-quality Euro-denominated securities as collateral for the Euros they received. These central banks would then on-lend the Euros in a similar manner and received their securities back once they returned the Euros. Other countries such as Iceland received access to Euros not through swaps with the ECB, which the ECB denied, but (in a fashion similar to the Asian experience) indirectly through swaps with countries that had such swaps, such as Sweden and Denmark. *(BIS, page 27, 30).* Although much smaller than the Fed’s dollar lines during the GFC, the ECB believed that their Euro provisions to local banks “helped to achieve the key objectives of the swap lines and calmed markets and funding concerns during the crisis while taking into account moral hazard considerations.” *(ECB, 2014).* Based on this assessment, the ECB converted some swaps to standing facilities.

While swap lines are established in response to currency strains, they can also serve other objectives. During the GFC, China established swap lines with six countries, which were also thought to have promoted the Chinese central bank’s policy objective of promoting non-dollar currencies as trading and investment currency. *(BIS, page 33).*

Credit Risk

The receiving central bank determines which of its domestic banks are creditworthy and on what terms (collateral, interest, maturity). Given this, central banks contemplating being on the receiving end of a swap should consider how they would adequately protect themselves through the eligibility, collateral, and other criteria that they establish.

Lending Eligibility and Flexibility

Lending of funds to the domestic banks can be done through various modalities and terms as established by the receiving central bank, although sometimes the loan rate is agreed to with the lending counterparty. Features that can be customized include:
• Setting rates through various methods, e.g., variable-rate tenders, fixed-rate tenders, bilateral transactions;

• Lending against various types of collateral, including both foreign currency and securities denominated in foreign currency;

• Varying and/or changing the maturities of lending;

• Limiting the amount of lending to any one participant or providing full allotment;

• Setting the terms of the program which may be extended.

As demonstrated above, terms can be easily altered to meet situations as they develop. Recent programs have been revised to: (i) lower the cost of funds, (ii) offer longer-term maturities, (iii) provide more frequent offerings, and (iv) expand the flow to additional countries. In the wake of the 9/11 terrorist attacks, funding was lent on an overnight basis. In October 2008, the major European banks (ECB, BoE, and SNB) agreed to lend on a longer term basis (at 7-day, 28-day, and 84-day maturities) to meet market needs.

Preservation of Reserves

Currency swap lines between central banks enable the receiving central bank to obtain foreign currency and redistribute it locally to its domestic banks without having to use its foreign reserves. This can be very valuable, since it allows the central bank to maintain its reserves for its own purposes. Swaps also can augment reserves that are inadequate to respond to an increase in demand.

Scalability

Once in place, swaps are easily scalable to meet changing conditions. Agreements can provide for a maximum amount, which need not be the same for each counterparty. For example, the agreement between Japan and Singapore permits Singapore to swap Singapore dollars for up to US$3 billion or its equivalent in Japanese yen from Japan, but permits Japan to swap Japanese yen for only US$1 billion from Singapore.

The amount of funds provided can be increased as the need arises and scaled back as conditions improve. On October 13, 2008, for example, the Fed announced that it would increase the size of its swap line to four central banks (BoE, ECB, SNB, Bank of Canada) so that the respective banks could provide more US dollar funding. The same arrangement was extended to Japan the next day. The original lines had been established at much smaller levels. For example, the swaps with the SNB and the ECB, as established in December 2007, were originally limited to $4 billion and $20 billion, respectively. By October 2008, the Fed had repeatedly enlarged the caps to $60 billion and $240 billion, respectively, before removing them entirely. Therefore, countries looking to establish a currency swap need not consider the initial limit binding should circumstances change.
Key announcements discussed herein:

- March 15, 2020 joint announcement
- March 19, 2020 announcement with Swap Lines FAQs
- March 20, 2020 joint announcement
Fed Creates Dollar Repo Facility for Central Banks, Extending Liquidity to Central Banks that Don’t Have Fed Swap Lines

By Greg Feldberg

Original post here.

On March 31, the Federal Reserve announced a dollar repo facility that will allow it to lend dollars to foreign central banks in exchange for US Treasury securities.

The temporary repurchase agreement facility for foreign and international monetary authorities, or “FIMA Repo Facility,” will allow foreign central banks to exchange US Treasuries for US dollars through overnight repurchase agreements (repos). They can then make those dollars available to companies in their own jurisdictions.

The unprecedented global COVID-19 crisis has intensified demand across the world for US dollars. Earlier, the Fed announced that it was revising and expanding dollar swap lines with foreign central banks. But the swap lines are now available to just 14 central banks (see the YPFS blog). The new FIMA Repo Facility, available from April 6, will allow the Fed to get dollars to central banks that are not participating in those swap lines. Also, unlike the swap lines, it is not an updated version of a tool used in the global financial crisis in 2007-09.

In FAQs, the Fed said the new facility will help prevent financial stress abroad from elevating risks in US markets: “The facility reduces the need for central banks to sell their Treasury securities outright and into illiquid markets, which will help to avoid disruptions to the Treasury market and upward pressure on yields.”

FIMA account holders are central banks and other foreign monetary authorities with accounts at the Federal Reserve Bank of New York (FRBNY). The Fed must approve applications to use the facility.

While transactions would be on an overnight basis, they could be rolled over. They will be conducted at an interest rate of 25 basis points over the Fed’s rate on Interest on Excess Reserves, which typically exceeds market rates in normal times.

The transactions will pose no foreign exchange risk or credit risk to the Fed. They will occur entirely in dollars and are fully collateralized by US Treasuries. Margins will reflect margins on similar collateral posted to the Fed’s discount window.

The Fed will disclose the amount of activity under the facility in its weekly H.4.1 release.

Fed and four of these central banks (excluding the Bank of Canada) announced that, beginning March 23, they would temporarily increase the frequency of their 7-day maturity operations from weekly to daily. As of March 25, the Fed had $206 billion outstanding in swaps with those four central banks. On March 19, the Fed announced swap lines with nine more countries, bringing the total to 14.
Reserve liquidity facilities shift from advanced economies to emerging markets

By Corey Runkel

Original post here.

On June 19, the European Central Bank (ECB) joined the central banks of England, Japan, and Switzerland in scaling back the frequency of their US dollar liquidity swaps with the Federal Reserve (Fed). Central bank liquidity swap lines facilitate access to foreign capital during periods of international financial stress. While these bilateral swap operations with the Fed have slowed, the ECB announced on June 25 the establishment of the Eurosystem repo facility for central banks (EUREP). The new facility will complement the ECB’s current bilateral swap lines by allowing for less stable currencies to participate in repurchase agreements. This post summarizes the recent activity on Fed swap lines and documents the shift in currency facilities from those aimed at the sturdiest reserve institutions to those aimed at central banks with smaller stocks of dollars.

Fed swap lines remain successful

Since the Global Financial Crisis (GFC), the Fed has maintained unlimited swap lines with the European Union, England, Japan, Canada, and Switzerland. On March 23, it began offering daily, 7-day tenor swaps on these unlimited lines. This development came on the heels of a March 19 expansion of bilateral agreements detailed by a previous YPFS blogpost: the expanded facility would provide up to $60 billion for the banks of Australia, Brazil, South Korea, Mexico, Singapore, and Sweden, and up to $30 billion for the banks of Denmark, Norway, and New Zealand.

During a dollar liquidity swap, the Fed enters into an agreement with another central bank that maintains an account at the Federal Reserve Bank of New York (FRBNY). The banks agree to perform two actions: first, the Fed’s dollars are exchanged for the foreign bank’s currency at the prevailing exchange rate; second, at some specified date in the near future, the foreign bank’s dollars are re-exchanged for their own currency at the same exchange rate as the original transaction, plus a small interest rate. The FRBNY is authorized by the Fed’s Open Market Committee under Section 14 of the Federal Reserve Act to establish swap lines, and has emphasized the benefits to American households and businesses by "helping to maintain the flow of credit to U.S. households and businesses by reducing risks to U.S. financial markets caused by financial stresses abroad."

Since the agreements peg both transactions to the same exchange rate, the Fed bears no risk that turmoil in foreign exchange markets translates to a loss of US dollars. Foreign central banks often use swap lines to get dollars that they can use to provide liquidity to domestic institutions in need of dollars. In 2007, the Fed lent money directly to US branches of European banks in addition to its heavy usage of the swap lines. The upshot of a liquidity swap was that, since the
Fed’s swap was with the other central bank, it was not exposed to the risk of default by the downstream borrowing institutions; this risk was borne by the central bank, which determined who it would lend to.

Though financial strains among countries with standing dollar swap lines have thus far been much weaker than during the GFC, the rejuvenated lines were equally effective at quelling turbulent dollar funding markets. Between March 6 and March 23, the US trade-weighted dollar index jumped to an historical high of 126.47, and posted its largest single-day percentage increase since the series was inaugurated in January 2006. With the acceleration of 7-day swaps on March 23, three days later the index subsequently posted its second largest drop since March 2009. It has not fluctuated by more than 1 point since April 7, though the index has remained higher and more volatile than recent, pre-pandemic levels.

The speed and authority with which the Fed provides liquidity for the largest reserve currency market have bolstered the central bank’s reputation. This most recent resurgence of swap lines has led some to assert that the Fed is not only a central bank to the US, but also to the world, offering short-term emergency liquidity when central banks -- liquid in their own currency -- are strapped for US dollars. As with domestic lender-of-last-resort operations, the transactions have always been initiated by a counterparty, never by the Fed. Although swap agreements are bilateral, the US has never drawn on a currency swap line.

Focus shifts to countries with weaker reserves

The Fed’s deceleration of currency swaps prompted praise for the speed and scale of relief. But the facility left unresolved the plight of weaker, systemically less important currencies. Already
burdened by higher interest rates on credit, countries without access to Fed swap lines saw a sharp uptick in the costs of accessing dollar funding markets, a Bank for International Settlements paper published in May found. Access to dollar funding has been exacerbated by capital outflows at rates higher than during the GFC.

In an attempt to provide reserves for dollar-strapped reserve banks, the Fed and ECB have each established repurchasing (repo) facilities for their currencies. The facilities work similarly to currency swap lines, providing short term liquidity and protecting against credit risk by dealing only with central banks. However, these repo facilities lie one step closer to secured loans, requiring foreign central banks to post collateral should they default on loan repurchasing. To protect against exchange rate risk, eligible collateral consists only of sovereign securities denominated in the lender’s currency. For example, the Fed’s Foreign and International Monetary Authorities (FIMA) facility -- detailed in a previous YPFS blogpost -- accepts US Treasury securities of any maturity, while the ECB’s EUREP accepts euro-denominated debt from any of its constituent states as well as the central bank itself.

These repo agreements allow foreign central banks to avoid dumping large amounts of sovereign bonds into illiquid markets, ensuring value for both the Fed and the foreign bank in need. But the facilities can be more limited than the swap lines due to shorter maturities and higher interest rates. The FIMA’s repo facility only offers overnight maturities. Though such maturities can be rolled over, the repo agreements contrast sharply in this regard with the swap lines, which offer up to 84-day maturities.

Additionally, pricing is slightly steeper in FIMA and EUREP facilities. Where Fed central bank liquidity swaps add 25 basis points to the overnight index swap (OIS), FIMA adds 25 basis points to the Interest Rate on Excess Reserves (IOER). Currently the benchmark US overnight rate, the Federal Funds rate, stands at 0.05%, with the IOER at 0.10%. These prices potentially mean that liquidity will be cheaper for emerging markets than swap lines were for Singapore, which paid 1.09% for a March swap, but more expensive than recent swaps with the Fed’s standing accounts, which have carried rates around 0.33%.

The ECB has yet to announce pricing for its facility, which will run until June 2021, but Turkey has been mentioned as a potential applicant. Bloomberg reported that the nation had sought talks with the Group of 20 nations for its inclusion in bilateral swap agreements. For emerging markets, the International Monetary Fund has also been very active in approving emergency fund disbursement and stand-by facilities, and has introduced the new, “swap-like” Short-term Liquidity Line, and may be on track for support more given its still-large reserves.
Federal Reserve extends temporary US dollar liquidity swap lines and FIMA repo facility to March 31, 2021

By Junko Oguri

Original post here.

On July 29, the Federal Reserve announced the extensions of its temporary U.S. dollar liquidity swap lines and the temporary repurchase agreement facility for foreign and international monetary authorities (FIMA repo facility). Now these facilities are set to expire on March 31, 2021.

These deadline extensions follow the extensions of other lending programs to December 31 as announced on July 28. The Fed had previously extended the termination date for the Municipal Lending Facility in April.

When the temporary U.S. dollar liquidity swap lines were established on March 19, the Fed announced that they will be “in place for at least six months” (see the YPFS blog here). The 9 counterparties of the temporary swap lines are the Reserve Bank of Australia, the Banco Central do Brasil, the Danmarks Nationalbank (Denmark), the Bank of Korea, the Banco de Mexico, the Norges Bank (Norway), the Reserve Bank of New Zealand, the Monetary Authority of Singapore, and the Sveriges Riksbank (Sweden).

The FIMA Repo Facility was announced on March 31 and implemented on April 6. In the former announcement, it was stated that the facility was set to “continue for at least 6 months” (see the YPFS blog here).

The table below lists the current expiration dates for the Fed’s programs in response to the COVID-19 crisis.

<table>
<thead>
<tr>
<th>Lending Facility</th>
<th>Original Expiration</th>
<th>New Expiration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary Dealer Credit Facility (PDCF)</td>
<td>September 20, 2020</td>
<td>December 31, 2020</td>
</tr>
<tr>
<td>Money Market Mutual Fund Liquidity Facility (MMLF)</td>
<td>September 30, 2020</td>
<td>December 31, 2020</td>
</tr>
<tr>
<td>Primary Market Corporate Credit Facility (PMCCF)</td>
<td>September 30, 2020</td>
<td>December 31, 2020</td>
</tr>
<tr>
<td>Secondary Market Corporate Credit Facility (SMCCF)</td>
<td>September 30, 2020</td>
<td>December 31, 2020</td>
</tr>
<tr>
<td>Term Asset-Backed Securities Loan Facility (TALF)</td>
<td>September 30, 2020</td>
<td>December 31, 2020</td>
</tr>
<tr>
<td>Paycheck Protection Program Liquidity Facility (PPPLF)</td>
<td>September 30, 2020</td>
<td>December 31, 2020</td>
</tr>
<tr>
<td>Main Street Lending Program (MSLP)</td>
<td>September 30, 2020</td>
<td>December 31, 2020</td>
</tr>
<tr>
<td>Municipal Liquidity Facility (MLF)</td>
<td>September 30, 2020</td>
<td>December 31, 2020</td>
</tr>
<tr>
<td>Commercial Paper Funding Facility (CPFF)</td>
<td>March 17, 2021</td>
<td>n/a</td>
</tr>
<tr>
<td>Temporary U.S. dollar liquidity swap lines*</td>
<td>September 19, 2020*</td>
<td>March 31, 2021</td>
</tr>
</tbody>
</table>
*In March announcements, temporary U.S. dollar liquidity swap lines and the temporary repurchase agreement facility for FIMA repo facility were set to last to “at least six months”.

The Federal Reserve has also activated its standing U.S. dollar liquidity swap lines with the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, and the Swiss National Bank. (See this YPFS blog).

At the press conference on July 29, Chair Powell noted that “the introduction of the swap lines has really restored dollar funding markets around the world to fairly normal levels of activity” and the facilities served their purposes. Meanwhile, he underscored that the purpose of extension is to “facilitate planning by other central banks, and just so people will know that those facilities are still there.” This is consistent with the earlier Fed’s research showing that simply announcing the facilities helped restore market confidence.

For more information on liquidity swap lines, see our resources guide.
ECB Announces New Eurosystem Repo Facility to Provide Euro Liquidity

By Aidan Lawson

Original post here.

On June 25 the European Central Bank (ECB) announced a new facility to provide euro liquidity to non-eurozone central banks. The announcement does not specify the total size of this new facility.

The Eurosystem repo facility for central banks (EUREP) is designed as a “precautionary backstop to address pandemic-related euro liquidity needs outside [the] euro area” (see here). It is intended to reduce both the impacts and risks of sudden sell-offs of euro-denominated assets and any potential confidence-related spill-over effects into the euro area. The EUREP complements the ECB’s standing swap lines with 11 countries (see here) and one bilateral repo agreement (see here), addressing the limited access to euros that central banks have.

Any non-Eurosystem central bank can request a EUREP line, even those that already have existing bilateral swap lines or repo arrangements. The ECB’s Governing Council, which consists of 25 total members - 6 from the Executive Board and the governors of the 19 national central banks - makes the final decision. Central banks that are accepted will be able to borrow euros in exchange for euro-denominated debt issued either by euro-area governments or supranational institutions.

While a term sheet has not yet been released, the ECB has specified that the facility will be "slightly" more expensive than its existing bilateral swap and repo lines. The range of collateral will be narrower (see here). These terms, and the involvement of the Governing Council, reflect the ECB’s desire for the facility to be used exclusively as a backstop, rather than a facility that non-euro central banks turn to immediately.

EUREP may also be seen as a complement to its U.S-based counterpart: the Federal Reserve’s temporary repurchase agreement facility for foreign and international monetary authorities, or “FIMA repo facility.” The FIMA repo facility, created on March 31, mirrors the EUREP’s function as a liquidity backstop. However, unlike EUREP, it is only available to central banks and other foreign monetary authorities with existing accounts with the central bank. For more information on the FIMA repo facility, see the following YPFS blog. The usage of FIMA repo facility has been low, with $1.4 billion in dollar repos outstanding as of the week of May 13, and limited activity since then.

However, the Fed’s existing swap lines with 14 central banks have been used extensively, peaking at over $440 billion at the beginning of May (see here). The ECB has not published usage data for their swap lines or bilateral repo agreements. Swap lines were an effective tool in meeting demand for widely used currencies, especially during the Global Financial Crisis (GFC). The Fed’s swap lines were used extensively by the ECB, the Bank of Japan, and other major...
central banks during the GFC (see here). For more information on usage of swap lines currently and during the GFC, see the following YPFS blog.

EUREP will be active through June 2021, and the exact pricing, collateral eligibility and tenor of the repos are still unknown. We will publish updates as details become available.
Oversight & Communication

Sweeping relief programs, if unchecked, can consume scarce funds and overrun their legal authorities. In many cases, the full account of a government’s actions will not be known for years. Oversight and official communication address this problem by bolstering transparency and communication while allowing policy administrators to focus on the work at hand.
Communicating in a Crisis: Lessons Learned from the Last One

By Rosalind Z. Wiggins

Original post here.

It has become a common sight during the current COVID-19 crisis to see Federal Reserve (Fed) Chairman Powell standing at the podium, calmly explaining that the Fed is using the full range of its tools, including its emergency lending powers, to counter the severe economic effects of the actions taken to combat the virus. Powell further commits that the Fed will “continue to use these powers forcefully, proactively and aggressively” until the virus is under control and the economy is on the road to recovery.

We are witnessing a new, heightened level of communications from the government during this economic crisis when compared to the global financial crisis of 2007-09 (GFC). Former Treasury Secretary Hank Paulson has said that his one regret was that he and his peers "were never able to convince the American people that what they did wasn't for Wall Street, but was for them."

Arguably, better communications may have headed off the widespread disapproval of government actions during the crisis, and the anti-government populist movements that emerged in its wake. This time, government officials seem more focused on avoiding such a legacy.

While the government cannot program the public’s response to a crisis, it can and, some would argue, has a duty to communicate about its actions and words in a manner that is open, honest, and consistent. Doing so will at least maximize the availability of information regarding actions taken and the intent behind them, thereby increasing the likelihood that responses will be based on facts, whatever their nature. The government may not be able to totally avoid errors, missteps, charges of favoritism, or a lack of transparency; however, it can counter these with credibility, accountability, and transparency.

As Former Chairman Yellen stated in 2012, “[The] challenges facing our economy in the wake of the financial crisis have made clear communication more important than ever before.” This statement is as true today as it was then. Here are some lessons learned from the last crisis that can help:

- Communicate clearly and often
- Be consistent and credible
- Clarify roles
• Foster accountability: Admit mistakes and address them when they arise
• Do not underestimate the public: Speak to all Americans.

Communicate Clearly and Often

Fed and Treasury officials have specialized knowledge about the economy, and when the economy is distressed the markets and public want to hear from them. As early as September 2007, Fed officials began to signal that the distress in the housing market might spill over to the broader economy. Yet, for months the Fed’s plan of attack remained unclear.

If government officials do not communicate, an information gap develops, and uncertainty arises. Other parties will rush to fill in an information vacuum. Once that happens, it may be impossible to regain control of the narrative. In the face of uncertainty, financial institutions and markets will retreat into defensive modes, further aggravating underlying systemic weaknesses. We saw this in the GFC and again in March of this year, when bond markets began to freeze.

But the Fed is now demonstrating that it has learned from the last crisis. At a January 29 press conference, Chairman Powell began speaking publicly about the virus and possible impacts: “There is likely to be some disruption to activity in China, and possibly globally, based on the spread of the virus to date and the travel restrictions and business closures that have already been imposed.” Roughly a month later, as the threat reached the U.S., the Fed said that “the coronavirus poses evolving risks to economic activity” and “will weigh on economic activity in the near term and pose risks to the economic outlook.” The Fed also announced that it was “prepared to use its full range of tools to support the flow of credit to households and businesses (emphasis added).”

The Fed moved quickly to add additional liquidity to the banking system, buying Treasuries and agency mortgage-backed securities to stabilize these markets, and on March 17, it activated its emergency lending authorities under Section 13(3) of the Federal Reserve Act. Powell assured the country that, “When it comes to lending, we are not going to run out of ammunition... That just doesn’t happen.” The swift and aggressive response exceeded, in speed and scope, the extraordinary response levels reached in combating the GFC. The markets reacted with confidence and trust.

The Fed’s communications have, at least for the time being, also carved a new normal characterized by frequent and clear communications. The Fed is not only speaking about the programs it is implementing, but also about the expected prognosis and its overall policy stance and plan for supporting the economy.²

One of the many reasons for this change is an evolution of the Fed’s communications practices. Writing in 2013, Mark Wynne of the Dallas Fed found that: “Over the past two decades, the FOMC has gone from being quite secretive in its deliberations to very transparent.”

When the television news show 60 Minutes called the Fed for an interview with then Chairman Ben Bernanke, the Fed’s representative laughed out loud and replied, “the Chairman never does
an interview.” To Bernanke’s credit, in March 2009, he did sit down with 60 Minutes; it was the first that he had done in his three-year tenure. By contrast, Chairman Powell first sat down with the popular news show just 13 months after he was appointed Chairman.

During his tenure, Powell has implemented live press conferences after every FOMC meeting rather than just half of them. He has also committed the Fed to a “plain-English initiative.” The increased visibility at live press conferences and other appearances allows the Chairman to answer questions and add nuance to his explanations. Plain English potentially increases the likelihood that greater numbers of Americans will come to understand the Fed’s mission and actions.

With respect to the current crisis, such developments seem to be paying off. Michael Feroli, chief U.S. economist at JPMorgan Chase, recently said: “The Fed is playing a confidence game and its communications should continue to repeat the message that it will do whatever it takes to nurse the economy back to health.”

Be Consistent and Credible

Frequency of communication is important, but so is content. It is not enough for government officials to appear to communicate; in order to be perceived as credible, they must speak clearly and consistently about the government’s plan, how it will be applied, and under what circumstances it will be modified. Such forward guidance is a powerful tool of monetary policy and crisis fighting. When officials speak with one voice and do not contradict each other, credibility is increased.

During the GFC, Secretary Paulson stated that there would be “No more bailouts,” and the government did not make a loan to Lehman Brothers. However, just days later, the Fed loaned AIG $85 billion, and markets dipped precipitously. Some commentators believe that these actions looked inconsistent and ad hoc.

By contrast, since January, Chairman Powell has repeated versions of the same message, especially since the President declared a national emergency on March 13: “The Federal Reserve is committed to using its full range of tools to support households, businesses, and the U.S. economy overall in this challenging time.” (March 23, 2020).

Those tools include the Fed’s emergency authority under Section 13(3) of the Federal Reserve Act, pursuant to which the Fed has announced nine programs implemented with the consent of Treasury Secretary Mnuchin, as required by law, and providing potentially up to $2.3 trillion in liquidity. With one exception, these programs are backstopped by Treasury investments totalling $185 billion from a $454 billion funding pool provided by the CARES Act.

During an interview on April 9, Powell said: “We do these [programs] with the consent of the…Treasury Secretary and with fiscal backing from the Congress through the Treasury.” He also said: “We’re using that fiscal backstop to absorb any losses that we have.” (Powell at Brookings, 11:45-12:45).
In early statements Mnuchin seemed to agree with Powell, describing the Fed programs as providing trillions of dollars to the economy with the Treasury “putting up money to support the credit for the Fed.” However, he later seemed to retreat from initial statements, calling into question whether he was willing to let the Treasury’s investments absorb losses from the programs: “We are looking at it in a base case scenario that we recover our money.”

The lack of clarity added to the debate of whether the programs’ terms were liberal enough to ensure that aid reached the broad array of intended participants. It wasn’t until May 19 that Mnuchin put the discussion to rest and provided clarity. “The answer is absolutely yes,” Mnuchin said in response to questions from legislators in a virtual hearing of the Senate Banking Committee. “By definition that capital is at risk, and we are fully prepared to take losses, in certain scenarios, on that capital.” See a related YPFS Blog here.

The Fed has made available trillions of dollars in liquidity using its traditional monetary policy tools and emergency Section 13(3) powers. Chairman Powell has been clear about the plan for use of these emergency tools, which, prior to the GFC, had not been used for 70 years: “The Fed will use these tools for as long as is necessary until the virus is overcome and when the emergency is over, those tools will be put away.” Secretary Mnuchin has said that he will commit additional funds to the Fed programs if needed.

Market commentary and a recent Gallup poll indicate that confidence in the Chairman and the Fed is strong. Fifty eight percent (58%) of respondents stated that they had a “great deal or fair amount” of confidence in the Chairman to do what was right for the economy. Secretary Mnuchin garnered a similar confidence rating of 51%. The ratings received by Powell and Mnuchin were higher than those for the President, and the Congress. The current ratings are significantly above the 30% rating (excellent/good job) that the Fed received in July 2009, while still taming the GFC. It was rated the lowest of nine different agencies at the time, including the Internal Revenue Service.

Clarify roles

During the GFC, the Fed had a long lead during which it was the sole authority with the resources to address market distress. It was criticized for consulting with the Treasury when exercising its authority; this was before Dodd-Frank essentially codified this practice. Fed officials have explained this by citing the benefits of governmental coordination, presenting a united front to the public, and a premonition that in a worst-case scenario the Fed’s lending authority might be insufficient to quell a full-scale crisis. Fiscal authority ultimately was required, most notably, the $700 billion Troubled Asset Recovery Plan (TARP) passed by Congress in October 2008.

In the current crisis, given the compressed nature of its onset, the fiscal authority has been engaged almost from the beginning. Congress passed the CARES Act on March 27, which provided for direct payments and some loans to individuals and businesses, such as the Small
Business Administration’s Payroll Protection Program, assistance to airlines, and direct payments to individuals. Secretary Mnuchin has been the main spokesperson regarding these supports.

The CARES Act also provided $454 billion that the Secretary could use in coordination with the Fed to establish programs under its Section 13(3) authority. Under Section 13(3), as amended by the Dodd-Frank Act, when the Fed triggers its emergency authorities the Chairman is required to consult with and get approval from the Secretary for any proposed program. Mnuchin has approved the nine programs proposed by the Fed and has backed several of them with credit support ($20 billion) and equity investments ($195 billion).

Chairman Powell has consistently explained the complementarity between the Fed’s role (monetary policy) and that of the Treasury (fiscal) and the shared responsibility for financial stability. Powell has also stressed that the Fed’s emergency Section 13(3) tools were activated with the “approval and support of the Congress and Treasury,” that they are “lending tools,” and that “it fully expects its loans to be repaid.” (Brookings 2020). Chairman Powell has also emphasized that as powerful as they are, the Fed’s emergency authorities may not be able to help everyone. Other lending assistance, and non-lending assistance such as grants and direct payments, come from the fiscal authority of the Congress and Treasury.

At different times we have heard the Chairman toss the ball back over to the Treasury as he did on May 13, 2020, suggesting that more fiscal support might be needed if the economic effects are prolonged: “Additional fiscal support could be costly but worth it if it helps avoid long-term economic damage and leaves us with a stronger recovery.” Ultimately, delineating clear roles can create areas of accountability so that each entity is judged on its responsibilities and what it can do.

Foster Accountability. Admit mistakes and fix them when they occur.

During the GFC the government implemented several programs designed to provide relief to homeowners, by incentivizing mortgage servicers to work with homeowners to refinance mortgages to avoid foreclosure. The administration and results of some of these programs were debated and may have added to an unbalanced view of the government’s actions.

Fast forward to the COVID-19 crisis; some programs have likewise been questioned. When it was exposed that numerous large, publicly traded companies had received (forgivable) loans under the Small Business Administration’s Payroll Protection Program (PPP), which had been announced as a key resource to keep small and medium-sized businesses afloat, Secretary Mnuchin said that was not what was intended. He actively sought to have several corporations publicly return the funds, supported set-asides for smaller financial institutions in the new PPP tranche of $310 billion, and threatened to investigate any borrower who abused the program. (See a YPFS blog on the recent changes to the PPP.)

The government has set high expectations for fighting this crisis. The Fed and Treasury have deployed programs of unprecedented number and scope in record speed; there are bound to be missteps and errors. It is not sufficient, however, for the government to lessen diligence once
programs are implemented, or hand off the administration of, and responsibility for, programs involving trillions of dollars of taxpayer funds to banks or other third parties who pick the winners and losers according to their interpretation of the government’s criteria or administrative ease, at the risk of possibly distorting the intended outcomes.

The clearer such rules are, and the more effort expended by the government to ensure that they are followed as intended, or amended if advisable, the more credible the government and the programs are likely to be perceived.

There are likely to be other areas that may require such attention, for example, the friction between the terms of the PPP and the enhanced unemployment benefits, and the potential fallout from broad based rental and eviction forbearance. The longer shelter-in-place orders and high unemployment persists, it may be impossible for millions of individuals to pay months of back rent once the moratoria expire. How the government addresses such issues has the potential to become a broken promise or a last-minute save; either result could have a long-lasting impact on our socio-economic and political future.

Do not underestimate the public. Speak to all Americans.

Because the current crisis originated from a pandemic requiring government-imposed economic shutdowns to mitigate the health crisis, interventions to support the economy and lessen the economic fallout from those efforts have also been broad-based. For two months, businesses, schools, retail establishments, and entertainment venues have been shuttered and tens of millions have lost their jobs. The government’s response has been robust, making trillions of dollars available to businesses, communities, and individuals in record speed. Still, the shut-down has the potential to impact almost every citizen, and many are vulnerable and worried. A Fed survey recently reported that “[a]mong people who were working in February, almost 40 percent of those in households making less than $40,000 a year had lost a job in March.” A recent Pew survey found that 77% of Americans believe the coronavirus will be a threat to their personal financial situations, while a Gallup poll showed that 48% are worried about experiencing severe financial problems.

The government faces a significant challenge to mitigate the impact of its shut-down order and maintain credibility, while continuing to fight the virus. However, success does not require perfection. Criticisms of the government’s actions during the GFC did not focus on errors per se but were aimed at programs (like the bank recapitalization and AIG restructuring) that were perceived as having taken too much risk with taxpayers’ money, lacking a general sense of fairness, and failing to provide an appropriate level of transparency. Many felt that they had been betrayed when their government bailed out Wall Street banks while ordinary Americans lost their jobs and homes on Main Street. Had the government been able to convince the American people that the bank rescues were necessary to protect their pensions and maintain their school arts programs, perceptions about government, big business and trust might have been different.
The GFC involved complicated financial issues that were challenging for even Congress and the media to understand and with which most Americans were unfamiliar: mortgage securitization, collateralized debt obligations, shadow banking, and derivatives. Since most of the programs implemented by the Fed were directed at the financial industry, government officials and their press releases used financial industry language. In the heat of the battle, only limited efforts were made to explain to the average citizen the connection among the collapsing financial system, the massive rescue actions, and the basic credit cycle underpinning car buying, vacations, pensions, and life insurance.

One exception is the government’s assistance to General Motors and Chrysler and other industry entities, which involved government commitments of $80 billion and assistance negotiating concessions from unions, pension plans, and investors. The Obama administration communicated the rescue of the auto companies in a more detailed and straightforward manner than it did some of the rescues of large financial organizations; at one point a video was even made. Even though the auto rescue is the only part of the GFC rescues in which the government lost money ($9.3 billion), it has come to be perceived far more favorably than the bank recapitalizations, which remain highly disfavored.

The government’s current efforts to prop up the economy and citizenry until economic activity can safely resume are very broad-based and recognize that many stakeholders are impacted. To be optimally effective, the government’s communications must do the same. One of the country’s foremost experts on crisis communication, Timothy Coombs, writes:

“The goal of crisis communication is to reduce the damage a crisis inflicts on an organization and its stakeholders …too often there is too much focus on the organization. Crisis teams must ensure the physical safety and psychological well-being to stakeholders affected by the crisis.”

(Coombs, p. 136)

If we think of the government as the “organization” and the economy, industry, communities, and individuals as the “stakeholders,” a rubric evolves where one of the guiding principles in managing and communicating crisis-fighting efforts is to minimize harm to the stakeholders. This can be done by adhering to the lessons set forth above and by keeping all stakeholders and the big picture always in mind.

Americans have been asked by their government to make significant sacrifices to defeat the pandemic. The government should do everything in its power to honor those sacrifices and minimize negative impacts on the economy, communities and households in as effective and fair a manner as possible. If it does, it will prove that its current positive Gallup Poll ratings are deserved, and those ratings may even improve. If it does not, it risks criticisms, negative market reactions, and claims of betrayal that may have lasting impact.

2. “The Federal Reserve is carefully monitoring credit markets and is prepared to use its full range of tools to support the flow of credit to households and businesses and thereby promote its maximum employment and price stability goals.” (Fed PR March 15, 2020).

3. One of the nine programs is the Payroll Protection Plan Liquidity Facility, which provides loans to financial institutions to fund Small Business Administration-guaranteed Payroll Protection Plan (PPP) loans to small and medium-sized businesses. The Fed accepts the PPP loans as collateral for the PPPLF loans, which are non-recourse. The first round of PPP funding was depleted and Congress authorized a $310 billion second round of funding to restart the program increasing the potential under the nine programs to $2.6 billion from the original $2.3 billion.

4. The Term Asset-Backed Securities Loan Facility, which was established by the Federal Reserve on May 12th prior to the passage of the CARES Act is supported by a $10 billion Treasury equity investment from the Exchange Stabilization Fund.

5. For example, “The Fed lowered interest rates, provided liquidity to banks and foreign central banks to keep the credit markets open and the flow of dollars steady, and it buys massive amounts of debt.” (Brookings 2020).
The Uncertain Future of the Fed’s CARES Act Facilities
By Steven Kelly

Original post here.

After a rare public disagreement with the Treasury, the Federal Reserve says it will return the bulk of the funds that the Treasury provided to buttress the Fed against any losses on four emergency lending programs. The Treasury, in turn, has stated its intent to transfer all unused funds that Congress had allocated to it for use in the Fed facilities to its General Fund by year-end.

On November 19, Treasury Secretary Steven Mnuchin sent a letter to Fed Chair Jerome Powell discussing the future of the Fed’s current set of Section 13(3) emergency lending facilities. The Secretary stated that he will not extend the four emergency lending facilities that use funds from the Coronavirus Aid, Relief, and Economic Security (CARES) Act after December 31. He asked the Fed to return the Treasury’s unused funds for those facilities, all but approximately $25 billion—the amount it has extended to borrowers under the four facilities. This would require the Fed to return about $78 billion of the money it has received so far from Treasury.

The letter also requested a three-month extension of a separate set of four facilities that do not use CARES Act funding. These facilities currently have extended about $60 billion in total credit.

On November 19, the Fed released a public response to Mnuchin: “The Federal Reserve would prefer that the full suite of emergency facilities established during the coronavirus pandemic continue to serve their important role as a backstop for our still-strained and vulnerable economy.”

The next day, though, Chair Powell confirmed the Fed would return the unused portions of the funds allocated to the CARES Act facilities as Mnuchin had requested.

In the CARES Act, passed on March 27, Congress allocated $454 billion to the Treasury to provide loss-bearing support for Fed facilities to lend to a variety of businesses, nonprofits, and government entities. Of that amount, Treasury committed $195 billion to four programs the Fed created earlier this year. It has disbursed a total of $102.5 billion of that committed amount to the Fed. To date, the Fed has committed $25 billion of loans and assets purchases under these programs.

Mnuchin’s decision means that the Fed will return about $78 billion of the $102.5 billion it has received, and retain $25 billion. The Treasury will then transfer $429 billion of the $454 billion set aside for Fed programs from its Exchange Stabilization Fund (ESF) back into its General Fund.
The Treasury also used its Exchange Stabilization Fund funds prior to the passage of the CARES Act to support two lending facilities that the Fed established, the Commercial Paper Funding Facility (CPFF) and the Money Market Mutual Fund Liquidity Facility (MMLF). It has disbursed $11.5 billion to the Fed for these programs of the $20 billion it has committed. The MMLF now has $4.9 billion in outstanding loans; the CPFF has none.

The Treasury Secretary noted that it still has available pre-CARES Act funds in the Exchange Stabilization Fund. These amount to roughly $75 billion; the Fed and Treasury could access these funds without new Congressional authorization. Mnuchin has said that the Fed could leverage those remaining funds to provide up to $800 billion in new lending, if necessary.

Earlier in the year, the Fed had said its emergency lending could reach up to $4 trillion using the CARES Act funds to protect it from losses.

**Secured to the Satisfaction**

The Fed’s Section 13(3) emergency lending programs require the ongoing approval of the Treasury Secretary under 2010 revisions to the Federal Reserve Act. Under Section 13(3), any emergency lending also must be “secured to the satisfaction” of the Federal Reserve. The 13 programs the Fed created this year have varying setups for absorbing losses—broadly falling into three buckets.

In the first bucket are the Paycheck Protection Program Liquidity Facility and Primary Dealer Credit Facility, which have no equity support from the Treasury as designed. The PPPLF currently has about $55 billion in outstanding loans to businesses; the PDCF has about $250 million.

In the second bucket are the CPFF and MMLF. The Treasury agreed to give both programs $10 billion of equity protection from the Treasury’s Exchange Stabilization Fund.

In his November 19 letter, Secretary Mnuchin asked the Fed’s board to approve an extension of these four facilities. The CPFF had previously been set to expire on March 17, 2021; the Fed had earlier extended the other three programs’ expiration to December 31, 2020 with Treasury approval. On November 30, the Fed said it would extend these four programs to March 31, 2021.

In the third bucket are the programs that have equity funding the Treasury provided under the CARES Act. These facilities may purchase corporate bonds and loans, municipal bonds, and asset-backed securities (the Corporate Credit Facility (CCF), Main Street Lending Program (MSLP), Municipal Liquidity Facility (MLF), and Term Asset-backed Securities Loan Facility (TALF)). On April 9, the Treasury announced that it intended to use CARES Act funds to purchase equity in these facilities. The Fed would leverage the Treasury’s equity as much as 10 or 14 times, depending on the type of loan or asset it purchased.

**The Future of Emergency Lending**
Both Mnuchin’s and Powell’s letters reiterated that the Fed and Treasury would still be able to use the rest of Treasury’s unused Exchange Stabilization Fund funds that pre-date the CARES Act. These funds amount to about $75 billion. Indeed, the Fed originally announced that the Treasury would backstop the CCF and TALF with this core Exchange Stabilization Fund funding before Congress passed the CARES Act.

There remains some legal uncertainty about the return of the CARES Act funds. In his letter, Secretary Mnuchin cited “Congressional intent” for the Fed facilities to make no new loans after December 31. However, the Fed’s initial response on November 19 expressed a preference for the facilities to remain active beyond that date. Powell’s November 20 letter did not address Mnuchin’s legal argument; it deferred to the Secretary, acknowledging that the Secretary had “indicated that the limits on [the Secretary’s] authority do not permit the CARES Act facilities to make new loans or purchase new assets after December 31, 2020.” Powell’s testimonies to Senate and House committees on December 1-2 echoed this position, saying the Treasury Secretary has “sole authority over [CARES] funds.”

The CARES Act refers to the Treasury’s ability to make new disbursements and does not affect the Fed’s emergency lending authority. The contracts associated with the CARES Act facilities call for agreement from the Fed and the Treasury to reduce the scope of the facilities. (See the Fed’s and Treasury’s Limited Liability Company Agreements setting up the facilities; for instance in the case of the CCF, see pages 7-9 here.) This is consistent with the process for the wind-down of the 2008-era TALF.

The only Fed facility with an injection of subordinated funds from the Treasury during the GFC, the 2008 TALF, was supported by $20 billion of TARP funds—intended to enable up to $200 billion of lending. When the facility closed to new loans in 2010, just $43 billion in loans were outstanding. Within a month, the Federal Reserve and Treasury agreed to downsize the Treasury’s position to $4.3 billion. That amount reflected a loss-bearing investment that would be consistent with the 10-to-1 leverage ratio built into the facility’s design.

The future of the facilities under a new presidential administration remains unclear. A future Treasury Secretary may deem it legal to restore the $195 billion of CARES Act funds that the Treasury had previously committed to the Fed lending facilities.

Mnuchin has stated his intent to move the returned funds from the ESF to the Treasury’s General Fund—a fund which requires specific congressional approval to access. The CARES Act does not require unused funds to be moved from the ESF to the General Fund until 2026. Rather, the CARES Act stipulates that any funds remaining on January 1, 2021 of those allocated to the Treasury’s ESF “may be used only for modifications, restructurings, or other amendments of loans, loan guarantees, or investments.” It may thus be the case that a new administration’s Treasury determines Mnuchin’s accounting move inconsistent with the law and undoes Mnuchin’s transfer of CARES Act funds from the ESF to the General Fund. If the funds remain in or are returned to the ESF, it could also be the case that a move by the Treasury and
Fed to increase the size of the previously committed equity injections might be deemed legally consistent with the “amendment” authority available until 2026.

Furthermore, the Fed and Treasury designed the CARES Act facilities to leverage the Treasury’s equity several times over—over 14 times in the case of the MLF—with the Fed’s loan funding. The Fed deemed the Treasury equity necessary to bear losses so its loans to nonfinancial borrowers would be secured to its satisfaction, consistent with Section 13(3). However, Secretary Mnuchin has elected to leave $25 billion behind—which covers all of the outstanding credit these facilities have extended, rather than just Treasury’s equity tranche. This contrasts with how it downsized the 2008-era TALF. In that case, the Treasury retained just its equity tranche in order to provide leverage for the Fed. It thus remains possible that the next Treasury Secretary could authorize the Fed to extend substantially more credit without allocating any additional equity funds. Such a move would give the Fed’s CARES Act facilities approximately $250 billion of lending/purchasing capacity.

Restoring the full $195 billion to the facilities would return them to their stated $1.95 trillion capacity. An interpretation of the CARES Act’s amendment authority that allowed uncommitted funds to increase the size of the existing facilities would lead to greater capacity still. If the unassigned $209 billion of the $454 billion originally allocated by the CARES Act was restored to the ESF and available to support existing facilities, the originally envisaged backstop capacity of approximately $4 trillion would again be available.
Redux: Outlook for 13(3) and Fed Crisis Response
By Steven Kelly

Original post here.

After a weekend of congressional negotiations in which the Federal Reserve’s emergency lending authority hung in the balance, the Fed’s Section 13(3) authority appears to remain intact.

Section 13(3) of the Federal Reserve Act gives the Fed the authority to lend to entities other than banks in emergencies. It has been a central component of the Fed’s crisis response during the COVID-19 pandemic, as it was in the Global Financial Crisis of 2007-09 (GFC).

Language limiting this authority became a last-minute sticking point in the negotiation over the latest economic relief and omnibus appropriations legislation. Following recent disputes over some of the more novel Section 13(3) facilities that the Fed created since the pandemic began, some members of Congress raised starkly opposing views on the future scope of these COVID-specific facilities after they expire on December 31. The legislative text last week would have permanently amended the Fed’s 13(3) authority to prevent any facilities similar to the novel facilities it created in response to COVID-19.

However, the final bill did not include this language. In the version passed by Congress on December 21, the legislation leaves the Fed’s existing authorities in place, closes the emergency facilities in which the Treasury has invested CARES Act appropriations, and limits the Treasury’s ability to participate in such facilities in the future.

Background

In the Coronavirus Aid, Relief, and Economic Security (CARES) Act, passed on March 27, Congress allocated $454 billion to the Treasury’s Exchange Stabilization Fund (ESF) to provide loss-bearing support for Fed facilities to lend to a variety of businesses, nonprofits, and government entities. Of that amount, the Treasury committed $195 billion to four Federal Reserve programs. The Treasury has disbursed a total of $102.5 billion of that committed amount to the Fed. To date, the Fed has committed $25 billion of loans and asset purchases under these programs.

Under the Federal Reserve Act, any emergency lending must be “secured to the satisfaction” of the Fed. Section 13(3) programs also require the ongoing approval of the Treasury Secretary, under 2010 revisions to the Act.

The 13(3) programs that have equity funding from the Treasury under the CARES Act allow the Fed to purchase corporate bonds and loans, municipal bonds, and asset-backed securities (the Corporate Credit Facility (CCF), Main Street Lending Program (MSLP), Municipal Liquidity Facility (MLF), and Term Asset-backed Securities Loan Facility (TALF)). The Fed programs leverage the Treasury’s equity as much as 10 or 14 times, depending on the type of
Having the Treasury backstop aided the Fed in meeting the requirements of Section 13(3) and influenced its eligibility criteria.

In November, citing “Congressional intent,” Treasury Secretary Steven Mnuchin said that he would not extend the four emergency lending facilities that use funds from the CARES Act after December 31. He asked the Fed to return the Treasury’s unused funds for those facilities, all but approximately $25 billion—the amount the Fed has extended to borrowers under the four facilities. The Fed first said it would prefer the facilities to remain available, but Chair Jerome Powell later said that the Fed would defer to Secretary Mnuchin’s interpretation of the law. On December 17, the Congressional Research Service issued a memorandum saying a court would likely disagree with Mnuchin’s interpretation.

Mnuchin’s decision meant that the Fed would return about $78 billion of the $102.5 billion it has received and retain $25 billion. Mnuchin also stated that the Treasury would then transfer $429 billion of the $454 billion set aside for Fed programs from the ESF into Treasury’s General Fund—a fund that requires specific congressional approval to access.

A recent YPFS post discussed the possible future of the Fed’s CARES Act facilities, which were then set to lapse on December 31. The new relief bill specifically prevents the Fed from resurrecting these facilities.

**The New Legislation**

Section 1003 of the new legislation immediately rescinds $429 billion of the $454 billion allocated to the Treasury by the CARES Act to support the Fed’s Section 13(3) emergency lending programs. This measure will prevent the Treasury from reinstating any of the $195 billion of equity support it previously committed to the CARES Act facilities. The legislation will also prevent a further injection of equity under the CARES Act’s Section 4027(c)(1)(A), which had allowed the Treasury to use uncommitted funds from the $454 billion until 2026 to amend existing investments.

The new bill also definitively closes the CARES Act facilities on December 31 by prohibiting the Fed from making any new loans or asset purchases under such programs. Previously, the Treasury had said it would leave $25 billion of equity to support the outstanding credit of the facilities. Before the new act closed the facilities, the Fed and a future Treasury Secretary could have potentially leveraged this equity to support as much as $250 billion of lending. Additionally, Section 1005 of the legislation explicitly prohibits the Fed from “authorizing transfer of such funds to a new [or modified] program or facility established under Section 13(3).”

Section 1005 also removes some of the Treasury Secretary’s discretion in using the ESF. It says that the ESF “shall not be available for any program or facility established under section 13(3) … that is the same as any such program or facility” that Treasury invested in with CARES Act ESF funds, except the TALF.
Section 1006 of the legislation states that, aside from the restrictions described above regarding the specific facilities in which the Treasury Secretary has already injected CARES Act Funds, “nothing in this Act shall be construed to modify or limit the authority of the Board of Governors of the Federal Reserve System under section 13(3) . . . as of the day before the date of enactment of the CARES Act.” This section clarifies that the restrictions being imposed are limited to the Treasury’s ESF authority and the existing CARES Act facilities. Previous wording applied broad limits to the Fed’s 13(3) authorities; Congress ultimately removed this language from the final text and said that 13(3) remains unchanged.

Taken together, these sections serve as a limitation on the equity support the Treasury can offer the Fed via the ESF to meet the latter’s security requirement for 13(3) facilities. The Treasury no longer has the authority to use ESF funds to support a Fed facility that is “the same as” the MLF, CCF, or MSLP. How broadly the Treasury will interpret the “same as” language in the future remains an open question.

If the Fed wanted to create a 13(3) facility that falls within the scope of the new language, it would have to find other ways to secure the loans to its satisfaction. The Treasury will not be able to assist the Fed in meeting that standard with ESF funds. The new legislation does not newly preclude the Fed from intervening in any particular asset or market via new facilities, and the Fed will face the same security requirements under 13(3) that it faced before and after the passage of the CARES Act.

**Going Forward: 13(3) in Practice**

As always, the Fed can construct 13(3) facilities that do not use any equity funding when it deems itself sufficiently secured by other risk-management techniques, such as haircuts or safer collateral. The Fed utilized this method during the COVID-19 crisis when constructing the [Primary Dealer Credit Facility](#) (PDCF) and [Paycheck Protection Program Liquidity Facility](#) (PPPLF) and during the [GFC](#). Of course, all 13(3) facilities will continue to require the Treasury Secretary’s approval.

If the Fed deems an equity cushion in a 13(3) facility required in order to be “secured to [its] satisfaction,” but can’t source it from Treasury, the Fed can obtain the protection of a first-loss tranche by other means. The Fed put this strategy to use several times in 2008 during the GFC. During the Fed’s first iteration of the [Commercial Paper Funding Facility](#) (CPFF), once-expected equity funding ended up being withheld by the Treasury. The Fed secured itself to its satisfaction by requiring borrowers to pay insurance premiums, which functioned as loss reserves; requiring the up-front payments assured a sufficient equity cushion for the facility as a whole. When the Fed established the [Money Market Investor Funding Facility](#) later in 2008 to support money market funds facing redemptions, it required firms that elected to sell assets to this facility to take a subordinated debt position in the facility equivalent to 10% of the amount they sold. The Maiden Lane programs the Fed set up to facilitate the purchase of assets from Bear Stearns and AIG also required the sellers to take first-loss equity positions.
Of the myriad 13(3) facilities set up during the GFC, only the 2008 TALF used subordinated funds from the Treasury. None of the 13(3) facilities set up during the GFC suffered losses.

Under the new law, the Treasury can still provide equity protection to 13(3) facilities using non-CARES Act ESF funds, as long as the facilities are not “the same as” the MLF, CCF, or MSLP. Approximately $75 billion remains in the ESF that the Treasury can use for this purpose, providing some flexibility for the Treasury Secretary and Fed Chair to set up such structures as they deem necessary. The Fed’s current CPFF and Money Market Mutual Fund Liquidity Facility (MMLF) both have equity cushions courtesy of these funds. The CCF and TALF, as the Fed originally announced them, were to have equity infusions of this kind. The Fed also stated prior to the passage of the CARES Act that it intended to “announce soon the establishment of a Main Street Business Lending Program.” Later, when the Fed officially announced the MSLP, Congress had passed the CARES Act and the Treasury was able to use it to provide equity support.

While the new legislation pared back the Treasury’s ability to use ESF funds to assist the Fed in constructing 13(3) facilities, the final text explicitly preserved the Fed’s crisis-lending authorities. With the Treasury Secretary’s agreement, the Fed has broad authority and a wide range of tools to use to combat crises as they arise.
Case Studies and Policy Changes

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

By Pascal Ungersboeck and Rosalind Z. Wiggins

Original post here.

In response to the Covid-19 crisis, Congress has passed four economic stabilization and health funding bills. The Coronavirus Aid, Relief, and Economic Security (CARES) Act enacted on March 27 contains the most substantial relief measures, with $2.2 trillion to be allocated. Among other programs, Title IV, Subtitle 4 of the Act (subtitled the Coronavirus Economic Stabilization Act (CESA)) provides the Treasury with $500 billion for direct lending to specified businesses in the aviation industry and businesses critical to national security (up to $46 billion) and for supporting Federal Reserve emergency lending programs to be established under section 13(3) of the Federal Reserve Act ($454 billion).

The CESA provides for the establishment of a Congressional Oversight Commission to publish regular reports on the use of these funds. Per the Act, the commission includes 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 first report on May 18, the chairman position has not been filled; even so, the commission provided guidance on how it intended to conduct its role and reported on the status of the programs for which it had responsibility, most of which were not yet operational.

Oversight Role

The commission was established to provide oversight regarding the use of the $500 billion allocated under CESA. It is also charged with overseeing the implementation of related programs by the Treasury and Fed. It is required to report to the Congress every 30 days on the following points:

- The use by the Fed of authority under Subtitle A, including with respect to the use of contracting authority and administration of the provisions of Subtitle A.
- The impact of loans, loan guarantees, and investments made under Subtitle A on the financial well-being of the people of the United States and the United States economy, financial markets, and financial institutions.
- The extent to which the information made available on transactions under Subtitle A has contributed to market transparency.
The effectiveness of loans, loan guarantees, and investments made under Subtitle A of minimizing long-term costs to the taxpayers and maximizing the benefits for taxpayers. (p.5).

In its first report the commission sets out questions that provide insight into the areas that it will seek to explore in undertaking its duty. These questions include inquiry into a number of areas that have seen much discussion since the bill passed and some new areas including: the amount of risk the government is willing to undertake, ensuring the funds reach the intended parties, maximizing the impact of funds on markets and the economy, the effectiveness of direct vs. indirect distribution channels, and accountability for compliance with the terms of the Act. Questions include:

- How will the Treasury and Fed (the “agencies”) assess the success or failure of this program?
- How can the agencies best determine how much of the Treasury’s $454 billion to allocate among Fed lending facilities and when to allocate such funds in order to help support and stabilize the economy?
- How can the agencies best estimate the risk of loss to taxpayer funds in each Fed lending facility?
- How will the Fed ensure it complies with all restrictions to emergency lending under Section 13(3) of the Federal Reserve Act, including those prohibiting lending to insolvent borrowers?
- Are the agencies prepared to lose taxpayer dollars in an effort to facilitate more lending and support to a broader set of entities?

The full list of questions can be accessed at page 14 of the report, which also includes specific questions regarding the individual programs.

Status of Programs

The commission noted that as of May 18, the Treasury has not disbursed any of the $46 billion reserved for direct lending; it further noted that the Treasury had published application procedures and requirements for these funds in March and April and that it was processing applications for loans received from airlines and other businesses critical to national security. The commission also noted that the Treasury had disbursed grant funds to airlines under the Payroll Support Program, a program authorized under a different provision of the CARES Act and not under their jurisdiction.

On April 9, the Treasury announced its intention to use available funds under CESA to make equity investments into special purpose vehicles established under Fed lending programs. The commission noted that so far the Treasury has pledged $185 billion of the $454 billion available to be invested in these facilities. This includes $75 billion intended for the Main Street Lending
Programs, $35 billion for the Municipal Liquidity Facility (MLF), $50 billion for the Primary Market Corporate Credit Facility (PMCCF), and $25 billion for the Secondary Market Corporate Credit Facility (SMCCF).

The commission noted that on May 11, the Treasury invested $37.5 billion of the $75 billion equity investment committed for the Corporate Credit Facility LLC, the SPV established by the Fed for the PMCCF and SMCCF. No other of the committed amounts have yet been invested. It also noted that the size of these investments can grow as a large share of the appropriated funds remains unused.

Other Fed facilities, including the Term Asset-Backed Securities Loan Facility (TALF), the Commercial Paper Funding Facility (CPFF), the Money Market Mutual Fund Liquidity Facility (MMLF), and the Primary Dealer Credit Facility (PDCF), do not fall under the commission’s jurisdiction according to its report. All but the last of these programs also have the benefit of $10 billion in Treasury credit support through Emergency Stabilization Act funds that the Treasury agreed to provide prior to passage of the CARES Act.

The commission noted that although the Fed has not started lending through the CARES Act Fed Facilities, with the exception of the SMCCF which was operational by May 12, the announcement of the programs in general has had a positive impact on market conditions, citing recovering equity prices and decreased bond spreads.
Federal Reserve to Report Monthly on CARES Act Program

By Priya Sankar

Original post [here](#).

On [April 23](#), the Federal Reserve said it will include additional detailed information in its monthly reports that are released to the public on four lending and liquidity programs it is establishing with Treasury equity under the Coronavirus Aid, Relief, and Economic Security (CARES) Act.

A week earlier, Bharat Ramamurti, member of the COVID-19 Congressional Oversight Commission, [had requested](#) from Chairman Powell enhanced public disclosure for these and other Fed programs utilizing Treasury funds.

The [policy will cover](#) the $600 billion Main Street Lending Program, [two corporate debt purchasing programs](#) totalling $750 billion, and its $500 billion program to purchase state and municipal debt, according to press reports. The Treasury has made available a combined $185 billion for such programs.

Section 13(3) of the Federal Reserve Act, which governs the Fed’s emergency authority and the above programs, requires that it make an initial and then monthly [reports](#) to Congress upon the establishment of a new program. Although the identities of participants and details of loans are required to be included in such reports, the Chairman may request that they be kept confidential. For each of the four facilities receiving Treasury equity support, the Fed’s recent announcement states that it will publish the reports without redacting the names and details of participants; amounts borrowed and interest rate charged; and overall costs, revenues, and fees.

Many observers criticized the Fed for not revealing the identities of banks and other companies that it supported during the global financial crisis (GFC). In 2010, through [the Dodd-Frank Act](#), Congress required the Fed to publish transaction data one year after closing an emergency facility.

There are concerns that the disclosure requirement may cause a stigma, leading borrowers to not use the facilities for fear of being perceived as troubled and potentially undermining the goal of the facilities to restore financial stability. [Former Fed general counsel](#) Scott Alvarez is concerned that stigma may be worse in the current crisis. He said, “It could be more discouraging to businesses if that information is disclosed” contemporaneously with the program, revealing financial details that could advantage competitors.

These enhanced public disclosures [will not include information](#) on recipients of Paycheck Protection Plan (PPP) loans, as they are administered by the Small Business Administration, although the Fed has also created a liquidity facility for banks making PPP loans (the Paycheck Protection Plan Liquidity Facility). The enhanced disclosure also does not cover other Fed lending programs directed towards financial markets. However, the Fed will release higher-level
aggregate data on all Section 13(3) programs monthly, and is legally obligated to disclose borrowers one year after the programs end.

“The Federal Reserve is committed to transparency and accountability by providing the public and Congress detailed information about our actions to support the economy during this difficult time,” Chair Jerome H. Powell said in the Fed’s press release.
Mnuchin Clarifies that Treasury is Prepared to Lose Money on Fed Programs

By Rosalind Z. Wiggins and Greg Feldberg

Original post here.

U.S. Treasury Secretary Steven Mnuchin clarified Tuesday that the Treasury is prepared to take losses as it provides unprecedented credit support to the Federal Reserve’s COVID-19 lending programs.

“The answer is absolutely yes,” Mnuchin said in response to questions from legislators in a virtual hearing of the Senate Banking Committee. “By definition that capital is at risk, and we are fully prepared to take losses, in certain scenarios, on that capital.”

In March, Congress made a $500 billion funding pool available to the Treasury Department, part of the $2 trillion CARES Act. The legislation directed the Treasury to allocate up to $46 billion of that amount for airlines and other distressed companies. It directed the Treasury to use the balance of at least $454 billion to support Fed lending programs.

Mnuchin and Fed Chairman Jerome Powell appeared before the Senate Tuesday to present their first quarterly report to Congress on their use of these funds.

On April 9, the Fed announced four joint Fed-Treasury programs under the CARES Act. These included facilities for corporate credit; loans to municipalities; loans to small and medium-sized companies (the “Main Street Lending Program”); and asset-backed securities. In total, these programs would commit $195 billion of the $454 billion in taxpayer funds available to the Treasury. Those funds would back up to $1.95 trillion in Fed lending.

Senators in Tuesday’s hearing questioned why so little of the $454 billion has been used to date. Only one program has launched: On May 11, the Treasury provided $37.5 billion to the Fed to cover half of the promised equity for the Corporate Credit Facility. The Fed had lent the facility only $305 million as of May 13, to buy exchange-traded funds.

Powell said Tuesday he expects all of the new programs to be “stood up and ready to go by the end of this month.” The Fed has released term sheets for each new program, and made revisions in some cases in response to thousands of public comments. The facilities are complex and delve into risk areas that are new to the Fed in its lending operations. “People are working literally around the clock and have been for weeks,” Powell said.

Treasury to take losses?

In earlier posts, we considered how the Treasury’s use of the funding pool authorized by the CARES Act to backstop Fed programs might leverage the funds into trillions of liquidity for the economy. In earlier comments, Powell has said the Fed could leverage the whole of the Treasury’s $454 billion to lend as much as $4 trillion.
The Fed’s emergency-lending authority, under Section 13(3) of the Federal Reserve Act, requires the central bank to make sure emergency loans are adequately secured and protect taxpayers. A lingering question has been whether the Treasury’s potential absorption of losses was consistent with Section 13(3). Although there seemed to be a common consensus developing between Powell and Mnuchin that this was indeed the case, later statements by Mnuchin raised uncertainty.

During an interview on April 9, Powell said: “We do these [programs] with the consent of the…Treasury Secretary and with fiscal backing from the Congress through the Treasury.” He also said: “We’re using that fiscal backstop to absorb any losses that we have.” (Powell at Brookings, 11:45-12:45).

However, before Mnuchin’s statements Tuesday, it wasn’t clear whether the Treasury shared this view.

In March, Mnuchin initially echoed Powell’s position, describing the program as providing trillions of dollars to the economy with the Treasury’s assistance by “putting up money to support the credit for the Fed.”

But on April 29, Mnuchin seemed to indicate that he might be retreating from his earlier stance. He said he was “looking at it in a base case scenario that we recover our money.” At that time, he contrasted the Fed lending programs with spending programs also included in the CARES Act. “If Congress wanted me to lose all the money, that money would have been designed as subsidies and grants as opposed to credit support.”

Uncertainty regarding how the Treasury’s backstop will operate goes directly to the amount of risk that the Fed might undertake in designing its lending programs. The Treasury’s willingness to bear losses might result in less stringent, but still prudent, participation standards that could potentially reach a broader number of participants. Commenters and prospective borrowers have questioned whether some of the Fed programs were initially drawn too narrowly to provide the intended assistance.

At the hearing Tuesday, Mnuchin sought to put the discussion to rest and provide clarity. “For any facility that the Fed believes puts them at risk, I do put up capital, so by definition that capital is at risk, and we are fully prepared to take losses, in certain scenarios, on that capital.” While his response was emphatic, the allusion to “certain scenarios” suggests some ambiguity. Mnuchin’s prepared testimony is here.

**Fed’s language evolves**

The Fed has consistently said in its required reports to Congress on the emergency lending programs that it is comfortable that it won’t lose money in part because the Treasury has agreed to take losses first. Powell repeated that in his prepared testimony Tuesday. But the language has evolved.
In its March 29 report on the Term Asset-Backed Securities Loan Facility (TALF), the Fed wrote: “As TALF credit is non-recourse to the borrower, the Federal Reserve and the Department of the Treasury, through its equity investment, will bear the risk of loss on the collateral… The Board does not expect at this time that the TALF will result in losses in excess of the Department of the Treasury’s equity investment. Accordingly, the TALF is not expected to result in losses to the Federal Reserve or the taxpayer.” It used similar language in other 13(3) reports in March.

In April, though, the Fed has used slightly different wording in its reports to Congress. It deemphasizes the loss-bearing nature of the Treasury’s equity investments. But it has also dropped the expectation that programs will not result in losses to the taxpayer. For example, the April 28 report said, “As described in the Board’s initial report to Congress regarding the TALF, the TALF includes features that are intended to mitigate risk to the Federal Reserve. The Board continues to expect that the TALF will not result in losses to the Federal Reserve” (italics added).

**Fed has lent $120 billion through other facilities in the COVID-19 crisis**

The Fed launched its first COVID-19 emergency lending facilities for financial markets in March in the weeks before Congress passed the CARES Act. These facilities mirrored facilities the Fed created during the global financial crisis of 2007-09.

As of May 13, the Fed had roughly $120 billion outstanding in loans through its discount window and a half-dozen emergency facilities. Two of these facilities – the Money Market Mutual Fund Liquidity Facility and the Commercial Paper Funding Facility – are each backed by $10 billion in loss-bearing equity that the Treasury agreed to provide prior to the passage of the CARES Act (see the YPFS blog).

The Fed also has roughly $450 billion outstanding in swaps with foreign central banks to provide liquidity in dollar-denominated assets.

The video and transcript of the entire hearing can be accessed here.
Paycheck Protection Program highlights numerous oversight concerns even as the SBA makes first disclosures

By Corey Runkel and Rosalind Z. Wiggins

Original post here.

The Coronavirus Aid, Relief, and Economic Security (CARES) Act, which passed on March 27, established the Paycheck Protection Program (PPP), the US government’s largest and most controversial program put in place to address the economic impacts of the COVID-19 virus. Since April 3, the PPP has issued nearly 4.9 million loans guaranteed by the Small Business Administration (SBA). As of June 30, banks and other private lenders have extended $521 billion in government-guaranteed, forgivable loans under the program. The government’s support measures have enjoyed popularity with taxpayers compared to those enacted during the Global Financial Crisis (GFC). However, the PPP has been under constant scrutiny from Congress and industry critics since implementation. In response to such criticism and changing economic conditions, both Congress and the SBA have repeatedly modified the program.

At least seven oversight bodies have responsibility for ensuring that the PPP is administered according to its Congressional mandates. These include the Pandemic Response Accountability Committee (PRAC), composed of 20 standing federal inspectors general (IGs); the SBA IG; and the newly-created Special Inspector General for the Pandemic Response (SIGPR), which is tasked with tracking and evaluating loans and loan guarantees made by the Department of Treasury. The PPP is also subject to oversight by the Government Accountability Office and three congressional committees on small businesses. More detail about the PPP oversight bodies appears at the end of this blogpost.

A number of PPP oversight bodies have criticized the SBA for not releasing sufficiently detailed information about the PPP loans to enable it to properly perform their duties; they have specifically asked for loan-level details so they can properly analyze the efficacy of the program and determine whether it is meeting its statutory mandates. Other issues raised are listed below:

1. disclosure of detailed loan information
2. insufficient incentives for lender due diligence
3. differential accessibility for large and small borrowers
4. failure to implement statutory priorities
5. confusing eligibility criteria and limited application diligence
6. integrity of the loan forgiveness process
7. auditing processes.
This post will elaborate on the issues above, compare PPP oversight thus far with oversight during the Global Financial Crisis (GFC), and discuss greater implications for transparency of the government’s COVID crisis programs.

**Design of the Paycheck Protection Program**

The goal of PPP is to make loans that help “businesses keep their workforce[s] employed during the Coronavirus (COVID-19) crisis.” Eligible SBA-approved lenders facilitate loans to small businesses that the Treasury guarantees. Under the SBA and Treasury’s original rules, the government would forgive a loan so long as the borrower used at least 75% of lent funds for payroll expenses. The program began processing loans just seven days after Congress passed the CARES Act. After nearly two weeks of loan processing, the SBA had approved more than 1.6 million loans through nearly 5,000 lenders, a massive increase over its normal volume. As of June 30, lenders have extended more than $521 billion of the total $659 billion appropriated for the government guarantees. On that same day, Congress voted to extend the PPP until August 8. At the time of the vote, the PPP had $139 billion available.

**Major issues and challenges**

**Disclosure of detailed loan information**

The disclosure of loan recipients has been a primary issue raised by oversight authorities. Several PRAC inspectors general wrote a letter to several members of Congress in early June expressing concern that an opinion from the Treasury General Counsel would exempt PPP loans from PRAC’s inspection, which they argued was contrary to how they interpreted their statutory duties. At stake in disclosure are the specific businesses and activities funded by potentially hundreds of billions of public dollars, some of which are known to have landed in the bank accounts of publicly traded corporations with other viable lending sources, and in small businesses connected to members of Congress.

The SBA made its first PPP disclosures on July 6; however, it released loan-level data including business names, addresses, NAICS codes, zip codes, business type, demographic data, non-profit information, jobs supported, and loan amount ranges only for loans of $150,000 or larger. For loans of less than $150,000, the exact amounts were disclosed, but the borrowers were anonymized and identified by zip code, industry, and business type.

PPP applications included provisions notifying applicants that loan data would likely be disclosed pursuant to Freedom of Information Act requests. Secretary Mnuchin also originally agreed with this in April, but FOIA requests were rebuffed, triggering a lawsuit by several media organizations. Secretary Mnuchin’s position, based on a Treasury counsel opinion, was that for small businesses such information is “confidential” and “proprietary.” Following demands from the House Select Subcommittee, and lagging SBA cooperation noted in the GAO report, the
administration on June 19 retreated from that position, announcing the current, two-tiered disclosure model.

A June 23 YPFS blogpost noted that, while 75% of approved funding passed through loans of $150,000 or larger, 86% of PPP borrowers were lent less than $150,000. The Treasury’s new standard leaves a wealth of information undisclosed despite applicants’ acknowledgment that such information would be disclosed. Several oversight bodies and members of Congress continue to push for release of all PPP recipient names and loan details.

The SBA’s limited disclosure is problematic for a number of reasons. The failure to collect information and limited disclosure will possibly limit the ability of oversight authorities to properly fulfill their roles analyzing programs and their efficacy. Senator Ben Cardin made this point at the June 10 hearing on the PPP: “One reason we would like to get more granular data is so we can understand the scope of the issues” (2:12). And even after the SBA’s recent disclosure of redacted information, Senator Chuck Schumer continues to push for full disclosure of the names of all recipients so that the effectiveness of the program can be properly assessed.

A Treasury OIG report dated May 18 raised a similar point with respect to the Treasury’s failure to provide a mechanism for recipients to report regarding use of the funds received from the Coronavirus Relief Fund, which provided $150 billion to states, tribal governments and municipalities for COVID related expenses: “This position negatively impacts our office’s ability to efficiently and effectively carry out oversight responsibilities.”

Second, limited disclosure under the PPP and other programs creates two levels of disclosure under programs established with CARES Act funds. The Federal Reserve has established under Section 13(3) of the Federal Reserve Act several lending programs using $195 billion of CARES Act funds from the Treasury. Section 13(3) requires that the Fed make an initial report, followed by monthly updates to Congress upon the establishment of a new program. Although the law requires the Fed to include the identities of participants and details of loans in such reports, Fed Chairman Powell may request that they be kept confidential.

For four facilities receiving Treasury equity support with CARES Act funds, the Fed’s April announcement states that it will publish the reports including the names and details of participants; amounts borrowed and interest rate charged; and overall costs, revenues, and fees. See a YPFS blogpost on this announcement. A month later the Fed announced that it would make similar disclosures with respect to the Term Asset-Backed Securities Loan Facility and the Paycheck Protection Program Liquidity Facility (PPPLF), programs not covered by the CARES Act disclosure and reporting rules. The Fed stated that it was making these more liberal disclosures because it “remains committed to providing the public and Congress with detailed information about our efforts to support households and businesses during this unprecedented time.”

Third, at stake is the question of possible favoritism and impropriety if the names of recipients and other loan details are not made public. A recent Politico report connected four members of
Congress with PPP loans. And on July 6 the SBA released its first set of PPP loan data; the release revealed more loans to businesses related to members of Congress and senior executive-branch officials, as well as to other entities that did not appear to be the small “mom-and-pop” shops often associated with the program.

To be clear, the CARES Act does not prohibit lawmakers from applying for or accepting PPP funds. SBA standard policy requires lawmakers with significant stakes in businesses applying for SBA loans to receive individual approval from the SBA’s Standards of Conduct Committee. But the Washington Post reported that in April SBA Administrator Jovita Carranza waived these requirements for members of Congress, SBA officials, and their families.

Section 4019 of the CARES ACT provides a conflict of interest provision that prohibits any company in which the President, Vice President, an executive department head, Member of Congress, or their immediate family member has a substantial interest in from benefiting from programs funded with Title IV funds and programs, which are funds targeted to the aviation industry and used to support Federal Reserve lending programs. The provision doesn’t extend to the PPP and its Title I, under which it is authorized, does not contain a similar provision. Nevertheless, the appearance of impropriety is important.

In response to criticism on the matter, Senator Rubio countered that “Congress plays no role in who gets a loan and who doesn’t.” Since the PPP offers funds to all who meet its eligibility criteria, he argued, it contrasts with competitive contract awards (where award decisions have to be made); such awards have historically been at the center of corruption cases.

However, for any program, a blanket waiver should raise concern. The SBA waiver neutralizes the application of its usual ethics review process. There is no evidence in the statute that Congress intended this. Further, it creates a duality of standards under the Act. Arguably, Congress’s inclusion of section 4019, was meant to do just the opposite--to create a more equal process of ethics review under the Cares Act for companies affiliated with government officials.

On top of the questionable blanket waiver, failure to disclose details of loans only furthers a sense of unfairness and a lack of integrity in the process. Even the disclosure of details that call into question whether the funds have been distributed in accordance with statutory mandate would allow for an airing of the facts and review by oversight authorities and the public.

**Insufficient incentives for lender due diligence**

PPP loans are distributed to borrowers through SBA-approved lending financial institutions, which receive a fee for each loan processed. Per Section 1102(2)(36)(O)(i), PPP loans receive 0% risk weight in the capital requirements of eligible lenders. In the June PRAC report (p. 41), the SBA Inspector General expressed the concern that SBA’s 100% participation in the loans would cause lenders to “not exercise due diligence in originating loans, thereby increasing the risk of potential financial losses to SBA.” In other words, the diffusion of loans through thousands of lenders could set up a principal-agent problem whereby lenders are incentivized by the fees on each loan origination to approve as many loans as possible and there were few
incentives to ensure borrower quality. The IG went on to recommend that the SBA implement “proper controls in the loan approval phase to ensure eligibility of participants.”

**Differential accessibility for large and small borrowers**

As loan approvals began, reports filtered out that large and publicly traded borrowers had received loans quicker and easier than had small and new borrowers.

Lawmakers inveighed against differential treatment of businesses trying to borrow from the PPP in letters addressed to Secretary Mnuchin and SBA Administrator Carranza. Missouri Senator Joshua Hawley warned in an early letter that the program was becoming a vector for “corporate greed” with two tiers of borrowers. He alleged that large and existing clients of lenders received loans larger, faster, and easier than small and new borrowers. Democratic Representatives later made similar claims in letters addressed to the SBA as well as to several of the largest lenders.

Members of the Senate Committee on Small Business & Entrepreneurship raised concerns during a June 10 hearing that this misalignment would foster a divide of the sort described by Senator Hawley. Committee Chair Marco Rubio defended the PPP, saying that “these bumps in the road were and are the price of a successful program.” Rubio went on to argue that the need for relief necessitated the velocity of loan approvals.

The eligibility of several publicly traded corporations that applied for PPP funds was controversial. Bloomberg reported that $38.5 billion in PPP funds have been canceled since the program’s launch, after a mix of realizations that loans would not be forgiven or that assistance was not necessary. Such returns came in the wake of press coverage that included Secretary Steven Mnuchin insisting that they were not the program’s targeted audience (and could face prosecution). Yet, on other occasions, the Secretary has not addressed why the PPP was not administered in a manner to target the markets prioritized by Congress.

**Figure 1.** Most approved loans came early in the PPP’s initial run.
In aggregate, large loans may be closer to the exception than the rule. SBA data show that loans of $1,000,000 or more makeup just 1.7% of loan approvals. As shown below, the vast majority of loan approvals were for loans smaller than $150,000.

**Failure to implement statutory priorities**

Section 1102(a)(36)(P)(iv) of the CARES Act requires the agency to issue guidance to lenders prioritizing small business concerns and entities in “underserved and rural markets.” In a May 8 report, the SBA Office of the Inspector General (OIG) noted that the SBA had not yet issued guidance to lenders directing them to prioritize loans to these markets. In a June 10 Congressional hearing, members questioned why the SBA had still not issued such guidance, but received no explanation from Secretary Mnuchin or SBA Administrator Carranza (at 52:00).
As a result, lenders were not notified to target these priority areas. The extent to which entities in underserved and rural areas participated in the program is unknown since the SBA opted not to collect demographic information from prospective borrowers. It did include the option to provide such information on its application for loan forgiveness. The result is that it will be difficult for the agency to determine how much of the PPP funds went to the entities that Congress had intended lenders to prioritize.

Confusing eligibility requirements and limited application diligence

In order to implement the program quickly, the SBA relied on a limited application process, which was shortened after borrowers complained about the burden of the original application. Applicants self-certified that key loan eligibility requirements were met rather than provide detailed documentary evidence to support their claims. Treasury and the SBA say this was done to speed processing of an unprecedented number of applications.

A June 25 GAO report warned that “reliance on applicant self-certifications can leave a program vulnerable to exploitation by those who wish to circumvent eligibility requirements or pursue criminal activities.” The report also noted that frequent changes in the SBA guidance had led to confusion and “raised program integrity concerns.” It concluded that the agency should draw up oversight plans detailing how it would address potential risks and review PPP loans of all sizes.

Speed also apparently resulted in confusion regarding the actual criteria for PPP loans, as SBA issued guidance on a rolling basis: “18 interim final rules and 17 updates to its frequently asked questions [FAQs], as of June 15, 2020” (GAO pp.35, 241-2). These rules and FAQs addressed topics such as eligibility, payroll cost calculation, and loan forgiveness, but were at times confusing rather than clarifying and were issued at times that made compliance challenging for lenders and borrowers (GAO pp.241-2). For example, the guidelines for how independent contractors and self-employed persons could borrow were issued only two days before the first tranche of funding was exhausted (GAO pp.243-4).

Legislators have questioned some of the SBA’s decisions to streamline the application process in the interest of speed. A similar point was also considered by oversight authorities who reviewed the government’s decisions regarding assistance to AIG during the Global Financial Crisis. Then, the Congressional Oversight Panel summarized its conclusion like this:

Through a series of actions, including the rescue of AIG, the government succeeded in averting a financial collapse, and nothing in this report takes away from that accomplishment. But this victory came at an enormous cost. Billions of taxpayer dollars were put at risk, a marketplace was forever changed, and the confidence of the American people was badly shaken. (page 9.)

Likewise, it will be the role of the PPP oversight authorities to consider whether the trade-offs made have been appropriate and effective in getting the PPP funds into the hands of the intended recipients.

Integrity of the loan forgiveness process
Since the start of PPP lending, Congress has significantly expanded eligibility for loan forgiveness.

First, the Paycheck Protection Program Flexibility Act lowered from 75% (as originally set by the SBA) to 60% the minimum portion of a loan spent on retaining or rehiring employees to qualify for forgiveness. The prior threshold of 75% had also been a forgiveness “cliff” -- that is, if 74.9% of the loan had been spent on payroll, the borrower would receive no forgiveness. The act changed this provision, creating a schedule of loan forgiveness amounts depending on the percentage of funds used for payroll expenses.

A previous YPFS blogpost details these changes. As revised, the PPP now more closely resembles the fixed-cost supports that many countries have enacted to help businesses in affording rent, mortgage payments, utilities, and other overhead expenses. Nonpayment of such costs may cause businesses to close permanently, precluding the SBA goal that such businesses maintain their workforces.

The Act also amended the time period borrowers had to use PPP funds in order to qualify for loan forgiveness. Originally, borrowers had to use funds within 8 weeks of receipt. Now borrowers can choose whether to use an 8-week period or a 24-week period to apply for forgiveness. The extension of the covered period under the PPPFA allows borrowers to use the loan proceeds to cover eligible expenses over a longer period of time but also creates a second chance for borrowers that might have failed to comply with the original terms of their loans. A YPFS blog discusses this change.

In the same act, Congress indicated that an employer should not be penalized if it cannot retain or rehire employees due to compliance with requirements or guidance issued by health authorities. The policy change responded to feedback from borrowers, but it arguably weakens the incentives for employers to retain employees.

A related concern is that the SBA’s original five-page loan forgiveness application also relies on extensive self-certifications for key criteria. Additionally, the agency introduced a simplified three-page “EZ” loan forgiveness application that requires even less information. Without sufficient or verified information being collected, there is the risk that the SBA will forgive some loans that should not be forgiven.

Auditing Processes

Although Secretary Mnuchin originally stated that all loans under the program would be subject to audit, he later reversed this position. The SBA has already announced that it will likely not look closely at borrower eligibility or forgiveness for loans smaller than $2 million, which comprise 79.3% of PPP loans as of June 27. Only approximately 30,000 loans that represent about 21 percent of the approved dollar amount of PPP loans (as of June 12) would be subject to audit under this standard.
The GAO Report has asked what the review plans are for loans of $150,000 or less and has cautioned that “because of the number of loans approved, the speed with which they were processed, and the limited safeguards, there is a significant risk that some fraudulent or inflated applications were approved.” It also warned that the announced limited review guidelines have “increased the likelihood that borrowers may misuse loan proceeds or be surprised they do not qualify for full loan forgiveness.”

Comparisons with Global Financial Crisis oversight

The oversight approach represented by the PPP is difficult to compare directly to the interventions the Department of Treasury employed during the GFC, reflecting to some extent the different natures of the two crises. During the Global Financial Crisis, the federal government did not provide direct support to small businesses; GFC-era programs focused on providing market liquidity and on maintaining financial institution solvency. Because of this, most funds went to large, mostly financial, institutions. The majority of funds were disbursed through Federal Reserve programs (and all of which were repaid).

However, oversight committees and observers criticized the Fed during the GFC for disparate treatment of some borrowers, refusing to reveal details of loans -- including borrower identities -- and the absence of written guidance for its loan procedures. Overall, these perceived weaknesses threatened taxpayer acceptance and generated suspicion of the Fed and the programs, despite their arguable success in preserving financial stability. In 2010, through the Dodd-Frank Act, Congress required the Fed to publish transaction data one year after closing an emergency facility; the Fed’s current practices go beyond this requirement.

Signed into law on October 3, 2008, the other major government intervention during the GFC, Treasury’s Troubled Asset Relief Program (TARP), primarily funded loans to, and investments in, financial institutions and car manufacturers -- institutions with significant experience in financial compliance. Of the $443.9 billion spent under TARP, only $368 million was allocated to small businesses outside the financial sector. Similar to PPP, the federal government’s primary recourse against the financial risks of TARP was audits, fines, and litigation. The Special Inspector General for the TARP launched criminal investigations that succeeded in recouping monies from TARP recipients that had used the funds as part of accounting and securities fraud schemes (p.7).

But what worked during the GFC may not work for the PPP (or for other COVID-19 programs) due to the difference in borrower sizes. Litigation against the 86% of PPP borrowers that sought less than $150,000 would likely cost more than forgiving the disputed loan. These policy choices demonstrate the altered cost-benefit calculus of crisis oversight.

While greater loan underwriting and other pre-disbursement policies carry less risk, they are commensurately slower. The SBA leaned towards speed in the current situation, a position approved by some. Senator Rubio said at the June 10 hearing that, “the speed of the lockdown meant we needed to get funds to small businesses with urgency,” and speculated that, “without
PPP’s temporary lifeline, tens of millions of Americans would have been permanently separated from their livelihoods and stripped of dignified work.” Several other members agreed with him. However, the June PRAC report explored this tension between speed and integrity, noting that “increased loan volume, loan amounts, and expedited loan processing timeframes may make it more difficult for SBA to identify red flags” (p. 41).

The minority of TARP funds that touched homeowners and small businesses can be useful in understanding what might have happened. Then, the Home Affordable Modification Program was encumbered by embedded oversight mechanisms that effectively reduced risk but also reduced coordination, accessibility, speed, and, hence, efficacy. Requiring only limited loan underwriting, as the Treasury and SBA have functionally done, has arguably allowed the agencies to distribute PPP loans before businesses go bankrupt.

However, it can also be argued that the SBA’s reliance on self-certifications, coupled with less stringent forgiveness criteria, and a limited audit processes, have potentially produced a program far from its original statutory intent. Despite the SBA’s heroic effort to process thousands of loans in a very short time period, which must be acknowledged, this type of confused administration is not likely to engender confidence in taxpayers that their money has been well-spent.

**Major PPP Oversight Bodies**

As alluded to in the discussion above, at least seven oversight bodies have responsibility for reviewing the PPP. The CARES Act established two oversight bodies. The Pandemic Response Accountability Committee (PRAC), composed of 20 standing federal inspectors general (IGs), is charged to “prevent and detect fraud, waste, abuse, and mismanagement” in all CARES Act-funded disbursements and guarantees to non-federal organizations. The SBA IG is part of this group. Soon to be added to the PRAC roster is the Special Inspector General for the Pandemic Response (SIGPR), tasked under Section 4018(c)(1) of the CARES Act with tracking and evaluating loans and loan guarantees made by the Department of Treasury.

Also overseeing the PPP are the Government Accountability Office, the House of Representatives’ ad hoc Select Subcommittee on the Coronavirus Crisis, and the standing Senate and House committees on small business.
**Figure 3. Newly-created PPP Oversight Bodies**

<table>
<thead>
<tr>
<th></th>
<th>Pandemic Response Accountability Commission (PRAC)</th>
<th>Special Inspector General for Pandemic Recovery (SIGPR)</th>
<th>House Select Subcommittee on the Coronavirus Crisis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date established</td>
<td>March 27, 2020</td>
<td>March 27, 2020</td>
<td>April 23, 2020</td>
</tr>
<tr>
<td>Containing body</td>
<td>Council of the Inspectors General on Integrity &amp; Efficiency</td>
<td>Department of Treasury</td>
<td>House Committee on Oversight &amp; Reform</td>
</tr>
<tr>
<td>Scope</td>
<td>Funds disbursed to non-Federal entities used to address the coronavirus crisis</td>
<td>Treasury disbursements via CARES Act programs</td>
<td>“taxpayer funds and relief programs to address the coronavirus crisis”</td>
</tr>
<tr>
<td>Basis of authority</td>
<td><a href="#">H.R. 748 Sec. 15010</a></td>
<td><a href="#">H.R. 748 Sec. 4018</a></td>
<td><a href="#">H.Res. 935</a></td>
</tr>
<tr>
<td>Mandate</td>
<td>“prevent and detect fraud, waste, “conduct […] audits and abuse, and mismanagement; and investigations of the making, purchase, management, and sale of loans, loan guarantees, and other investments”</td>
<td>report on: efficacy, fraud, and efficiency of federal response; national preparedness; economic and health impacts; cooperation between federal branches and investigators</td>
<td></td>
</tr>
<tr>
<td>Funding</td>
<td>$80,000,000</td>
<td>$25,000,000</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Report schedule</td>
<td>Biannually</td>
<td>Quarterly</td>
<td>As needed</td>
</tr>
<tr>
<td>Chair</td>
<td>Michael Horowitz</td>
<td>Brian Miller</td>
<td>James Clyburn (D-SC)</td>
</tr>
<tr>
<td>Can subpoena?</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Termination date</td>
<td>September 30, 2025</td>
<td>March 27, 2025</td>
<td>30 days after final report</td>
</tr>
</tbody>
</table>
Second Report of the Congressional Oversight Commission on the Use of CARES Act Funds

By Steven Kelly and Rosalind Z. Wiggins, with support from Pascal Ungersboeck

Original post here.

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

On June 18, the Congressional Oversight Commission published its second report on the programs the Federal Reserve has established under its CARES Act authorities with equity investments from the Treasury.

The Commission is charged with overseeing the implementation of Title IV, Subtitle A of the US Coronavirus Aid, Relief, and Economic Security (CARES) Act (subtitled the Coronavirus Economic Stabilization Act (CESA)). CESA includes $454 billion for the Treasury to support Fed emergency lending programs. It also includes up to $46 billion for direct lending to the aviation industry and businesses critical to national security.

In its second report, the Commission updated the status of the programs under its purview; however, the bulk of this report is focused on sharing recent answers provided by the Fed and Treasury to the Commission’s first round of questions. Between its first and second report, on May 29, the Commission sent the agencies a list of “Tier 1” and “Tier 2” questions—with the more general Tier 1 questions to be answered by June 8 and the latter group of questions, June 29. (The list of questions can be found in Appendix A of the report.)

The Commission is to publish regular reports on the use of CESA funds and is also required to report to the Congress every 30 days regarding effectiveness and other specified issues. See this YPFS blogpost for further discussion of the Committee composition and mission.

Status of Programs

On April 9, the Treasury announced its intention to use available funds under CESA to make equity investments in special purpose vehicles established under Fed lending programs. The Treasury has pledged $195 billion of the $454 billion available as follows: $75 billion for the Main Street Lending Program (Main Street), $35 billion for the Municipal Liquidity Facility (MLF), $50 billion for the Primary Market Corporate Credit Facility (PMCCF), $25 billion for the Secondary Market Corporate Credit Facility (SMCCF), and $10 billion for the Term Asset-Backed Securities Loan Facility (TALF).

As of June 10, the Treasury had invested:

- $37.5 billion of the $75 billion equity investment committed for the Corporate Credit Facility LLC, the SPV established by the Fed for the PMCCF and SMCCF
$17.5 billion of the $35 billion equity investment committed to the MLF
$37.5 billion of the $75 billion equity investment committed to the three Main Street facilities.

Between the May and June reports, only one of the facilities—the MLF—was stood up, the SMCCF having already been active by the May report. As of June 10, the SMCCF had made $5.5 billion in corporate bond ETF purchases. The MLF had purchased $1.2 billion of assets, solely from the State of Illinois. (See this YPFS post for the most updated status of Fed lending programs.)

As of the June 18 publication date, the Fed had established six facilities with equity from the Treasury. Four of these facilities were then operational: the two 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 the Exchange Stabilization Fund (ESF), not CARES Act funds, and thus are outside the purview of the Commission.

The report notes that no loans have been made from the $46 billion allocated under Subtitle A for the airline industry and firms essential to national security. However, several airlines have made public proclamations regarding their expected use of these programs.

Without commenting directly on its new inclusion under the Commission’s umbrella, the report does mention the TALF. As originally conceived, the TALF was to receive its equity investment from the ESF, but this was changed with the Fed’s May 12 update of the TALF term sheet: the TALF was instead to be capitalized by CARES Act funds. While the TALF was not included in the Commission’s May 18 report, the Commission has pulled the facility into its orbit—though, as noted, the program is not yet lending.

The Commission noted that the announcement effect from these Fed facilities seems to have been robust—pointing to a strong stock market rally in recent months and the record-breaking debt issuance by both investment-grade and high-yield firms. However, at many points in the report, the Commission—mandated to answer the question of who is being helped by the disbursement of CESA funds—also expressed skepticism over this market boon’s inclusiveness, noting that middle-market firms without access to the bond market are likely being left behind and that even firms with credit access are not necessarily maintaining their workforce and payroll.

Broad Concerns: Too Lax

The Commission’s questions and its discussion of the agencies’ answers are a good indication of how it views its oversight mandate and mission. Major concerns raised included: the interrelationship of Fed lending programs with employment concerns, the integrity of the lending process, consistency across various government programs, and alignment of the administration with the Act’s terms.
In evaluating the agencies’ responses to the Commission’s Tier 1 questions, the oversight body noted that some firms are taking advantage of the newfound calm in the bond market only to lay off workers after a successful debt issuance—and sometimes even continue paying dividends. The Commission noted that the facilities for medium-sized firms—the three Main Street lending facilities—have yet to be made operational. The report additionally probed why the agencies opted to design the Main Street facilities to operate through banks, as opposed to creating a direct lending facility as the Act suggested, but did not mandate.

Further, the Commission noted that none of the facilities require that recipients maintain their workforce in the manner of the Paycheck Protection Program, a $650 billion program to provide forgivable loans to small businesses if they retain or rehire employees. The PPP is administered by the Treasury and the Small Business Administration. The strictest provisions in this regard come only with the Main Street facilities and simply require recipients to make “commercially reasonable efforts” to maintain payroll.

Furthermore, the agencies indicated a limited focus on employment impact in their response to the Commission’s probing on this definition: the agencies will not monitor firms’ adherence to this stipulation and will only evaluate it at a macro level. That is, they will monitor whether commercially reasonable efforts were made via observing the status of “the economic recovery and employment broadly rather than on a borrower-by-borrower basis.”

The report also expressed concern that, as updated, the Main Street facilities no longer require that the end-borrowers attest to needing financing “due to the exigent circumstances presented by the coronavirus.” While the Commission acknowledges that the COVID-19 emergency has greatly impacted the entire economy, it also expressed concern that, at the micro-level, many firms who are not in need of emergency financing will still seek it—stoking an inconsistency with the CARES Act’s discussion of these facilities being for eligible borrowers in need due to “losses incurred as a result of the coronavirus.”

The Commission is similarly concerned about the value of the SMCCF. Given the record issuance levels of corporate debt and historically low yields in the bond market, the Commission argued that the SMCCF might not need to make purchases, or at least not at the rate it currently is. After all, the stated purpose of the facility is to restore functioning to the corporate bond market. The Commission asked the agencies for clarity on the distinction between a functioning and non-functioning corporate bond market and questioned why the PMCCF is not itself sufficient. Furthermore, it reminded the agencies that the Fed’s Section 13(3) emergency lending authorities require the presence of “unusual and exigent circumstances.” “The COVID-19 crisis clearly created such circumstances,” the Commission noted. “However, it is important that the Federal Reserve’s use of these emergency powers not extend for a longer period of time than is necessary.”

Broad Concerns: Too Strict
Nonetheless, the Commission also expressed the concern that some of the restrictions placed on the facilities are too strict. It noted that Treasury has allocated less than half of the $454 billion available to capitalize Fed facilities, three months after the passage of CARES.

For starters, the Commission noted the cliff effects associated with the terms of the PMCCF—namely, that it is reserved for investment-grade borrowers or those who were as of March 22 and haven’t fallen further than a BB- credit rating—a date chosen by the agencies to coincide with the last day before the program was announced. In their responses, the agencies noted that there can be steep rises in borrowing costs associated with even a single downgrade—which can put pressure on firm’s employment and output.

The report points the agencies in two possible directions to support expanding these purchases to a wider group of recipients. First, the agencies could use more of the Subtitle A funds for capitalization of the PMCCF (or simply allocate more of the equity already in the SPV to each purchase), thus maintaining the requisite level of security for Fed emergency lending while still being able to move down the risk scale.

Secondly, the Commission points to the agencies’ own words justifying the purchase of sub-investment-grade ETFs with the SMCCF in which the agencies note that the “increased risk associated with acquiring instruments issued by high-yield companies is managed by investing through instruments that allow for the creation of a diversified portfolio;” that this logic is not evenly applied to the PMCCF left the Commission to question high-yield bonds’ exclusion from the primary market facility.

Similarly, the report noted that the leverage requirements built into the Main Street facilities may be too exclusive or, at the least, not fit for their intended purpose. It is especially critical of the discrepancy between the leverage restrictions of the two new-loan facilities: the Main Street New Loan Facility—which allows borrower leverage of 4x adjusted earnings—and the Main Street Priority Loan Facility—which allows new loans to borrowers with leverage of up to 6x adjusted earnings. The agencies responded to the observation of the former’s stricter terms by noting that the latter requires 15% loan retention by the lender while the former only requires 5% retention. However, the agencies had changed these terms on June 8; both facilities now only require 5% lender retention. The agencies themselves noted this update to the facility’s terms elsewhere in their responses, so their use of the dated higher retention requirement for this particular answer was incongruous, leading the Commission to respond to this answer by pointing out the agencies’ justification was inconsistent.

The Commission also more generally encouraged the agencies to expand access to the Main Street facilities (such as by lowering minimum loan requirements—currently $250,000 for new loans and $10 million for expanded loans) and the MLF (such as by easing the terms to the point of U.S. territories being eligible).

Other concerns
The Commission noted some other broad concerns but framed them more as yet-to-be-answered questions. Concerns included a desire for more background information on how certain cutoffs were determined in program designs—e.g., that the PMCCF can only purchase up to 25% of an issuance if participating alongside other investors. The Commission also questioned justifications for deferrals to specific outside groups, such as the group of credit rating agencies whose ratings are accepted by the Fed, and the use of BlackRock to manage the CCFs—with a questionable information barrier between its duties to the Fed/public and its other business activities. As the Commission noted, some BlackRock executives are “permitted to provide ‘investment management, trading or advisory services’ in any asset class and to purchase investments for themselves in any asset class after a two-week cooling-off period.”

The Commission’s “Tier 2” questions, which it requested be answered by June 29, generally hew to the themes discussed above, continuing to probe for justifications of specific stipulations and cutoffs built into the design of the program and better data points to monitor program efficacy and compliance. It is expected to address the agency’s Tier 2 responses in its next report.

Per the Act, 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 today, the chairman position remains unfilled.
GAO Report Highlights Opportunities to Improve Federal COVID Response and Recovery Efforts

By Devyn Jefferies

On June 25, 2020 the Government Accountability Office (GAO) provided a comprehensive report to Congress detailing the US government’s response to the COVID pandemic, particularly the four relief laws passed prior to June 2020, and actionable steps to improve those efforts. Within these four laws, $2.6 trillion has been mobilized (breakdown below). However, the GAO does not have insight into the actual expenditures, only appropriations, as the federal agencies will begin detailing spending in their July 2020 monthly reporting. In regards to the overall federal response, the GAO notes the speed with which the programs were launched. However it faults agencies for “[making] only limited progress so far in achieving transparency and accountability goals.”

The recommendations outlined in the GAO report cover health and economic programs; in this blogpost, our discussion is limited to the economic programs. The report includes suggested legislative actions and program-specific changes to increase the efficiency of the federal response. In addition to providing specific advice, the GAO highlighted lessons which parallel these steps and should be strongly considered during future interventions.

GAO Recommendations for Congressional Consideration

1. Require coordination between the Department of Transportation and relevant agencies

The potential for air travel to be a catalyst for widespread contraction of COVID, as well as its vital economic role, led the GAO to recommend deepening the relationships between the Department of Transportation and agencies such as the Department of Health and Human Services and Department of Homeland Security. The intended outcome of this coordination includes a national aviation-preparedness plan regarding disease outbreaks that “could establish a mechanism for coordination between the aviation and public health sectors and guide preparation for communicable disease nationally and for individual airlines and airports.” Without a unified mechanism for coordination, it is likely that stakeholders will have a fragmented response to outbreaks, including disparate airline policies of ramping up capacity (as we are now experiencing). A unified policy would mitigate potential outbreaks while decreasing consequences for commerce and travel.

2. Give the Department of the Treasury access to the Social Security Administration’s death data

The Treasury Inspector General for Tax Administration has reported that almost 1.1 million payments of approximately $1.4 billion dollars have gone to deceased recipients through economic impact payments as of April 30. These improper payments stem from tension between a desire to make payments speedily as promised to the public and an initial decision by the
Internal Revenue Service (IRS) counsel that the statutory wording compelled payment to individuals who had filed taxes but were deceased at the time of payment. The IRS counsel believed that the "IRS did not have the legal authority to deny payments to those who filed a return for 2019, even if they were deceased at the time of payment." Also, the counsel claimed that decedents were not precluded from the program as the CARES Act required the IRS “to apply the same set of processing rules to recipients who had filed a 2018 return but not yet a 2019 return.” After being informed of the situation, the Department of the Treasury coordinated with the IRS to reverse the previous determination and define payments to decedents as improper.

**Figure 1. Allocation of Funds for COVID Response as of May 31, 2020 (Source: GAO Report)**

<table>
<thead>
<tr>
<th>Program*</th>
<th>Implementing Government Entity</th>
<th>Summary of Program</th>
<th>Appropriation Amount in billions</th>
<th>Percentage of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paycheck Protection Program</td>
<td>Small Business Administration</td>
<td>Provides funding to guarantee loans— that may be forgiven— to small businesses and other eligible entities to cover payroll and other costs over 8 weeks</td>
<td>670</td>
<td>26%</td>
</tr>
<tr>
<td>Economic Stabilization and Assistance to Distressed Sectors</td>
<td>Department of the Treasury</td>
<td>Provides liquidity to support lending to eligible businesses, states, municipalities, and tribes related to losses incurred as a result of the pandemic.</td>
<td>500</td>
<td>19%</td>
</tr>
<tr>
<td>Unemployment Insurance</td>
<td>Department of Labor</td>
<td>Provides income support to unemployed individuals by expanding eligibility for unemployment compensation benefits, increasing weekly benefit amounts by $600, and extending the number of weeks of benefit eligibility.</td>
<td>375</td>
<td>15%</td>
</tr>
<tr>
<td>IRS Economic Impact Payments</td>
<td>Department of the Treasury</td>
<td>Provides direct payments of up to $1,200 per qualifying adult and up to $500 per qualifying child.</td>
<td>282</td>
<td>11%</td>
</tr>
</tbody>
</table>
Public Health and Social Services Emergency Fund | Department of Health and Human Services
Provides financial assistance for a variety of healthcare-related costs including vaccine development, testing, health insurance costs, among others | 9%

Coronavirus Relief Fund | Department of the Treasury
Provides payments to states, local, tribal, and territorial governments for pandemic-related spending | 6%

Other | | 14%

Total | 2,574 | 100%

Additionally, the Social Security Act only provides the IRS access to the Social Security Administration’s death records. However, it does not give access to the Department of the Treasury and Bureau of the Fiscal Service, which handle payment distribution. In response to these improper payments, the GAO suggests an amendment to the Social Security Act to provide access and mandate its use for future payments. Although this would not have stopped the initial payments that resulted from the IRS counsel’s legal decision, it will assist the integrity of future payments and act as a safeguard.

3. Incorporate GAO formula into Medicaid’s benefit calculations

Based on historical observations, the Federal Medical Assistance Percentage (FMAP), which dictates the amount of state funding towards Medicaid services the federal government matches, has been insufficient during economic downturns. Since it is calculated based on the state’s per capita income, the current FMAP formula fails to adequately account for present conditions. Attempts to temporarily increase funds under FMAP in these situations have been slow.

Since the Families First Coronavirus Response Act allocates supplemental temporary funding to states through the FMAP, the GAO has constructed a formula that aims to assist states early in the downturn and provide sufficient funding based on their individual needs. This formula will initiate when there has been a persistent decrease in the states’ employment-to-population (EPOP) ratio, which is a purposefully easily accessible data point. In addition, its calculations integrate the below variables into its allocation of funding to states, making it more dynamic.

- Increases in unemployment, as a proxy for changes in Medicaid enrollment;
- Reductions in total wages and salaries, as a proxy for changes in states’ revenues

GAO Recommendations for Administration Consideration

1. Mandate the Department of Labor, Small Business Administration, and Department of Treasury to disseminate information to state unemployment agencies regarding the PPP loans and potential for incorrect payments
The interaction between the newly introduced Unemployment Insurance programs and the Paycheck Protection Program (PPP) has resulted in potential improper payments. The PPP provides loans to small businesses that can be forgiven in exchange for rehiring or retaining employees, while Unemployment Insurance programs provide relief to newly unemployed individuals. Situations may arise where an individual receives both wages paid by employers that received PPP loans and payments from Unemployment Insurance. The GAO notes that the agencies have not put any safeguards in place to avoid these situations and that the Department of Labor has failed to provide guidance to state unemployment agencies regarding these risks. Therefore, it recommends that the Department of Labor go beyond its broad disclosure to state unemployment agencies about the potential for fraud in these programs and specifically inform them of the risks associated with these two programs and steps to mitigate their likelihood.

2. Request that the Internal Revenue Service examine low-cost ways for improper recipients to return impact payments

The speed with which economic impact payments were distributed, over $147 billion consisting of 81 million payments in the two weeks following the CARES Act enactment, led to a number of improper payments. As previously mentioned, there have been issues with these payments being sent to deceased recipients. Other examples of fraudulent payments include payments to incarcerated individuals, false tax filers, and identity theft.

The IRS has worked to instruct incorrect recipients on how to return payments, including advertising the improper payment return procedure on its website, disclosure on the physical letters containing check payments regarding returning payments made to decedents, and working with federal and state prisons to return payments made to incarcerated recipients. However, the GAO notes that the IRS has failed to take further steps and urges greater outreach, including potentially sending letters to a group of identified incorrect recipients containing specific instructions. The GAO notes that the outreach should be based on “intended audience, availability of information, and cost to communicate information.”

3. Require the Small Business Administration to construct plans to increase robustness of the PPP loans aimed to “ensure program integrity, achieve program effectiveness, and address potential fraud, including in loans of $2 million or less.”

The Paycheck Protection Program (PPP) has been quickly implemented and resulted in the disbursement of $512 billion, approximately 76% of the entire budget, consisting of 4.6 million loans as of June 12, 2020. However, the speedy deployment of this program has led to a number of significant issues including haphazardly disclosing details of the program such as eligibility, overreliance on borrower certification by lenders, and lack of oversight procedures for loans above and below the $2 million threshold which states that loans smaller than $2 million are afforded less oversight regarding eligibility and forgiveness.

These issues as well as other PPP oversight measures are further elaborated in this YPFS blog post.
Evolving Lessons from the Interventions

Stemming from its observations and recommendations, the GAO described four key evolving lessons shown below for consideration during future interventions. The interconnection between the GAO’s high-level “evolving lessons” and the aforementioned recommendations demonstrates the shortcomings of current programs, ways to improve current programs, and lessons learned for the future.

1. Establish clear goals and define roles and responsibilities.
2. Provide clear, consistent communication.
3. Collect and analyze adequate and reliable data to drive future decisions.
4. Establish transparency and accountability mechanisms.

Keying off these lessons, the report concludes with analysis of, and recommendations regarding the government’s structural framework for responding along with a further detailed analysis of dozens of specific programs.
Third 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 third report - click here to access the full report.

On July 20 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 (subtitled the Coronavirus Economic Stabilization Act (CESA)), and the related programs established by the Federal Reserve (“Fed”) and the Treasury (collectively, “the agencies”) – published its third report. In its third 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 – as well as its concerns about the design and progress of the CESA programs.

Title IV, Subtitle A provides the Treasury with $500 billion for direct lending to businesses in the aviation industry and businesses critical to national security (up to $46 billion) and for supporting Fed emergency lending programs to be established under section 13(3) of the Federal Reserve Act ($454 billion). The Committee 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 Committee composition and mission.

Status of Federal Reserve Programs with Treasury Equity Support

On April 9, the Treasury announced its intention to use available funds under CESA to make equity investments into special purpose vehicles established under Fed lending programs. The Treasury has pledged $195 billion of the $454 billion available to various Fed programs. See this YPFS blog post for a description of the allocation of the pledged funds to the various facilities.

Between the June and July reports, the Term Asset-Backed Securities Loan Facility (TALF) and the Main Street Lending Program (MSLP) became operational. The other programs were already operating as of the second report.

As of July 15:

- The Secondary Market Corporate Credit Facility (SMCCF) had made $11.4 billion of individual corporate bond and corporate bond ETF purchases in secondary markets.

- The Primary Market Corporate Credit Facility (PMCCF) remains unused.
• The Municipal Liquidity Facility (MLF), as was already the case by the June report, had purchased $1.2 billion of assets, solely from the State of Illinois.

• The MSLP had purchased $12 million worth of one loan.

• The TALF had lent $937 million.

As of the July 20 publication date, the Fed had established six facilities with equity from the Treasury. All of these facilities are now operational: the four 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 the Exchange Stabilization Fund (ESF), not CARES Act funds. Between the June and July reports, the TALF and the MSLP became operational. The other programs were already operating as of the second report. See this YPFS blog for a discussion of usage under these Fed programs as of July 22.

**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 report. The agency responses and the report note, however, that the Treasury has received 190 applications for such funds and has signed letters of intent to lend funds with ten passenger air carriers so far.

For the $17 billion allocated to national security interests, the Treasury has received 70 applications, of which 25 have met one of the two possible requirements to qualify for the funds (notwithstanding possible intervention from the Secretary of Defense or Director of National Intelligence). One loan was made with such funds: for $700 Million to YRC Worldwide Inc. (“YRC”) on July 1. Per the report, YRC is “a holding company that provides transportation and logistics services throughout North America via its operating companies, including to the Defense Department.” The terms of the YRC loan (including the Treasury’s equity stake) are described here. The Treasury noted of the applications that it “anticipates approving and disbursing loans in the near future.”

**Agency Responses to Questions**

The Report also shares the agencies’ responses to the Commission’s so-called “Tier 2” questions—the second section of the Commission’s written questions sent on May 29 to the agencies. Unlike the June report, which shared the agencies’ responses to the Tier 1 questions, the Commission (without explanation) did not share a question-by-question response to the agencies’ answers.

In their Tier 2 responses, the agencies offered little information not already available elsewhere or stated previously in other public settings. The agencies also did not directly respond to the Commission’s last report, in which it asked for more clarity about some of the agencies’ responses. However, the Commission was able to share insights gleaned from a meeting it had
with Treasury Secretary Steven Mnuchin and Fed Chair Jerome Powell on June 24. Some of those insights included indirect responses to the Commission’s June concerns.

Corporate Bond Purchases

As in June, the Commission’s third report questioned the necessity of the secondary market corporate bond purchases. While the Commission acknowledged Powell’s defense of such purchases as necessary to demonstrate the Fed was keeping its commitments, it also noted his comments stating the purchases would taper according to the condition of the market. Given that the secondary corporate bond market has largely returned to proper functioning and PMCCF remains available to directly finance firms otherwise unable to secure usual bond financing, the Commission has pledged to watch the Fed’s scale of corporate bond-buying particularly closely.

Main Street Lending Program

The Commission devoted significant space to a discussion of the newly operational MSLP. The Commission was critical that the program took more than three months from its original announcement to become operational, and expressed expectations that future adjustments to the MSLP be more expedient. Similarly, the Commission expressed disappointment that, given the scale of the economic stress facing small and medium-sized firms, the MSLP had only purchased its share of one loan—and for only $12 million since becoming operational on July 6.

Secretary Mnuchin and Chair Powell disagreed with the Commission that low utilization was an indication of design flaws. The Secretary and Chair also suggested that MSLP usage may increase over time given the tightening of lending terms for middle market lending and given feedback they are getting from lenders. Furthermore, the Commission conceded that the Fed’s 13(3) authority is limited to providing secured loans on approved terms.

In response to questions about gaps in the reach of the MSLP and the other lending facilities, Chair Powell and Secretary Mnuchin briefly described plans to establish an asset-based lending facility. This facility would lend to firms such as new businesses, inventory-rich retail firms and real estate firms that fail the MSLP’s earnings requirements based on 2019 results but otherwise represent a reasonable credit risk, particularly on a collateralized basis. The Commission suggested that the Secretary and Chair also consider expanding the MSLP to second-lien lending in cases of sufficient cash flow and collateral.

The Commission also noted its intent to hold a hearing on the MSLP “in the coming weeks.”

Municipal Liquidity Facility

As with the MSLP, the Commission expressed a lack of conviction that MLF had been helpful for state and local governments. The facility made no purchases between the Commission’s June and July reports. Illinois remains the only direct beneficiary, and received the bulk of its new financing via private investors.
In response to the Commission questioning the facility’s limited uptake, the agencies defended the MLF’s three-year maturity limit (Appendix C, p. 15) and above-market interest rates (p. 12).

The agencies offered a two-part answer to the question about the maturity limit. First, they invoked the Section 13(3) rules of Fed emergency lending and Regulation A principles of discount window lending which, respectively, require that circumstances be “unusual and exigent” for a loan to be made and encourage disuse of the facility in “normal” times. The agencies noted the limited maturity encourages repayment and disuse of the facility as unusual circumstances recede. The agencies also implied an unwillingness to hold municipal securities longer than necessary, saying: “Short repayment terms also allow the agencies to buy and hold municipal securities and passively exit the market without causing significant disruption as market conditions normalize.” It’s not clear why the Fed has set a longer, five-year maturity limit for its purchases of corporate bonds.

Chair Powell and Secretary Mnuchin said of the above-market rates that they are not attempting to compete with the interest rates of a functioning municipal bond market, but are simply seeking to act as a backstop. They once again noted that they do not see low facility utilization as indicative of the MLF’s level of effectiveness. The Commission, in its Report, cited Fed research suggesting that the MLF has restored functioning to the municipals market.

Furthermore, the Commission agreed that, as is noted in that research, new lending does not solve the longer-term financing problems of many state and local governments, particularly as most operate under balanced budget amendments. Municipalities received some direct economic assistance from the CARES Act and are expected to receive more in a new economic relief bill—currently being debated on Capitol Hill.

Section 13(3)

A total of $259 billion of funds that Congress allocated to Treasury to capitalize 13(3) programs remains unassigned to any facility. The agencies provided more clarity in their Tier 2 answers on their current thinking with respect to the 13(3) facilities. These answers also indirectly responded to Commission concerns noted in June about the unused funds.

The agencies signaled an explicit willingness to use the unused funds to capitalize new facilities or further capitalize existing facilities as needed to support the economic recovery. They also signaled a willingness to resize the Treasury’s equity tranche in each facility as needed to support facility goals and efficiently satisfy 13(3) security requirements.

YRC Worldwide’s National Security Loan

The Commission’s strongest words were reserved for discussing the $700 million loan to YRC, which was part of the $17 billion allocated for firms “critical to maintaining national security”.

As noted by the Commission, the Treasury accepts that such standard is met by a firm if it “is at the time of its application performing under a defense contract of the highest national priority or...
operating under a top secret security clearance”—unless it otherwise received a recommendation and certification from the Secretary of Defense or Director of National Intelligence. YRC qualified through certification from the Defense Secretary.

The Commission said it intends to investigate this decision and the process leading up to it further: “It is far from clear that the fourth-largest [less-than-truckload] shipping company in the United States is critical to maintaining national defense because it reportedly delivers ‘food, electronics and other supplies to military locations around the country.’”

The Commission noted that YRC “has been rated non-investment grade for over a decade, struggled financially for years before the COVID-19 crisis, and was at risk of bankruptcy before it obtained a loan.” The Commission said it was concerned that the loan does not meet the CARES Act’s standard for taxpayer protection. Under that standard, a loan must be sufficiently secured or charge a rate reflective of the risk of the loan and at least as high as prevailed on comparable obligations pre-pandemic. The Commission noted that the rate charged to YRC is 4% lower than a five-year loan the firm received in September 2019, and that the Treasury’s 29.6% equity stake it received may not be sufficient taxpayer protection given the firm’s history of consistently nearing bankruptcy.

In light of this loan to YRC, the Commission said it intends to further explore the Treasury’s risk tolerance. Given the Commission’s inference that the Treasury has a higher tolerance for national security loans than other CESA programs’ loans, the Commission said it would like to better understand any justification.

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 third report on July 20, the chairman position remains unfilled.
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.
Disagreements over the Municipal Liquidity Facility Erupt
By Sean Fulmer

Original post here.

The Congressional Oversight Commission (COC) released its fifth report on October 21, twenty-five days after the report was legally required to be distributed. The report focuses on the Municipal Liquidity Facility (MLF) established by the Federal Reserve (Fed), which was the subject of a COC hearing on September 17. The MLF, established by the Fed under its emergency authority under Section 13(3) of the Federal Reserve Act, was announced on April 9 and became operational on May 26. The program is designed to provide liquidity to states and municipalities by purchasing up to $500 billion of bonds issued by these entities. Thus far the program has only purchased two notes, issued by the State of Illinois and the New York Metropolitan Transportation Authority (MTA). A number of commenters view the program as inaccessible and various legislators, including Senator Elizabeth Warren, have urged the Fed to amend the terms of the program to make it more available to the states and municipalities that are its intended participants and which are currently struggling with the effects of the pandemic on revenue.

The Democrats and Republicans on the Commission disagreed for weeks over the purpose and goals of the MLF, which led to the delayed release of the report. Previous reports from the COC attempted to present a singular opinion by not naming which commissioners approved or dissented from certain sections. This report, however, abandons the common voice of the previous reports by naming specifically what the individual commissioners believe, a reflection of the divided opinions within the COC.

On one side, Representative Donna Shalala and Bharat Ramamurti (the Democrats) believe that the MLF needs to be extended and expanded in order to better serve state and local governments. Conversely, Senator Patrick Toomey and Representative French Hill (the Republicans) state that the MLF has succeeded in its goals and that Congress never intended for the MLF to be an active participant in the municipal bonds market, but rather a backstop.

The COC hearing on the MLF consisted of two panels of expert witnesses. Kent Hiteshew, a Deputy Associate Director at the Fed tasked with creating the MLF, was the first witness. The second panel consisted of:

- Chris Edwards, Director, Tax Policy Studies, Cato Institute
- Marion Gee, President, Government Finance Officers Association & Finance Director, Metropolitan St. Louis Sewer District, Missouri
- Patrick McCoy, Director of Finance, Metropolitan Transportation Authority
- Dr. Mark Zandi, Chief Economist, Moody’s Analytics
Additionally, the Treasury Department did not send a representative to the hearing despite a request to do so. The Treasury has provided a $17.5 billion equity investment in the MLF, out of a committed $35 billion. In a response to follow-up questions posed by the COC, the Treasury did not differ from the public statements given by the Fed on the MLF, stating that the MLF does not require any of the changes that were proposed by the Democrats on the COC.

As a result of the hearing and further research, the COC identified seven potential changes to the MLF, of which none have the support of all four commissioners. While discussing the possible need for a facility for the secondary market purchasing of municipal bonds, the COC agreed that another facility operating in the secondary market, the Secondary Market Corporate Credit Facility (SMCCF), should be shut down, as it has fulfilled its purpose in their opinion.

Expiration

Currently, the MLF is scheduled to terminate on December 31, 2020. The Fed announced in early October that issuers need to file letters of intent to the MLF at least 30 days before this termination date, further pushing up the timeline.

The Democrats on the COC believe that this expiration date will arrive too soon, before municipal market conditions have normalized. The municipal bond spread to Treasuries remains high relative to pre-pandemic levels, while yields have recently increased as a result of the failed stimulus talks. Furthermore, many state and local governments are required by balanced budget laws to either change their laws or seek voter approval in order to authorize MLF borrowing. In some instances, this may not be able to occur before the expiration date.

Senator Toomey and Representative Hill disagree with the Democrats’ proposed extension of the MLF termination date. They believe that liquidity has been restored to the municipal bonds market and the MLF is therefore no longer needed. Additionally, they state that access to credit is currently available due to low interest rates.

Purpose

The Fed states on its website that “the immediate purpose of the MLF is to enhance the liquidity of the primary short-term municipal securities market.” This positions the Fed as a lender of last resort, rather than extending effective credit subsidies. Treasury Secretary Mnuchin has also affirmed that the MLF, and other facilities authorized under the CARES Act, are solely intended to restore liquidity. However, members of the COC disagree on this interpretation of the MLF’s purpose.

The Democratic members of the COC believe that there is no explicit restriction requiring the MLF to provide only short-term liquidity. Other Federal Reserve Section 13(3) programs such as the Main Street Lending Program (MSLP) and the SMCCF have not limited themselves to short-term liquidity purposes. Although the Democratic members do not believe that the MLF is a substitute for fiscal policy, they view the restriction to short-term liquidity as creating a much
more punitive program than is offered to corporate borrowers. Several organizations representing potential MLF participants have also noted a lack of parity.

The Republican segment of the COC reiterates the Fed and Secretary Mnuchin’s points regarding short-term liquidity. Furthermore, they cite the CARES Act section 4002(c)(3)(E), which states that the implementation of facilities should provide liquidity to the municipal bond markets. However, it is not explicitly clear that providing more affordable loans to state and local governments under the MLF would be inconsistent with the facility’s purpose to provide liquidity.

**Term Length of Purchased Notes**

The MLF currently allows the purchase of three-year notes, while the SMCCF, the MSLP, and Primary Market Corporate Credit Facility (PMCCF) allow for four- or five-year terms. Some states are unable to issue debt shorter than three years due to balanced budget restrictions, which would preclude them from the MLF under the current terms. According to the Fed, there is no explicit legal restriction stopping it from amending the MLF’s terms to provide for the purchase of longer term notes. However, Mr. Hiteshew stated during the hearing that the Fed has not purchased longer-term municipal debt because that would shift their purpose away from short-term liquidity.

The Democratic members of the COC recommended increasing the term lengths to at least four- or five-year terms, while Dr. Zandi suggests a term length of ten years. Since the Fed does not have any legal restriction from extending the term length, they see no reason why the MLF terms are shorter than those for the corporate bond purchase programs. However, the Republicans members do not see any need to extend the length of eligible debt, considering their interpretation of the MLF as providing short-term liquidity.

**Pricing**

The Fed, under Regulation A in 2015, adopted a penalty-rate requirement applicable to Section 13(3) programs. According to this regulation, the rate offered must be a “rate that is a premium to the market rate in normal circumstances”. This penalty rate is not quantitatively defined and is open to interpretation. In response to feedback, the Fed previously reduced the interest rate on MLF loans by 50 basis points across all credit rating categories. (See this YPFS blog discussing the Fed’s earlier action reducing pricing under the MLF.)

The Democrats on the COC believe that the penalty rate offered by the MLF is much too punitive on state and local governments. Regulation A states that the penalty rate should be relative to the market rate in normal circumstances, not the current pandemic market. The gaps between the MTA’s and Illinois’s pre-pandemic and MLF rates are 158 and 61 basis points, respectively. Additionally, the Democratic members state that the pricing offered to corporate borrowers through the SMCCF are much more favorable than those offered to state and local governments. Furthermore, the commissioners raise concerns that the differential in pricing between municipal
and corporate borrowers adversely affects minorities, as those laid off in the public sector are 20% more likely to be black than those laid off in the private sector.

The Republican contingent sees no issues with the pricing set up by the Fed for the MLF. They state that interest rate yields for investment-grade municipal debt are below the pre-pandemic levels (although Democrats claim that spreads are a more important factor, which have not yet recovered). Senator Toomey criticizes the MTA in the report for financial mismanagement, which the Democrats note are concerns that he did not voice during the hearing. He documents the financial struggles the MTA has faced, which he believes is cause for the rates charged to the MTA to be even higher. However, the Democrats note that the MTA has never defaulted on a bond.

Use Restrictions

The MLF limits the use of proceeds from the purchasing of a note to mitigating cash flow impacts accompanying income tax deferrals, increases in expenses, or declines in revenues as a result of the COVID-19 pandemic. Additionally, proceeds can be used as a conduit to purchase notes issued by political subdivisions that might not be eligible to participate in the MLF. However, state and local governments cannot use the proceeds for longer-term capital investment projects. This ties back to the Fed’s position that the MLF is not currently seen as a form of fiscal stimulus, but rather provides liquidity support.

Consistent with the discussions on the purpose of the MLF, there are disagreements within the committee on how flexible the use of loan proceeds should be. As currently constructed, the MLF intends to only provide short-term liquidity to state and local governments. The Democrats believe that proceeds from the MLF should be allowed more flexibility than just liquidity. This could come in the form of long-term capital projects, local and state stimulus funds, or paying off long-term budget issues. However, the Republicans believe that this would shift the Fed into providing fiscal stimulus and continue to believe that the MLF should only be used for short-term liquidity.

Eligibility Rules

According to the current eligibility criteria for the MLF, territories and native tribes are unable to access the MLF. Guam reportedly considered utilizing the MLF, but was barred by that restriction. The Fed stated that the MLF eligibility criteria was intended to reach the largest issuers while excluding some of the smaller issuers for administrative reasons. The Democrats on the COC believe that the MLF should be opened up to a wider, more diverse range of issuers. However, the Republicans on the COC believe that the current eligibility criteria are sufficient, since smaller entities can still access the MLF through a conduit. (See this YPFS blog for a discussion of the Fed’s earlier actions twice amending the program to broaden the number of eligible entities.)

Secondary Market Purchases of Municipal Bonds
After the discussion about differential interest rates between corporate and municipal bonds purchased by the Fed during the hearing, the Fed’s Office of General Counsel conferred with the COC to provide further explanation for the differential. In their opinion, that differential is a direct result of the differences between the primary and secondary markets on which the bonds were purchased. The Fed does not interpret Regulation A (which established the penalty-rate requirement) as applying to secondary market purchases, which is why the SMCCF purchased bonds at a lower rate. There is currently no facility for secondary market purchases of municipal bonds.

The entire COC recommends that the SMCCF cease operations, as they believe the Fed’s programs have succeeded in buoying corporate bond markets. Despite this consensus, the commissioners disagree when it comes to establishing a facility for secondary market purchases of municipal bonds. The Fed testified that there is no advanced interest in such a facility, which runs counter to both the recommendations of the Democrats on the COC and a coalition of state and local government groups. The Democrats on the COC state that municipal spreads to Treasuries, which they maintain is a more significant factor than rates, still remain higher than pre-pandemic levels and that a facility for the secondary market purchases would push these spreads down, as corporate secondary market purchases did for primary-market corporate bonds.

ADDITIONAL UPDATES TO CARES ACT PROGRAMS

National Security. The COC requested additional information from the Department of Defense on the loan made by the Treasury to YRC Worldwide on the grounds of national security, despite concerns about YRC’s financial conditions. The Department of Defense originally stated that their response would be provided by September 18, but no information or follow-up has been received by the COC.

Main Street Lending Program. City National Bank of Florida is responsible for issuing about 40% of the loans made through the MSLP. It recently announced its acquisition of Executive National Bank, which would bring the bank’s total asset base to approximately $18 billion. The COC is currently in contact with the bank to understand its outsized involvement in the MSLP; providing over $500 million in loans has stood out in a banking sector that has been hesitant to lend through the MSLP. Pursuant to the terms of the program, the Fed assumed 95% of the loans made through the MSLP, leaving another 5% on lenders.

Aviation. The Treasury Department announced that it had closed loans to seven passenger air carriers, after three additional airlines dropped out of consideration. The COC is currently reviewing these loans, which are estimated to total $14.66 billion, out of the $25 billion allocated to such loans by the CARES Act. Of these loans, American Airlines and United Airlines account for approximately three-quarters of the loan total.
In the Congressional Oversight Commission (“COC”) November Report, the members of the Commission focused on questions surrounding the U.S. Treasury Department’s (“Treasury”) $700 million loan to YRC Worldwide, under the auspices of the Coronavirus Aid, Relief, and Economic Security (CARES) Act provision for loans to businesses critical to national security. Treasury Secretary Steven Mnuchin appeared before the commission at a public hearing on December 10 to discuss the national security loan program. Additionally, the report provided an update on the various CARES Act lending facilities.

### Loan to YRC Worldwide

The CARES Act allocated up to $17 billion to the Treasury Department for loans and loan guarantees to businesses “critical to maintaining national security.” While the Treasury administers the program, it defers to the Department of Defense or the Director of National Intelligence to designate businesses as crucial to national security. At the time of the COC November report, the Treasury has disbursed $735.9 million in loans to 11 businesses deemed critical to national security, with YRC Worldwide accounting for $700 million (95%) of that amount.

YRC Worldwide is the fifth largest trucking company in the United States and employs over 30,000 individuals, the majority of them unionized. Prior to the pandemic, YRC operated at a loss and struggled with low liquidity levels, as a result of significant pension commitments, and poor credit ratings, which can be seen in Figure 1.

#### Figure 1

<table>
<thead>
<tr>
<th>Prior to COVID-19</th>
<th>Start of COVID-19</th>
<th>During COVID-19</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Rating</td>
<td>B2</td>
<td>Caa1</td>
</tr>
<tr>
<td>Speculative Grade Liquidity</td>
<td>SGL-3</td>
<td>SGL-4</td>
</tr>
</tbody>
</table>

On April 29, YRC entered into an agreement with the Treasury for a $700 million loan, which is separated into two tranches as described in Figure 2. The Treasury also received a 29.6% equity stake in YRC to compensate for the risk of the loan. That equity stake was worth $40 million at the end of July and $67 million at the time of the COC report. The financial advisor to the Treasury determined that this equity position would produce a total return of 12% per annum if the Treasury holds it for the entire four-year period of the loan.
**Financial Concerns**

The COC notes that the interest rate offered to YRC by the Treasury is significantly lower than that on loans provided to YRC prior to the pandemic, and lower than the market rate offered to borrowers with similar credit ratings during the pandemic. Beyond the terms of the loan, the COC questions the assessment of the 29.6% equity stake in YRC performed by the Treasury’s financial advisor, since YRC faces serious risks of defaulting on its debt obligations in the near future. Furthermore, the lien position obtained by the Treasury puts it at a less favorable position compared to YRC’s other creditors who share first- and second-priority liens on YRC assets. Finally, YRC has several obligations that come due prior to the Treasury loan on September 30, 2024. The COC cited all of these issues as reasons for concern that the Treasury investment in YRC is significantly more risky than the Treasury has estimated.

In response to the concerns of the COC, the Treasury acknowledged that the loan to YRC is risky, which should be expected in a crisis. However, the Treasury believes that it has appropriately protected itself from needless risk. The equity stake received by the Treasury, originally worth $30 million in June, is now worth about $75 million, which could cover potential losses. During the COC hearing, Secretary Mnuchin mentioned the possibility of selling the loan in the summer of 2021 for a profit. Additionally, the Treasury loan is secured by $546 million in excess existing collateral (78% collateralization level). If YRC draws on the entirety of Tranche B ($400 million), the total collateral securing the Treasury loan will be $866 million (124% collateralization level), since Treasury holds a first-position lien on equipment purchased with Tranche B funds at a 20% discount.

**Administration Concerns**

Beyond the credit risk of the YRC loan, the COC also continued to question the designation of YRC as critical for national security. The Department of Defense stated that YRC is the largest single provider of less-than-truckload services for it, delivering food and electronic supplies to the military throughout the country. The COC questioned whether these deliveries can be classified as critical for national security, to which the Defense Department replied that it is
important for the military to have access to the supplies it needs. The Defense Department informed the COC that it does not have any contingency plans for a possible bankruptcy of YRC.

The COC will address these issues at a hearing on December 17 at which Undersecretary Ellen Lord of the Department of Defense and Director of National Intelligence John Ratcliffe will appear.

In a recent related report, the Government Accountability Office (GAO) also raised questions about the YRC loan. According to the GAO, Treasury officials did not follow the standard loan approval process established for evaluating applications. The report also points out that Treasury approved the YRC loan three months earlier than any other national security loan, and that it was executed before the first-stage or second-stage loan application evaluation procedures were finalized. Treasury has said that this was due to the urgency of YRC’s financial situation. The GAO report also notes that the Treasury staff that negotiated the loan were not the staff that had worked on the creation of the loan program.

**Congressional Hearing**

On December 10, the COC hosted Treasury Secretary Mnuchin at a public hearing to discuss the CARES Act national security loans program. The members of the COC focused on the riskiness of the YRC loan, albeit from different angles. Representative French Hill (R-Ark.) disagreed with the Treasury’s assessment of YRC’s collateral and future financial health. Commissioner Bharat Ramamurti (a Democrat appointee) questioned whether Secretary Mnuchin knew of YRC’s significant debt obligations to Apollo Global Management, a private equity firm that has also loaned significant amounts to a business controlled by the Kushner family; the Secretary denied any such knowledge. Senator Patrick Toomey (R-Pa.) noted that several of the loans to other businesses designated as critical to national security went to startups in amounts larger than their 2019 revenues. In response to criticisms of the disparity in application approval times, Secretary Mnuchin said that the department needed to implement several major loan programs simultaneously and that lawmakers on both aisles asked him to expedite the YRC loan.

The hearing also included brief discussions of Secretary Mnunchin’s decision to withdraw support from five CARES Act credit facilities established by the Federal Reserve under its Section 13(3) emergency authority, which the COC has jurisdiction over (the Primary Market Corporate Credit Facility, Secondary Market Corporate Credit Facility, Municipal Lending Facility, Main Street Lending Program, and Term Asset-Backed Securities Loan Facility). In a letter dated November 19, 2020, to Fed Chair Jerome Powell, the Secretary stated that the programs were little used and no longer needed, and that he believed that under the CARES Act Congress intended to permit the origination of new loans and the purchase of assets only through December 31, 2020. He therefore requested Powell to return the $195 billion in funds supporting these programs to the Treasury, effectively closing them to new activity. Commissioner Ramamurti asked that Secretary Mnuchin provide a written legal opinion to the
commission supporting that action. See this YPFS blog for more discussion of this issue, including Powell's response.

Other Updates

The COC notes that the Federal Reserve continues to buy $20 million in bonds every day through the Secondary Market Corporate Credit Facility, which the Commission had recommended terminating in its fifth report. The November report reiterates that recommendation, stating that the facility is not needed anymore.

In response to COC criticism of the administration of the Main Street Lending Program (MSLP), the Federal Reserve announced on October 30 that the minimum loan size would be lowered from $250,000 to $100,000 for three of the five MSLP facilities. Also, the Fed adjusted the fee structures to be inversely proportional to loan size so that lenders would better accommodate smaller borrowers. The COC corresponded with City National Bank of Florida to better understand its role as provider of the majority of MSLP loans. According to City National Bank, an early investment in training staff to handle MSLP applications led to a significant uptake in program usage. However, the bank warned that many of its loans currently in the pipeline are at risk of not closing in time for the program’s deadline of December 31.

Also, see this recent YPFS blog providing an update on the use of several of the Federal Reserve programs under the COC’s jurisdiction.
Policy Proposals & Market Commentary

Rather than describe the administration of crisis-fighting programs, these articles analyze the design of policies and comment on economic trends that are not easily contained in a single policy arena. They are largely prospective in nature, though some articles reflect on novel aspects of the coronavirus recovery without limiting their scope to a single policy area.
Analysis

The FHLBs May Not be the Lenders-of-Next-to-Last Resort during the Coronavirus Crisis

By Chase P. Ross

Original post here.

During the global financial crisis, the Federal Home Loan Banks (FHLBs) were the lenders of “next-to-last” resort, as banks and other FHLB members preferred to use their funding rather than the Federal Reserve’s discount window, the traditional lender of last resort (LOLR). Banks felt using the discount window might stigmatize their image with other market participants.

But it’s unclear whether the FHLBs will play that role this time. Market data suggest that banks are turning to the Fed—partly because the stigma of using the Fed is reduced, partly because of pricing.

The FHLB system is a government-sponsored enterprise operating with an implicit guarantee from the government. The FHLB system provides advances to its members—mostly depository institutions, but also insurance companies—to help finance housing-related assets. The system has a simple leverage multiple of 19.5 and has roughly $1 trillion in assets as of Q4 2019, of which $650 billion are advances.

In 2008, the FHLB system financed its LOLR activities by ramping up debt issuance. Auctioned discount notes grew from $120 billion pre-crisis to almost $300 billion in May 2008. Money-market mutual funds were important buyers of that debt. However, after the near-failure and government takeover of the other two prominent GSEs—Fannie and Freddie—money funds were less willing to buy FHLB debt. The FHLBs were “guilty by association.” The systems’ debt outstanding shrunk rapidly, and only eventually recovered after the crisis (Figure 1).

In the aftermath of the Reserve Primary Fund breaking the buck in September 2008 and Treasury’s subsequent money fund guarantee, regulators sought to limit the systemic risk of money-market mutual funds. In 2016, the SEC implemented reforms that required funds to report floating net asset values (NAV) unless the fund imposed gates and fees or invested only in government securities. The gate structure allows the fund to temporarily prevent investors’ redemptions to cash in times of stress and would, in principle, limit a run from the money fund.

The effect of the reform has been a marked shift from prime funds, which invest primarily in commercial paper, toward government funds since government funds have a fixed $1 NAV without gates or fees. Money fund investors clearly prefer the fixed value and the option to run in bad times over the comparatively higher yield offered by prime funds.
In my recent working paper, I show that these post-crisis reforms made FHLBs new crucial safe asset producers. Government money funds can buy FHLB debt—as of late 2017, almost 40% of government money fund assets were FHLB debt. The FHLBs use the proceeds from the debt to make advances to banks, and banks prefer funding via FHLB advances (rather than issuing commercial paper) because post-crisis liquidity regulations are friendlier to FHLB advances.

During the rapidly unfolding coronavirus pandemic, preliminary and incomplete evidence—based on the public data available so far—suggests the FHLBs provided substantial liquidity in the initial stages of the recent funding market pressures. But it ceded that role when the Federal Reserve boosted its lending operations.

From February 26 to March 12, government money funds saw about $150 billion of inflows—a 5% increase in assets under management in just a week. They used a good chunk of these inflows to purchase FHLB debt. From January 1 to March 11, FHLB auctioned debt outstanding (with maturity less than one year, excluding overnight debt) increased about 12%, or $22 billion (Figure 2, Panel A). Government funds likely bought up the incremental issuance.

For that period, it appears the FHLBs were once again acting as a next-to-last LOLR. They used the proceeds from their increased debt issuance to help banks handle increased financing demands from the real economy. One estimate puts the magnitude of unfunded commitments of the largest banks to COVID-exposed industries via revolving credit facilities at $125 billion.
Compare that to the $850 billion in cash and $2 trillion in securities at those same banks. Fed data shows that over the same time period commercial and industrial loans increased $16 billion, and loans to nondepository financial institutions also increased $16 billion.

However, beginning March 12, the Federal Reserve increased its provision of financing to the banking system via repurchase operations, and on March 16 it “encourage[d] banks to use [the] Federal Reserve discount window” after cutting the primary credit rate on March 15. Both actions had significant uptake: from March 4 to March 18, repo lending by the Fed increased from $200 billion to $450 billion, and discount window lending increased from $0 to $28 billion (Figure 2, Panels B and C).

Beginning March 17, short-term auctioned FHLB debt outstanding began falling quickly. FHLB debt spreads flipped from roughly -20 basis points to 30 basis points, and they’ve stopped regularly auctioning debt at the 4-week maturity.

Why? In part, the Fed’s actions siphoned some flows from the FHLBs. On March 16 — after the Fed cut the discount window rate — the all-in cost to finance a highly rated MBS was 26 basis points with the discount window and 65 basis points with an FHLB advance. This is unusual; advances are typically cheaper than the discount window, as shown in (Figure 2, Panel D).

FHLBs cannot provide a large amount of liquidity now without increasing their debt issuances. In its latest quarterly filing, the system reported $5 billion in cash holdings, and it seems unlikely they’d pull back their repo lending ($50 billion in Q3 2019) to make space for more advances.
The FHLBs could scale back their fed funds lending—$55 billion—to finance advances, but the action would have distributional effects. The FHLB system cannot earn interest on its account at the Federal Reserve; it instead lends in the fed funds market to foreign banks, which arbitrage the difference between interest on excess reserves and the fed funds rate. That is, if the FHLBs shifted from providing liquidity via fed funds to advances, they would be moving liquidity from foreign banks to domestic banks, despite evidence that foreign banks have stronger demand for dollar funding during the coronavirus crisis.

Are the FHLBs a systemic risk right now? Unlike Fannie and Freddie, they do not have risky investment portfolios, and their statutory super-senior lien means they are unlikely to face significant credit losses. The more worrisome problem is the amount of maturity transformation they’re doing—half of their advances are longer maturity than one year—and the average maturity of FHLB debt held by money funds is 40 days as of 2018.

The FHLBs provided a valuable lender of next-to-last resort channel in 2008—and although the Fed has worked to destigmatize the discount window in the past weeks, the FHLBs will remain important intermediators between banks and money-market mutual funds in the coming weeks. Keep an eye on the FHLBs.
The coronavirus crisis has caused significant turmoil in funding markets in recent weeks. Although the Fed unveiled an alphabet soup of aggressive lending programs across many markets, a flight from maturity continues across many money markets, including interbank Eurodollar funding and commercial paper (CP).

Unlike a flight to quality—in which lenders entirely shift to the highest quality safe assets like Treasurys—a flight from maturity occurs when lenders preserve the option to exit quickly by lending at shorter maturities. Risk builds and funding structures grow precarious as lenders place a larger and larger premium on the exit option.

We build on the work of Gorton, Metrick, and Xie (2015) to show the flight from maturity during the coronavirus crisis. We measure maturity shortening using the steepness of money markets’ term structures. In normal times, the spread between 3-month and overnight rates are low and flat since the money market instruments are similarly nearly riskless. But in times of stress money markets’ term structures steepen, as was the case during the global financial crisis. The steepening reflects the diverse preferences of lenders and borrowers in a crisis. Lenders want to lend at a short maturity so they can quickly exit if borrowers approach insolvency, while borrowers—often banks—want to borrow long to lock in funding and are willing to pay higher term rates.
We look at publicly available high-frequency data on money markets: Libor and US CP. Both measures show flight from maturity at levels approaching the peaks last seen during the financial crisis.

CP spreads remained relatively low as the initial news of COVID-19 arrived in February and early March. Beginning March 16, however, spreads increased very quickly for all flavors of CP as concerns about cash liquidity for corporate borrowers grew. Coincident headlines highlighted large fund outflows from corporate bond funds, discounts of bond ETF to net asset value, and several businesses drawing down credit lines. From 2010 to 2019, the average spread of nonfinancial CP, financial CP, and asset-backed (ABCP) 3-month rates to target fed funds ranged from 8 to 22 basis points. The week of March 16 spreads increased to 185 bps (nonfinancial), 220 bps (financial), and 240 bps (ABCP),—exceeding the peak spreads in the financial crisis of 2008 for financial and nonfinancial CP (ABCP spreads peaked at 310 bps in the financial crisis).

Figure 1 shows the term structure of CP and Libor spreads, calculated as the money market rate less the fed funds target rate. We show this term structure at three points in time: at the start of the year during “normal times;” on March 16, following the Federal Reserve’s 100 bps rate cut on March 15; and on March 24, the latest day of available data for ABCP.

At the start of 2020, the term structure was fairly flat: overnight ABCP and Libor rates were close to the fed funds target rate, and the 90-day ABCP and 3-month Libor spreads at less than 50 bps above that. But the term structure for both money markets steepened during March. On Sunday, March 15, the Federal Reserve announced a set of macroprudential policies, including
enhancing US dollar swap lines with other central banks and asset purchases of $500 billion in Treasuries and $200 billion in MBS. The Federal Reserve also decreased the interest rate target, and the March 16 spreads of ABCP and Libor increased to reflect this change.

These actions did not stop the flight from maturity, which accelerated the following week. On March 16, Libor’s spread steepened over the term structure, with 3-month Libor spread at nearly 80 bps and the overnight rate at 11 bps. As coronavirus cases increased and markets continued to remain volatile, the term structure of CP—across all types of issuers—steepled, too. By March 24, the 3m/overnight spread for ABCP was 150 bps. Financial CP had an even steeper curve of almost 240 bps.

To get a sense of how the funding curves compared to the global financial crisis, Figure 2 shows the slope of the yield curve for CP and Libor by plotting the time series spread between the 3-month and overnight rates. The steepness of these curves is approaching levels last seen during the financial crisis (Table 1).
High-frequency CP issuance data makes the freeze in term CP markets clear: the shortest maturity CP, less than 4 days, doubled from $45 billion to $90 from March 11 to March 24 (Figure 3). At the same time, term issuance—defined as CP issuance with greater than 4 days maturity—fell. Issuance data obscures the composition of issuers as comparatively riskier issuers pre-coronavirus crisis have likely left the market.

At first glance, it might be surprising the Federal Reserve’s CP funding facility (CPFF, announced March 17) had little impact on CP rates. This is partly because the CPFF
focuses only on 3-month CP. Although the facility is very similar to the 2008-era program, the pricing is different relative to market conditions. In 2008, the spread was 3m OIS+100 bps plus a 100 bps credit surcharge, whereas the COVID19 facility is 3m OIS+200 bps. But there was minimal initial takeup during the current crisis because financial, nonfinancial, and asset-backed CP 3-months rates were well below OIS+200bps at announcement. Moreover, there is so little issuance of lower-rated A2/P2 the Fed has not stopped consistently reporting term rates, and the initial CPFF design excluded A2/P2 paper.

On March 23, the Fed expanded the CPFF: reducing pricing to OIS+110bps and expanding the facility to lower-rated A2/P2 CP issuers at OIS+200 bps. At the time of writing on March 25, financial and ABCP issuers will likely soon use the program as rates have continued increasing.

The progression of the term structure echoes a similar pattern to that of 2008 with maturity shortening as lenders aim to maintain the ability to make a quick exit. This is concerning given a flight from maturity creates a more fragile financial system. In the current coronavirus crisis, the trend may be particularly problematic: the yield curve for many money markets have steepened even after aggressive action by the Federal Reserve. Although the current crisis is a pandemic—not yet a financial crisis like 2008—short-term debt holders are ready to run, should something appear to threaten issuers’ ability to pay. Work remains for central banks to bend the funding curves down.
CARES Act $454 billion Emergency Fund Could add up to Much More for Businesses, States and Municipalities

By Rosalind Z. Wiggins

Original post here.

The Coronavirus Aid, Relief, and Economic Security Act (“CARES Act”) that President Trump signed into law on March 27th provides $454 billion (the Emergency Fund) for the Secretary of the Treasury to make direct loans or to guarantee loans made by the Federal Reserve to assist business, states, and municipalities dealing with the pandemic. The Fed may do this through (i) purchasing obligations or other interests directly from issuers or other interests; (ii) purchasing obligations or other interests in secondary markets or otherwise; or (ii) making loans, including loans or other advances secured by collateral.

By providing the ability for the Treasury to guarantee or backstop Fed loans, the provisions create the possibility that the impact of the fund can be leveraged up significantly as stated by Secretary Mnuchin—“We can lever up to $4 trillion to help everything from small businesses to big businesses.” Fed Chairman Powell has echoed the Secretary—“Effectively, $1 of loss-absorption is worth $10 worth of loans.” Therefore the Emergency Fund could result in trillions of dollars being made available to the public. See this YPFS blog post for further discussion on the Treasury backstop.

The legislation creates great possibilities but also raises questions about limitations on the Fed’s authority. Section 4003(C)(3)(B)) of the CARES Act explicitly provides “for the avoidance of doubt” that the requirements of Section13(3) of the Federal Reserve Act would apply to any Fed program or facility relying on such funds “including requirements relating to loan collateralization, taxpayer protection, and borrower solvency.” We discuss herein the intersection of the Emergency Fund with Section 13(3).

Federal Reserve Act Section 13(3)

Section 13(3) of the Federal Reserve Act, often called the Fed’s emergency lending provision, provides the central bank with authority in “unusual and exigent” situations to broaden its permitted borrowers to include “any individual, partnership, or corporations.” The section was enacted during the 1930s and has been called a “broad and extraordinary authority.” (Alvarez 05/26/2010). The provision was used several times during the Depression, and although use was authorized twice during the 1960s, funds had not been lent under the provision in the 70 years prior to the 2007-09 global financial crisis (GFC). (Alvarez 05/26/2010).

Section 13(3) during the GFC

During the GFC, Section 13(3) authorized the Fed to extend credit to any individual, partnership or corporation if certain criteria were met:
• At least five members of the Board members determined that “unusual and exigent” circumstances exist
• The lending must be “indorsed or otherwise secured to the satisfaction of the [lending] Reserve Bank.”
• The borrower was “unable to secure adequate credit accommodations from other banking institutions”
• The credit complied with any limitations, restrictions and regulations prescribed by the Board. (FRA Sec 13(3), 2008).

During the GFC the Fed found that “unusual and exigent circumstances” existed and extensively used the provision, which became one of its most important tools to provide numerous broad-based programs aimed at providing liquidity to markets. The Fed has recently reintroduced versions of several of these programs to address the COVID-19 pandemic: the Term Asset-Backed Securities Loan Facility (TSLF), the Commercial Paper Funding Facility (CPFF), the Primary Dealer Credit Facility, the Money Market Mutual Fund Liquidity Facility (MMIF).

Most recently, on March 23, the Fed and the Treasury reintroduced a modified version of another GFC-era program the Term Asset-Backed Loan Facility (TALF) to support credit flows to households and businesses by maintaining the flow of asset-backed securities markets. Pursuant to the TALF the Federal Reserve Bank of New York (FRBNY) will make loans to a SPV that will in turn make a total of $100 billion three-year nonrecourse loans to U.S. companies that own eligible ABS. The SPV will be funded by a recourse loan from the FRBNY and an initial $10 billion equity investment by the Treasury. The Fed again relies on the Section 13(3) authority and the Treasury uses the Exchange Stabilization Fund (ESF) to backstop the program. The TALF is thought to be a good candidate for use of the Emergency Fund to support lending by the Fed because of its demonstrated flexibility. See a YPFS blog on the 2020 TALF and Federal backstop here.

During the GFC, the Fed also relied on its Section 13(3) authority to stabilize systemically important firms such as Bear Stearns and AIG, and to design ring-fencing programs like it did for Citigroup and Bank of America. The extensive use of Section 13(3) programs provided trillions of dollars of liquidity to the financial system and contributed greatly to the effort to quell the GFC. There has generally been little criticism of the Fed’s use and interpretation except for its Maiden Lane facilities in support of Bear Stearns and AIG.

Dodd-Frank Amendments

Following the GFC, in which some of the Fed lending was criticized, particularly assistance to individual companies, Congress enacted changes to Section 13(3) through the Dodd-Frank Wall Street Reform and Consumer Protection Act, which added several significant provisions including:
the Fed can now only conduct emergency lending through a “program or facility with broad-based eligibility,”

the purpose of the program must be “providing liquidity to the financial system, and not to aid a failing financial company”

that the security for emergency loans is sufficient to protect taxpayers from losses

that for any loan, a Federal Reserve bank must assign, consistent with sound risk management practices and to ensure protection for the taxpayer, a lendable value to all collateral for a loan under Section 13(3) in determining whether the loan is secured satisfactorily.

That credit may not be given to any company that is insolvent.

Prior to introduction of the COVID-19 era programs, Section 13(3) had not been used since the GFC and thus, the Dodd-Frank amendments are untested.

**Broad-based Eligibility.** The amended provision seeks to prohibit the Fed from customizing assistance to individual firms and focuses on assisting the broad market and financial system. A program or facility has “broad-based eligibility” if it is (i) designed to provide liquidity to an identifiable market or sector of the financial system, not designed to aid one or more specific companies, and (ii) at least five companies would be eligible to participate in. (FRA Reg. Sec. 201.3(b). Excluded from this definition is any program “structured to remove assets from the balance sheet of a single and specific company, or that is established for the purpose of assisting a single and specific company avoid bankruptcy” or some other insolvency proceeding. (Fed Website-Sec.13) (Fed Register vol 80, no. 243, 12/18/15).

**Collateral/Security and Protecting Taxpayers.** Other Dodd-Frank amendments relate to the section’s requirement that any loan be indorsed or secured to the satisfaction of the lending reserve bank (the “indorsed or secured requirement”) which address issues of collateral/security and with the new amendments, protection of taxpayers’ interest. The Fed was required to establish regulations designed to ensure that (i) the “the security for emergency loans is sufficient to protect taxpayers from losses” and (ii) that require a reserve bank to “assign, consistent with sound risk management practices and to ensure protection for the taxpayer, a lendable value to all collateral for a loan.” (Fed Register vol 80, no. 243, 12/18/15). The regulation adopted by the Fed provides that in determining whether an extension of credit under any program or facility established under Section 13(3) is secured to its satisfaction, a Federal Reserve bank must, “prior to or at the time the credit is initially extended, assign a lendable value to all collateral for the program or facility… to ensure protection for the taxpayer.” (Fed Register vol 80, no. 243, 12/18/15).

Thus, it appears that through its new regulation the Fed retained much of its traditional discretion. Other than the new requirement to value collateral, it remains committed to its prior position and seems to have conflated the new valuation requirement into the traditional indorsed
or secured requirement. By meeting this standard, it will presumably ensure “that the security for emergency loans is sufficient to protect taxpayers from losses.” This is consistent with the Fed’s long-held interpretation of its authority.

Administratively, the Dodd-Frank changes also require that:

- any such program must be established with the approval of the Secretary of the Treasury
- additional initial notification and ongoing reporting must be made to Congress
- any such program is terminated in a timely and orderly fashion. (Fed Website-Sec13).

**How does Section 13(3) apply to the Emergency Fund?**

**Broad-based Eligibility.** Under the amended Section 13(3), the individual assistance given to Bear Stearns and AIG, including their Maiden Lane facilities would not be permitted. However, it appears that the Dodd-Frank amendments leave intact many of the broad-based plans that the Fed employed in the GFC under Section 13(3) and which it has also chosen to redeploy to address the COVID-19 pandemic.

**Collateral/Security and Protecting Taxpayers.** It should be noted that the provisions of the original statute, nor the amendments provide guidance as to what constitutes sufficient satisfaction as to endorsement or collateral/security. The matter of what type and how much collateral, or what type of endorsement is sufficient is left to the Fed’s broad discretion. (Alvarez 2009) (Mehra 2010). Courts generally have afforded great deference to the Fed’s actions and its interpretations of its authority. (Alvarez, Baxter, Hoyt 2018).

Traditionally, as expressed by former Chairman Bernanke, the Fed has interpreted its Section 13(3) authority as only permitting it to make loans secured by collateral sufficient to provide reasonable assurance that they will be repaid. This position was thrust into the spotlight during the GFC when the Fed did not lend to Lehman Brother because it concluded that Lehman did not have sufficient collateral to secure a loan of the size that it would need to save itself. The lack of a loan resulted in the investment bank’s filing for bankruptcy. Under the amended section the Fed could reach the same conclusion but would have to assign values to the potential collateral and report on its decision to Congress.

One Fed legal memo from the GFC discussing the 2008 CPFF and sheds light on how the Fed interprets Section 13(3), and in particular the indorsed or secured requirement. The CPFF, which the Fed reintroduced on March 18th, is a broad-based program under which the FRBNY provides loans to a SPV that purchases eligible secured and unsecured commercial paper from eligible issuers. In discussing the CPFF, the Fed legal staff considered not only if the loan to the SPV would satisfy the indorsed or secured requirement, but also considered whether the requirement would be met if each purchase of commercial paper was considered an extension of credit to the issuer. The staff concluded that in both cases, the standard would be met in several ways:
1. by a third-party endorsement or guaranty (which did not apply to the CPFF)
2. by the commercial paper held by the borrower SPV,
3. by the pools of assets underlying ABCP held by the SPV, and
4. by paying a fee for an insurance premium, which applied to unsecured commercial paper under the CPFF (Alvarez 2009).

Thus, stated another way, the requirement can be met by a loan being secured by:

1. collateral with legal recourse to the borrower or a third-party guarantor,
2. an endorsement by a third-party guarantor without collateral, or
3. recourse to collateral without an endorsement. (Alvarez 2009).

In another context, Fed counsel have also considered whether the central bank could extend a loan not expecting to be fully repaid and concluded that it could not—"To be consistent with the purpose of the statute, the security required to satisfy the lending Reserve Bank needed to be at a level sufficient for the bank to reasonably believe it would be fully repaid." (Alvarez, Baxter, Hoyt 2018.)

But there is a not an absolute prohibition on the Fed incurring losses. In providing assistance to Bear Stearns in March 2008 the Fed agreed to purchase a portfolio of Bear’s assets to facilitate the merger of the troubled investment bank with JPMorgan Chase (JPMC), an extraordinary transaction for the Fed that became known as Maiden Lane, the name of the special purchase vehicle created to hold the mortgage securities. The loan to the SPV was to be fully collateralized by the Bear portfolio (whose value had been determined to be able to support the loan) and would be non-recourse to JPMC. The lending Federal Reserve Bank of New York (FRBNY) determined that the indorsed and secured standard was met, yet, it also sought an indemnification from Treasury Secretary Paulson for any losses that might be incurred. Legally unable to grant an indemnification, Paulson issued the FRBNY a letter recognizing that there might be losses that would reduce the net earnings transferred by the FRBNY to the Treasury general fund. (Paulson 3/2008). Paulson issued a similar letter with respect to the Fed's assistance to AIG with respect to securities lending (Paulson 10/2008). These actions are consistent with the views of then FRBNY President Geithner that “a central bank should be prepared to take losses” and that it is “highly likely … that the appropriate use of the lender of last resort authority might well result in some losses.” (Geithner 2019).

Thus, a reasonable interpretation would conclude that as long as at the time of lending the Fed had a reasonable expectation of being repaid, either by the borrower, through access to collateral or insurance, or to a third-party guarantor, in this case the Treasury, the indorse or secured requirement would be satisfied. Further, satisfaction of this standard appears consistent with the current requirement under Section 13(3) to protect taxpayers from losses. In the event there was
a loss that had to be absorbed by the Treasury’s equity contribution or guarantee, these funds in
effect had already been appropriated by Congress.

However, it would be prudent for the Fed to consider not only whether an individual default
under a program would be covered by the Treasury backstop but also the likelihood that the total
potential losses under a program could realistically be absorbed by the Treasury’s guarantee. If
they could, then it appears that Section 13(3) would have been complied with. The Fed recently
reached a similar conclusion in its letter to Congress regarding the 2020 TALF – "the Board does
not expect at this time that the TALF will result in losses in excess of the Department of the
Treasury’s equity investment. Accordingly, the TALF is not expected to result in losses to the
Federal Reserve or the taxpayer (emphasis added)." (TALF Report.)

Insolvency. The Dodd Frank amendments prohibit the Fed from directly or indirectly lending to
any firm that is insolvent. Insolvent has been defined to mean (i) in bankruptcy, in a Dodd-
Frank resolution proceeding, or in another insolvency proceeding, (ii) generally not paying its
undisputed debts as they become due during the 90 days preceding the borrowing under the
program or facility, or (iii) as otherwise determined by the Board or Federal Reserve Bank. (Fed
Register vol 80, no. 243, 12/18/15).

Under the second definition above, a company that is generally not paying its undisputed debts
as they become due during the 90 days preceding borrowing is considered insolvent and
ineligible for a loan. (Fed Register vol 80, no. 243, 12/18/15). However, government COVID-
19 assistance may provide forbearance relief to companies effected by the pandemic. One
question in this situation may provide forbearance relief to companies effected by the pandemic. One
question in this situation is whether these missed payments, which may be legally excused, could
be disregarded by the Fed for purposes of determining insolvency under Section 13(3). If they
cannot be then a quirk in the law will constrain potential borrowers to choose which form of
relief may be more valuable, a result which was perhaps unintended.
The FHLBs During the Coronavirus Crisis, Part II
By Chase P. Ross

Original post here.

In my last note, I raised the question of whether the Federal Home Loan Banks (FHLBs) would be the lender of “next-to-last resort” during the coronavirus crisis, as they were in 2007 and 2008. Data released since my last note provides an updated picture of the FHLBs’ actions in the first months of the current crisis.

Total FHLB debt outstanding increased by about $180 billion from February to March 2020. The increase in debt outstanding came from an increase of discount notes issued through their window rather than via auctioned discount notes. Total discount note debt outstanding increased from $377 billion to $577 billion over the same period—roughly a 50% increase (Figure 1). The weighted average maturity (WAM) of the FHLBs’ discount notes increased substantially. From February 2020 to March 2020, the WAM of their discount note debt rose from 51 days to 80 days (Figure 2), the highest value in the sample back to 2008.

This increased debt outstanding very likely flowed through to increased FHLB advance loans to members. The data available so far suggests the FHLBs have indeed provided lender of “next-to-last” resort-type liquidity to its members in the first month of the coronavirus crisis. After more data comes out over the coming months, including balance sheet data on FHLB advances, we’ll be able to directly compare the amount of liquidity provided by the FHLBs and the Federal Reserve.
A Long Way to Go for Emerging Markets

By Ahyan Panjwani and Chase P. Ross

Original post [here](#).

The developing world will soon become the frontlines in the battle against the coronavirus, and markets are bracing for the resulting fallout. The Covid-19 crisis has already had an unprecedented effect on emerging markets—more than 100 of the IMF’s member countries have already asked for aid: Simultaneous health and financial crises add fuel to the linkages between sovereign debt crises, banking crises, and growth and competitiveness crises. In this note, we discuss financial markets’ responses in the first months of the current crisis, the unique challenges EMs face compared to wealthier nations, and reasons for cautious optimism at the present moment.

Emerging and developing economies’ reported cases remained low in the initial stages of the pandemic as the virus migrated from China. However, in the past three weeks, confirmed cases in EMs have tripled to 630,000 cases compared to 1.9 million cases in developed economies (Figure 1, panel A). Looking across several measures—health care expenditures; the number of hospital beds, doctors and nurses; or GDP per capita—it’s clear EM’s health infrastructure is less equipped to manage the virus.

![Figure 1: Cases and Government Response Across Advanced and Developing Economies](image)

Despite these looming initial conditions, data from the Oxford COVID-19 Government Response Tracker show EM governments have moved as quickly as developed economies to impose social distancing policies, like school closures, and travel bans (Figure 1, panel B).

Emerging markets have unsurprisingly taken a financial shellacking. With risk off and hot money running for the exits, equities fell, credit spreads widened across the quality spectrum,
and FX weakened. From peak to trough, equities have fallen by 20% and spreads for EM sovereign spreads have increased by more than 400 bps (Table 1).

<table>
<thead>
<tr>
<th>Table 1: Peak-to-Trough</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007/8</td>
</tr>
<tr>
<td>Covid-19</td>
</tr>
<tr>
<td><strong>Equity (%)</strong></td>
</tr>
<tr>
<td>EM</td>
</tr>
<tr>
<td>LatAm</td>
</tr>
<tr>
<td>Asia ex. J</td>
</tr>
<tr>
<td><strong>Credit (bps wider)</strong></td>
</tr>
<tr>
<td>EM CDX</td>
</tr>
<tr>
<td>EM HY</td>
</tr>
<tr>
<td>EM IG</td>
</tr>
<tr>
<td>EM Sov.</td>
</tr>
<tr>
<td><strong>FX (%)</strong></td>
</tr>
<tr>
<td>EM</td>
</tr>
</tbody>
</table>

Note: Covid-19 is YTD April 23, 2020.

The EM CDX, an index of about 20 emerging market sovereign issuers’ CDS spreads, increased almost 300 bps (Figure 2). Compare that to the 10 bps increase in US CDS spreads, despite the US’s discretionary fiscal expansion of 7% of GDP compared to EMs’ of 3.5%, as estimated by Goldman Sachs.

![Figure 2: Emerging Market Sovereign Debt CDS Index (5Y CDX)](source: Bloomberg, Markit)

We calculate market expectations by imputing sovereign debt default probabilities from CDS spreads. Across our sample of 17 countries, the average market-implied default probability was 6.7% on January 1, increasing to 16.0% on April 22. On the country-level, each country’s default probability has increased. However, there is considerable variation across countries: Turkey increased from 18% to 35%, Pakistan from 26% to 42%, South Africa from 11% to 26%, while default probabilities increased by less than 5% for China, the Philippines, and Chile (Figure 3).
This spike in perceived risk can have dire consequences for public finances in individual countries. Since the financial crisis of 2008, investors from advanced economies have searched farther and farther afield for attractive yields. This Marco Polo-esque search for yield has cushioned the public finances for many emerging markets (Figure 4). On the flip side, international reserves for many emerging economies have increased noticeably; on average, reserves have tripled in the last two decades. As a by-product, exchange rates have stabilized despite a slow walk towards a floating or quasi-floating mechanism (Bianchi, Hatchondo, and Martinez, 2018). Now, the public-debt binge is over, and unceremoniously so.
Central banks in emerging markets are in a peculiar position due to these headwinds. On the one hand, there is an incentive to increase interest rates to compensate for the increase in risk premia. However, the deflationary nature of the crisis and possible political economy factors call for a loosening of monetary policy. While EM central banks have heeded the latter with 113 rate cuts globally this year, the flight to safety is a potent threat to EM public finances, especially with government budgets due soon in many countries.

Another cause of concern for some emerging economies is the possibility that their citizens working in other countries have to return home. This scenario compounds the problem due to the financial shock as it may reduce remittances and increase domestic labor supply, a double whammy. Countries like Pakistan and India with patchy social safety nets would have to grapple with significant unemployment and wage pressure while another source of dollars—remittances—deals a blow to national accounts (Figure 5).

To complete the nightmarish prospect, a slump in global demand means economies reliant on commodities are in for a rude awakening. Although oil has grabbed worldwide attention prices for zinc, scrap steel, copper, and tin have declined precipitously since January 2020—dropping by 18%, 17%, 16%, and 13%, respectively. While mine closures in South Africa and the DRC have steadied prices for some metals, the net pressure on public coffers will be significant, feeding into investor concerns mirrored by the CDS spreads.

There is reason for hope yet. The exposure of emerging markets to a Covid-19 outbreak—very roughly proxied by Goldman Sachs’ economists using the countries’ age distributions, prevalence of smoking, access to sanitation and clean water—is no worse than that of advanced economies. Markets have yet to plumb the lows seen during the global financial crisis (Table 1). Although EM credit spreads have widened, especially for high yield corporates, sovereign and high-quality issuers are still trading well below 2008 peaks.
In recent days, the G20 announced a repayment freeze for bilateral loans through 2020. This development is significant, despite an initial outlay of only $20 billion, as it has set the trend for further easing the debt burden for the most vulnerable societies. However, bringing private creditors on board will be a thorny issue and may blunt the G20 efforts. Moreover, the IIF estimates the same countries receiving G20 assistance owe about $140 billion in external debt service payments in 2020, so the relief program is only a first step.

The spike in CDS spreads may prove to be a canary in the coalmine vis-à-vis possible credit events on sovereign debt. Such an event could prove to be regionally disastrous and may prolong the health crisis itself if a government has to direct resources towards litigation instead of public health.

In 2017, the World Bank set up the Pandemic Emergency Funding Facility wherein a bond would provide funding if a pandemic occurred in certain member countries deemed most vulnerable. After initial hiccups determining whether the criteria were met or not, the securities were adjudged as in the money. While the payoff is less than $200 million, it is only part of the institution’s response to the ongoing crisis. More importantly, this development highlights the importance of financial innovation: state-contingent assets can prove to be an invaluable lifeline for at-risk communities.

Recent decades have marked a comeback of official lending relative to private lending. A wide range of region-specific development banks, bilateral, and multilateral lending agreements are available and ready to act. Horn, Reinhart, and Trebesch (2020) argue today’s “global financial safety net is large and diverse.” We will find out soon enough.
Understanding Parametric Triggers in Catastrophe Insurance

By Vaasavi Unnava

Original post [here](#).

In the midst of a global pandemic, many businesses are finding that their property and casualty insurance policies do not provide protection against business losses resulting from the pandemic.

Some property and casualty policies do include business interruption insurance, which provides supplementary coverage against interruptions to revenue flows due to external disruptions. However, business interruption insurance typically excludes coverage for viral perils—that is, threats to revenues due to viral outbreaks that force businesses to close in the interest of public safety.

A small niche has emerged for epidemic insurance in recent years, in the wake of the SARS, MERS and Ebola outbreaks. However, few businesses purchased it. Moreover, even under such policies, businesses may face lengthy litigation attempting to prove coverage or the amount of benefits owed from insurance companies.

Not every catastrophe results in the delays and challenges that characterize a claim under business insurance policies due to COVID-19. For years, insurers have utilized parametric triggers—explicit conditions that, once met, automatically trigger coverage—to provide catastrophe insurance in the event of flooding, hurricanes, or earthquakes. Insurance companies have also used parametric triggers for pandemic and epidemic policies written during the Ebola and zika outbreaks.

Such triggers are especially useful for quick deployment of payments; traditional indemnification claims can take several weeks to process compared to the near immediate payments issued through parametric policies. Additionally, as a bulk of parametric insurance policies payout an already agreed-upon sum, policyholders spend less time attempting to determine the extent to which their policies cover their losses. In the context of pandemics, the quick payments to businesses may provide the necessary capital for businesses to install safety equipment or purchase necessary safety supplies. Quick payments may also keep businesses with high fixed cost commitments afloat during quarantine or social distancing measures.

This blog discusses two types of parametric triggers utilized in business interruption insurance: statistical parameters and civil authority orders. Many proposals for business interruption insurance in a pandemic landscape rely on parametric triggers that begin payouts by the status of civil authority orders. Other proposals rely on externally generated statistics through statistical parameters to determine when payouts should begin. Both of these triggers may provide a useful framework for building business insurance policies for pandemics.

**Statistical Parameters**
Statistical parameters require measures to meet or exceed a specific statistical threshold before coverage payouts begin. These triggers often rely on third-party consultants to determine whether the trigger has been satisfied.

These triggers are typically utilized in catastrophe bonds and insurance-linked securities, instruments connected to insurance-related risks that provide issuers funding for specific events, such as tornadoes or hurricanes, as a type of reinsurance. There are several metrics which insurance companies may use.

Catastrophe bonds, bonds issued with the stipulation that the issuer no longer pays principle or interest to investors if certain conditions are met, may halt payouts based on the strength of the covered catastrophe, such as an earthquake’s magnitude or a hurricane’s wind speed and barometric pressure.

Insurance-linked securities include mortality swaps, investment products where cash flows depend on a mortality index. Other insurers use parametric triggers for business interruption insurance, such as the rate of hotel bookings in comparison to year-on-year averages or the measures of footfall in pedestrian areas.

For pandemic and epidemic insurance, the epidemic data analytics firm Metabiota developed a pathogen sentiment index to measure the effects of fear on drops in consumption. While some parametric triggers rely on one datapoint, others are based on an index of available data to determine when the policy payouts can begin.

Parametric triggers often utilize externally determined statistics for triggers. For example, the World Bank Pandemic Emergency Financing Facility’s (PEFF’s) catastrophe bonds relied on publicly available data to determine how much money the facility would release. According to the World Bank, “[the] triggers are based on outbreak size (the number of cases of infections and fatalities), outbreak growth (over a defined time period), and outbreak spread (with two or more IBRD/IDA countries affected by the outbreak.” Payout occurred after all three conditions were met.

Similarly, Springboard, an independent firm, generates the footfall metric utilized by Aon, which measures changes in pedestrian traffic. The footfall metric could be particularly helpful in determining unexpected business losses due to drops in consumer sentiment; for example, it could have been used in 2018, when a fake terrorist report caused £3 million in losses to London retailers.

However, though parametric triggers are unambiguous, they may not necessarily result in timely payouts. The World Bank’s pandemic catastrophe bonds, issued in July 2017, utilized a series of parametric triggers to determine when payments would begin. Once trigger conditions were met, funding from the bond issuance was made available to 77 countries through the PEFF’s insurance window. Payouts required a slew of conditions: 1) a rolling daily average of at least 250 cases; 2) the virus to exist for at least 84 days; 3) total confirmed deaths to be greater than
250 cases (for class B issuances) or 2,500 cases (for class A issuances); 4) an exponential growth rate; and 5) geographic spread of the virus.

The World Bank’s pandemic bonds have faced criticism for their relatively late payout. With the number of elements making up the parametric triggers, global statistics met conditions to trigger halting interest payments for the bonds only on April 17, nearly 40 days after the WHO officially characterized COVID-19 as a pandemic.

Used thoughtfully, these triggers hold promise as a means of efficiently triggering payouts to business interruption insurance policyholders in the case of a global pandemic by providing a means of speedy coverage determination.

**Civil Authority Parameters**

Within pandemic and epidemic insurance, insurers may rely on local decrees to determine payouts. During viral breakouts, cities and municipalities may institute lockdown or social distancing orders. In 2014, during the Ebola outbreak, NAS Insurance, an American insurer, provided business interruption insurance that would automatically pay out if there was a mandatory shutdown ordered for the area specified in the policy. To account for mobility, the Insurance Services Office (ISO), an insurance advisory organization, proposed a new policy endorsement in response to COVID-19 that also triggers coverage if civil authorities suspend travel services in the area where the business is located.

The Caisse Centrale de Réassurance (CCR), a French publicly administered reinsurance company, demonstrates an interesting implementation of local decree triggers through a public-private reinsurance program. Like the insurance policies outlined above, insurers (reinsured by CCR) automatically begin payouts to policyholders once a local government declares an emergency and the policyholder meets a deductible. However, the size of the deductible changes based on the number of times the local government has declared an emergency for the same catastrophe event in the previous five years. The standard deductible will apply for the first two incidents and will rise with each succeeding incident to four times the standard deductible for the fifth incident in a five year period.

Many proposals aimed to protect businesses from losses resulting from a possible second wave of the virus incorporate civil authority response triggers to determine when funding should be provided to businesses. An insurance industry proposal, entitled the Business Continuity Protection Program, only pays out once a state or local government orders a shutdown. As mentioned above, the ISO COVID policy endorsements trigger payment exclusively based on civil authority decrees. Munich Re’s product, Pathogen RX, triggers if a government orders a shutdown or travel ban.

Civil authority triggers provide a strategy to account for non-physical damages, which most business insurance policies do not currently include in their coverage. Courts have repeatedly held under common policy wording that the following types of incidents were not covered: government action that negatively impacted the insured without physical damage to the insured
property or an adjacent property, government action predating any physical damage, physical damage not resulting from a covered event, and when government orders did not actually prohibit customers from entering the property. By instituting civil authority triggers, physical damages would no longer be a necessity when responding to the economic consequences of a pandemic.

While civil authority triggers can be indicative of the extent to which pandemics have affected the local economy, some cities may lift quarantines and social distancing guidelines before individuals feel safe enough to participate in the economy again. Cities in a rush to reopen may still experience depressed sales and slow economic growth as consumers and employees are cautious about returning to normal activities. Fear of the spread of COVID reduced consumption even before government shutdown orders came into effect, indicating that government shutdown triggers alone may not be enough to define periods of lost revenue due to pandemic fears. Under traditional indemnification, losses due to lack of consumption may not be completely captured if relying exclusively on civil authority triggers. However, automatic payments of predetermined sums common to parametric insurance addresses some of the difficulties in determining the scale of losses.

The Mexican government’s economic response to the COVID-19 pandemic

By Manuel Leon Hoyos

Original post here.

Mexico, the second largest Latin American economy, has been hit hard by the COVID-19 crisis as the death count surpassed 46,000—making it the third highest in the world. Unlike other countries in the region, though, its government has kept crisis spending relatively low, at about 3% of gross domestic product (GDP), to avoid massive government debt issuance.

Mexico’s sovereign credit rating and the national oil company, Pemex, were downgraded in April and further again in June. Since February, the Mexican peso has depreciated by over 20%. The country has experienced shortages in foreign exchange liquidity and a sharp fall in commodity prices—particularly crude oil prices. According to the Bank of Mexico, the crisis has brought “the greatest contraction ever recorded of holdings of emerging economies’ assets, especially of fixed-income instruments” (see a YPFS blog post on the Bank of Mexico’s liquidity measures). In April, Mexico’s economy contracted by 17.3% as 12 million people dropped out of the labor force. The second quarter contraction was 18.9% in respect to last year. The IMF currently expects a 10.5% GDP contraction in 2020.

While many Latin American countries have increased public debt to boost fiscal expenditures in response to the COVID-19 crisis, the Mexican government has taken a different stance. According to various estimates, economic packages in Latin American countries such as Brazil, Argentina, Chile, and Peru range between 5% and 10% of GDP. In Mexico, it is estimated to be lower at about 3% of its GDP (Bloomberg, IMF, Statista) including the $7.7 billion (0.7% of its...
GDP) Emergency Prevention and Assistance Fund announced in March through which the federal government directed additional resources to respond to the COVID-19 crisis.

Mexican President Andrés Manuel López Obrador has firmly committed that Mexico would not be issuing public debt to get out of the current COVID-19 crisis, but would rather reallocate resources and take austerity measures.

On April 5, President López Obrador outlined the principles and measures for the Mexican government’s economic response to the COVID-19 crisis. These were further outlined on April 22 and established in a decree on April 23.

The principles include an “austerity law” to reduce public expenses for non-priority programs. The President ordered the termination of federal public trusts (fideicomisos) deemed non-strategic and directed these resources for the current health and economic emergency (April 3). These public trusts are established to support a variety of purposes, including the economy, health, arts, cinema, and sciences. The government’s plan is financed with savings coming from the Stabilization Fund of Budgetary Revenues (Fondo de Estabilización de los Ingresos Presupuestarios) and commits to not increase Mexico’s public debt, taxes, or gas prices, or to lay off government workers.

The President highlighted that in addition to strengthening social programs to protect the poor and credits for small businesses, the government will concentrate resources to prop up Mexico’s national oil company Pemex and pay Mexico’s public debt. “We are going to allocate most of the resources to the debt, because we do not want the debt to increase, we want to do everything possible to maintain the commitment to continue to ensure that there is no increase in public debt” (April 3).

In 2019, the Mexican Congress approved up to $5.3 billion for external debt for 2020. Despite having access to the IMF Flexible Credit Line for $61.4 billion, the Mexican government plans not to make use of it. “The commitment is to get out of the crisis without getting into debt” (April 16).

President López Obrador said that in previous crises such as in 1994-1995, Mexico borrowed funds from international organizations and used those for the Bank Fund for Savings Protection (FOSBAPROA), which were accompanied by a great deal of corruption. “The government bought portfolios and gave the banks promissory notes on behalf of the government, and all of this became the enormous public debt that paralyzed and prevented the country from growing for two decades” (April 28). He has opposed rescue packages and emphasized that his administration will not execute the “recipes of the neoliberal period because they do not solve the problem, but rather aggravate and deepen corruption” (April 6).

In late April, Mexico did conduct a $6 billion bond issuance, one of the country’s largest, with an average rate of 4.7125%. Finance Minister Arturo Herrera emphasized that this will help consolidate the government’s funding sources and operate programs responding to COVID-19 crisis. The bonds were issued at terms of 5, 12, and 31 years.
In May, Mexico received a $1 billion loan from the World Bank. President López Obrador said that the transaction was a routine operation approved last year to manage government finances (June 8).

The economic measures outlined by the government include:

- A hiring freeze. No government workers will be fired. Wage payments for those unable to work due to lockdown measures are extended until August 1.
- Salaries for high-ranked government officials will be voluntarily reduced by up to 25% and they will not receive bonuses at the end of the year.
- Each government agency will only be allowed to use 25% of the allocated budget for general services, materials, and supplies.
- Government spending is postponed, with certain exceptions for priority social programs and major infrastructure projects.
- The elimination of 10 Under Secretaries. Employees of these Under Secretaries will preserve government employment with the same income.
- Beneficiaries of pension payments will receive two months upfront. These include over eight million senior citizens and 744,000 young people with disabilities, for up to $2 billion overall (July 2).
- The government, through the Ministry of Economy and multiple national social institutions, will provide housing loans and four million credits of up to $1,100 per credit, to small businesses and workers in both the formal and informal sector. By July 12, the government had granted over 1.4 million credits (July 12).
- Unemployment insurance for three months, for workers that hold a mortgage with INFONAVIT.
- The creation of two million jobs through major infrastructure projects such as the “Maya” train in the Yucatan Peninsula, an oil refinery in the state of Tabasco, and a new airport in Mexico City-Santa Lucía.
- Provide liquidity support through development banks.
- The program of fiscal incentives and low gas and energy prices will continue at the northern border, as well as prompt VAT refunds to taxpayers.

Following the initial announcement of the government’s economic plan in April, business groups criticized it as “underwhelming” or “incomplete.” This month, a group of 30 Mexican writers and academic scholars criticized the management of the COVID-19 pandemic as “suicidal austerity” (July 15). President López Obrador has argued that critics seek to restore old neoliberal regimes, characterized by corruption and inequality (July 16).
A Bank of America report said that Mexico could lose its investment grade credit rating next year as public debt is expected to rise to over 60% of GDP. The Bloomberg Editorial Board said that the President is making the crisis worse and that “the government’s indifferent fiscal response is inexcusable.” Minister of Economy Graciela Márquez Colín, has maintained that Mexico cannot easily increase debt. She said that “if at a certain point we need to raise more debt, we will. It is not a closed-off road.” However, taking on debt, she said, could cause problems.

Recently, the Mexican Minister of Finance Arturo Hererra Gutiérrez said that although originally the international consensus estimated lockdown measures to last a couple of months followed by an immediate economic recovery, “the recovery horizon will be much longer, as long as an effective vaccine or treatment is not available, and therefore economic policy, particularly fiscal and financial, must adjust to the new reality” (July 18). Gerardo Esquivel, Bank of Mexico’s Deputy Governor appointed by President López Obrador last year, estimates that poverty will increase in the country as a result of the pandemic by at least nine million more people. He said that “it is essential that additional measures be taken to alleviate the enormous economic and social costs that this crisis will leave” and urged for action, “let’s learn from history, act smart, prevent more people from falling into poverty, and help weld the broken pipes of our economy. Let’s do it before it’s too late” (July 29).

In contrast, the Bank of Mexico quickly unveiled a series of liquidity measures totaling $30 billion (3.3% of last year’s GDP) in April to “foster an orderly functioning of financial markets, strengthen the credit channels and provide liquidity for the sound development of the financial system.” The Bank of Mexico has cut its benchmark rate 225 basis points this year to a 5% target rate (see a YPFS blog post on the Bank of Mexico’s liquidity measures). The Bank of Mexico also holds swap lines with the US Federal Reserve and US Treasury for $60 billion and $9 billion respectively. The peak usage was at $6.6 billion in April and currently about $5 billion is outstanding.

Other COVID-19 related responses within Mexico include the Mexican Business Council, in collaboration with IDB Invest—the private-sector arm of the Inter-American Development Bank—announcing $12 billion in loans a year to SMEs.
In the first blogpost in a series, we introduce the ongoing crisis in Lebanon. On March 9, the country defaulted on its sovereign debt for the first time in its history. At the time, it had one of the highest ratios of debt to GDP in the world. While the government was in the midst of negotiations with IMF for a support program, on August 4, the country’s capital faced a catastrophic explosion caused by neglected ammonium nitrate.

On March 9, Lebanon missed a payment on a $1.2 billion Eurobond. It was Lebanon’s first sovereign default in its history. The market had been wary of the solvency. The price fell to 57 cents on the eve of default while the yield on the bond surpassing 1,000% (Figure 1). The government subsequently announced it would discontinue all principal and interest payments on foreign currency-denominated Eurobonds.

Figure 1
The government also disclosed that the foreign exchange reserves held by Banque du Liban (BdL), the Lebanese central bank, were experiencing a “rapid downward trend.” The $29 billion foreign exchange reserves as of January 2020 were too low to sustain the Lebanese economy facing immense debt (Figure 2). The government claimed that $22 billion out of the $29 billion foreign exchange reserves consisted of liquid assets. Meanwhile, given the opacity of the BdL’s foreign exchange disclosure, some question the actual size of liquid foreign-currency assets.

Figure 2
The country’s debt-to-GDP ratio was 151.0 percent as of 2018, one of the highest in the world (Figure 3). The government estimates that the ratio surged to 178 percent of GDP at end-2019. Meanwhile, Lebanon faces $20 billion in debt amortization in 2020, and even more in coming years (Figure 4).

**Figure 3**
The accumulating large debt and the outflows of US dollar deposits also led to a severe depreciation of the domestic currency. The country has committed itself to a fixed exchange rate, pegging the Lebanese Pound (LBP) at 1,507.5 to the US dollar since 1997. This was a critical policy to stabilize the financial market back then. In 1992, prior to the introduction of the fixed rate, the LBP saw a severe depreciation by more than two-thirds against the USD and inflation rose above 100 percent (Gaspard, 2017).

However, the fixed exchange rate meant to stabilize the financial market has led to a parallel market with an official rate and a black market rate. There is a huge discrepancy between them. As of September 15, the unofficial currency rate on the black market has depreciated by 79.9 percent compared to the official fixed exchange rate (Figure 5). Furthermore, as Lebanon imports 80 percent of its food needs, the rapid de-facto currency depreciation is significantly affecting households.

Figure 5
In April, the government said that its economy is in “free fall” and projected that its 2020 GDP would plummet by 13.8 percent. It expects annual inflation to rise from 2.9 percent in 2019 to 27.1 percent in 2020. Meanwhile, the monthly inflation rate has risen as high as 57 percent. It was 190 percent for food and non-alcoholic beverages (Figure 6).

Figure 6
On July 27, Moody’s lowered Lebanon’s issuer rating to C, the lowest rating possible, as low as that of Venezuela. S&P and Fitch also had downgraded Lebanon’s debt rating in March, to selective default (SD) and restricted default (RD) individually (Figure 7).

**Figure 7**

While the government has not imposed formal capital controls, private banks have limited depositors’ access to US dollar cash withdrawals, implementing a kind of de-facto capital control.

The unemployment rate also soared to 11.4 percent. The employment situation has particularly worsened for younger workers. Inequality is already significant in Lebanon. According to a study by the United Nations, in terms of the Gini coefficient, a measure of statistical dispersion intended to represent income inequality, the country is ranked 129 out of 141 countries, implying a severe income disparity.

According to an IMF report, in 2015, 1 percent of bank accounts held 50 percent of total deposits and 0.1 percent of bank accounts held 20 percent of total deposits. Another study by World Bank shows that 22 percent of the Lebanese population are under the extreme poverty line and 45 percent are under the upper poverty line.

**Negotiations with the IMF**

After the default, the Lebanese government began to work with the International Monetary Fund (IMF) to restructure its debt and negotiate a support program. On April 30, the government proposed an initial financial recovery plan to the IMF.
According to the plan, the country’s accumulated loss of LBP241 trillion ($68.9 billion) includes the items shown in Figure 8. These losses are calculated at an exchange rate of 3,500 LBP/USD, and the amount could increase if the currency devalues further. The central bank itself accounts for about $50 billion of these losses.

**Figure 8**

*The Financial Recovery Plan*  
*Total Loss Accounting more than LBP 241 trillion*

<table>
<thead>
<tr>
<th>Entity</th>
<th>Amount (% of total loss)</th>
<th>Loss details (from the recovery plan)</th>
</tr>
</thead>
<tbody>
<tr>
<td>BdL (Central Bank)</td>
<td>LBP73 trillion (30.3%)</td>
<td>Related to the restructuring of the government’s debt - Losses generated by excessive fiscal deficits over a long period of time, and notably by very high interests paid to local banks and BdL</td>
</tr>
<tr>
<td></td>
<td>LBP66 trillion (27.4%)</td>
<td>Related to BdL past accumulated losses - Losses generated by loss making transactions aimed at preserving the peg and maintain a high dollar inflow, including the financial engineering since 2016</td>
</tr>
<tr>
<td></td>
<td>LBP38 billion (15.8%)</td>
<td>Net losses on the balance sheets of BdL - The losses will materialize in the balance sheets of the BdL based on an estimation of the Lebanese Pound at the rate of 3,500 US$/$LBP</td>
</tr>
<tr>
<td>Banks</td>
<td>LBP40 billion (16.6%)</td>
<td>Net losses on the balance sheets of the banks - The losses will materialize in the balance sheets of the banks based on an estimation of the Lebanese Pound at the rate of 3,500 US$/$LBP</td>
</tr>
<tr>
<td></td>
<td>LBP24 trillion (10.0%)</td>
<td>Related to banks’ losses on their credit portfolio - Losses related to non-performing loans generated by the recession</td>
</tr>
</tbody>
</table>

Note: Applying the Lebanese Pound at the rate of 3,500 LBP/USD, the conversion rate which was referred in the recovery plan.

The total losses of $68.9 billion exceeds Lebanon GDP in 2019, which was $53.4 billion.

The recovery plan incorporates expected support from the IMF, considering the IMF’s ability in managing the balance of payment crises. Though the details of the negotiations have not been disclosed, the Lebanon is said to be asking IMF for $10 billion.

However, after more than 17 rounds of discussions, the negotiation with the IMF is still ongoing and has not reached a conclusion. In the midst of the negotiations, two members in the Lebanese negotiating teams resigned, “refused to be part of, or witness to, what is being done”.

At an IMF press conference held on July 13, Athanasios Arvanitis, Deputy Director of the Middle East and Central Asia Department, said that the reform plan was going in “in the right direction.” However, he noted that for further productive discussions, Lebanese authorities have to “unite around the government’s plan.” Furthermore, Mr. Arvanitis expressed particular concern about Lebanese authorities’ attempts to “present lower losses and difficult measures.”

Though the rescue plan backed by a consulting firm, Lazard, was useful to kick off the negotiations, the government and central bank do not seem to agree on the estimates of actual losses. The unconfirmed losses for the private sector have also been wrecking the negotiations. Furthermore, a few have questioned the feasibility of the restructuring plan, which largely
depends on tourism. While the government hopes to double the number of tourists from 2 million to 4 million over a 5-7-year period, the outbreak of COVID-19, the global economic downturn, and the explosion in Beirut may keep tourists away from visiting Lebanon.

Meanwhile, in assessing the losses and available foreign exchange reserves, the BdL’s balance sheet and its accounting are under scrutiny. Governor Riad Salame, who has been in charge of the BdL for 27 years, is said to have been relying on discretionary accounting practices, concealing the actual amount of risky liabilities on the central bank's balance sheet. These accounting practices may have burgeoned the BdL’s assets by $6 billion.

Indeed, there is no dominant generally accepted accounting framework for central banks (Archer and Moser-Boehm, 2013); some adopt common accounting standards such as IFRS, while others use home-grown frameworks embedded in central bank or other laws. However, recording expected seigniorage, the profit made from printing money, as an asset, apparently a common practice in the BdL, is rather unconventional. Most central banks record seigniorage as an income stream.

On April 14, the BdL published a statement defending its accounting practices. The BdL sought to justify its unorthodox accounting measures, arguing that direct implementation of IFRS would lead to “the disclosure of market sensitive activities” and thus excluding certain standards and implementing special treatments should be justified. The BdL also argues that its practice of recording future seignorage profits as assets to offset its losses is not unique should be justified. The BdL also argues that its practice of recording future seignorage profits as assets to offset its losses is not unique; the document refers to Costa Rica in the early 1980s, Peru in the 1980s, Thailand after the Asian Financial Crisis, and Hungary in the 1990s as precedents.

On July 20th, a Lebanese judge ordered Governor Salame to freeze some of his personal assets. It is uncertain whether the court order will be implemented for now. Furthermore, the government called for a forensic audit of the BdL’s balance sheet. IMF also underscored the need for the forensic auditing. The audit will be conducted by Alvarez & Marsal, KPMG, and Oliver Wyman.

On July 29, Ministry of Finance published a press release noting that “[t]he Government stands firm in its belief that an IMF programme is the cornerstone of this recovery pathway.” However, the deal with the IMF has yet to be announced.

The Beirut explosion

On August 4, 2,000 tons of ammonium nitrate exploded and destroyed most of Beirut port and its surroundings. According to the United Nations, the blast killed approximately 180 people and injured more than 6,000 people. Furthermore, the explosion damaged six hospitals, 20 health clinics, and 120 schools, facilities much needed not only to care for the victims of the blast but also to control the rising COVID-19 pandemic.
The catastrophic explosion could also jeopardize insurance companies in Lebanon, according to the Economist. If the explosion is proven to be an “accident,” it would not fall under the force-majeure clauses and insurance companies would need to pay for all claims. The Lebanese financial system is largely dominated by banks (see Part II). Insurance companies and other nonbanks account for only 3 percent of financial-system assets (IMF, 2017). But banks or global financial groups own 18 insurance companies, and these represent most of the market, according to IMF data for 2016. In 2017, IMF warned that the bank regulator and the Insurance Control Commission had not sufficiently collaborated in analyzing the risks posed by insurance companies owned by banking groups.

It became apparent that the 2,000 tons of ammonium nitrate, a component of fertilizer that could turn into explosives, had been left without appropriate care since 2013. On August 10, Prime Minister Hassan Diab resigned, blaming “political corruption” for the tragedy. Lebanon’s president and parliament appointed Mustapha Adib, previously Lebanon’s ambassador to Germany, as the new Prime Minister on August 31. Meanwhile, Talal F. Salman, the Finance Ministry advisor who had been Lebanon’s lead negotiator with the IMF, resigned and Lebanon has been struggling since then to form a new cabinet due to the sectarian fragmentation.

Consecutive resignations of prime ministers and government officials may complicate and delay the IMF negotiations. Kristalina Georgieva, the IMF’s managing director, commented that the devastating explosion was a “terrible tragedy, coming at a terrible time;” she said it is now “the moment for Lebanese policymakers to unite and address the severe economic and social crisis.” While she noted that the IMF is “ready to redouble our efforts,” she urged the Lebanese government and people to carry out four reforms: (i) restoring the solvency of public finances and soundness of the financial system, (ii) implementing capital controls, (iii) reducing protracted losses in many state-owned enterprises, and (iv) expanding the social safety net for the most vulnerable people.

France, the former colonial power, has reached out to Lebanese officials to facilitate access for aid and reforms (see Part III). French President Emmanuel Macron visited Beirut twice after the blast. However, he emphasized that France does not intend to grant “a carte-blanche, or a blank check,” and the aid will be subject to reforms, as underscored by the IMF director.
What led Lebanon into this financial crisis, the biggest challenge the nation has faced since its 1975-1990 civil war? The underlying economic problems are complex and interrelated. In this blogpost of the Lebanon series, we provide an overview of the causes, focusing on five areas: 1) the large current account deficit, 2) the unsustainable fiscal deficit, 3) the fragile financial sector, 4) the Bank of Lebanon’s “financial engineering,” and 5) slow growth, political deadlock, and the impact of the Syrian crisis.

#1: The large current account deficit

For years, Lebanon has run a large current account deficit, equivalent to roughly 25 percent of annual gross domestic product (GDP). The vast majority of imports are composed of fuel and food; Lebanon depends on imports to meet 80 percent of its daily needs of these items (Figure 1).

Figure 1
As introduced in Part I, Lebanon has committed itself to a fixed exchange rate, pegging the Lebanese Pound (LBP) at 1,507.5 to the US dollar since 1997. The fixed exchange rate, which stabilized Lebanon’s inflation over a decade, eventually led to the overvaluation of the Lebanese pound (LBP); IMF (2019) suggests that the LBP is overvalued by more than 50 percent. As a result, under the fixed exchange rate regime, Lebanon enjoyed access to imports but its export sector suffered from the lack of competitiveness. Corruption and insufficient business foundation also hinder the development of the export sector (IMF, 2019).

Lebanon depends on imports for petroleum products and fuel; unlike the neighboring Gulf States, Lebanon does not enjoy oil money and its recent attempt to exploit offshore hydrocarbon reserves exploration has been failing. Most of the energy used in Lebanon is derived from oil.

The majority of exports is led by services, namely the tourism industry. The total contribution of the sector was estimated to be $10.4 billion or 19.1 percent of GDP in 2018. However, the outbreak of protests, travel restrictions imposed by COVID-19, and the recent explosion in Beirut cast a dark shadow on the outlook for the leading industry. Compared to the previous year, the total visitor arrivals to Lebanon plunged by 98 percent in May 2020 (Figure 2).

Figure 2
#2: The unsustainable fiscal deficit

The weak tax regime, large and inefficient public sector, and unsustainable debt issuance in foreign currency has led to low government revenue (17,402 billion LBP, or 20.5 percent of its GDP in 2018) and high expenditure (26,754 billion LBP, or 31.5 percent of its GDP). Consequently, Lebanon has been suffering from large fiscal deficits, -11.3 percent of GDP in 2019 (Figure 3). The total public debt increased from 131 percent of GDP in 2012 to an estimated 160 percent of GDP at end-2019.

Figure 3
The low tax revenue is the result of slow economic growth and a tax regime riddled with loopholes. In the past, the IMF has encouraged the government to raise and broaden the base for corporate income taxes, property taxes, value-added-taxes (VAT), and fuel taxes; remove tax exemptions; and strengthen compliance by cracking down on tax evasion. For instance, currently, foreign-registered yachts, diesel used for electricity generation, and road vehicles are exempted from VAT. Furthermore, the conflict in neighboring Syria since 2011 has caused a large influx of refugees into Lebanon (see #5). One study suggests the Syrian conflict has led to a negative fiscal impact of $2.6 billion in 2012–14 (about 6 percent of 2013 GDP).

Lebanon is suffering from expenditures that far exceed government revenue. The largest costs include a subsidy to the main state-owned electricity company, personnel costs in the public sector, and interest payments. According to the IMF (2019), personnel costs were 9.7 trillion LBP, the subsidy to the electricity company was 2.6 trillion LBP, and the debt service was 8.2 trillion LBP.

First, the subsidy to Electricité du Liban (EdL), a state-owned electricity company, is sizable at 4 percent of GDP. The EdL is notorious for failing to supply electricity to its citizens. In 2019, the IMF reported that “(i) installed capacity is well below consumers’ demand; (ii) losses (technical, non-technical and non-collection) represent 43 percent of production—i.e. only 57 percent of electricity produced is actually transmitted, billed, and collected; and (iii) electricity tariffs are subsidized, which imposes a heavy burden on the government budget.” According to a World Bank estimate in 2018, the sector’s overall costs are $2.6 billion, while revenues are only $884 million (Figure 4). Arabnews reported that losses are due to fuel oil subsidies; low consumer tariffs, which have been based on an oil price of $20 per barrel since 1994; and theft. According
to the same news source, oil and fuel products are often smuggled to neighboring Syria, contributing to the losses for EdL. Currently, the daytime power cut lasts more than 20 hours.

Figure 4

Second, government personnel costs account for 11.4 percent of GDP. This is due to hiring in state owned enterprises. The Lebanese government owns and often enjoys a monopoly in important sectors such as utilities (telecom landlines, mobile companies, electricity, and water supply), casino, tobacco, and the national airline. In 2017, then-President Michel Aoun raised salaries in the public sector close to parliamentary elections. This new salary scale was more expensive than anticipated, increasing the fiscal burden by spiking expenses related to pension payments and early retirements. Furthermore, IMF (2019) reports that the ongoing new hiring in the public sector despite a hiring freeze has further raised spending on personnel.

Third, debt service accounts for nearly half of government revenues, further aggravating the fiscal balance. Figure 5 compares Lebanon’s interest payments to peer countries. The recent currency devaluation will further raise the debt-to-GDP ratio, as more than one-third of the government debt is denominated in foreign currency (Figure 6). This is partially due to the country’s history; during the post-civil war era, government had to borrow at high double-digit rates, or issue bonds in US dollars to attract foreign investors (Figure 6). According to an article by Reuters, Lebanon’s government does not necessarily know the identity of many of the holders of Eurobonds. This would further challenge the debt-restructuring process.

Figure 5
#3: The fragile financial sector

For many years, the unsustainable “twin deficits” have been supported by the strong financial sector, which relies on the constant inflow of remittance from diaspora families.
Historically, many people migrated to other countries from Lebanon. Most recently, there were three waves of migration: (i) from the mid-19th century to World War I, (ii) during the civil war (1975–90), and (iii) after the end of the civil war. Consequently, more people of Lebanese origin live outside Lebanon than inside. Some estimate that there are 8 to 20 million Lebanese people outside Lebanon in contrast to its 6.8 million population. This diaspora is global but concentrated in Arab countries.

The remittance from these diaspora people has supported the Lebanese economy for years. Over the past decade, the annual remittance has been over $7 billion, more than 10 percent of GDP. Remittance has become an indispensable part of the country’s safety net, representing over 40 percent of household income.

The remittance and credit kept flowing into Lebanon even when many other emerging economies suffered from the pullback of credit after the Global Financial Crisis (GFC). In contrast to most countries, private-sector credit growth surged from 2008 to 2010. An IMF report concluded that the improved political environment had contributed to the surge in demand for credit; low domestic interest rates had led to the surge in supply. Salim Chahine, professor at the American University of Beirut, argued that Lebanon benefitted from the GFC as Lebanese people withdrew money from low-rate US banks and parked the money at Lebanese financial institutions with higher rates. The influx of cash caused by the asymmetry in the interest rate further contributed to the growth of the banking sector (Figure 7); retail banks started to campaign for personal loans. This fueled leverage by households and firms and eventually changed lending habits. From 2006 to 2017, the country’s lending via personal loans and credit cards rose from $3.7 billion to $20.5 billion.

Figure 7
Meanwhile, foreign direct investment, which is typically more steady and stable over the long run, have declined by approximately 40 percent after 2010, given the unfavorable investment environment.

Capital inflows from remittances and increasing domestic borrowing supported the growth of the banking sector. By the middle of 2019, banking sector assets had increased 83 per cent in eight years to $253bn, equal to roughly five times the country’s economic output. According to IMF (2017), as of December 2015, 66 banks account for 97 percent of financial system assets, while nonbanks play a minor role. As Figure 7 shows, the development of the banking sector eventually turned the small country into the second-largest in the world in terms of banking assets relative to GDP (Lebanon Finance Minister, March 2020).

Lebanese banks are primarily deposit-funded, and the secondary debt market is undeveloped (IMF, 2017). Deposit concentration, rooted in the significant inequality in the country, has been another concern in the banking sector. The IMF’s Financial Sector Assessment Program (FSAP) report in 2016 warned that the largest one percent of deposit accounts held 50 percent of total deposits, while the largest 0.1 percent of accounts held 20 percent of total deposits. Furthermore, those deposits have short maturity. About 60 percent of total deposits by value are either demand deposits or mature in less than 30 days.

Bank assets are somewhat concentrated as well. Banks have large exposures to the public sector. As of September 2019, more than 70 percent of banking sector assets are composed of government securities and deposits at the BdL, the central bank. Under the current treatment in the Basel regulatory framework, in calculating risk-weighted assets under the standardized approach, banks can apply low risk weights to their sovereign exposure or BdL deposits if those
are issued or funded in domestic currency. According to the IMF’s 2016 FSAP report on Lebanon, such sovereign exposure accounted for more than six times Tier 1 capital owned by assessed banks on a non-risk-weighted basis.

The BdL has been allowing banks to assign a 50 percent risk weight for foreign currency-denominated BdL debt, and 100 percent for foreign currency-denominated Lebanese government debt. That is much more generous than Basel II recommends for internationally active banks. The Basel II standardized approach would require risk weightings of 100 or 150 percent based on Lebanon’s sovereign credit ratings, which range from B- to CC (see IMF, 2017). Given the large sovereign exposure, a sovereign debt write-off or a haircut by the Lebanese government could make some banks insolvent. Even after the IMF’s 2016 warning, banks’ exposures to the BdL and government debt further increased after the implementation of “financial engineering” by the central bank, as described below under #4.

Banks only lend 25 percent of their balance sheets to the private sector. In recent years, the overall lending to the private sector has fallen significantly (Figure 8). The real estate sector, whose performance had been stagnant in recent years, accounts for the majority of private-sector loans; however, more recently, some report that the real estate market is rapidly reviving while other assets rapidly lose value. As the economy slowed down, non-performing loans have surged; they now account for more than 10 percent of total loans.

Figure 8

Banks are also vulnerable in terms of liquidity risks, given the currency and maturity mismatches on their balance sheets. Attracted by higher interest rates, banks in recent years increased their
exposure to longer-term government debt, sometimes up to 30 years. This has elevated interest-rate risks and maturity-transformation risks, as bank deposits have short maturities.

In order to ensure that banks would have sufficient liquidity, Basel III, the post-crisis regulatory reforms, introduced two liquidity ratios: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). The LCR, designed to ensure that banks survive a period of significant liquidity stress lasting 30 calendar days, requires banks to hold high-quality liquid assets (HQLA). HQLA are cash or assets that can be converted into cash quickly through sales (or by being pledged as collateral) with no significant loss of value.

IMF (2017) questions whether much of the government and BdL debt held by banks could really be convertible in private markets under stress. According to the IMF’s 2016 FSAP report, the BdL considers term deposits and certificates of deposit to be safe in a crisis (see #5 for the role of certificate of deposits in Lebanese financial system and the BdL). While Lebanese banks met both LCR and NSFR requirements in the 2016 FSAP, the IMF warned that most banks would fall short of the LCR threshold of 100 percent, if long-term term deposits parked at the BdL were excluded from the HQLA; this indicates that widespread foreign currency liquidity pressures could threaten the financial system.

The constant inflow of remittance from the diaspora kept the fragile financial sector together for many years. However, the remittance has started to ebb in recent years, partially due to the oil price plunge from mid-2014 (Figure 9). Conventionally, an oil-importing country is expected to benefit from a cheaper price of oil. However, in the case of Lebanon, the decline in the oil price could slow the economy by reducing capital inflows and external demand in its service industry, including tourism. Both remittance and tourism dollars rely on Lebanese expatriates who live in oil-producing countries that are affected by falling oil prices. The IMF estimates that the oil price drop led to a decline in capital inflows by at least 19 percent, approximately 3 percent of GDP.

Figure 9
Commercial banks used various approaches to sustain deposits, particularly in foreign currency. According to IMF (2017), banks tried to attract USD by offering very attractive rates on sizable deposits, selling Eurobonds earned by the financial engineering (see #4) to foreign investors, and by repatriating funds from correspondent banks. Recently, despite these attempts, the deposits in commercial banks plummeted and capital inflows dried up significantly after the outbreak of protests in October 2019 (Figure 10; see Part III for the cause of the protest). While the government has not implemented capital controls, banks are implementing de facto capital controls by limiting the withdrawal of cash by depositors. While some in the international community have suggested a haircut on depositors, Lebanese authorities have strongly rejected levying any haircuts on bank creditors.

Figure 10
Lebanon started to face dwindling inflows from diaspora families in mid-2015. To preserve the large stock of foreign reserves that are the foundation of currency stability, Riad Salamé, the BdL Governor, implemented so-called “financial engineering” in 2016.

The financial engineering scheme involved three steps among the BdL (central bank), Ministry of Finance (Government), and private Lebanese banks. The financial transactions across these actors were designed to resolve the pressing concerns each of them had been facing: the foreign exchange scarcity for the BdL, the high debt service for the Ministry of Finance, and the insufficient capital and liquidity for private banks (Figure 11).

In short, BdL paid banks an extraordinary return on dollar deposits, effectively around 15 percent, in order to maintain its dollar reserves and to provide a windfall boost to bank earnings and capital. However, it created such an incentive to park funds with the government that banks sharply slowed lending to the real economy. Moreover, the BdL’s generosity was ultimately financed with Eurobond sales by the Ministry of Finance. While BdL’s gross reserves grew, its net reserves (after accounting for liabilities) fell. Its reserve adequacy metric, a measure the IMF uses to evaluate countries’ forex risk, fell below 100% at the end of 2018 and the situation seems to be worsening as time passes. The government’s growing dollar liabilities also made it vulnerable to a potential devaluation in the event it fails to hold the dollar peg.

The scheme included the following steps:

Figure 11
• **STEP 1:** BdL swaps Lebanese Pound (LBP) denominated treasury bills (TBs) held in its portfolio with equivalent Eurobonds issued by the Ministry of Finance.
  
  o The government liabilities increase in USD but decrease in LBP. This reduces the cost of debt service, as long as the exchange rate is stable. Furthermore, this lengthens the public debt maturity structure. However, it also increased the government’s exposure to the USD.
  
  o The BdL has converted part of its assets from LBP to USD.

• **STEP 2:** BdL sells the recently acquired Eurobonds and issues USD-denominated long-term Certificates of Deposits (CDs) to commercial banks against USD inflows provided by banks.
  
  o The BdL’s foreign exchange reserves increase, supporting the currency peg.
  
  o Commercial banks earn higher margins for holding Eurobonds and USD-denominated central bank CDs instead of cash.
  
  o Banks can also reduce their risk-weighted assets (RWAs), increasing their capital ratios, because BdL allows banks to weight the USD-denominated central bank CDs at 50 percent, compared with 100 percent for the Treasury-issued Eurobonds. (As noted in #3, according to **IMF (2017)**, risk weights are currently set at zero for government and BdL debt in LBP, and at 100 percent and 50 percent, respectively, for foreign currency denominated government and BdL debts).
• **STEP 3:** BdL pays banks an effective interest rate of about 15 percent to finance LBP-denominated debt (TBs) and LBP-denominated BdL CDs that banks hold on their balance sheets. The amounts of these loans are set at an amount equivalent to the previous transactions (Eurobonds and USD CDs). Banks paid no interest on these transactions, which gave banks an incentive to participate. In exchange, the BdL also benefits from 50 percent haircut on interest rates, which is voluntarily offered by participating commercial banks.

  - The LBP liquidity in the market increases by converting long-term assets of banks into liquid cash.
  - **IMF (2017)** notes that the discount at zero percent is “akin to a money-financed capital injection (without any equity stake in return […]), which helped strengthen banks’ capital buffers.”

**IMF** (2019) and others have analyzed the impact of financial engineering. First, they found that, under the quasi-fiscal scheme, the BdL ultimately became the primary actor to finance the government debt. As of 2018, the banking system as a whole provided almost 12 percent of GDP of new financing to the government (more than the overall deficit since foreign investors reduced their Eurobond holdings), with about three-quarters of the financing coming directly from the BdL (Figure 11).

Second, the Eurobond yields seemed to settle down, but only for a while. In contrast to the expectation, the yield has surged rapidly, particularly after the Prime Minister Hariri’s temporary resignation in November 2017 (Figure 12). The sudden disappearance of the Prime Minister was resolved only after a political intervention by French President Emmanuel Macron. This political fiasco seems to have had unsettling impacts on foreign investors and depositors.
Third, the scheme successfully boosted the BdL’s foreign currency holdings in the short term (Figure 13). However, the downside was the high rate that BdL offered commercial banks to attract deposits. According to the IMF report, for each new deposit at the BdL in USD, banks would earn a 6.5 percent interest in USD; this interest rate offered by the BdL is very generous, especially given the persistently low interest rates in international markets (Gaspard, 2017). In addition, the BdL would give the bank an opportunity to borrow a slightly larger amount in LBP at 2 percent and re-deposit it at the BdL at 10.5 percent for 10 years. As a result, the commercial bank effectively earned approximately 15 percent on its foreign currency holdings, a much higher return than any commercial loans banks would underwrite. Consequently, the high rates banks could earn on USD deposits through the financial engineering scheme affected the USD lending rates. They rose from roughly 7 percent in early 2018 to 9.7 percent in June 2019. This had a negative impact on private-sector credit, as banks preferred to park their money at the BdL rather than take risks by lending.

Fourth, the sovereign-risk exposure of banks significantly increased since the launch of the scheme. As of June 2020, banks’ exposures to the BdL and government increased to 70 percent of their total assets, more than eight times their Tier 1 capital (Figure 13).

Figure 13
While the BdL claimed that the financial engineering was “based on a win-win situation” and “didn’t burden the Central Bank neither the Lebanese Government with any costs,” many questioned its long-term viability term. Indeed, in an interview with the Financial Times in 2017, Mr. Salamé, the Governor of the BdL since 1993, admitted that his financial engineering has amounted to short-term fixes to keep the economy afloat until a more sustainable solution is found. “If the Syrian war ends, then we have major sectors that can drive the economy forward.” Unfortunately, the long-term fix was never implemented.

On the other hand, many criticized the potential risks embedded in the framework. Nasser Saidi, a former central bank vice governor, has explained the scheme as a “Ponzi scheme” as it relies on fresh borrowing to pay back existing debt.

The recovery plan prepared by the government for the ongoing IMF negotiations said that the financial engineering transactions had “proved unsustainable and very risky (… They) couldn’t address the core imbalances that generated the regular fall in FX reserves (a very large current account deficit) and they transferred to BdL a large exposure to FX risk.”

The financial burden on BdL increased. Although BdL has not reported its losses from the scheme, many suspect that these losses are included under the surging “other assets” item on its reported balance sheets (Figure 14).

**Figure 14**
#5: Slow growth, political deadlock, and the impact of the Syrian crisis

Compared to its peers, the Lebanese economy is known for slow growth. The overvalued currency has diminished the competitiveness of its export sector. High production costs, which could be partially explained by the dependence on imports, also hinder growth. Also contributing to the high costs are the antiquated administrative system, the poor electricity supply, and other infrastructure and poorly defined or protected property rights. Furthermore, Lebanon is known for rampant corruptions; the country has ranked 137 out of 180 countries on Transparency International's 2019 Corruption Perception Index. Many of the distortions that constrain growth could be attributed to governance and political uncertainties.

Lebanon’s politics is known to be inefficient. The Economist in 2018 explained that “it took two and a half years for the country to elect its current president, nine years to hold parliamentary elections and 12 years to pass a budget.” This is due to the historical divide in the domestic and international politics.

Excluding refugees, Lebanon has a population of 5.4 million, which is constituted by mixed religions: Christian 33.7 percent (Maronite Catholics are the largest Christian group), 30.6 percent Sunni, 30.5 percent Shia, and others. Following the power-sharing agreements established during the French colonial era, parliamentary seats are allotted proportionally to 18 religious groups, as are government posts and public-sector jobs. This leads to deadlocks in policy planning and implementation.

Political interference by Hezbollah, a Shia Islamist political party and military group, has increased tension with international communities as it has been designated as a terrorist group by the US and several other countries. Hezbollah holds parliamentary seats and has strong social
and political influence, including the nomination of the Minister of Public Health and other ministries. A number of municipalities are also run by Hezbollah politicians.

The fragmented political environment also hinders formation of effective cabinets. Not only domestic but also geopolitical risks are material: enmity between Hezbollah and Israel, US policy against Iran (where Shia Islam is dominant), and the rivalry between Saudi Arabia (where Sunni Islam is dominant) and Iran. The sanctions by the US on Hezbollah also disrupt the economy of those areas governed by Hezbollah.

The conflict in neighboring Syria since 2011 has had significant impacts on the country’s economy. Although data are unreliable, the influx of Syrian refugees is estimated to account for more than 10 percent of its population (Figure 15). An IMF Report illustrates that the scale of the impact for Lebanon is akin to “the United States experiencing a refugee influx the size of the Canadian population, or Germany absorbing the combined Austrian and Swiss populations.” According to the same report, the conflict in Syria not only increased geopolitical tensions but also heightened uncertainty, contributing to the decline in consumption, business investment, and tourism. The fiscal burden for the government has increased, especially in health and education.

Figure 15
Part III of Crisis in Lebanon: Public Protests, COVID-19 Crisis, and International Support

By Junko Oguri

Original post here.

In this last blogpost of the Lebanon series, we explore how the COVID-19 has impacted the country while it was already undergoing a severe economic and financial crisis. With the limited fiscal space and lack of resources, the most vulnerable Lebanese people are at risk. Aside from the potential IMF support, which is still under discussion, the government could seek to unlock the pledged CEDRE aid or ask for bilateral support. In any case, the road to recovery will be long and winding.

*The author would like to thank Rana Alayli for research support and comments.

The start of the crumble in late 2019

In October 2019, an austerity plan based on proposed taxes on tobacco, petrol, and voice calls via WhatsApp ignited a mass protest against corruption, bad governance, and inequalities. In a speech on October 21, Prime Minister Hariri promised economic and fiscal reforms, including halving government officials’ salaries. However, Hariri resigned only eight days later, leaving the government leaderless for months. In late January 2020, the new government was finally formed. Hassan Diab, a professor and former education minister, was named prime minister. His appointment was backed by Hezbollah (Figure 1).
The public has vented its frustration not only toward the government but also toward banks and business elites. Since the outbreak of the protest, most banks either shut down or limited dollar cash withdrawals by their depositors, an unofficial capital control. Meanwhile, according to Alain Bifani, a former top finance civil servant, banks themselves successfully circumvented the de facto capital control and “smuggled” approximately $6 billion outside the country. The social unrest led to the further flight of deposits and shortage of the USD, exacerbating the ongoing financial crisis.

COVID-19 Crisis

The COVID-19 crisis came on top of an economic, financial, and political crisis that was already underway in Lebanon. The government was relatively swift in responding to the crisis; on January 31, the newly appointed government established a National Committee for Covid-19, issuing stay-at-home orders in March to contain the pandemic. The first case of COVID-19 was confirmed in the country on February 21.

In early April, the Lebanese government announced that it would distribute LBP400,000 (approximately $265 at the official fixed exchange rate) to the poorest. It further pledged LBP 75 billion for sanitary and nutritional assistance. Local media reported that LBP 18 billion out of the 75 billion would be distributed in the form of food and health goods. However, there has been little information on distribution and it is uncertain whether these aids have materialized.
Infection numbers started to surge in mid-July. The government is re-imposing the once-lifted lockdown. The increase was particularly significant after the explosion in Beirut (Figure 2). As of August 20, new confirmed cases (seven-day rolling average) have exceed 400. According to the UNOCHA, the explosion damaged six hospitals and 20 health clinics, facilities much needed for the most vulnerable.

Figure 2

The COVID-19 Crisis in Lebanon

The negative impact of the economic and financial crisis on Lebanon’s health infrastructure had been apparent prior to the outbreak of COVID-19. In December 2019, Human Rights Watch reported that the Ministry of Finance had been failing to pay US$1.3 billion in dues to private hospitals, which account for 82 percent of Lebanon’s healthcare capacity. Furthermore, Lebanon imports 100 percent of its medical supplies; hospitals receive their payments in LBP and purchase medical equipment in USD. As the LBP plunges in value, hospitals and doctors struggle to secure essential medical supplies. The financial constraint on the healthcare industry is only exacerbating as the COVID-19 spreads. Hospitals are laying off staff, and nearly a third of Lebanon’s 15,000 physicians aim to or already have migrated.

The chronic electricity shortage is also hindering the delivery of essential services. Most recently, widespread power cuts lasting longer than 20 hours forced hospitals to restrict their capacity as they rely on generators and fuels to sustain the essential care units.

On July 20, Hamad Hassan, the Minister of Health, said that the country is sliding toward a “critical stage,” referring to the spike in positive cases. While the country reopened the economy by early July, the government had to reintroduce lockdown on August 3 due to the rise in cases.
International Support

The lack of fiscal space and political impasse have made it difficult for the government to provide support to the most vulnerable people in Lebanon. The proposed IMF support of about $10 billion could ease some of the pressure; however, the progress of negotiations has been sluggish, and it is uncertain when the government and the IMF could reach an agreement. Furthermore, structural reforms requested by the IMF will be painful and would be subject to demur by incumbent elites.

Further international support could come from other multinational organizations, such as the Gulf Cooperation Council (GCC). Lebanon could also unlock the $10.8 billion in aid that France and 47 other countries and institutions pledged in 2018. In April 2018, France, led by President Emmanuel Macron, hosted CEDRE (Conférence économique pour le développement, par les réformes et avec les entreprises), an international conference aimed to support Lebanon’s development and reforms. At the conference, the Lebanese government presented its Capital Investment Program focusing on infrastructure. The CEDRE participants agreed to support the Program conditional on reforms, including the reform of Electricité du Liban (EdL), the dominant state-owned electricity company that is known to be failing (see Part II for more details). The pledged aid included $10.2 billion in loans and $860 million in grants. The loans are reported to consist of $4 billion from the World Bank; $1.35 billion from the European Bank for Reconstruction and Development; and $1 billion via a credit line from Saudi Arabia, which was a renewal of a previously pledged loan. Pierre Duquesne, a French diplomat assigned by President Macron to monitor the process, notes that those required reforms are “simple” and “achievable” in the short term. However, to date, Lebanon has failed to implement the promised reforms. Thus, CEDRE support has not come through.

Bilateral support is another option included in the recovery plan that the government published in April in preparation for IMF negotiations. According to the plan, the government envisages a deal “similar to what Egypt unsuccessfully tried to do back in 2014 with Saudi Arabia and the UAE to avoid the currency devaluation the IMF was asking for as a precondition to its intervention.” The recovery plan hints that such a deal is less likely than that earlier proposal to require austere reforms; it said that the “immediate visible costs to the Lebanese people would be smaller, with only a modest fiscal consolidation.” The report also acknowledged that it would leave the burden of accumulated losses to the next generation.

Any of these bilateral deals, if they happen, would need to be sizable. Considering that all countries are suffering from fiscal challenges caused by COVID-19, they may not be forthcoming. Lebanon also faces difficulties in securing international aid due to the geopolitical tensions between Hezbollah and international communities. For instance, US officials are said to be concerned that any humanitarian aid for Lebanon could be routed to Hezbollah; this makes the US hesitant to support aid beyond emergency food and medical supplies.

Meanwhile, the government and Hezbollah may seek help from China. On June 16, Hezbollah leader Hassan Nasrallah hinted that Lebanon should welcome Chinese investments in key
infrastructure projects, while blaming the US for the shortage in foreign exchange. According to the Washington Post, China has offered to help Lebanon by building power stations and supporting other infrastructure through Chinese state-owned companies. It is still uncertain whether the Chinese aid will materialize.

Debt restructuring and reform are likely to take a long and winding journey for Lebanon and most likely will require external support.
Case Studies and Policy Changes

Forecasting the Economy During COVID-19
By Chase P. Ross and Sharon Y. Ross

Original post here.

The coronavirus crisis has left economists scrambling to rejigger their forecasts. In this note, we briefly describe how forecasters have updated their outlook for the US economy, what sort of data they use in their projections, and how economists link the public health outlook to the economic outlook.

Even in normal times, forecasters have a tough job but do it well on average. For example, analysis of a large data set on forecasts—the Survey of Professional Forecasters—shows that forecasters are most accurate looking one quarter ahead, and beat simple model forecasts like no-change forecasts or autoregressive models. Over a longer time horizon, the accuracy of projections declines.

At the beginning of 2020, the Bloomberg consensus saw Q2 real GDP growing at 1.7%, and the unemployment rate at 3.6% (following convention, the quarterly growth numbers we reference are the annualized quarter-over-quarter growth rate). Before the crisis hit, the economy was cooling slowly: growth in 2018, 2019, and 2020 (expected) was 2.9%, 2.3%, and 1.7%, respectively. In a typical recession, the economy gradually adjusts to lower output and higher unemployment via financial channels. But the virus, and especially the government response to the virus, have accelerated the normal process as workers are laid off because they physically cannot work safely.

Accordingly, consensus growth estimates quickly fell, as shown in Figure 1. From March 12 to April 12, consensus Q2 growth fell 24 percentage points (pp) from 1.8% to -22%. The consensus unemployment forecast in Q2 grew from 3.6% to 12% over the same period. As forecasters downgraded Q2, they upgraded Q3—implying a sort of “V” shaped recovery. From March 12 to April 12, Q3 estimated GDP growth grew roughly 8pp to 9.8%. News over the following month revised Q2 forecasts even lower to -33.5% and an unemployment rate exceeding 16.5%. Putting it together, expected growth for the full year fell from 1.7% to -5.8%.

Hidden in these point estimates is a tremendous amount of uncertainty, as shown in Figure 2. The spread between the low and high forecast for 2020 full year growth was 2.9pp on January 1 and rose to 13pp by May. This level of dispersion in forecasts is unprecedented. Even in the worst year (in terms of growth) of the global financial crisis, 2009, the maximum dispersion in forecasts was 7pp.

Several high-frequency data points have become particularly important in recent weeks. A non-exhaustive list of commonly used high-frequency indicators includes: Google Mobility Reports.
movie attendance, electricity utility generation, Redbook same-store retail sales, initial unemployment insurance claims, fuel sales to end-users, the Rasmussen Consumer Index, American Staffing Index, raw steel production, TSA traveler numbers, bankruptcy statistics, San Francisco Fed’s news sentiment, and the list goes on. Google Mobility data is particularly novel, as it provides granular location data, giving some sense of how strict lockdowns are and what share of the labor force is staying at home. The Federal Reserve Bank of New York now releases a Weekly Economic Index, which aggregates several high-frequency indicators to GDP units.

**Figure 1: Consensus Forecasts**

![Consensus Forecasts](image)

Source: Bloomberg

**Figure 2: Forecast Dispersion in 2009 vs. 2020**

![Forecast Dispersion](image)

Note: Grey shading reflects range from the lowest to highest forecast.
Source: Bloomberg
While each forecaster’s process varies, many use models like the IHS Markit’s Macroeconomics Advisors’ **MA/US model**, or the Federal Reserve **FRB/US model**. Both models are large-scale structural econometric models and produce estimates for all major categories in the US national accounts. Reasonably, the models do not explicitly account for pandemics, nor do they expressly embed epidemiological assumptions into their forecasts in normal times.

A common approach to producing forecasts during the COVID-19 crisis involves three steps. First, the forecasters use high-frequency data to forecast granular industry-level effects—e.g., hospitals, outpatient care, hotels, food services, and car rentals. The step also involves overlaying the government’s classification of “**essential critical infrastructure workforce**,” the ability for an industry to work from home, and state-by-state lockdowns. Google Mobility data is especially useful in capacity utilization estimates.

Second, the forecaster aggregates these granular location-industry specific forecasts to produce shocks to aggregate demand components, which themselves can be fed into a model like MA/US. The forecasters also need to make assumptions about fiscal stimulus, global growth (excluding the US), and financial conditions. Often, the latter category includes assumptions about short- and long-term Treasury yields. At banks and broker/dealers—where many private-sector forecasters work—economists often take interest rate forecasts from their “interest rate strategy” team, and so there is a nontrivial effort to make sure the different teams’ estimates are internally consistent.

Third, the forecasters plug their aggregated shocks into the model. Armed with the resultant GDP forecasts, many forecasters will use rules of thumb like Okun’s Law to produce unemployment forecasts. For example, if the GDP projection implies a 10pp output gap, then unemployment would increase 5pp—but the forecaster has to make a subjective judgment about how quickly job losses will occur.

Complicating the forecasting process, official data is subject to more uncertainty now. For example, the net jobs created by births and deaths are roughly stable, and the BLS models account for this typically-flat relationship. The COVID-19 crisis breaks the validity of that assumption, and so the BLS **updated its model** specifically in response to the challenges of the crisis. Moreover, whether or not the BLS would impute zero employment for non-responding companies was a first-order question for forecasters. Forecasting with considerable uncertainty about the official data estimates’ methodology is not new, as experienced in the aftermath of Hurricane Katrina and the October 2013 government shutdown. During the 2013 shutdown, the BLS did not release payroll employment (ultimately **releasing** the report two weeks later), and the Commerce Department suspended publishing construction spending and factory orders.

As the public health crisis continues and states contemplate relieving lockdown restrictions, we look into what matters for macro forecasts—is it realized deaths, lockdown, or both?

The Goldman Sachs Effective Lockdown Index measures the intensity of virus control measures. The daily lockdown index equal-weights two measures: a government policy measure and a
policy effect measure which are constructed using data from Oxford University’s Blavatnik School of Government dataset on government virus policy measures and data from Google on personal smartphone behavior, respectively.

In Figure 3, we plot the time series and weekly change in the lockdown index and actual deaths in the United States, which is compiled by The New York Times and begins on January 21.

The lockdown index increased rapidly in early March as markets teetered, liquidity became constrained, and the Federal Reserve announced rate cuts and other interventions. The increase in the lockdown index occurred ahead of actual deaths, but since the peak weekly increase in deaths, the weekly differences have been positively correlated: as new deaths decrease, the lockdown index has declined.

Many epidemiology models forecast COVID-19 deaths. As economists, we are not experts in assessing the best model, so we look to the COVID-19 Forecast Hub’s ensemble forecast, which takes the average estimate across many models. This data includes forecasts for deaths 1- to 4-

Figure 3: US Lockdown Index and Covid-19 Deaths

Source: Goldman Sachs, Oxford University’s Blavatnik School of Government, Google, New York Times, COVID-19 Forecast Hub

weeks ahead: Figure 3 shows the ensemble 1-week forecasted deaths. The forecasts are plotted by the target date, meaning that the forecast was made one week prior. The ensemble forecast appears to move closely with actual deaths both in level terms and one-week changes. If the ensemble forecast were 100% correct, the red dots would line up on the blue line exactly. Importantly, the ensemble forecast is weekly and only begins in April, but as more data comes out, market participants may look toward how forecasted deaths fluctuate with the Lockdown Index and macro forecasts.
Empirically, both deaths and the degree of lockdown are correlated with macro forecasts. We regress daily changes in consensus GDP and unemployment forecasts on daily changes in deaths, lagged by one day, and we regress daily changes in the macro forecasts on daily changes in the Lockdown Index, lagged by one day. We plot the regression coefficients in Figure 4. Broadly the results highlight that as deaths and the lockdown increased, the consensus GDP forecasts declined, and the unemployment forecasts notched higher.

The regression results coefficient says that for an increase of 1,000 new deaths is correlated with a decline in Q2 GDP consensus forecast of 0.25pp, and a 10 unit increase in the lockdown index is associated with a 0.44pp drop in the Q2 GDP forecast. Meanwhile, the Q2 unemployment forecast increases by 0.14pp when deaths increase by 1,000 and by 0.16pp for a 10 unit increase in the lockdown index.

Over a longer horizon, an increase of 1,000 new deaths is associated with a 0.05pp decline in the 2020 GDP forecast and a 0.08pp increase in 2020 unemployment rate. Unsurprisingly, the coefficients show that lockdown and deaths hurt Q2 macro variables more than growth and employment for the full year.

Of course, this back of the envelope analysis does not suggest that the key to boosting growth and lowering unemployment is simply relaxing lockdowns. Economic outcomes follow the public health crisis; lockdowns may have curbed deaths from ramping even higher. The virus will continue to hamper growth and employment until the general public has confidence in the ability to resume normal life. Thoughtful policy remains critical for both health and growth outcomes.

Pandemics are thankfully rare enough that we have limited data to study the effects of a virus on the economy. Data available from the Jordà–Schularick–Taylor Macrohistory Database give a
sense of the impact of the most notorious pandemic, the 1918 Spanish Flu, on the US economy. It’s not possible, of course, to isolate the effect of the pandemic on the economy as many other important events were simultaneously occurring: namely, the end of the Great War and considerable inflation in the late 1910s.

![Figure 5: 1918 Spanish Flu](image)

We plot real GDP per capita and real consumption per capita relative to their pre-1918 trends in Figure 5, panels A and B. Real GDP fell to a low of 11pp below trend. Consumption dropped considerably from 1917 to 1921, amounting to a fall of about 20pp below trend. We also show the real cumulative return for safe assets, including bonds and bills, and risky assets, including housing and equities. In real terms, safe assets lost 35pp and risky assets 9pp, owing in part to high levels of inflation. It’s not possible to ascribe these fluctuations to the 1918 Spanish flu alone, but the exercise provides a useful historical benchmark.

The past 60 days of economic data have been historic in the worst way. An annual growth rate of -6% means there has been, and will continue to be, tremendous human misery at levels unseen in our lifetimes. Last week, Chair Powell noted:

> John Kenneth Galbraith famously said that economic forecasting exists to make astrology look respectable. We are now experiencing a whole new level of uncertainty, as questions only the virus can answer complicate the outlook.

Consensus, however, is optimistic and forecasts a quick rebound in Q3—the “V” shaped recovery. Let’s hope.
Countries Propose Catastrophe Insurance Through Public-Private Partnerships

By Vaasavi Unnava

Original post here.

On May 26, Congresswoman Carolyn Maloney introduced the Pandemic Risk Insurance Act of 2020 (PRIA). The PRIA would provide a framework for insurers to supply business interruption insurance to businesses affected by the COVID-19 pandemic. Insurance companies that choose to participate would offer pandemic coverage to businesses and, should aggregate insurance industry losses exceed $250 million, the federal government would cover most of the losses.

Business interruption insurance provides insurance for losses caused by natural disasters or catastrophes. In the context of the PRIA, insurers would provide business interruption insurance for pandemic-related losses. In addition to pandemic-related losses, the bill would also cover event cancellations, including awards shows, film and TV productions, and sporting events.

The structure of the PRIA would closely follow the Terrorism Risk Insurance Act of 2002 (TRIA), which was passed to make terrorism insurance available to businesses in the U.S. economy while protecting insurers’ solvency. Like the TRIA, the PRIA federal backstop has an annual cap, though the PRIA’s $750 billion cap far exceeds the TRIA’s $100 billion.

Under the PRIA, insurers would pay a 5% deductible (measured as 5% of direct earned premiums from the previous year) before the federal government provides any aid for losses incurred from business interruption insurance policies. The TRIA has a 20% deductible. After the deductible is reached, the government would pay 95% of additional costs and the insurer would be responsible for a 5% copay; under the TRIA, the copay increased stepwise from 10% in the first year to 15% until ultimately setting a copay of 20%.

Participation in the PRIA would be voluntary. The TRIA required insurance companies to include terrorism insurance in all commercial policies for two years after the legislation passed.

The PRIA complements other proposals in the United States. Congressman Mike Thompson proposed the Business Interruption Insurance Coverage Act of 2020, which would require insurers to make business interruption insurance broadly available to businesses, though the bill has not progressed since its introduction in April. Industry groups have proposed the Business Continuity Protection Program (BCPP). The BCPP would allow businesses to purchase revenue replacement insurance from state-regulated insurance entities. The insurers would participate on a voluntary basis and funding would come from FEMA as a direct subsidy. Viral emergency declarations would automatically trigger payments. While some industry groups have put forth their own plan, others have endorsed the PRIA.
Similar to the PRIA, other legislative proposals around the world seek to revitalize or revamp frameworks used for catastrophe insurance funding. In the United Kingdom, the insurance industry is working with Pool Re, an insurance pool established in 1993 to act as a terrorism reinsurance fund. The British government established Pool Re to provide policy-level reinsurance to terrorism insurance policies through a government guaranteed reinsurance pool. The program has faced criticism for its slow administration, its vulnerability to system-wide shocks, and tendency to crowd out private actors.

The Federation of European Risk Management proposed a similar public-private partnership for insurance companies in the European Union, which would specifically tailor contracts to cover events categorized as “non damage denial of access” events--where businesses have lost revenues due to denial of access to services rather than physical damage--similar to events covered under business interruption insurance in the United States. France is currently developing a series of proposals for a federal insurance backstop, which includes repurposing the structure of its existing public-private partnership for natural disasters called the Caisse Centrale de Reassurance (CCR). It has provided terrorism insurance since the terrorist attacks of 2001.

In April, economists Samuel Hanson, Jeremy Stein, Adi Sunderam, and Eric Zwick published a proposal suggesting the provision of “business continuity insurance” targeted to companies in the greatest need. The authors propose to evaluate need by utilizing income reporting from the previous year’s tax documents to examine firm capital stock as well as industry-level shortfalls. Another proposal of theirs suggests providing low-cost junior subordinated loans to firms based on the same targeting metrics.

These proposals contrast with the World Bank Pandemic Emergency Financing Facility’s catastrophe bonds, issued in July 2017. Catastrophe bonds are high-interest financial instruments that stop making payments to investors the moment a catastrophe happens. The World Bank’s catastrophe bonds have faced criticism for their relatively low payout and high financing costs. In addition to other criteria like rolling case totals (rolling daily averages) and number of deaths, only an exponential growth rate of a coronavirus would trigger the bonds’ payout; this year, global statistics met conditions to trigger halting interest payments for the bonds only on April 19, nearly 40 days after the WHO officially characterized COVID-19 as a pandemic.

Other attempts to hedge the systemic risk of a system-wide catastrophe include the creation of insurance-linked securities, such as sidecars. Sidecars cede premiums to investors with enough capital to ensure that claims are paid should they arise.
Debt Mounts for US Retail and Lodging Mortgagors

By Corey Runkel

Original post here.

Government-mandated shutdowns in response to the novel coronavirus have triggered delinquencies among commercial mortgages as businesses struggle with revenue. The purpose of this article is to characterize the risks to US commercial real estate posed by COVID-19 responses. Due to reporting incentives, data on mortgages packaged into commercial mortgage-backed securities (CMBS) is more accessible and granular than data on the whole commercial mortgage market. Even though CMBS-associated properties constitute just 20% of outstanding multifamily and commercial debt, the data generated by such properties can indicate how the whole commercial real estate sector may be affected. On June 4, commercial real estate research firm Trepp reported its largest jump in delinquencies among mortgages involved in the $1.4 trillion CMBS market, with the rate spiking from 2.29% to 7.15%.

There is real stress on commercial landlords. But that stress sits narrowly within the commercial market. The same Trepp report disaggregated delinquencies, noting nearly 20% of lodging, and more than 10% of retail mortgages were delinquent in May. Less than 4% of multifamily, office, and industrial mortgages were delinquent over the same period. Despite historically high unemployment, government stimulus supports have perhaps helped sustain rental payments. Publicly traded equity real estate investment trusts (REITs) invested in apartments collected at least 93% of rents in April, with most trusts collecting 95% or more. Meanwhile, offices continue to operate remotely, and warehousing has become more valuable as delivery services take on new importance.

Retail shows signs of life

The speed at which consumers return to retail and lodging will factor importantly into the viability of mortgages in those sectors. The same data on publicly traded equity REITs reports rent collection figures for several owners of regional malls and shopping centers. Overall, between 50% and 65% of April rents were collected in shopping centers, while regional malls collected just 26% to 30% of rental payments.

As states re-open, rent payments may increase quite quickly. In Arizona, Florida, Georgia, and Texas, as of June 2, retail foot traffic had already surged from its April nadir, but only to 38-52% of 2019 levels. Retail nationwide grew 17.7% in May, beginning to make up for sales contractions in March and April of 8.3% and 14.7% respectively. Further, the distribution of volume among types of businesses is unknown. The lockdowns have already caused the bankruptcy of JCPenney and Hertz, with AMC movie theaters currently being threatened. But stock data indicates that investors believe retail real estate has already bottomed out. After crashing in late February, prices of several large mall operators and REITs have stabilized and trended up.
The market’s gradual recovery may have been informed by other indicators than the overall delinquency rate. Though 7.15% of securitized commercial mortgages were delinquent in May, 70% of those were only one month late. Trepp noted that a large number of mortgages remained in their 30-day grace period or actually reverted to current on their payments, though historically high delinquencies should still be expected.

Despite these expectations of recovery, the woes for commercial real estate may have just begun. Financial Times pointed to June as a crucial test for businesses, since debt two months late often
triggers serious penalties. Moreover, data collected by the Federal Reserve Bank of St. Louis since 1991 show commercial delinquencies spiking as recessions end (Fig 2). Moreover, bond prices for CMBS exposed to lodging have tumbled. The same Financial Times article noted that BBB-rated tranches exposed to lodging shed approximately 40% of their value since early March. The asset specificity of hotels only lowers the value of real estate already faced with structural devaluation by services such as Airbnb.

**Support for commercial real estate must proceed carefully**

Landlords and owners are navigating treacherous waters should commercial tenants require serious rent assistance. While CMBS loans tend to be non-recourse, it is standard practice for loans to feature “bad boy” covenants designed to guard against principal-agent risk. Such covenants provide recourse in the event that borrowers commit actions that (in normal times) are irresponsible. Real estate attorneys point to two such actions in particular: significant rent renegotiation, and taking on senior indebtedness without investor consent.

US programs have thus far steered clear of these debt covenants, and offer viable channels should further support be authorized. The Payroll Protection Program (PPP), offering forgivable and unsecured loans to businesses, recently expanded the amount that could be used for non-payroll expenses to 40%, opening the door to rent support. Borrowing terms for the three programs under the Main Street Lending Program have also eased. The Priority and Extended lending facilities (MSPLF and MSELF, respectively) require loans to be secured, and prohibit subordination, but carve out exceptions for outstanding mortgage debts.

Given that these programs appear to avoid the dangers posed by “bad boy” covenants, it seems likely that strained borrowers are equipped with the resources to secure credit lifelines to at least prolong defaults for several more months. On the other hand, it seems unlikely that the Federal Reserve (Fed) would engage private CMBS markets in a more direct fashion. Thus far only two Fed actions support private CMBS. In March it included agency CMBS in its plan to make Open Market Desk purchases of $200 billion of MBS, and in April it expanded the eligible collateral for the Term-Asset Securities Lending Facility to include AAA tranches of CMBS. A previous YPFS article found that the Fed’s purchasing announcement had a positive effect on agency mortgage REITs (mREITs) while having only minimal effects on non-agency residential mortgage REITs.

Equity REITs face different issues, principally those of eligibility and restrictions on usage. While property management companies are eligible for both PPP and MSLF loans, it is unclear as to whether equity REITs are eligible. They may violate the Small Business Administration’s rules making ineligible for loans “developers and landlords that” generally “do not actively use or occupy the assets acquired or improved with the loan proceeds.” However, equity REITs have applied for, and received PPP loans, potentially pushing this issue to the oversight bodies authorized by the CARES Act.
Additionally, the CARES Act prohibits the payment of dividends by corporations receiving support. While several programs have received blanket waivers from the Treasury Department, the Main Street Lending Facility has not. The legal structure of REITs requires the payment of dividends, and many REITs have opted to pay mostly in stock. REIT trade associations have already written to the Treasury Department requesting a waiver for this particular case, while the Internal Revenue Service has reprised rules adopted during the Global Financial Crisis, allowing REITs to hold (and therefore distribute) less cash.

The New York Times highlighted name-brand tenants—Gap, LVMH, Starbucks—that had stopped paying rent and started renegotiating leases. The article noted that “the strongest tenants — those most able to pay — are driving the hardest for a discount.” When renters know that the options for landlords are either lease renegotiation or a total loss of income, those with the ability to pay may augment the demands of those that cannot pay, further pressuring landlords.

A Deloitte report noted that real estate development had flagged, with more than half of US construction firms surveyed halting projects. Social distancing rules precipitated decreased demand and disrupted construction sites. Commercial real estate’s sensitivity to economic downturns compounded the effects of decreased demand. The Deloitte report suggested that developers adapt rental properties to meet the needs of a changed society and strengthen resilience to future pandemics. The shock to brick-and-mortar businesses is likely to accelerate permanent transitions to online retail, work, and customer service across sectors. While several large companies have started these transitions, they will likely take several years to complete. Such a timeframe would flatten and spread the risks to commercial real estate finance.

In contrast, the greatest short-term risks posed by US commercial mortgages sit narrowly in lodging and retail, though high-turnover coworking spaces have already seen slashed revenues. CMBS-associated mortgages account for one fifth of outstanding commercial debt. While data are more widely and finely available for properties underlying CMBS loans, concerns similar to those discussed above exist with respect to non-securitized commercial mortgages. Where investors are exposed to lodging, prices have slumped, and questions abound regarding the sector’s long-term viability as nearly 20% of the CMBS-associated mortgages were reported delinquent in May. Retail activity is growing, but there is concern as to whether the recovery will be fast enough to stave off default in a sector with more than 10% of securitized mortgages in delinquency, which could hamper the real economy’s general pace of recovery.
U.S. Banks to Maintain Dividends for Now, Following Pre-COVID Stress Test

By Devyn Jeffereis and Greg Feldberg

Original post here.

Most of the largest U.S. banks announced Monday that they will continue to pay dividends in the third quarter at the same level as the second quarter. This news comes just two business days after the Federal Reserve announced the results of its annual stress test and an unprecedented “sensitivity analysis” estimating the potential impact of different economic recoveries from the COVID recession on bank performance. Based on these scenarios, the Fed announced a number of temporary restrictions on dividends and other corporate actions.

The Fed’s stress test forecasted $433 billion in loan losses for the 33 largest banks under a severely adverse scenario that it announced in February, prior to the COVID crisis (see page 19). The test extends nine quarters, through March 2022.

Losses are much worse under all of the Fed’s scenarios in the sensitivity analysis, which takes COVID into account. The analysis forecasts $560 billion in loan losses under the most optimistic post-COVID scenario, which assumes a rapid “V-shaped” recovery. Projected loan losses are just over $700 billion in a “U-shaped” recovery and $680 billion in a “W-shaped” recovery. For comparison, the 33 banks had $10.4 trillion in risk-weighted assets and $1.2 trillion in capital at the end of 2019 (see page 23).

The Fed uses the results of its stress test to determine large banks’ capital requirements every year. However, it plans to “assess banks’ capital plans more frequently during this time of uncertainty” (see page 1). It will require banks to re-submit their capital plans later this year based on revised scenarios that the Fed will provide. The results could reveal larger capital deficits and lead to more aggressive restrictions on corporate actions.

Maintaining dividends

On Thursday, the Fed said it would allow banks to pay common stock dividends in the third quarter, but no more than their average income over the prior four quarters and no more than they paid in the second quarter, whichever is less. It won’t allow share repurchases in the third quarter; the eight U.S. global systemically important banks (G-SIBs) voluntarily suspended share repurchases in the second quarter.

All but one of the eight G-SIBs said Monday that they plan to maintain their dividends in the third quarter at prior levels. Wells Fargo, which appears to be the only G-SIB whose recent dividends have exceeded its average net income, said in a statement that it expects second-quarter losses will exceed first-quarter losses, and that it plans to reduce its dividend.

Goldman Sachs hinted that it may have to rebuild capital to maintain its dividends. The company is the only G-SIB whose capital is below the Fed’s required buffer based on the stress
test results—its common equity tier 1 capital (CET1) ratio was 12.5% at the end of March, compared to the 13.7% the Fed will require it to reach by October 1. However, Goldman said it has recently brought the ratio back over 13%.

“We have a track record of rebuilding capital when necessary,” its chairman and CEO, David Solomon, said in the press release. “We fully intend to continue this dynamic capital management while helping our clients continue to navigate challenging markets.”

As shown in the below table, there have been significant changes in net income over the past four quarters. However, those declines have not translated into changes in the dividends expected to be paid in the third quarter. Analysts forecast that 27 of the 33 banks will report second-quarter net income below the average of the four prior quarters. Twenty-five of the 33 banks have announced, or are forecasted, to pay dividends in the third quarter equal to those they paid in the second quarter.

The Fed’s bank dividend policy has been controversial within the central bank. Fed Governor Lael Brainard released a statement critiquing the policy. “[Dividend] payouts will amount to a depletion of loss absorbing capital,” she wrote. “This is inconsistent with the purpose of the stress tests, which is to be forward looking by preserving resilience, not backward looking by authorizing payouts based on net income from past quarters that had already been paid out.”

Fed Governor Randal Quarles, who is also the Fed’s vice chairman for supervision, explained his support for the measures. “[The] approach builds on our existing standards on capital distributions, which restrict distributions based on recent income,” he wrote. “If the circumstances warrant, we will not hesitate to take additional policy actions to support the U.S. economy and banking system. I support today’s actions to ensure banks remain an ongoing source of strength to the U.S. economy.”

**Stress test revisions: Setting the new Stress Capital Buffer**

The Fed introduced a new method for setting capital requirements for the largest banks in this year’s stress test (see the staff memo, page 7). Previously, the Fed required these banks to meet two sets of standards: the Basel III standards (agreed to by international regulators), and the results of its annual stress test. The new method essentially merges the two.

The Fed continues to require the largest banks to hold CET1 equal to 4.5% of their risk-weighted assets, at minimum. G-SIBs are also required to hold an additional buffer based on their systemic importance, currently ranging from 1.0% to 3.5% for the eight U.S. G-SIBs.

The new part is the “stress capital buffer.” It is based on each bank’s net loss in the stress test--the difference between the bank’s starting and minimum projected capital ratios--plus four quarters of planned dividends as a percentage of risk-weighted assets. The stress capital buffer can’t be less than 2.5%, the level of the capital conservation buffer under Basel III.
Any bank whose capital ratio falls below the sum of the 4.5% minimum, the individual G-SIB surcharge, and the individual stress capital buffer will be subject to automatic restrictions on capital distributions.

In its stress test report, the Fed reported each bank’s net loss. The Fed confidentially told each bank its individualized stress capital buffer, including projected dividends.

Most of the largest banks publicly disclosed their stress capital buffer on Monday. For five of the G-SIBs, their net losses in the stress test were low and the Fed set their stress capital buffer at 2.5%. The Fed set JP Morgan Chase’s stress capital buffer at 3.3%, Morgan Stanley’s at 5.9%, and Goldman Sachs’s at 6.7%.
## Dividend History and Net Income Analysis (Source: Bloomberg)

<table>
<thead>
<tr>
<th>Firms (USD except as noted)</th>
<th>Q3 2020 Dividend (consensus estimate or announced) (based on payable)</th>
<th>Q2 2020 Dividend (based on payable)</th>
<th>Q1 2020 Dividend (based on payable)</th>
<th>Q2 2020 Net Income (consensus estimate) in millions</th>
<th>Q1 2020 Net Income (estimates) in millions</th>
<th>Q4 2019 Net Income (in millions)</th>
<th>Q3 2019 Net Income (in millions)</th>
<th>Four Quarter Net Income Average in millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ally Financial Inc.</td>
<td>0.190</td>
<td>0.190</td>
<td>0.190</td>
<td>37.23</td>
<td>-319.00</td>
<td>378.00</td>
<td>361.00</td>
<td>118.31</td>
</tr>
<tr>
<td>American Express Company</td>
<td>0.439 (Announced 5/07)</td>
<td>0.439</td>
<td>0.439</td>
<td>134.67</td>
<td>367.00</td>
<td>1,693.00</td>
<td>1,755.00</td>
<td>967.42</td>
</tr>
<tr>
<td>Bank of America Corporation</td>
<td>0.180</td>
<td>0.180</td>
<td>0.180</td>
<td>2,896.38</td>
<td>4,010.00</td>
<td>6,944.00</td>
<td>5,777.00</td>
<td>4,911.84</td>
</tr>
<tr>
<td>The Bank of New York Mellon Corporation</td>
<td>0.310</td>
<td>0.310</td>
<td>0.310</td>
<td>814.57</td>
<td>660.00</td>
<td>1,440.00</td>
<td>1,036.00</td>
<td>1,066.14</td>
</tr>
<tr>
<td>Bank of America, N.A. (BA)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>270.38</td>
<td>826.00</td>
<td>666.00</td>
<td>-27.00</td>
<td>455.85</td>
</tr>
<tr>
<td>BMO Financial Corp. (BMO)</td>
<td>1.069</td>
<td>1.069</td>
<td>1.069</td>
<td>699.30</td>
<td>1,592.00</td>
<td>1,194.00</td>
<td>1,557.00</td>
<td>1,256.00</td>
</tr>
<tr>
<td>BNP Paribas USA Inc. (EUR)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>1,549.71</td>
<td>1,826.00</td>
<td>1,849.00</td>
<td>1,936.00</td>
<td>1,854.80</td>
</tr>
<tr>
<td>Capital One Financial Corp.</td>
<td>0.400</td>
<td>0.400</td>
<td>0.400</td>
<td>-547.40</td>
<td>-1,340.00</td>
<td>1,178.00</td>
<td>1,385.00</td>
<td>156.30</td>
</tr>
<tr>
<td>Citigroup Inc.</td>
<td>0.510</td>
<td>0.510</td>
<td>0.510</td>
<td>866.50</td>
<td>2,522.00</td>
<td>4,879.00</td>
<td>4,913.00</td>
<td>3,328.13</td>
</tr>
<tr>
<td>Citizens Financial Group Inc.</td>
<td>0.300</td>
<td>0.300</td>
<td>0.300</td>
<td>-47.26</td>
<td>34.00</td>
<td>650.00</td>
<td>446.00</td>
<td>221.83</td>
</tr>
<tr>
<td>Credit Suisse Holdings (USA), Inc. (CHF)**</td>
<td>-</td>
<td>0.069</td>
<td>-</td>
<td>700.78</td>
<td>1,314.00</td>
<td>852.00</td>
<td>861.00</td>
<td>907.44</td>
</tr>
<tr>
<td>DB USA Corporation (EUR)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-400.40</td>
<td>43.00</td>
<td>-1,518.00</td>
<td>-856.00</td>
<td>-683.00</td>
</tr>
<tr>
<td>Discover Financial Services</td>
<td>0.440</td>
<td>0.440</td>
<td>0.440</td>
<td>44.80</td>
<td>-61.00</td>
<td>709.00</td>
<td>770.00</td>
<td>395.40</td>
</tr>
<tr>
<td>FIFTH Third Bancorp (Announced 6/19)</td>
<td>0.271</td>
<td>0.270</td>
<td>0.240</td>
<td>216.90</td>
<td>46.00</td>
<td>734.00</td>
<td>946.00</td>
<td>598.45</td>
</tr>
<tr>
<td>The Goldman Sachs Group, Inc.</td>
<td>1.250</td>
<td>1.250</td>
<td>1.250</td>
<td>1,219.00</td>
<td>1,817.00</td>
<td>1,877.00</td>
<td>1,567.00</td>
<td>1,567.39</td>
</tr>
<tr>
<td>HSBC North America Holdings Inc.</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>304.38</td>
<td>2,248.00</td>
<td>-5,310.00</td>
<td>3,477.00</td>
<td>176.85</td>
</tr>
<tr>
<td>Huntington Bancshares Incorporated</td>
<td>0.153</td>
<td>0.153</td>
<td>0.153</td>
<td>124.49</td>
<td>48.00</td>
<td>517.00</td>
<td>372.00</td>
<td>215.37</td>
</tr>
<tr>
<td>JPMorgan Chase &amp; Co.</td>
<td>0.903</td>
<td>0.903</td>
<td>0.903</td>
<td>3,046.30</td>
<td>2,865.00</td>
<td>8,520.00</td>
<td>6,600.00</td>
<td>5,678.50</td>
</tr>
<tr>
<td>KeyCorp</td>
<td>0.185</td>
<td>0.185</td>
<td>0.185</td>
<td>141.50</td>
<td>146.00</td>
<td>496.00</td>
<td>416.00</td>
<td>260.13</td>
</tr>
<tr>
<td>NTT Bank Corporation</td>
<td>1.100</td>
<td>1.100</td>
<td>1.100</td>
<td>306.40</td>
<td>268.82</td>
<td>493.07</td>
<td>480.08</td>
<td>387.00</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>0.350</td>
<td>0.350</td>
<td>0.350</td>
<td>1,567.67</td>
<td>1,998.00</td>
<td>2,239.00</td>
<td>2,173.00</td>
<td>1,928.92</td>
</tr>
<tr>
<td>MUFG Americas Holdings Corporation (JPY)**</td>
<td>-</td>
<td>12.50</td>
<td>-</td>
<td>118,600.00</td>
<td>-58,127.00</td>
<td>-25,680.00</td>
<td>218,861.00</td>
<td>63,801.00</td>
</tr>
<tr>
<td>Northern Trust Corporation</td>
<td>0.769</td>
<td>0.769</td>
<td>0.769</td>
<td>267.80</td>
<td>360.00</td>
<td>571.10</td>
<td>384.80</td>
<td>355.53</td>
</tr>
<tr>
<td>The PNC Financial Services Group, Inc.</td>
<td>1.150</td>
<td>1.150</td>
<td>1.150</td>
<td>1,310.25</td>
<td>906.00</td>
<td>1,367.00</td>
<td>1,379.00</td>
<td>1,241.06</td>
</tr>
<tr>
<td>RBC US Group Holdings LLC (CAD)**</td>
<td>1.069</td>
<td>1.069</td>
<td>1.069</td>
<td>1,494.00</td>
<td>3,504.00</td>
<td>3,201.00</td>
<td>3,263.00</td>
<td>2,863.00</td>
</tr>
<tr>
<td>Regions Financial Corporation</td>
<td>0.153</td>
<td>0.153</td>
<td>0.153</td>
<td>93.97</td>
<td>162.00</td>
<td>386.00</td>
<td>400.00</td>
<td>292.77</td>
</tr>
<tr>
<td>Santander Holdings USA, Inc. (EUR)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>1,395.20</td>
<td>331.00</td>
<td>2,783.00</td>
<td>501.00</td>
<td>1,246.06</td>
</tr>
<tr>
<td>State Street Corporation</td>
<td>0.020</td>
<td>0.020</td>
<td>0.020</td>
<td>467.80</td>
<td>634.00</td>
<td>564.00</td>
<td>583.00</td>
<td>562.30</td>
</tr>
<tr>
<td>TD Group US Holdings LLC (CAD)**</td>
<td>0.769</td>
<td>0.769</td>
<td>0.740</td>
<td>1,516.30</td>
<td>2,080.00</td>
<td>2,858.00</td>
<td>3,248.00</td>
<td>3,652.00</td>
</tr>
<tr>
<td>Texas Financial Corporation</td>
<td>0.450</td>
<td>0.450</td>
<td>0.450</td>
<td>1,029.80</td>
<td>1,060.00</td>
<td>721.00</td>
<td>825.00</td>
<td>906.95</td>
</tr>
<tr>
<td>US Bancorp</td>
<td>0.420</td>
<td>0.420</td>
<td>0.420</td>
<td>430.78</td>
<td>1,171.00</td>
<td>1,486.00</td>
<td>1,908.00</td>
<td>1,248.94</td>
</tr>
<tr>
<td>Wells Fargo &amp; Company</td>
<td>0.200</td>
<td>0.510</td>
<td>0.610</td>
<td>872.30</td>
<td>853.00</td>
<td>2,873.00</td>
<td>4,610.00</td>
<td>3,200.06</td>
</tr>
</tbody>
</table>

*Due to differences in the Canadian Fiscal Calendar the quarters for these companies end dates are as follows: Q2 2020 (4/30/2020), Q1 2020 (1/31/2020), Q4 2019 (10/31/2019), Q3 2019 (7/31/2019)

**Credit Suisse Holdings (USA), Inc. announced two dividends on 4/09, .0694 CHF payable 5/11 and .1388 CHF that has no paydate

***MUFG Americas Holdings Corporation announced a dividend of 12.50 JPY on 5/15 that has no paydate / Japanese Fiscal Calendar differs such that Q2 2020 is Q1
The first figure below shows each G-SIB’s total capital requirement, based on Monday’s announcements, compared to their actual CET1 ratios reported for the end of the first quarter. The second figure shows the cushion or deficit based on those figures. Banks have until October 1 to resolve any deficits.

2020 stress test: Aggregate results

This year, the Fed analyzed 33 firms in its stress test. The severely adverse scenario consisted of 28 variables, including a maximum drop in gross domestic product (GDP) of about 8.5% from the pre-recession peak and a jump in unemployment to a high of 10%.

The results projected aggregate losses of $552 billion for the 33 firms, including $433 billion in loan losses, $6 billion in securities losses, $85 billion in trading and counterparty losses, and $29 billion in other losses. Nine-quarter loan loss rates were 6.3% in aggregate. The Fed projected the aggregate CET1 ratio for the 33 companies to fall from 12.0% at the end of 2019 to 10.3% in March 2022, hitting a minimum of 9.9% during the period (see page 23).

The results aren’t directly comparable to the Fed’s 2019 stress test, because it now requires smaller banks to conduct the test every two years. But the Fed reported that losses were roughly comparable for the 18 largest banks that participated in both tests. These banks had projected losses of $410 billion in the 2019 test and $433 billion in the 2020 test (see page 1).

The Fed made other important changes in its methodology. It now assumes that a bank’s assets won’t grow over the projection horizon and that a bank won’t pay dividends on common stock, or issue new stock. These changes significantly improve banks’ projected capital ratios (see page 22). Dividends in recent stress tests prior to the change in methodology amounted to about 70 basis points for GSIBs and 100 basis points for other banks, according to a paper last year (see page 10). To be sure, the new methodology takes back much of that benefit by adding four quarters of dividends in computing the stress capital buffer.

2020 sensitivity analysis: Aggregate results

In addition to the stress test, which uses scenarios that the Fed began constructing in late 2019, the Fed released a supplemental sensitivity analysis to account for the emerging economic impacts of the COVID pandemic.

Due to the uncertain economic implications of the COVID pandemic, the sensitivity analysis includes three hypothetical scenarios based on potential recovery paths. In comparison to the severely adverse scenario outlined in the stress test, each of the pandemic scenarios uses similar methods and analyzes the same 33 firms. Unlike the stress test, the Fed did not disclose firm-specific data about the sensitivity analysis.

The sensitivity analysis also incorporates higher peak unemployment and larger decreases in GDP, along with targeted adjustments. Unlike the stress test, it assumes bank balance sheets will grow: It assumes a 12% increase in outstanding corporate loans and a 30% increase in risk-weighted assets for the first quarter of 2020.
To adjust for industry-specific stress, the Fed incorporated a one-letter-grade credit downgrade for loans in impacted sectors.

The Fed also included temporary amendments regarding tax loss carrybacks and carryforwards in the tax code from the CARES Act into its calculation of post-stress capital.

The three scenarios are “V-shaped,” “U-shaped,” and “W-shaped”:

- The V-shaped scenario begins with a deep recession in the immediate first two quarters, with real GDP contracting by 31.5% (annualized) and unemployment jumping to 19.5%. This is followed by a rapid recovery in the third and fourth quarter of 2020, resulting in above-trend GDP growth in 2021 and 2022 and a decline in unemployment that remains above the low rate achieved before the pandemic. In this scenario, the Fed projects the aggregate CET1 ratio will fall from 12% at the end of 2019 to as low as 9.5% during the nine-quarter period (see page 2). The Fed projects the aggregate nine-quarter loan loss rate at 8.2%.

- The U-shaped scenario has a prolonged recession in which the unemployment rate peaks at 15.5% and maintains that level for a number of quarters before levelling off above the actual March 2020 rate. In addition, GDP fails to rebound meaningfully and does not reach its previous trend. As a result, the projected CET1 ratio falls as low as 8.1%. The projected nine-quarter loan loss rate is 10.3%.

- The W-shaped scenario has an initial recovery that is stymied by a second outbreak and resulting downturn. In the first phase, real GDP contracts by 37.5% (annualized) and unemployment increases to 16% in June 2020. However, GDP growth rebounds strongly in the second half of 2020, returning nearly to pre-crisis levels. This recovery is halted by a second outbreak and lockdown. In response, GDP falls 12% in the first quarter of 2021 and unemployment rises again as high as 14%. The second recession is more shallow but longer. The projected CET1 ratio falls as low as 7.7% and the projected nine-quarter loan loss rate is 9.9%. Beyond the projection horizon, the loan loss rates are persistently higher and CET1 ratios are lower than in the other scenarios.
Scenario Variables and Aggregate Results

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Peak Unemployment</th>
<th>Peak-to-trough GDP Change</th>
<th>Lowest 10-Year TSY Rate</th>
<th>Minimum CET1 Ratio**</th>
<th>Loan Loss Rates* (est. Q1 2020-Q1 2022)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Severely Adverse</td>
<td>10.0</td>
<td>-8.5</td>
<td>0.7</td>
<td>9.9</td>
<td>6.3</td>
</tr>
<tr>
<td>V-Shaped</td>
<td>19.5</td>
<td>-10.0</td>
<td>0.8</td>
<td>9.5</td>
<td>8.2</td>
</tr>
<tr>
<td>U-Shaped</td>
<td>15.6</td>
<td>-13.8</td>
<td>0.6</td>
<td>8.1</td>
<td>10.3</td>
</tr>
<tr>
<td>W-Shaped</td>
<td>16.0</td>
<td>-12.4</td>
<td>0.5</td>
<td>7.7</td>
<td>9.9</td>
</tr>
</tbody>
</table>

*Note that projected loan losses across scenarios are the main driving force of differences in the CET1 ratio

**The aggregate CET1 ratio at the end of 2019 was 12.0%

Key takeaways from stress test and sensitivity analysis

The results of the stress test and sensitivity analysis display a broad range of potential outcomes. Banks’ projected CET1 ratios remain significantly above regulatory minimums in both the severely adverse scenario of the stress test and the V-shaped scenario of the sensitivity analysis. The bottom 25th percentile firm-level post-stress CET1 ratio is 8.0% for the severely adverse scenario and 7.5% for the V-shaped scenario. Both are significantly above the 4.5% minimum, although some banks may fall below their buffer levels and be subject to automatic capital restrictions under those scenarios.

On the other hand, the Fed projects CET1 ratios will remain above minimum requirements in aggregate but will fall to dangerous levels for many banks in the U-shaped and W-shaped scenarios. The bottom 25th percentile firm-level post-stress CET1 ratio is 5.5% in the U-shaped scenario and 4.8% in the W-shaped scenario. This suggests that several banks could break the 4.5% minimum; many others could break their buffers and be subject to automatic capital restrictions under those scenarios.
The Bank of Greece proposes a national “bad bank”

By Alexander Nye

On July 16, the Bank of Greece (BOG) proposed a public asset management company (AMC) to buy non-performing loans (NPLs) from banks using public funds. Yannis Stournaras, governor of the BOG, argues that an AMC could help banks clean up their balance sheets and allow them to raise capital.

Unlike the AMCs that governments created during the Global Financial Crisis (GFC) of 2007-09, a Greek AMC would not be able to subsidize banks by acquiring NPLs above market prices. Europe’s Bank Recovery and Resolution Directive (BRRD), passed in 2014, now prohibits European government from providing most forms of the vast majority of state aid to banks outside of the resolution process, including through AMCs. This means the AMC’s purchase of the NPLs would likely subject participating banks to large haircuts, eating into their capital.

The BOG has not put forward a detailed description of the bad bank proposal. In its July 2020 Financial Stability Report (FSR), the BOG said that a new AMC would not fundamentally change the country’s existing banking infrastructure. Third parties would be brought in to help the bad bank, though this could mean anything from contracting with private asset managers to having private-sector entities take an equity stake in the AMC (as they did in Ireland during the GFC).

In its FSR, the BOG also suggested the AMC could have a loss-sharing element; participating banks would solely bear any losses. However, that does not seem to be the case. The Greek proposal would have the banks endure those losses, but would only do so upon reaching their minimum capital ratios. If a bank’s capital ratio fell below the minimum allowed level, the Greek taxpayers may help cover the losses. If this is the case, the FSR is contradicting itself. The BOG wrote that this element of the plan was to keep the government from having to put any of the participating banks into resolution.

Greece does have other tools for dealing with NPLs. One is the Hellenic Asset Protection Scheme, better known as “Hercules,” a program approved in late 2019 by the Greek government and the European Commission. The program removes €30 billion in NPLs from bank balance sheets and places it in SPVs owned by the Greek government, which then securitize the debt into tranches and sell it. The government added up to €12 billion in guarantees to the senior tranche as a way to make them more attractive to investors.

However, Stourarans has said that creating a bad bank is the only way to get rid of NPLs quickly. He supported a proposal to create a European AMC or national AMC, explaining either one was acceptable so long as they happened quickly. The European Union spent part of April discussing the prospect of a bad bank, but the idea faced resistance within the European Commission.
HEROES Act would provide $3 trillion in additional benefits but unlikely to progress

By Priya Sankar

Original post here.

The $3 trillion Health and Economic Recovery Omnibus Emergency Solutions (HEROES) Act, which the House of Representatives passed on May 15, is the fourth and largest legislative rescue package proposed by the US Congress in response to the COVID-19 pandemic. It would help to mitigate the economic impact of continued shelter-in-place orders and soaring unemployment rates.

Some key allocations of the HEROES Act include:

- $915 billion to state, local, tribal and territorial governments
- $650 billion for additional Economic Impact Payments to individuals
- A $200 billion fund for hazard pay to essential workers
- $100 billion in grants to low-income renters
- $100 billion in support to state education programs

The HEROES Act allocates $500 billion in direct, flexible aid to state governments, $375 billion to local governments, $20 billion to tribal governments and $20 billion to US territories.

The HEROES Act calls for a second round of Economic Impact Payments (EIP) to individuals, and would provide $1,200 for each dependent without regard to age, up to three dependents per family. The bill retains the $1,200 payment per individual for a potential maximum of $6,000 per two-parent family. The CARES Act limited dependent benefits to $500 per child under 18. Both the CARES Act and the HEROES Act reduce the amount of the payment above certain income thresholds. Because its benefits to those with dependents are greater, the HEROES Act would provide a reduced benefit to some persons who would not receive a payment under the CARES Act. The Act appropriates $650 billion for EIP payments as compared to the $292 billion estimated cost of similar payments under the CARES Act.

The HEROES Act also supports families with $10.1 billion for child care and other services like support for utilities for low-income families. Emergency family medical leave would be extended from December 2020 to December 2021. This is a marked increase from the CARES Act allocation of $3.5 billion for the child care development block grant to states.

The bill would establish a $200 billion “Heroes’ Fund” to provide hazard pay to essential workers. Employers could apply for grants to provide their employees with a $13 per hour premium in addition to their regular wages, up to a total of $10,000 per employee, or $5,000 for highly compensated essential workers. The bill also would appropriate $850 million so states...
can provide child care for essential workers; other provisions would increase the production and availability of personal protective equipment.

Supplemental unemployment benefits of $600 per week, which the CARES Act provided through the end of July, would be extended until January 2021.

The HEROES Act would set aside over $14 billion in food aid, including $10 billion to support increased use of SNAP benefits, $3 billion for child nutrition programs, and $1.1 in food assistance for women, infants, and children.

The HEROES Act also would set aside funds for renters and homeowners. The CARES Act had provided that individuals could take advantage of forbearance for their rent and mortgage payments for up to one year for properties financed with federal government guarantees. Title II of the HEROES Act would allocate $100 billion in grants for low-income renters at risk of eviction once that forbearance ends. It also would provide $75 billion for states, territories, and tribes to distribute to homeowners for mortgage assistance and other housing costs.

The bill also would provide $10 billion in grants to small businesses that have suffered losses due to the pandemic. It would ease many of the requirements for small business loans, providing flexibility in payment deferrals, waiving fees, and increasing the guarantee provision. It also would increase the employee retention tax credit from 50% to 80% of applicable wages.

The bill also calls for extending the CARES Act student loan payment plans to those who borrowed from private lenders, providing up to $10,000 in relief to be applied to such loans, paid monthly until September 2021. In addition, $100 billion would go to states to support education programs.

The HEROES Act would support the United States Postal Service with $25 billion, as it would otherwise run out of money this autumn. This money is available until September 2022, and would also support providing personal protective equipment for postal workers.

The bill calls for over $30 billion to support transportation, both for highways and for support to transit agencies to maintain basic services.

The bill sets aside $75 billion for additional COVID-19 testing, contact tracing, and treatment efforts, aiming to ensure that all Americans could receive COVID-19 treatment for free. It also supports the National Institutes of Health with $4.7 billion, the Center for Disease Control with $2.1 billion, underserved populations with $7.6 billion, and the Indian Health Service with $2.1 billion.

The bill proposes $16.5 billion be set aside for direct grants to agricultural producers.

The bill would allocate $3.6 billion in grants to states to support election security efforts.

The bill is viewed as partisan, as it passed the House with mainly Democratic support. It is not expected to become law. "Instead of going big, it seems you went crazy. This is a political messaging bill that has no chance of becoming law," House Minority Leader Kevin McCarthy, R-
Calif. said on the floor. The Trump Administration does not support the bill. The White House issued a statement saying: “This proposed legislation, however, is more concerned with delivering on longstanding partisan and ideological wishlists than with enhancing the ability of our Nation to deal with the public health and economic challenges we face.” While Senate Majority Leader Mitch McConnel has refused to consider the bill, he stated on May 30 that the Senate would likely consider a “4th and final” stimulus bill “in about a month” and that the focus would be on jobs and schools and possibly additional assistance to small businesses.

<table>
<thead>
<tr>
<th>Allocation</th>
<th>Purpose</th>
</tr>
</thead>
<tbody>
<tr>
<td>$915 billion</td>
<td>Aid to state, local, territorial, and tribal governments</td>
</tr>
<tr>
<td>$650 billion</td>
<td>Direct payments to individuals and dependents</td>
</tr>
<tr>
<td>$200 billion</td>
<td>Heroes’ Fund - Hazard pay to essential workers</td>
</tr>
<tr>
<td>$14 billion</td>
<td>Food aid - including SNAP benefits and child food aid</td>
</tr>
<tr>
<td>$100 billion</td>
<td>Grants for low-income renters</td>
</tr>
<tr>
<td>$10 billion</td>
<td>Grants to small businesses</td>
</tr>
<tr>
<td>$100 billion</td>
<td>Support to state education programs</td>
</tr>
<tr>
<td>$25 billion</td>
<td>Support to US Postal Service</td>
</tr>
<tr>
<td>$30 billion</td>
<td>Support for transportation including highways and transit agencies</td>
</tr>
<tr>
<td>$75 billion</td>
<td>COVID-19 testing, contact tracing, and treatment</td>
</tr>
<tr>
<td>$4.7 billion</td>
<td>National Institutes of Health</td>
</tr>
<tr>
<td>$2.1 billion</td>
<td>Center for Disease Control</td>
</tr>
<tr>
<td>$2.1 billion</td>
<td>Indian Health Service</td>
</tr>
<tr>
<td>$16.5 billion</td>
<td>Direct grants to agricultural producers</td>
</tr>
<tr>
<td>$3.6 billion</td>
<td>Grants to states for election security efforts</td>
</tr>
</tbody>
</table>
Senate Republicans introduce HEALS Act, next round of COVID-19 response

By Natalie Leonard & Corey Runkel

Original post here.

On July 27, Senate Republicans introduced components of the Health, Economic Assistance, Liability Protection, and Schools (HEALS) Act. The HEALS Act would extend and alter many of the programs included in the CARES Act, the third COVID-19 response bill. Some key programs, such as enhanced unemployment insurance (UI) benefits, expired on July 25. The bill also introduces new provisions related to education spending and liability protections.

As of August 3, a single HEALS Act is theoretical: the term instead refers to ten distinct bills and proposals introduced in the Senate. The two bills that constitute the bulk of the fiscal provisions under the HEALS Act are the American Workers, Families and Employers Assistance Act and the Continuing Small Business Recovery and Paycheck Protection Program Act. Read the full text of these bills here and here, respectively.

In this post we discuss the major provisions of the HEALS Act and, where appropriate, compare it to provisions of the $3 trillion HEROES Act passed by the Democratic-led House of Representatives on May 27.

Summary of provisions, by dollar cost:

- $300 billion for second round stimulus checks
- $200 billion in tax breaks for businesses
- $158 billion for loans to small businesses
- $110 billion for UI benefits extension
- $105 billion for schools
- $111 billion for health related expenses
- $63 billion for domestic industries
- $39 billion other
- Total: $1.1 trillion

Spending for individuals

Expanded Unemployment Insurance
The HEALS Act would extend the weekly unemployment bonus through July 2020 implemented by the Federal Pandemic Unemployment Compensation (FPUC) under the CARES Act, but lower it initially from $600 to $200.

The FPUC payment supplements state unemployment insurance, which varies widely from state to state. The FPUC was controversial, because workers in some situations could receive more than their previous wage. Under the HEALS Act, the added federal UI benefit would be $200 a week through September; starting October 5, the funding would change to 70% of previous wages, when combined with state unemployment benefits. In most states, state-level unemployment benefits provide 45-50% of a worker’s previous wages, so the HEALS Act would add an additional 20-25% to UI benefits.

This plan poses some logistical challenges. Each state has its own unemployment insurance program, and states determine benefits differently. It might be technically challenging -- if not impossible -- to switch from a flat FPUC benefit that augments standard UI payments to a UI payment that is a percentage benefit before October 5. The Senate bill would give states two months to update their UI programs, but there are wide-spread doubts that the necessary upgrades can be finished in that time frame.

<table>
<thead>
<tr>
<th>CARES Act</th>
<th>HEROES Act</th>
<th>HEALS Act</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unemployment “bonus” of flat $600 a week, on top of state unemployment insurance; expired July 25.</td>
<td>Unemployment “bonus” of flat $600 a week, on top of state unemployment insurance; extended through July 2020.</td>
<td>Unemployment “bonus” of $200 a week through October 5; then additional federal unemployment benefit such that total benefits equal 70% of former wages.</td>
</tr>
</tbody>
</table>

A second round of Stimulus Checks

The HEALS Act includes a one-time stimulus check that has a nearly identical structure to the stimulus checks under the CARES Act. All single tax filers who have adjusted gross income (AGI) under $75,000, heads of household with AGI under $112,000, and joint filers with AGI under $150,000 will be sent $1,200 plus $500 per dependent. Stimulus checks will phase out as AGI approaches $99,000 for single filers, $146,500 for heads of household with one dependent, and $198,000 for joint filers.

Under the CARES Act, dependents over the age of 18 were not included in the stimulus package; the HEALS Act would provide benefits for all dependents, regardless of age. Including dependents over the age of 18 would expand the pool of dependents by at least 26 million people.
One-time stimulus check of $1,200 per single tax filer with AGI under $75,000; $2,400 for head of household with AGI under $112,000 or joint tax filers with combined AGI of $150,000; additional $500 per dependent under 18 (no cap).

Funds to Address other COVID-related expenses

State/local funding

The HEALS Act would create the Coronavirus Emergency TANF Fund, an expansion of the pre-existing Temporary Assistance for Needy Families (TANF). The Act would appropriate $2 billion in grants to qualifying states with significant expenditures on “basic assistance, non-recurrent short-term benefits, and work supports for eligible families.” These funds would also be available to states to update their unemployment insurance systems. The state funding in the HEALS Act is minimal when compared to $150 billion in direct aid secured by the CARES Act and the HEROES Act’s proposed $1 trillion.

<table>
<thead>
<tr>
<th>CARES Act</th>
<th>HEROES Act</th>
<th>HEALS Act</th>
</tr>
</thead>
<tbody>
<tr>
<td>Established $150 billion Coronavirus Relief Fund for grants to states/local/tribal governments; $35 billion to capitalize Municipal Liquidity Facility.</td>
<td>Grants totalling $915 billion for state/local/tribal governments: including $500 billion to state governments and $375 billion to local governments.</td>
<td>Expands Temporary Assistance for Needy Families (TANF), adds $2 billion in grants to shore up state/local/tribal governments.</td>
</tr>
</tbody>
</table>

Education
The HEALS Act provides $100 billion for education, with $70 billion reserved for K-12 education and $30 billion for post-secondary education. The funds will be disbursed as grants through the Elementary and Secondary School Emergency Relief Fund and the Higher Education Emergency Relief Fund, both established by the CARES Act.

Of the $100 billion, one third would be distributed for the two funds established by the CARES Act, while two thirds would be reserved for schools that are reopening in the fall. Specifically, two-thirds of the funds’ total will be exclusively available for grants to schools with at least 50% attendance for 50% of the school year. Distribution to a state will be based on its percentage of student-aged residents that are under the poverty line.

The HEALS Act also includes changes to student loan repayment. Normally, student borrowers have nine repayment plan options, ranging in maturity length and rate. The Senate bill would reduce these options to two plans: one with a 10-year fixed annual payment; and one wherein students would pay 10% of their discretionary income for 20 years (in the case of undergraduate debt) or 25 years (in the case of graduate school debt) before the remaining balance is forgiven.

<table>
<thead>
<tr>
<th>CARES Act</th>
<th>HEROES Act</th>
<th>HEALS Act</th>
</tr>
</thead>
<tbody>
<tr>
<td>$30 billion for education, with $13 billion to K-12 schools and $14 billion to post-secondary schools; suspension of student loan repayment through October 2020.</td>
<td>$100 billion in direct aid for schools; $10,000 in student loan forgiveness and suspension of loan repayments through October 2021 for those with “greatest need” (approximately 20 million people).</td>
<td>$100 billion for schools, with two-thirds reserved for schools that re-open in the fall; income-based payment option for student loans.</td>
</tr>
</tbody>
</table>

Tax credits and deductions

The HEALS Act amends and expands tax credits and deductibles available to businesses that retain employees. It amends the CARES Act Employee Retention Credit to offer a deduction to businesses equal to 65% of a retained employee’s wages, up from 50%, and increases the maximum deduction from $10,000 to $30,000 per employee. The bill also introduces a new Safe and Healthy Workplace tax credit. This tax credit gives businesses a deduction equal to 50% of the costs of employee protection and workplace reconfiguration expenses, due to new COVID-19 regulations.

Childcare

The HEALS Act provides $15 billion for childcare, $5 billion more than the funding included in the HEROES Act that was passed by the Democrat-controlled House of Representatives on May 15. Read the full text of the proposal here.

Liability Protections
Senator Mitch McConnell has repeatedly said that liability protections will be in any relief deal that passes the Senate. Liability protections appear in the HEALS Act via the Safeguarding America’s Frontline Employees to Offer Work Opportunities Required to Kickstart the Economy Act, abbreviated the SAFE TO WORK Act. The Act would protect healthcare providers, businesses, volunteers, local governments, and administrators from liabilities associated with COVID-19 from December 2019 through October 2024. The first wave of lawsuits associated with the disease has just begun. Some argue that the Act would give employers a blanket waiver to skirt protections for workers’ health. The CARES Act did not limit legal liabilities. It did include a provision requiring the Occupational Safety and Health Administration to draft new regulations to protect employees from COVID-19. The HEROES Act does not contain provisions limiting liability for employers, businesses, or schools.

Changes to the Paycheck Protection Program (PPP) and additional small business programs

The Continuing Small Business Recovery and Paycheck Protection Program Act (PPP) thoroughly revamps the PPP’s scope to target the hardest-hit businesses that have experienced revenue losses; disqualifies publicly traded companies and other types of firms that the original legislation had included; and eases the loan forgiveness process. These changes are headlined by a second round of PPP loans to businesses with fewer than 300 employees, a lower general loan cap of $2 million, and an expansion of eligible uses for funds that do not jeopardize loan forgiveness.

Much of the language is taken up with clarifying the PPP’s intent by patching perceived holes in the program, which has already seen successive legislative and administrative changes. For example, the bill explicitly disqualifies several business structures and industries to address concerns raised when publicly traded companies and lobbying firms were awarded PPP loans.

Finally, the proposed legislation clears paths for loan forgiveness. The CARES Act mandates that borrowers submit evidence to support their loan application such as payroll tax filings, mortgage statements, and utility bills, along with a certification that such evidence is true and correct. The proposed legislation does away with the submission of evidence, significantly lowering the hurdles to both borrower and lender compliance. For loans smaller than $150,000, which comprise 87% of approved PPP loans as of July 24 (6), borrowers must attest that they “made a good faith effort to comply with the [forgiveness] requirements” and maintain records relevant to compliance efforts. For loans between $150,000 and $2 million, the process is similar, but the Act specifies supporting documents that must be maintained.

By paring borrower eligibility down to only those hardest hit, this bill starts to wean small businesses off a lending program that seems ever more likely to become a grant program. The proposal also introduces two new long-term lending programs -- Recovery Sector Loans and the Small Business and Domestic Production Recovery Investment Facility -- which we summarize at the end of this section. These programs are not designed to deliver short-term relief, but rather to facilitate investments. Taken together, the PPP eligibility adjustments and new programs point toward recovery and away from a relief mindset.
Targeting the hardest-hit businesses

Congress extended the PPP’s application period from its original June 30 deadline to August 8, with nearly $140 billion left in appropriated funds. But the program has seen much less uptake than during its initial run. Rather than expand eligibility, the Senate bill addresses this funding surplus by narrowing its general criteria in two ways. First, the bill allows a second loan to PPP recipients with fewer than 300 employees. Second, businesses must have suffered revenue losses of at least 50%, defined as the change in gross receipts in 2020 from a period in 2019 when that business was open.

These “second draw” loans are limited to the lesser of 2.5 times the monthly value of an applicant’s payroll and $2 million. This $2 million cap would also extend to first loans. Finally, the bill further targets small borrowers by requiring at least $25 billion of second-draw PPP loans to go to businesses with fewer than 10 employees.

A May report from the SBA Inspector General found that guidance to lenders prioritizing rural and underserved markets had not been issued by the SBA. As this guidance was specified by CARES Act Section 1102(a)(36)(P)(iv), the report raised concern that the program might not be operating in a manner consistent with Congressional intent. The SBA did issue such guidance at a later date. The proposed bill does not alter CARES Act language, but would complement it by setting aside $10 billion for small lenders and community financial institutions. Small lenders, often located in rural markets, delivered PPP loans faster than large lenders during the program’s initial round and there is some evidence that rural areas were well represented among loan recipients. Data released by the SBA also suggest that community development financial institutions lent to underserved markets -- which the CARES Act defines as women, minorities, and veterans -- at somewhat higher rates than other lenders.

The bill includes $90 billion of entirely new appropriations for the Paycheck Protection Program’s second draw loans. It also combines the existing PPP pool with money already

<table>
<thead>
<tr>
<th>Current program</th>
<th>HEROES Act</th>
<th>HEALS Act</th>
</tr>
</thead>
<tbody>
<tr>
<td>$659 billion for PPP</td>
<td>No mention of PPP</td>
<td>$749 billion for PPP</td>
</tr>
<tr>
<td>$10 billion in small business grants</td>
<td>$10 billion in 15-year loans to small business investment companies</td>
<td>$100 billion in 20-year “recovery sector loans” to hard-hit businesses, manufacturers, seasonal employers, and firms in small business low-income tracts</td>
</tr>
</tbody>
</table>
available for Economic Injury Disaster Loans. This consolidation aims to give the programs more flexibility in effectively meeting demand from applicants. The proposal would also extend the application period until the end of the year; the application period is now set to close on August 8, 2020.

Disqualifying specific types of recipients that had raised controversy

The PPP came under fire from oversight bodies and media for awarding loans to publicly traded companies, lobbying firms, and insurance agencies. Section 106 of the new bill significantly redefines PPP eligibility, explicitly disqualifying those types of organizations, as well as think tanks, banks, and other lenders.

Media coverage also focused on loans to businesses owned in part or whole by members of Congress and their family members. Normally, SBA reviews small business loans for any conflicts of interest, but that practice appears to have been waived by the SBA. While the PPP lends through thousands of retail banks, constructing a buffer between the executive branch and lending, a previous YPFS blogpost argued that “a blanket waiver should raise concern.” Section 117 of the Republican proposal requires members of cabinet and Congress to disclose controlling interests in companies when applying for PPP loans, creating a middle ground between case-by-case review and the blanket waiver.

Finally, the bill wades into the debate over economic decoupling with China. It introduces novel language that excludes businesses with significant stakes in entities located in the mainland or Hong Kong, and disqualifies those with board members who reside in China. While the executive branch has led federal efforts to distance US interests from Chinese production, in the last week Senate Republicans have introduced several bills that would limit American dollars from flowing into the People’s Republic. Though inconsequential (few businesses small enough to be eligible for PPP are likely to maintain close ties with China), were this language to be adopted it would be the first mention of China in any of the United States’ coronavirus response laws.

Easing the loan forgiveness process

The Senate proposal would also ease the loan forgiveness process. For loans under $150,000, which have constituted the vast majority of PPP loans by number -- though not by value -- borrowers would be assumed to have made a good-faith effort at adhering to loan forgiveness terms if they attest to, and keep “relevant records” of, such efforts for three years. Loans between $150,000 and $2 million require that lenders review and attest to the completion of the loan forgiveness application. Borrowers of these larger loans must also store “relevant schedules, worksheets, and supporting documentation” for three years.

All proposed and enacted legislation related to the PPP has asserted the right of the SBA to audit or review any loan it has made, and this proposal allows the SBA to retroactively modify loan or forgiveness amounts when it finds noncompliance. However, the relaxation of loan forgiveness requirements and compliance is likely to result in most loans becoming grants with the filing of
forgiveness applications. Since the enactment of the Paycheck Protection Program Flexibility Act on June 5, the PPP has allowed loan forgiveness to borrowers that used at least 60% of the loan for payroll expenses, with the rest allowed for covered expenses such as rent, insurance, and public health compliance.

The Senate proposal also clarifies protections for eligible lenders. Despite 100% participation by the SBA, some lenders have remained skittish about lending and forgiveness due to fears over potential liability and compliance. The Senate proposal codifies SBA guidance on this matter by assuring safe harbor protections to lenders who receive attestations or certifications from applicants.

**Other provisions**

The bill also introduces two new programs which businesses may apply for as an alternative to the PPP: Recovery Sector Loans and the Small Business and Domestic Production Recovery Investment Facility. These programs are significant in size and scope, costing the Treasury up to $67.7 billion if enacted. They focus not on short-term relief, but long-term changes to businesses, with long loan maturities, allowances for proceeds to be spent on capital purchases, and a focus on hard-hit businesses and domestic manufacturing. However, these proposals are wholly novel and have no corollaries in the HEROES Act.

The proposal authorizes $100 billion for recovery sector loans up to $10 million. These loans are attached to narrower eligibility requirements than the PPP: borrowers must have lost revenues in excess of 50% from 2019, be seasonal businesses (defined in Subsection 112(38)(A)(iii)), or do significant business inside a new statistical creation, the small business low-income census tract (defined in Subsection 112(38)(A)(v)). Rather than provide quick relief, these loans can be used for Small Business Act 7(a) covered expenses in addition to fixed capital improvements, upgrades, and debt refinancing. These loans carry 20-year maturities at the Secured Overnight Financing Rate plus 3% and do not include forgiveness provisions.

The proposal would also appropriate $10 billion for a lending facility to small business investment companies. In this model, the SBA would buy 15-year bonds from investment companies at an interest rate not exceeding 2%. The proposal would cap loan amounts at $200 million. Proceeds from the sale would then fund investments into manufacturing supply chain resiliency, small business low-income census tracts, and businesses that lost at least 50% of revenue between 2019 and 2020. The bonds, however, carry some characteristics of equity holdings, notably a condition ensuring some amount of profit flows back to SBA should an investment be successful.

**Conclusions**

The bills put forward by Senate Republicans alter and extend the provisions of the CARES Act programs, enacted on March 27 but in some cases revised by further legislation.
These provisions seek to accomplish three goals. First, direct payments to individuals would provide needed support to the unemployed and stimulus for the battered American economy. Second, the proposal would transition recovery programs to targeting longer-term policies as schools and businesses seek to reopen while upgrading their public health practices. Third, the bills seek to fix problems discovered during the implementation of CARES Act programs. Within the context of the other eight bills that together constitute the GOP spending proposal, it is clear that both Republican Senators and the White House administration are prioritizing re-opening businesses and schools amid broad disagreement about the fate of fall education.

The HEALS Act will have to be negotiated against the $3 trillion HEROES Act. (This YPFS blog discusses the HEROES Act in more detail.) The two acts both include a second-round of stimulus payments, funding for childcare, and enhanced unemployment payments. However, the HEROES Act substantially expands the amount of money available for each of these purposes.

Currently, there is no consensus on when a bill could pass both chambers. Congress is set to adjourn on August 7 for a month-long recess.
European and Japanese G-SIB Report Second-Quarter Results

By Junko Oguri

Original post here.

In the midst of the COVID-19 lockdown, earnings beat expectations for most European and Japanese banks in the second quarter due to a surge in non-interest income that offset rising loan-loss provisions.

In the blog post “Banks’ Second-Quarter Results Boosted by Non-Interest Income and Official Support”, we analyzed US large banks’ second-quarter earnings. Recently, European and Japanese banks also updated their earnings. In this blogpost, we analyze the results of 12 European global systemically important banks (G-SIBs, as of 2019) and three Japanese G-SIBs for the three months through June 30. (This period represents the second quarter of the 2020 financial year for European banks and the first quarter of the 2021 financial year for Japanese banks).

European G-SIBs: 12 financial institutions

<table>
<thead>
<tr>
<th>Reporting Date</th>
<th>Firm name</th>
</tr>
</thead>
<tbody>
<tr>
<td>7/24</td>
<td>UBS</td>
</tr>
<tr>
<td></td>
<td>Barclays</td>
</tr>
<tr>
<td>7/29</td>
<td>Santander</td>
</tr>
<tr>
<td></td>
<td>Deutsche Bank</td>
</tr>
<tr>
<td>7/30</td>
<td>Credit Suisse</td>
</tr>
<tr>
<td></td>
<td>Standard Chartered</td>
</tr>
<tr>
<td>7/31</td>
<td>BNP Paribas</td>
</tr>
<tr>
<td></td>
<td>Société Générale</td>
</tr>
<tr>
<td>8/3</td>
<td>HSBC</td>
</tr>
<tr>
<td></td>
<td>Groupe Crédit Agricole</td>
</tr>
<tr>
<td>8/6</td>
<td>ING Bank</td>
</tr>
<tr>
<td></td>
<td>UniCredit</td>
</tr>
</tbody>
</table>

Japanese G-SIBs: 3 financial institutions

*
Given the deep recession and prolonged COVID-19 crisis, earnings reports can serve as a thermometer of the economy and the financial system.

Similar to their US peers, the results were not as devastating as the market expected. While sluggish household and firm borrowing limited lending activities, financial institutions with investment banking businesses benefited from active bond issuance and the strong stock market. Most European banks adopted the new IFRS9 accounting standard and set aside higher expected credit loss (ECL) provisioning for future loan losses. Many of those banks took advantage of the transition treatment to ease the impact of the losses on their capital.

In general, the economic shocks that COVID-19 has created so far in Europe and Japan have been somewhat milder than those in the US. For instance, the euro area unemployment rate was at 7.8% in June 2020, compared to 11.1% of the US. In the second quarter of 2020, gross domestic product (GDP) dropped by 12.1% in the euro area and 32.9% in the US. Although Japan’s GDP dropped by 21.7% and consumer confidence hit its lowest on record, the death rate caused by the COVID-19 has been much milder than the US and the economy has begun to reopen. Still, the outlook may not be promising for Japan’s finance sector. Banks have already been challenged by prolonged low interest rates and low profitability.

In this blogpost, we analyze earnings reports in terms of six areas: 1) CET1 capital ratio, 2) Net income and revenues, 3) Non-performing loans, 4) Loan loss provisioning, and 5) Market reaction and equity price.

1. CET1 Capital Ratio

The common equity Tier 1 (CET1) capital ratio, an important regulatory indicator of bank solvency, increased quarter-on-quarter (QoQ) for 11 of the 12 financial institutions; the outlier was Société Générale (Figure 1-1). CET1 capital (the numerator) increased for all firms while risk-weighted assets (RWA, the denominator) decreased for 7 firms (Figure 1-2 and 1-3).
Figure 1-1: CET1 regulatory ratio

(Sources) Bloomberg, Bank quarterly reports

Figure 1-2: CET1 capital

(Sources) Bloomberg, Bank quarterly reports
Several European banks attributed the increase in CET1 to the suspension of capital distributions. For instance, HSBC noted that the cancellation of the quarterly unpaid dividend of $3.4 billion contributed to the increase of its CET1 capital.

As noted in our recent blog post, European and UK regulators have called on banks to suspend dividends and other capital distributions. In the UK, for example, the Prudential Regulation Authority asked the seven largest systemic UK banks to suspend dividends and share repurchases until the end of 2020 and to refrain from paying cash bonuses to senior executives. Switzerland and Japan have not introduced such measures.

Barclays and a few other financial institutions also noted that the IFRS 9 transitional relief contributed to the increase in CET1 capital.

While improved CET1 ratio for most financial institutions were driven by the surge in CET1 capital, some also managed to decrease their risk-weighted assets. For instance, the significant decrease in RWA for ING contributed to a 0.9% boost in its CET1 ratio. ING explained that the adoption of the standardized approach for sovereign exposures (0% risk weights for sovereign debts issued in domestic currency) and the amendments of EU regulations No 575/2013 (CRR) and 2019/876 (CRR II) (so-called “CRR quick fix”) led to the decrease in its credit risk, particularly for exposures to small business and infrastructure loans.

Some financial institutions attributed the increase in RWA to the surge in market risk.; for example, while overall RWA decreased, Standard Chartered said that its market risk RWA increased by $2 billion due to higher levels of Financial Markets activity, with increased value-at-risk from elevated market volatility.

Meanwhile, the regulatory required capital ratios have decreased for some banks, mainly due to the release of countercyclical buffers and capital conservation buffers (see the blog post here).
Some banks reported the resulting declines in their capital requirements. For instance, UBS reported that the buffer release by the Swiss National Bank and several other countries led to a 29 basis-point reduction in its CET1 capital requirement.

Under Basel III, all banks must hold high-quality capital equal to 4.5% of their risk-weighted assets, plus a 2.5% capital conservation buffer (CCB). The purpose of the CCB is to encourage banks to conserve capital. When the buffer is breached, banks must limit bonuses to managers and distributions to shareholders.

Before the current crisis, about a dozen countries had also imposed a countercyclical capital buffer on their banks (CCyB). The CCyB is a buffer under Basel III that countries can build during boom times and draw down during busts to absorb losses and mitigate the increase in risk-weighted assets; they may set it as high as 2.5%. The Basel III CCyB is calculated as the weighted average of the buffers in effect in the jurisdictions to which banks have a credit exposure. Furthermore, jurisdictional reciprocity will be applied in the context of internationally active banks. Among jurisdictions where G-SIBs domicile, France, Germany, and UK have lowered their CCyB while Switzerland lowered its sectoral CCyB targeted at residential mortgage loans from 2.5% (Figure 1-4).

**Figure 1-4: Major jurisdictions’ actions and statements on CCyB**

- **France**
  - French authorities to reduce the countercyclical capital buffer from 0.25% RWA to 0% RWA in accordance with the European Central Bank proposal. ([March 18](#))

- **Germany**
  - Deutsche Bundesbank announced its regulator intends to lower the countercyclical capital buffer from 0.25% to 0% as of April 1. ([March 18](#))

- **Italy**
  - Banca d’Italia has maintained the countercyclical buffer rate at 0% ([March 27](#) and [June 26](#))

- **Netherland**
  - DNB has decided to leave the CCyB unchanged at 0%. ([June 19](#))

- **Spain**
  - Banco de España holds the countercyclical buffer at 0%. ([March 31](#))

- **Switzerland**
  - Federal Council announced that it would retain the countercyclical capital buffer at 0% and sectoral CCyB targeted at mortgage loans financing residential property located in Switzerland at 2.5%. ([February 7](#))
  - On 27 March, Federal Council announced that it would release sectoral CCyB ([March 27](#))

- **UK**
  - Bank of England lowered the countercyclical capital buffer rate from 1% to 0% to support banks in extending credit facilities to customers. Also reinforced the expectation that all elements of capital buffers can be drawn
down as necessary to support the economy through the shock. In the statement, BOE noted that the release of the countercyclical capital buffer will support up to £190 billion of bank lending to businesses. (March 11)

2. Net Income and Revenues

Earnings rose for nine of the 15 firms, stayed roughly the same for one firm, and fell for the other five, compared to the first quarter. However, the results were better than market expectations (Figure 2).

Robust net earnings were backed by strong non-interest income. As well as their European peers, trading profit surged, particularly for the G-SIBs, due to the higher client trading activities induced by wider trading spreads in volatile financial markets as clients repositioned their portfolios.

Some financial institutions noted that their equity and fixed-income underwriting businesses also contributed to the rise in non-interest income; given the attractive low interest rates, clients’ demand for bond issuance has been growing. A few banks, including Deutsche Bank, noted the improvement in their cost management as well.

3. Non-Performing Loans

While banks’ earnings were stronger than expected, non-performing loans (NPLs) increased 7.0% in aggregate for the 13 banks compared to the first quarter (Figure 3). The ratio of NPLs to total loans increased for nine of the 10 financial institutions. Many banks noted that in addition to small and medium-sized corporate borrowers, commercial real estate, aviation, restaurants and leisure, retail, and energy-sector borrowers face severe challenges.
However, reported nonperforming loans would have been worse if banks had not provided relief to many borrowers, under the cover of accounting and other forbearance provided by jurisdictions in response to the COVID-19 pandemic. Many loans went under deferral programs or had their terms modified. (See here for more details on Loan Modifications, Non-Performing Loans, and Accounting relief).

The European Central Bank (ECB) has confirmed supervisory flexibility regarding the treatment of NPLs. For example, the ECB discourages banks from automatically classifying loans to borrowers who are unable to meet payments because of the pandemic. The ECB expects banks to take advantages of government guarantees. Furthermore, ECB is reportedly considering adopting bad banks, which are asset management companies that acquire bad loans (see our related blog post here). Other jurisdictions have also adopted similar forbearance and moratorium policies.

Banks varied widely in the details they reported on the impact of payment deferrals and other COVID-19 relief. In general, those with large retail banking businesses were more subject to the supervisory forbearance. For instance, Deutsche Bank reported over €17 billion in loans that were subject to moratoria, forbearance measures, and public-guarantee schemes.

4. Loan Loss Provisioning

For the 12 financial institutions combined, the loan loss provision decreased by 3% compared to the first quarter (Figure 4-1). The ratio of loan loss provisions to total loans increased for half of the banks.
ING experienced a particularly large increase; its loan loss provision doubled from the previous quarter. According to the Financial Times, ING was one of the largest lenders to Wirecard, a German payment firm that filed for insolvency in late June amidst scandal.

Some of the increases in loan loss provision for 23 European banks could be attributed to the new forward-looking credit loss standard in IFRS9. (Unlike most European banks, Credit Suisse reported its consolidated financial report under US GAAP; thus it adopted the current expected credit losses (CECL) standard, the new forward-looking standard in the US. Japanese banks report their consolidated financial reports under J-GAAP, which has not incorporated a forward-looking standard.)

Under IFRS9, if the credit risk has not increased significantly from the loan origination (Stage 1), banks recognize allowances based on 12 months of expected losses. However, if the credit risk has increased significantly (Stage 2) and if the loan is credit-impaired (Stage 3), the standard requires allowances based on lifetime expected losses (Figure 4-2). An ESRB paper and others argue that as the exposures transfer from Stage 1 to 2, there will be a “cliff effect” in loan loss provisions due to the changes in time horizon. They worry that this could lead to procyclicality in the financial system.
Second, the ECL in IFRS9 is forward-looking and “probability-weighted” and require banks to use “reasonable and supportable Information” to quantify credit losses. In 2015 guidance published by the Basel Committee on Banking Supervision (BCBS), banks are expected to assess and measure credit risk to the particular lending exposure using the information of past events, current conditions, and forecasts of future economic conditions. Under the increased uncertainty in the COVID-19 crisis, combined with the aforementioned stages features, some were concerned about the unpredictable negative impacts on bank capital.

Recognizing these concerns, the International Accounting Standards Board (IASB), the accounting setter of the IFRS9, and various authorities in different jurisdictions have announced measures to mitigate the negative impacts (see related blog post here). Many jurisdictions and authorities have emphasized that banks should not take a mechanical approach to moving credits into Stage 2 (significant increase in credit risk, “SICR”) in cases where borrowers are affected by the pandemic.

Figure 4-3: Major actions on Expected Credit Loss Accounting

- IASB released a statement clarifying how to apply IFRS 9 during this time of uncertainty. The Board also states that it is working with regulators in the current environment and encourages companies to consider guidance provided by prudential and securities regulators. (March 27)
- IOSCO supported professional judgment in applying accounting standards rather than applying in a mechanistic manner. (April 3)
- ECB recommended that all banks avoid procyclical assumptions in their models to determine provisions. (March 20)
<table>
<thead>
<tr>
<th>Location</th>
<th>Event/Measure</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>EBA</strong></td>
<td>released a statement on the application of the prudential framework with regards to classification of default, forbearance, and IFRS 9. (<a href="#">March 25</a>)</td>
</tr>
<tr>
<td><strong>European Parliament</strong></td>
<td>approved changes to the capital requirement regulation and clarified the treatment of IFRS 9 and expected credit loss. (<a href="#">June 19</a>)</td>
</tr>
<tr>
<td><strong>France</strong></td>
<td>AMF clarified accounting standards for calculation of expected credit losses in light of recent announcements from ESMA, EBA, and IASB. (<a href="#">April 7</a>)</td>
</tr>
<tr>
<td><strong>Germany</strong></td>
<td>BaFin and Deutsche Bundesbank shared the view that the current situation does not lead to an undifferentiated, automatic transfer of financial instruments from Level 1 to Level 2 or Stage 3. (<a href="#">March 27</a>)</td>
</tr>
<tr>
<td><strong>Netherland</strong></td>
<td>DNB guided banks to avoid excessively procyclical assumptions in their expected credit loss (ECL) estimations during the COVID-19 pandemic (<a href="#">April 24</a>)</td>
</tr>
<tr>
<td><strong>Spain</strong></td>
<td>Banco de España releases a briefing note stating that they adopt the measures notified by the ECB and extends them to all the financial institutions over which it exercises direct supervisory powers. (<a href="#">March 30</a>)</td>
</tr>
<tr>
<td><strong>UK</strong></td>
<td>Banco de España disclosed a FAQ about the use of the flexibility provided in the accounting regulations. (<a href="#">April 3</a>)</td>
</tr>
<tr>
<td><strong>Spain</strong></td>
<td>Banco de España allowed for greater flexibility in applying expert judgement for the credit-risk classification of forborne exposures. (<a href="#">June 16</a>)</td>
</tr>
<tr>
<td><strong>UK</strong></td>
<td>PRA issued guidance on impact of COVID-19 on ECL estimates under IFRS 9. The PRA expects the eligibility for the extension of mortgage repayment holidays should not automatically be a sufficient condition to move participating borrowers into Stage 2 ECL. (<a href="#">March 20</a>)</td>
</tr>
<tr>
<td><strong>UK</strong></td>
<td>Joint statement by FCA, FRC and PRA including guidance on application of IFRS9 and flexibility on meeting reporting timelines. (<a href="#">March 26</a>)</td>
</tr>
<tr>
<td><strong>UK</strong></td>
<td>The PRA published a letter to banks including application of IFRS 9 and flexibility in terms of application of loan covenants and recognition of default. (<a href="#">March 26</a>)</td>
</tr>
<tr>
<td><strong>UK</strong></td>
<td>PRA released a statement on application of IFRS 9 in light of COVID-19. (<a href="#">May 22</a>)</td>
</tr>
</tbody>
</table>

Source: Yale Program of Financial Stability, Institute of International Finance
Meanwhile, some bank reports indicated that they expect a “V”-shaped recovery as their central economic scenario in their ECL models (Figure 4-4). For instance, HSBC noted that “[m]inimal long-term damage to economic prospects is expected, allowing economic growth across our key markets to return to forecast trend rates” and noted that the V-shape recovery forecast reflected the unique nature of the pandemic lockdown.

If the actual economic recovery in the third quarter is not as rosy and the recovery takes an “L” shape, banks may have to adjust their forecasts and further increase loan loss provisions.

Figure 4-4: GDP growth estimates by HSBC and Deutsche Bank

(Sources) Bank quarterly reports

5. Market reaction and equity prices

The earning reports, overall, were better than market participants had expected. Figure 5-1 exhibits the differences between Bloomberg’s consensus estimates and the actual adjusted earnings per share (EPS); most banks outperformed the market estimates, sometimes by wide margins.
However, market prices suggest that the financial sector still faces many significant challenges. Figures 5-2 and 5-3 show financial firms' slow recovery in equity prices, while the STOXX Europe 600 and Nikkei 500 benchmark indexes have been showing robust recovery. The low rate that is likely to persist both in Europe and Japan for coming few years will continue to hamper profitability of banks. Even if the economy may recover in a “V” shape for banks, challenges would remain for the banking sector.

(Sources) Bloomberg

Figure 5-2: European Equity Price

(Sources) Bloomberg
Figure 5-3: Japanese Equity Price

(Sources) Bloomberg
The RBI expands its regulatory reach: Reforms to watch

By Alexander Nye

Original post here.

India’s urban cooperative banks (UCBs), which have total assets of more than US$81.5 billion as of March 2019, will now be able to issue equity and will be subjected to additional supervision by the Reserve Bank of India (RBI) under a new regulatory regime that the government introduced in June.

On June 26, India’s Union Cabinet put forward “The Banking Regulation (Amendment) Ordinance, 2020,” a policy that could change the regulatory landscape for India’s banking sector permanently if India’s parliament passes it into law by the end of September.

After ten years of mounting urban cooperative bank failures and consolidation, these cooperative banks need new money badly and allowing UCBs to issue equity also allow the market to judge the corporate governance of these banks. The RBI’s new powers under the ordinance also make it easier for the central bank to supervise UCBs and help improve their corporate governance.

All-in-all, cooperative banks only have about 4% of the assets of India’s banking system, based on 2019 data. However, cooperative banks are very important politically because they provide last-mile access to banking in impoverished and isolated areas. They constitute more than 99% of India’s credit institutions by number.

India’s cooperative banks

India’s constitution places responsibility for monetary policy and commercial bank regulation with the federal government, but leaves the regulation of cooperative societies (the institutions that, among other things, own cooperative banks) to state governments. This means that the process of supervising and governing cooperative banks in India is fragmented. Cooperative banking in India is best understood as being built on two foundations: Rural cooperative banks and urban cooperative banks.

In India, cooperative banks are institutions that are owned and run by cooperative societies. Cooperative societies are a legal category in India that lies somewhere between a trust and a company under US laws. They are similar to the UK’s friendly societies. Cooperative banks have some amount of capital, but cooperative societies themselves do not.

Rural cooperative banks

Rural cooperative banks (RCB), more accurately called rural cooperative credit institutions (as many are not technically banks), are financial institutions that were set up to provide credit to villages and small towns. RCBs can be divided into short-term and long-term lending institutions, based on the tenure of the loans they typically provide (See Figure 1).
The short-term institutions are arranged in a three-tier structure (See Figure 1). The smallest institutions, at the base of the structure, are the Primary Agricultural Credit Societies (PACS) that provide short and medium-term loans at the village level. These are not registered as banks and therefore do not have access to liquidity from the RBI. District Central Cooperative Banks (DCCBs) monitor and lend to the PACS. These DCCBs, and the State Cooperative Banks (StCBs) above them, are regulated by state governments, the RBI, and the National Bank for Agriculture and Rural Development (NABARD).

State government Registrars of Societies have power over cooperative banks through their regulation of the cooperative societies that own the cooperative banks. Registrars of Societies can determine who is allowed to be a Director of a cooperative society. Before the recent government action, the RBI did not have the power to shuffle around the boards of cooperative banks. This made it extremely difficult to improve management practices. The RBI is the main regulator of banking activity, but it had NABARD serve as its agent when it came to inspecting rural cooperative banks. That may be because the RBI has not had the human resources to inspect tens of thousands of small banks. Many of these banks do not have a direct line to RBI liquidity, as many are not registered as banks or are not scheduled by the RBI (in other words, they do not
have an account with the RBI). But they can rely on refinancing from NABARD so long as they continue to allow inspections. The other way that the RBI may regulate these cooperative banks comes from a policy change in the 1970s. Under these changes, some of the cooperative banks gained access to deposit insurance if their state government amended their laws to allow the RBI to inspect them. The problem with this arrangement is that not all of the state governments made the change and, unlike the Federal Deposit Insurance Corporation in the U.S., the deposit insurance corporation does not have the powers to affect resolution.

The long-term institutions are popularly known as land development banks and are organized in a two-tier structure (See Figure 1). They are not deposit-taking institutions and primarily use debentures to fund themselves. They ultimately rely on NABARD for funding. The smaller organizations here are called Primary Co-operative Agriculture and Rural Development Banks (PCARDB), which provide loans at the district or block level. Above them are State Co-operative Agriculture and Rural Development Banks (SCARDB), which act at the state level. Together, they aim to finance “medium to long-term loans for making investments in agriculture, rural industries, and lately housing.”

Urban cooperative banks (UCB)

The term UCB is merely a label for the primary cooperative banks, which are primary credit societies (PCSs) that have been licensed by the RBI as banks. There is no formal definition for UCBs, but the term tends to refer to PCSs that are located in urban and semi-urban areas. They may or may not be scheduled with the RBI. Those scheduled with the RBI have direct access to liquidity from the RBI and the RBI gains many of its supervisory powers over these banks through this leverage.

Like rural cooperative banks, urban cooperative banks cannot access capital markets; their main source of funding is loans and deposits. Unlike the rural cooperative banks, they can operate in a single state or in multiple states (the latter type is commonly known as multi-state cooperative banks). They tend to be much larger than rural cooperative banks, but are still quite small when compared to India’s scheduled commercial banks. As of March 31, 2019, India had 1,544 UCBs with aggregate deposits of about 3.8% of India’s major private banks (known as scheduled commercial banks (SCBs)). However, they are very important to India’s large urban lower and lower-middle class.

<table>
<thead>
<tr>
<th>Type of financial institution</th>
<th>Number of Banks (as of March 31, 2018)</th>
<th>Deposits (as of March 31, 2018, in INR billions)</th>
<th>Advances (as of March 31, 2018, in INR billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>UCBs</td>
<td>1,551</td>
<td>4,565</td>
<td>2,805</td>
</tr>
<tr>
<td>Rural cooperative credit institutions</td>
<td>96,248</td>
<td>5,948</td>
<td>6,529</td>
</tr>
</tbody>
</table>
**Public sector banks (PSB) (government-owned)**

<table>
<thead>
<tr>
<th></th>
<th>27</th>
<th>82,623</th>
<th>56,974</th>
</tr>
</thead>
<tbody>
<tr>
<td>SCBs</td>
<td>22</td>
<td>32,616</td>
<td>28,346</td>
</tr>
</tbody>
</table>

Source: [RBI](https://www.rbi.org.in), [IBEF](https://www.ibef.org), and the [Indian Banks’ Association](https://www.iba.org.in)

In recent years, some UCBs have expanded aggressively into large cities, though the UCB sector as a whole has been plagued by bank failures. UCBs are regulated by a mix of state cooperative regulators and the RBI. While the RBI manages their banking activities, the corporate governance of the organizations is **ultimately left to state regulators**. This leaves the RBI largely powerless when it comes to stemming corporate governance problems before it is too late, as seen in the **late 2019 collapse of Punjab & Maharashtra Co-operative Bank (PMC Bank)**. Years of collapsing cooperative banks have forced deposit insurance payouts to **over 400,000 Indian depositors**. Until the RBI puts the books of these banks in order, bank customers can **endure** months of withdrawal restrictions.

**What does the Ordinance change?**

**Cooperative banks gain new tools for fundraising**

The [Ordinance amended](https://www.rbi.org.in) the India Banking Regulation Act, 1949 to allow all cooperative banks to issue equity (through public issuance or private placement) as well as unsecured debentures or bonds. To issue such equity or debt, cooperative banks must receive approval from the RBI. The RBI also acquired the power to put conditions on the issuance of equity or debt securities by these banks. The RBI can also force cooperative banks to raise capital. In a way, this issuance of equity could lead cooperative banks in India down a road to **“demutualization”** similar to that experienced by U.S. savings banks. We do not yet know the details of what these new shares would look like (would they be issued with limited or unlimited liability, how would the expansion of the shareholder bank work, etc.).

Cooperative banks are **prohibited** from reducing or withdrawing share capital except in situations where it is required by the RBI. Cooperative banks cannot demand that surrendered shares be returned either.

**Major supervisory powers acquired by the RBI over urban cooperative banks**

The Ordinance also ended the exemption from portions of the [India’s Banking Regulation Act, 1949](https://www.rbi.org.in) that all cooperative banks previously enjoyed. **Now**, only PACS and “cooperative societies whose primary object and principal business is providing long-term finance for agricultural development” can receive the exemption. To qualify, these financial institutions cannot be banks (or use the words “bank,” “banker,” or “banking” in their names or business) and cannot cash checks. This could bring urban cooperative banks under the Banking Regulation Act, 1949.

By placing these other banks under the Banking Regulation Act, 1949, the Ordinance **extends** many of the RBI’s powers over commercial or public-sector banks to UCBs. The government
declared that this will “not affect existing powers of the State Registrars of Cooperative Societies under state co-operative laws,” though the RBI can now request the ability to supersede the board of a UCB registered under a state’s laws from that state’s government. The changes will also allow the RBI to prevail over bank management in cases of a conflict between the RBI and state cooperative regulators, who have traditionally been allied with cooperatives’ management.

**Expands the RBI’s resolution powers for banks and urban cooperative banks**

One of the most important changes is the RBI’s new resolution mechanism for commercial banks and cooperative banks. Previously, the RBI was required to put a moratorium on depositor withdrawals when it was resolving or selling a failing commercial bank. In the case of PMC Bank, this restriction has kept depositors from being able to access their money for months. Now, the RBI can frame a resolution scheme for all banks “even without making an order of moratorium, so as to avoid disruption of the financial system,” according to the finance ministry.

Back in March, the RBI’s efforts to restructure YES Bank involved the imposition of a two-week moratorium that restricted withdrawals to INR 50,000 per depositor. This spurred a run on the bank and was only stopped when YES Bank was taken over by state-owned lender State Bank of India (SBI). Although India does have a deposit insurance program that now covers up to INR 500,000, the old rules required the RBI to risk panics by imposing moratoria on failing banks.

**How has the change been perceived within India’s financial and regulatory communities?**

Professor Ila Patnaik, of India’s National Institute of Public Finance and Policy, is optimistic about the new rules related to issuing equity. She said that, with the ability to issue equity, “if you are a well functioning cooperative bank, you can actually grow,” and could become more accountable. She also reflected that it is good that the RBI is finally getting the regulatory powers it needs, but it will take time for it to build up the supervisory capacity to regulate these cooperatives effectively.

The same attorneys at the Madras High Court wrote in The New Indian Express that “The Ordinance has given the much needed legal impetus for regulation, revival, stabilization and recovery of the UCB sector which would enable the RBI to introduce Scheme’s [sic] of reconstruction or amalgamation similar to the one drawn up in the case of Yes Bank.” These kinds of processes involve the purchase of a troubled institution by a larger, more stable one. It provides some kind of continuity to depositors in a similar way to the FDIC’s “purchase and assumption” method. The Indian government had state-owned lender State Bank of India recapitalize and achieve a controlling stake in Yes Bank.

Others see this Ordinance as a long time coming. They believe the Ordinance is effectively a version of a bill the government was about to pass before COVID-19 shut down the parliament. Issuing an Ordinance while the parliament was not in session allowed the government to push through the policy without interference from local interests.
However, they also worry that the carve-out for rural cooperatives will mean that agricultural depositors will not benefit from the improved governance that may come from these reforms in UCBs. They lament that, despite the Ordinance, UCBs might still be uncompetitive with other small finance banks and might still be subject to interference by cooperative society management. The Ordinance has already been challenged at the Madras High Court by two cooperative banks arguing that it infringes on the rights of states in India’s constitution.

What is the significance of this policy in light of COVID-19?

Although this policy was not a response to COVID-19, it will be a significant part of India’s financial recovery from COVID-19. Since lockdowns began in March, state governments and the RBI have been putting forward moratoriums on term loan repayments. When those moratoriums eventually cease, those banks are likely to face a tsunami of non-performing loans.
Rewritten HEROES Act lops $800 million off first proposal, but unlikely to proceed
By Sean Fulmer and Corey Runkel

Original post here.

On October 1, the Democrat-led House passed an updated version of the Health and Economic Recovery Omnibus Emergency Solutions (HEROES) Act, with a headline spending level of $2.2 trillion.

The 2,154-page bill would allocate significantly less than the previous HEROES Act, which the House passed in May and which clocked in at $3 trillion. But, a wide gap remains between the Democrats’ bill and the $1.1 trillion Health, Economic Assistance, Liability Protection, and Schools (HEALS) Act that Senate Republicans offered on July 27 and which the Senate has not voted on. The White House confirmed last week that Treasury Secretary Steven Mnuchin had brought a $1.62 trillion offer to talks with Speaker Pelosi, but the two have yet to close the gap and reach an agreement.

Compared to the May edition of the HEROES Act, this proposal reduces grants to state, municipal, territorial, and tribal governments by $479 billion, cuts $1,200 stimulus payments for dependents to $500, and removes the proposed $190 billion fund for hazard pay to essential workers. However, the bill is still about $1 trillion larger than a revised Senate bill nearly agreed upon in August, and--as written--is unlikely to make it through the Senate.
Each of these proposals attempts to correct and supplement the Coronavirus Aid, Relief, and Economic Security (CARES) Act, passed on March 27. The CARES Act delivered $2 trillion to individuals, small businesses, municipalities, and critical industries such as commercial airlines. It also implemented a foreclosure moratorium and payment forbearance on mortgages issued by federally owned lenders, which, as of the third quarter of 2019, held 36% of outstanding mortgage debt on one- to four-family residences. Since the CARES Act, the US economy has proceeded in fits and starts as states struggle to contain the coronavirus.

Table 1. Comparison between HEALS and HEROES Acts.

<table>
<thead>
<tr>
<th>Category</th>
<th>HEALS Act</th>
<th>HEROES Act (September)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individuals</td>
<td>- Second round of stimulus checks with benefits for dependents regardless of age</td>
<td>- Second round of stimulus checks with benefits for dependents regardless of age</td>
</tr>
<tr>
<td></td>
<td>- Federal Pandemic Unemployment Compensation (FPUC) set at $200 until October 5, then 70% of former wages</td>
<td>- FPUC set at $600, as in the CARES Act</td>
</tr>
<tr>
<td></td>
<td>- Expands grants to low-income families</td>
<td>- All federal unemployment insurance enhancements extended through January 31, 2020</td>
</tr>
<tr>
<td>Small businesses</td>
<td>- New Paycheck Protection Plan (PPP) appropriation of $90 billion</td>
<td>- New PPP appropriation of $75 billion</td>
</tr>
<tr>
<td></td>
<td>- Second Draw PPP loans with refined eligibility and benefits</td>
<td>- Priority PPP loans with refined eligibility and benefits</td>
</tr>
<tr>
<td>State, territorial, and municipal finance</td>
<td>- Adds $2 billion in grants to all jurisdictions</td>
<td>- $436 billion for grants to all jurisdictions</td>
</tr>
<tr>
<td></td>
<td>- $20 billion in grants to producers</td>
<td>- MLF significantly expanded</td>
</tr>
<tr>
<td>Agriculture &amp; nutrition</td>
<td>- No eviction or foreclosure moratoria</td>
<td>- n/a</td>
</tr>
<tr>
<td></td>
<td>- $3.2 billion for housing assistance</td>
<td>- Extended and expanded eviction and foreclosure moratoria</td>
</tr>
<tr>
<td>Housing</td>
<td></td>
<td>- About $76 billion in housing assistance</td>
</tr>
</tbody>
</table>
Credit reporting & debt collection - n/a
- Prohibits negative credit reporting and related measures, and consumer debt collection, during COVID-19 pandemic and 120 days, and in some cases other disasters

Airlines - n/a
- $28.3 billion extension of the Payroll Support Program

Source: HEROES Act Division A

**Individuals**

Were Congress to pass the HEROES bill, it would extend a number of popular programs it established in its third wave of federal relief, the Coronavirus Aid, Relief, and Economic Security (CARES) Act, in March.

The revised HEROES bill includes a second round of special tax rebates, popularly branded as “stimulus checks.” As in the CARES Act, these base payments would amount to $1,200 for individuals or $2,400 for joint tax filers. The HEROES Act provisions differ from those in the CARES Act in two significant ways: they include all dependents, though at a reduced benefit from the Democrats’ May proposal; and they shield payments from all garnishments.

Some criticized the first round of direct payments for only issuing the $500 benefit for dependents younger than 17. House Democrats integrated those criticisms into its May HEROES Act proposal, which would have included older dependents while raising the benefit to $1,200. The revised HEROES Act would still include dependents 17 or older, but leave the benefit at $500, matching that of the HEALS Act. Like the first-round payments under the CARES Act, the base amount and the $500 benefits would be reduced in steps when Adjusted Gross Income tops $75,000 for single filers or $150,000 for joint filers.

The revised HEROES bill also protects stimulus-check recipients from garnishment under the Treasury Offset Program (TOP). In normal times, the TOP identifies various debts that taxpayers owe, and deducts those amounts from their tax refunds. The CARES Act exempted stimulus checks from all TOP deductions except child-support payments. However, this requirement proved difficult to execute: about 50,000 who filed jointly received payments lower than the base $1,200 because their spouse had an outstanding child-support debt. The first round of payments under the CARES Act also allowed other garnishment. For example, a bank could offset amounts owed to it against payments direct-deposited into taxpayers’ accounts. The revised HEROES Act would protect stimulus-check payments “from any form of transfer, assignment, execution, levy, attachment, garnishment, legal process, bankruptcy or insolvency law, and any other means of capture prohibited for payments made under Title II of the Social Security Act” (p. 37).
The revised HEROES bill would strengthen the Earned Income Tax Credit (EITC) for taxpayers without dependent children. The bill adjusts the eligibility formula for the credit and doubles the rate of the credit from 7.65% to 15.3% of annual income. The House Appropriations Committee summary of the HEROES Act said that, taken together, these provisions would increase the maximum credit for a single childless taxpayer from $539 to $1,487 (p. 38).

Division I of the revised HEROES bill would extend the various federal enhancements to unemployment insurance until January 31, 2021, a month past the end-of-year sunsets specified by earlier Congressional proposals as well as the CARES Act. Economists credited these benefits, along with the April stimulus checks, for keeping Americans afloat during the pandemic. The programs which comprise these enhancements are:

- Federal Pandemic Unemployment Compensation (FPUC), which provides a weekly benefit of $600 on top of states’ existing weekly benefits;
- Pandemic Unemployment Assistance (PUA), which expands eligibility for federal benefits to gig workers and other self-employed workers;
- Pandemic Emergency Unemployment Compensation (PEUC), which extends federal benefits by 13 weeks past normal state and federal benefit end dates.

Division I would also create a new program, the Pandemic Emergency Unemployment Extension Compensation, which would extend federal unemployment benefits by another 13 weeks to those who exhausted state or federal benefits. This, too, would expire on January 31, 2020.

Under the revised HEROES bill, Short Time Compensation (STC) programs, which a few states have established to pay employers for keeping employees with reduced hours, would also continue to receive funding through January 31, 2021. Some states had established STC programs prior to the pandemic, while others rolled out temporary programs. The revised HEROES Act would extend the full federal funding that the CARES Act provided for permanent STC programs, and half of the funding for temporary programs, until January 31, 2020.

Finally, the bill would boost the federal government’s food stamp benefit, Supplemental Nutrition Assistance Program (SNAP), by 15%, and increase the minimum monthly payment from $16 to $30 until September 30, 2021. It would exempt those receiving SNAP payments from mandatory work requirements for one year; the HEROES Act passed in May had a two-year exemption. The bill would appropriate $10 billion to the SNAP program to cover these benefits. Additionally, Pandemic Unemployment Compensation would not be regarded as income as it relates to SNAP benefit calculations. For comparison, the proposed HEALS Act would not increase SNAP benefits but would support the Temporary Assistance for Needy Families (TANF) program, which supplements the incomes of 1.1 million families.

Small Businesses
To small businesses, the HEROES Act looks substantially like the Republican HEALS Act. Both proposals would extend the Paycheck Protection Program (PPP), the $525 billion behemoth that issued 5.2 million loans between April and August 8. Both formulations would exclude publicly traded companies and nonprofits that engage in lobbying activities from securing loans. Both would concentrate eligibility in companies that have suffered year-on-year losses in revenue greater than 25% and that employ fewer than 200 employees. Both would also limit maximum loan sizes to $2 million. On other small business matters, the Democratic proposal agrees substantially with that of the Republicans in its treatments of the Emergency Injury Disaster Loans (EIDLs) and additional appropriations for Small Business Investment Companies (SBICs).

The revised HEROES bill would add $75 billion in appropriations to a revived PPP and introduce lending quotas to certain types of recipients and lenders (detailed in Table 2). The PPP finished with more than $133 billion remaining of the $649 billion Congress made available after expanding its budget.

To address these unused funds, the revised HEROES Act would also allow businesses that have already received PPP funds to apply for a second loan. These Priority PPP (P4) loans would concentrate aid in smaller recipients. Their maximum size would be $2 million; the Small Business Administration (SBA) reported that loans exceeding $2 million and $10 million composed just 0.6% of PPP loans, but 20.0% of funds (p. 6). The proposal would also narrow eligibility to firms with 200 or fewer employees, and to those that have suffered year-on-year revenue declines larger than 25%. This lost revenue threshold is less than the HEALS Act’s proposed 50% threshold for Second-Draw PPP Loans.

Table 2. Revised HEROES Act quotas for PPP funding.

<table>
<thead>
<tr>
<th>Quota</th>
<th>Borrower or lender requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>At least 10% of remaining CARES Act and future HEROES Act funding</td>
<td>Borrowers must have 10 or fewer employees, sole proprietors, and loans less than $250,000 to businesses in low- or moderate-income areas</td>
</tr>
<tr>
<td>Up to 30% of remaining CARES Act and future HEROES Act funding</td>
<td>Borrower must be non-profit organization, and is prohibited from lobbying activities</td>
</tr>
<tr>
<td>25% of remaining funding up to $15 billion</td>
<td>Lender must be Community Development Financial Institution (CDFI), Community Development Corporations (CDC), or Minority Depository Institution (MDI)</td>
</tr>
</tbody>
</table>

When Congress passed the CARES Act on March 27, it left the SBA with discretion in determining how to forgive loans. The SBA has changed its forgiveness guidance several times.
The Democrats’ proposal would address forgiveness with an approach similar to that of the Republicans. Forgiveness of smaller loans would rely on borrower self-certifications, while larger loans would require more pieces of evidence to establish compliance with PPP regulations; both would be subject to SBA audits, although a lack of documentation would likely constrain the capacities of federal auditors.

Last in small-business provisions, the revised HEROES Act would make significant changes to outstanding Economic Injury Disaster Loans (EIDLs). For non-COVID EIDLs, such as those made before February 15 or those extended to businesses harmed by the 2020 hurricane season, the SBA would cover the interest and principal payments for a 12-month period beginning at the borrower’s next due payment (p. 625). For COVID-related EIDLs, the proposal would allow borrowers to defer payments for up to four years and reduce interest rates.

**State, municipal, territorial, and tribal finance**

The HEROES Act revision makes its most significant cuts in state and municipal finances, an area which a Brookings Institution paper projects will encounter enormous shortfalls in the next few fiscal years. The first version of the HEROES Act allocated $915 billion to states, territories, and municipalities, and allowed funds to compensate for lost revenues as well as new expenses. City administrators took issue with the CARES Act’s $150 billion Coronavirus Relief Fund since it did not allow for funds to cover foregone revenues such as sales tax.

This revision would handle fiscal shortfalls in three ways. First, it appropriates $436 billion in grants to relief funds, cutting $479 billion from the bill passed in May. State, municipal, territorial, and tribal governments can draw from these funds to plug revenue gaps and finance unforeseen emergency and public health expenditures. Second, the proposal expands eligibility for the Municipal Lending Facility that the Federal Reserve and Treasury established under the CARES Act. Third, the bill includes funding for a number of infrastructure programs that would traditionally be the responsibility of states and municipalities, such as a proposal for $2.6 billion in competitive grants to Rural Electrification Act electric and telecom borrowers to continue providing utility services to rural households.

The revised HEROES Act would create two new Coronavirus Relief Funds that transfer monies to states and localities. The House Appropriations Committee provides a succinct breakdown of how such monies would be allocated:

- States and the District of Columbia - $238 billion based on a state’s share of unemployed workers
- Local governments - $179 billion, evenly divided between municipalities and counties
- $89.5 billion to municipalities using a modified CDBG [Community Development Block Grant] formula;
- $62.65 billion for entitlement municipalities (generally defined as those with populations of at least 50,000);
• $26.85 billion for non-entitlement municipalities (generally defined as those with populations of less than 50,000). These funds will be awarded to states, which must make awards to non-entitlement cities based solely on population within 30 days of receipt;

• $89.5 billion to counties based on population.

Other territories of the United States collectively would receive $9.5 billion, as would tribal governments.

The revised HEROES bill would also expand the Municipal Lending Facility (MLF), which the Federal Reserve created in April to purchase loans directly from states and municipalities. The Federal Reserve Bank of New York, which administers the program, has expanded the eligibility criteria for the program multiple times, but has only purchased the debts of two issuers. The revised HEROES bill would widen eligibility to all US territories and to any political subdivision with a population greater than 50,000. It would also address the broadest critique of the MLF—that it lends to municipalities at a penalty rate against equally creditworthy companies—by setting the interest rate at which states borrow equal to the Federal funds rate. Last, the proposal directs the Federal Reserve to purchase debt with maturities of up to 10 years, compared to the current maximum maturity of 36 months.

Agriculture and Nutrition

Division N of the revised HEROES Act would provide significant assistance to agricultural producers. The bill would allocate:

• $1.5 billion to assist contract producers of poultry and livestock that suffered from a decline in revenue as a result of COVID-19 (this was not included in the previous HEROES Act);

• $500 million in direct payments to dairy producers for donations of dairy products to nonprofit organizations such as food banks (the same level of funding as the previous bill);

• $500 million in recourse loans from the USDA to purchase dairy processors, packagers, and merchandizers (the same level of funding as the previous bill);

• $500 million in grants to support specialty crop farmers (compared to $100 million in the previous bill);

• $350 million in assistance to local farmers and farmers markets (compared to $50 million in the previous bill),

• $84 million to support existing farm stress programs operated by state departments of agriculture (compared to $28 million in the previous bill).

Housing
The revised HEROES Act would allocate $50 billion for emergency rental assistance grants under the Emergency Solutions Grants Program, a reduction from the previous HEROES Act allocation of $100 billion. These funds would provide short- or medium-term support to individuals at risk of homelessness. The revised HEROES Act would mandate that indigenous tribes and tribally designated housing entities receive two percent of the funds ($1 billion), while the Virgin Islands, Guam, American Samoa, and the Northern Mariana Islands would be allocated 0.3% ($150 million).

The HEROES Act would establish the Homeowner Assistance Fund, which would provide $21 billion in assistance to homeowners in order to avoid defaults, foreclosures, and displacements. This is a reduction in funding from the initial $75 billion allocation in the previous HEROES Act. Each state must receive at least $80 million according to a provision supporting smaller states. Responsibility for distributing funds would lie with state housing finance agencies, which would submit assistance plans to the Treasury for approval prior to disbursement. At least 60% of funds provided to states would go to homeowners with incomes equal or less than 80% of the area median income.

The revised HEROES Act would eliminate the $3 billion for the Housing Choice Voucher Program, $2 billion for the public housing operations fund, $309 million for rural rental assistance, and $100 million for housing counseling services that the initial HEROES Act included.

The revised HEROES Act would expand the eviction and foreclosure moratoria of the CARES Act. While only federally owned or -backed properties were eligible under the CARES Act, the revised HEROES Act would protect all mortgage holders and renters. The bill proposes a twelve-month eviction moratorium on all properties; that would extend past the current Centers for Disease Control eviction moratorium, which expires December 31, 2020. Additionally, the revised HEROES Act contains a six-month foreclosure moratorium for all properties. This bill further states that repossession of personal property used as a dwelling, such as a motor vehicle, is not permitted for six months as well.

Homeowners would be eligible for up to a 12-month forbearance period on their mortgage payments. While homeowners still typically need to request said forbearance, the revised HEROES Act proposes that homeowners who have become 60 days delinquent since the COVID-19 pandemic automatically would receive a 60-day forbearance with two potential extensions of 120 days. The HEROES Act also would mandate that servicers provide homeowners with loan repayment options at the end of a forbearance period rather than require a lump-sum payment, which was not addressed in the CARES Act.

While the CARES Act contained several protections pertaining to homeowners and tenants, it did not provide support to mortgage servicers, or Fannie Mae and Freddie Mac (the government-sponsored enterprises, or GSEs). Servicers are currently required to advance four months of payments to the GSEs for mortgages that are in forbearance, which could potentially cause liquidity problems. The revised HEROES Act would require the Federal Reserve to specifically
ensure that mortgage servicers are able to participate in the Main Street Lending Program, which was created by Section 4003 of the CARES Act. However, funds obtained from this facility would require servicers to demonstrate that they are properly informing consumers of their rights to payment forbearance, which was not previously required. Additionally, the revised HEROES Act would mandate that the GSEs cannot reject the purchase of single-family mortgage loans simply due to the use of forbearance as a result of COVID-19.

The bill would authorize $500 million in funding for senior and disabled resident communities. Of those funds, $200 million would go toward rental assistance and hiring additional staff, as well as providing personal protective equipment. The remaining $300 million would be disbursed as grants to provide service coordinators with the proper funding to respond to and prevent further COVID-19 outbreaks. This overall allocation of funds is consistent with the prior HEROES Act.

The revised HEROES Act would allocate $5 billion for the Emergency Solutions Grant program, which provides assistance for individuals experiencing homelessness. The funds could be used on infectious disease training, hazard pay for staff working directly to prevent the spread of COVID-19 and providing a hotel or motel voucher for a homeless individual or family. The original HEROES Act would have provided $11.5 billion for this assistance.

**Credit Reporting and Debt Collection**

The revised HEROES Act would suspend negative credit reporting and consumer debt collection during the COVID-19 pandemic and the 120 days following the end of the state of emergency. Additionally, credit agencies would not be allowed to implement any new statistical models that lower the credit scores of existing consumers. Additionally, the bill would permanently ban all medical debt arising from COVID-19 from being included in credit reports. Since the moratorium on consumer debt collection will likely cause liquidity problems for debt collectors, the HEROES Act would require the Federal Reserve to establish a credit facility for the collectors to obtain long-term, low-cost loans that do not need to be repaid until after the moratorium expires.

The revised HEROES Act (Title V, Division O) extends further student loan forbearance provisions to private student loan borrowers until February 2021. Additionally, the Treasury Department would receive $5 billion to forgive up to $10,000 in student loan debt for economically distressed private student loan borrowers, which is less than the allocation of $45 billion in the initial HEROES Act.

**Lending Institutions**

The revised HEROES Act (Title VI, Division O) would require the Federal Reserve to adjust requirements in the Main Street Lending Program (MSLP). The Fed did not make the program available to nonprofit borrowers until September 4, months after the initial announcement. The revised HEROES Act would require the Federal Reserve to immediately provide a low-cost loan option specifically tailored for nonprofit borrowers, with the option to defer repayment without
capitalization of interest. There would also be a loan option for small businesses, small nonprofits, and small public universities that would not have a minimum loan size, rather than the current $250,000 floor. Additionally, this Title would extend the maturity of loans made under the MSLP from five years to no less than seven.

The revised HEROES Act would codify the Minority Business Development Agency (MBDA) into an independent federal organization, instead of under the Department of Commerce. The bill would also allocate $3 billion to the MBDA to provide grants to minority-owned businesses. The funds would target businesses that were unable to participate in PPP or that operate in low-income areas. The bill would allow the Secretary of Commerce, or the MBDA if it is codified into an independent organization, significant leeway in deciding how exactly to distribute the funds and to whom. This was not included in the initial HEROES Act.

The proposed bill also dedicates significant funds to community financial institutions. The revised HEROES Act would require the Treasury Department to use $13 billion to create the Neighborhood Capital Investment Program, which would provide investments to minority depository institutions (MDIs) and community development financial institutions (CDFIs). These funds would come with restrictions on predatory lending, executive compensation, and share buybacks. The HEROES Act would also allocate $2 billion to the Community Development Institutions Fund, to increase investments in minority communities.

Restaurants and Airlines

The revised HEROES Act would provide $120 billion to the Restaurant Revitalization Fund, a new fund that would distribute grants to non-chain restaurants with less than 20 locations. These grants would target payroll costs, rent, mortgage obligations, utilities, and other expenses. Grants would be calculated by the difference in revenues during each calendar quarter in 2020 and 2019, as well as additional payments to account for paid sick leave. If a grant is provided based on estimated income that turns out to be less than actual income, then that amount of the difference would be converted into a loan with an interest rate of one percent and a maturity date of 10 years. The same loan conditions would apply for any funds that go unused by a restaurant. This program was not included in the previous HEROES Act.

The revised HEROES Act would extend the Payroll Support Program for a total of $28.3 billion. This would directly benefit air carriers ($25 billion), cargo air carriers ($300 million) and airline contractors ($3 billion). These funds could be used by companies to continue paying wages and salaries. As a condition of receiving these funds, companies would commit not to undertake involuntary furloughs of staff or cut salaries. They would also face limits on executive compensation until March 31, 2021. In most cases, applicants for HEROES Act funds would receive the same amount as they would under the CARES Act. Additionally, the HEROES Act proposes $13.5 billion of grants-in-aid to airports. At least 25% of the funds provided to an airport must be allocated to airport restaurants and retailers. Aid at this level was not included in the initial HEROES Act.
The recent negotiations between Secretary Mnuchin and Speaker Pelosi come at a time when the recovery appears to be slowing. Several major airlines have announced plans to furlough tens of thousands of workers and unemployment claims were up slightly in August. Although many legislators disagree, Mnuchin and notably Federal Reserve Chair Jerome H. Powell, have consistently argued that more stimulus is needed.
Congress Passes Additional $908 Billion Stimulus Bill

By Sean Fulmer

Original post here.

Both houses of Congress quickly passed a new coronavirus-related economic relief package with widespread bipartisan support in the late hours of December 21. The new stimulus legislation, estimated at $908 billion, includes further funds for the Paycheck Protection Program and other small business relief, another round of direct payments to households, extended unemployment benefits, and further support for airlines.

As vaccines for COVID-19 receive emergency-use authorization and begin distribution, Congressional negotiations focused on temporarily supporting the economy, without extending beyond a few months in the hopes that vaccinations will bring a quick end to widespread lockdowns. While the legislation passed with overwhelming bipartisan approval and the endorsement of President-Elect Joe Biden, many legislators said that this bill will not be enough to sustain the economy through a successful vaccination rollout.

### Major Provisions

<table>
<thead>
<tr>
<th></th>
<th>Cost Estimates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paycheck Protection Program</td>
<td>$284 billion</td>
</tr>
<tr>
<td>Direct Payments</td>
<td>$166 billion</td>
</tr>
<tr>
<td>Extended Unemployment Benefits</td>
<td>$120 billion</td>
</tr>
<tr>
<td>Education</td>
<td>$82 billion</td>
</tr>
<tr>
<td>Health Care</td>
<td>$63 billion</td>
</tr>
<tr>
<td>Nutrition and Agriculture Programs</td>
<td>$26 billion</td>
</tr>
<tr>
<td>Rental Assistance</td>
<td>$25 billion</td>
</tr>
<tr>
<td>Payroll Support Program for Aviation Workers</td>
<td>$16 billion</td>
</tr>
<tr>
<td>Emergency Grants to Performance Venues</td>
<td>$15 billion</td>
</tr>
</tbody>
</table>

The bill also closes all Treasury-supported liquidity facilities that the Federal Reserve established under the authority of the Coronavirus Aid, Relief, and Economic Security (CARES) Act. See the forthcoming YPFS blog post for further detail on this.

Paycheck Protection Program

The bill provides $284 billion for a second round of Paycheck Protection Program (PPP) loans. This program, which aimed to provide partially forgivable loans to small and medium-sized
businesses, was one of the largest and most used programs under the CARES Act. It has also faced some controversy about whether the funds were going to those most in need.

Under the new legislation, PPP loans will be available to eligible entities that have less than 300 employees and experienced a decline in gross receipts of at least 25% during any quarter of 2020 compared to the same period in 2019. The maximum loan offered would be the lesser of either $2 million or 2.5 times average monthly payroll costs. These are more stringent terms than the original PPP program, which had an employee cap of 500 and a maximum loan size of $10 million or 2.5 times average monthly payroll. The legislation raises the loan cap to 3.5 times monthly payroll costs for food service and accommodation companies (those with a NAICS code beginning with 72).

The Treasury will fully forgive PPP loans if businesses spend at least 60% of the funds on payroll during the covered period, which is either eight or 24 weeks (chosen by the recipient). This second round of PPP will utilize a simplified one-page loan forgiveness application for loans under $150,000, with businesses simply listing the loan amount, number of employees, and estimated total payroll. Banks can execute PPP loans until March 31, 2021, but it is currently unclear if there will be an earlier application deadline.

The stimulus package retroactively allows business owners to deduct for tax purposes the entirety of their PPP loans, which are not considered taxable income. This deduction has no guardrails or qualifiers. Secretary Mnuchin and the Internal Revenue Service argued prior to the release of the legislation that PPP loans should not be deducted, with Secretary Mnuchin terming it “double-dipping.” This provision potentially allows some business owners to claim a negative tax rate on their PPP loans. One economist estimated the cost to the government of those tax write-offs will be $200 billion or more. This price tag is not included in the Congressional estimate of the overall cost of the stimulus package, since it is a retroactive addition to the CARES Act and thus, not a new tax break.

The legislation widens eligibility for the PPP program to include hospitals, small news organizations, 501(c)(6) nonprofits, and others. 501(c)(6) nonprofits are only eligible if they spent less than $1 million on lobbying expenses in the most recent tax year. The bill also adds PPE expenses, outdoor dining costs, and supplier costs to the list of eligible and forgivable expenses.

The legislation grants $20 billion for Economic Injury Disaster Loans (EIDL). Under the CARES Act, entities that received an EIDL grant would have that grant deducted from their PPP forgiveness amount; the new legislation repeals that provision. Additionally, the legislation tweaks bankruptcy provisions to allow businesses in Chapter 11 to borrow PPP loans.

Direct Payments to Households

Congressional Democrats estimate that direct payments to households in the new legislation will cost $166 billion. Eligible households will receive $600 for each adult and $600 for every dependent under the age of 17, a change from the payments of $1,200 and $500, respectively,
provided by the CARES Act. The payments are based on 2019 income. Those with “individual” filing status and “married filing jointly” status are eligible for the maximum payment if their adjusted gross income (AGI) is $75,000 or less for individuals and $150,000 for married couples. For households with higher incomes, the payment amount will slowly phase out at the same 5% rate as under the CARES Act. For example, individual filers with AGI up to $87,000 would receive some payment. Despite previous inclusion in negotiations, adult dependents are not eligible to receive a direct payment.

The CARES Act blocked mixed-status households, in which some persons in the household do not have a Social Security number, from receiving any direct payment. However, the new legislation removes that restriction retroactively, allowing mixed-status households to receive direct payments based on their eligible members. This provision still excludes households with children who are US citizens but parents who both lack Social Security numbers.

Banks are legally prohibited from garnishing these direct payments in order to pay for pre-existing debts. Such a prohibition was not included in the CARES Act.

Treasury Secretary Steven Mnuchin said that he expected the direct deposits would reach households faster than the first iteration of the CARES Act, possibly before the end of 2020—“This is a very, very fast way of getting money into the economy.” The deadline for the delivery of payments is January 15, 2021. If an eligible household receives an incorrect payment or does not receive a payment, they can claim this error in their 2020 tax filings; a similar mechanism applies to CARES Act payments.

Extended Unemployment Benefits

The stimulus package allocates $284 billion toward extending and increasing unemployment benefits. The legislation extends the current temporary unemployment programs, including Pandemic Unemployment Assistance (PUA) and Pandemic Emergency Unemployment Compensation (PEUC), for an additional 11 weeks, until March 14, 2021. The PUA program provides benefits to eligible individuals usually excluded from regular unemployment insurance (UI), such as gig workers and self-employed workers. The PEUC program provides an extension of benefits for individuals who have exhausted their regular UI.

If an individual has not used up their maximum number of weeks for PUA or PEUC benefits by March 14, they are eligible to receive benefits until April 4. However, no new applications for benefits will be accepted after March 14.

Benefits under all federal unemployment programs will increase by $300 per week through April 4, which is half of the $600 per week addition to unemployment included in the CARES Act. The legislation did not make this enhancement retroactive, even though the enhanced CARES Act benefits ended in the summer.
Federal Unemployment Benefit Program  Continuing Claims  Estimated Average Benefit of Legislation (over the entirety of the benefit)
PUA  9.2 million  $6,230
PEUC  4.8 million  $7,400
Total UI  20.6 million  n/a

Source: Department of Labor and Century Foundation

The bill introduces reporting requirements for applicants to unemployment programs. Continuing claimants of PUA have 90 days after enactment to submit prior employment or self-employment documentation to state unemployment offices in order to remain eligible for the benefit. Previous PUA payments cannot be clawed back for a failure to submit documentation. New claimants who apply on or after January 31 only have 21 days to submit the documentation. Under the CARES Act, applicants for PUA previously only needed to submit a written attestation. This will likely cause a significant administrative burden on the states' unemployment offices, since there are about nine million continuing claims under PUA.

States must include return-to-work reporting as a result of the new legislation. This is expected to be in the form of a hotline that employers can use to notify state agencies that an individual receiving UI rejected an employment offer. This must be set up within 30 days of the enactment of the legislation.

Mixed earners, those with both employed and self-employment income, previously received a regular UI benefit that did not consider their self-employment income and were not eligible to claim both regular unemployment and PUA. The new legislation creates the option for states to provide a $100 benefit to these mixed earners in addition to their regular UI and the $300 additional benefit. This enhanced benefit applies to mixed earners with at least $5,000 in 1099 income. States do not have to provide the $100 benefit.

Rental Assistance and Eviction Moratorium

The bill contains $25 billion for rental assistance, a benefit that has been much debated over recent months as tens of millions missed rental payments without a clear end plan to avoid balloon payments and mass evictions. Prior to the passage of the new stimulus package, housing advocates called for at least $100 billion in rental assistance.

The assistance will be distributed to states based on a population-weighted formula. At least 90% of the funds must go toward directly paying individuals’ rent, rental arrears, utilities, utilities arrears and other expenses related to COVID-19. This aid should not last longer than a year, unless an extra three-month transitional period is needed to ensure housing stability. The aid should go directly from the state or locality to the landlord or utility company. Landlords can help a tenant apply for this aid or apply on their behalf, with the consent of the tenant.
Eligible households must meet one of the following requirements: qualify for UI benefits, experience a reduction in income due to COVID-19, be at risk of homelessness, or have a household income less than 80% of the area median income. The Secretary of Housing and Urban Development should reclaim unused funds on September 30, 2021, and reallocate them to grantees that have used at least 65% of their original funds.

The law also extends the Centers for Disease Control eviction moratorium, due to expire at the end of the year, until January 31, 2021, without any further changes to the composition of the order. This allows President-Elect Biden to extend the moratorium further once he takes office, without an interruption in protections. Additionally, the bill includes protections for those in arrears on their utilities payments, as long as they provide partial payment, which would limit utility shutoffs.

The bill introduces some minor alterations to the residential mortgage market. First, Chapter 13 debtors who have missed three monthly payments on a residential mortgage can still have their debt discharged, if the missed payments result from a financial hardship caused by COVID-19. Second, the legislation establishes a formal process for mortgage servicers to file forbearance proofs of claims received as a result of the CARES Act, which fixes an issue caused by the original CARES Act. However, the new bill does not provide any further relief, such as additional forbearance or foreclosure moratoriums, beyond the original CARES Act provisions.

Airlines

Although the CARES Act had allotted specific funding to support retention of aviation industry employees since March, the airlines experienced unprecedented decreases in ridership and several furloughed tens of thousands of employees when the funds ran out. The new legislation allocates $16 billion in payroll support to aviation companies, of which passenger air carriers will receive $15 billion. These funds shall “exclusively be used for the continuation of payment of employee wages, salaries, and benefits” to aviation employees. Aviation companies that already received CARES Act funds through the Payroll Support Program must recall within 72 hours any employees furloughed between October 1 (when previous aid and protections ran out) and the execution of an agreement in order to qualify for further funds. Employers are required to pay recalled employees missed pay and benefits for the period from December 1 until the execution of an agreement.

If an airline did not receive CARES Act funding and wishes to apply for new funding, they must recall all employees furloughed since March 27 within 72 hours of executing an agreement for new funding. They must also pay back pay and benefits from December 1 until the execution of an agreement. In the future, any recipients of new funds must refrain from involuntarily furloughing employees or cutting wages until March 31, 2021. Passenger air carriers receiving government funds under this legislation will not be allowed to pay dividends or pursue buybacks until March 31, 2022. Airlines expect to receive these new funds within 10 days of the bill signing.
In addition to the funds for airlines, the legislation appropriates $2 billion for airports, $14 billion for transit, $10 billion for state highways, $1 billion for Amtrak, and $2 billion for private bus companies. These funds primarily go to covering payroll costs and ensuring no declines in service quality.

**Miscellaneous Provisions**

The bill provides $15 billion in emergency grants to closed venues, such as theaters, museums, and concert halls. These businesses were hit severely by lockdown orders that forbid large gatherings. Entities are eligible if the venue operator has suffered a decline in gross earned revenue of at least 25% in any quarter of 2020 compared to the same period in the previous year. The legislation establishes two priority periods for disbursement of grants. During the first 14-day period, initial grants can only be made to entities that have revenues from April to December 2020 of less than 10% of the same 2019 level. The second 14-day period is open to entities that have revenues of less than 30% of the same 2019 level. After the priority periods, grants can be provided to any eligible entity. The bill dedicates $2 billion of the overall amount to venues with under 50 full-time employees.

Within the $26 billion allocated to nutrition and agriculture, $13 billion goes toward funding an increase in Supplemental Nutrition Assistance Program (SNAP) benefits. The value of SNAP benefits increases to 15% higher than the June 2020 value of the thrifty food plan, the baseline food basket for calculating SNAP benefits, and lasts from January 1, 2021 until June 30, 2021. In addition to this increased benefit, the legislation considers children under the age of six to count as eligible household members for benefit calculations, which means that those households would receive an entire extra allocation of benefits. Federal unemployment benefits are not considered income as it relates to SNAP income eligibility. The legislation further appropriates $12 billion to agricultural producers, on top of an already historic $46 billion that the federal government has funneled into the agricultural sector in 2020.

Recent reports showed that state and local governments faced a time crunch to spend their allocated funds before the initial CARES Act deadline of December 31, 2020, as bureaucratic delays restricted their timelines. The new bill extends the deadline for a year, until December 31, 2021, allowing states and localities greater flexibility to spend and develop assistance programs.

The relief package also includes a controversial provision championed by President Trump that allows entities to deduct 100% of the cost of business meals, an increase from the current 50%. Opponents argued that it would promote inside dining at a time when the pandemic is still not under control. The provision states that it applies until 2023 and applies to “food or beverages provided by a restaurant.” The Joint Committee on Taxation scored this provision at $6.3 billion in foregone revenue.

The package includes $69 billion for vaccines, testing, contact tracing, community health and health care provider support. The legislation allocates $12 billion for Community Development Financial Institutions and $82 billion for education, with a similar distribution as the CARES
Act. The bill writes off the $10 billion loan provided to the Postal Service through the CARES Act.

**Notable Omissions**

The stimulus package notably does not include two of the most controversial proposals: [unconditional aid to state and local governments](#) and [liability protections for businesses](#). Democrats dropped their request for further relief for state and local governments, which have lost 1.3 million jobs since the beginning of the pandemic. States and localities will still receive aid for less fungible purposes, such as vaccine distribution, education, and nutrition. In return, the Republicans shelved their proposed liability shield, which would have limited the ability of consumers and employees to bring COVID-related lawsuits against businesses.
European Commission gives tentative support for “network” of public asset management companies

By Alexander Nye

Original post here.

On December 16, the European Commission (EC) announced its support for the creation of a network of national asset management companies (AMCs) (also known as “bad banks”) and encouraged Member States to create AMCs. Such institutions would acquire and manage non-performing assets (NPAs) from the balance sheets of lenders in their home countries. Assuming participating lenders can withstand the losses associated with selling these NPAs, this could free up space for new loans and ultimately bolster profitability. European banks have had profitability problems since the Global Financial Crisis. The Wall Street Journal recently wrote that the proposal shows that “Officials are publicly acknowledging a key lesson from the 2008 crisis: Fast balance-sheet cleanup helped U.S. banks recover quickly, while European lenders struggled under a lingering hangover of bad loans.”

This comes as part of the EC’s action plan for “Tackling non-performing loans (NPLs) in the aftermath of the COVID-19 pandemic.” The action plan is made up of four goals:

1. Developing secondary markets for distressed assets
2. Harmonizing and benchmarking corporate insolvency and debt recovery law within the EU
3. Promoting the establishment of national AMCs
4. Facilitating precautionary public support measures under the EU’s state aid framework and Bank Recovery and Resolution Directive (BRRD)

The first two goals are in line with the EC’s agenda of the past few years. The EC has seen some progress on the first goal; it appears to have found a successful strategy in the securitization of NPLs. Commentators are less optimistic about the second goal. A recent article from Brugel, a European think tank, describes progress on the insolvency and debt recovery measures as either “very uneven” or “stuck in the inter-institutional process.” The policies related to this goal buck the trend that we have seen with COVID-19-era bankruptcy reforms, as their main focus is not on improving the lot of debtors.

The third part of the action plan describes how national AMCs are likely to benefit from their understanding of their domestic financial sectors, while sharing data via a European data hub and best practices as part of a network could create valuable synergies for AMCs across the EU. However, this would be contingent on whether enough countries actually establish national AMCs and on the extent to which those AMCs are similar to each other.
The action plan reflects the ongoing skepticism within the EC on the issue of an EU bad bank. Since March, European institutions have jostled over the issue of how to handle a surge of non-performing loans coming from the COVID-19 crisis. From spring through autumn 2020, various European policymakers argued over proposals for a pan-European asset management company or for various national asset management companies. A Q&A document accompanying the action plan remains skeptical of a pan-European AMC. It argues that the establishment costs would be large while the heterogeneous NPA portfolios and creditor-debtor laws among Member States would dampen the gains from scale that would come from an EU AMC.

The action plan’s theoretical support for a network of national AMCs (incorporating the ECB and the EBA) thus strikes a delicate compromise. The Governor of the Bank of Greece and the Chair of the ECB’s Supervisory Board pushed for an EU-wide AMC as the proper response to what might be a $1.7 trillion deluge of NPAs. These proposals come on the heels of an EU bad bank plan from the Chair of the ECB’s Supervisory Board drafted when he was an European Banking Authority (EBA) official, which was soundly rejected by eurocrats in 2017. However, the 2017 efforts did result in the publication of a detailed AMC blueprint. The new action plan refers to that blueprint; the network it proposes bears a striking resemblance to a section in the blueprint on “synergies and cooperation between AMCs.”

The action plan, as well as proposals for more national AMCs, have received criticism. Consumer advocates fear the sale of portfolios to “vulture funds” (a term for typically foreign hedge funds) that will aggressively enforce borrowers’ obligations. An EU banking lobby does not think that national bad banks would recover funds as efficiently as internal AMCs, that is, bad banks that are built out within existing financial institutions. Their criticism rests on the idea that the banks already owning these NPAs are more likely to understand their context and therefore are better able to maximize returns on them. Ireland, the home of one of the more notable European AMCs, the National Asset Management Agency (NAMA), also may be skeptical of more AMCs. An article in Ireland’s Independent.ie, notes that “the prospect of a new bad bank taking on small business or mortgage debt just as Nama is set to close is likely to be politically fraught.”

Alexander Lehhmann and Reiner Martin of Bruegel described several issues these AMCs will have to grapple with. First, the COVID-19 portfolio of NPAs is likely to be dominated by corporate loans rather than retail mortgages, unlike NPAs in the vast majority of EU Member States after the financial crisis. These loans are also more likely to be to companies that are ultimately viable, so restructuring rather than liquidation will probably be the best solution for them. Second, questions about loan valuation bogged down GFC-era AMCs’ efforts to acquire and restructure assets; this could prove deadly to the many businesses that are hanging on to viability by a thread in the case of COVID-19. The authors recommend that the EC “adopt and publish transparent and predictable valuation methodologies that reflect plausible scenarios for different sectors and asset types in the post-COVID-19 recovery.”

Finally, the EU’s state aid restrictions and banking directives put a limit on the amount of state support banks can receive by way of NPA purchases at above-market prices that more than
“make up for future likely losses in an adverse scenario” or by way of capital injections. This means that AMC operations may create large holes in bank balance sheets. Lehmann and Martin surmise that the uncertain economic conditions mean that the EC will likely have to clarify their state aid restrictions. This is where measures related to the fourth goal will be relevant.

Under the BRRD, banks that receive extraordinary public financial support must be declared failing or likely-to-fail, which triggers processes like bail-in, resolution, etc. The fourth goal articulates the EC’s position that governments should be able to circumvent these triggers during the COVID-19 crisis, so long as the bank being assisted is solvent. The exception comes under Article 32(4)(d) of the BRRD, which allows the “injection of own funds in or a purchase of capital instruments from a solvent institution to address a capital shortfall resulting from stress tests, asset quality reviews or equivalent exercises” without a failing or likely-to-fail declaration in cases where the measure “remedies, on a temporary basis, a serious disturbance in the economy of a Member State and preserves financial stability.” The action plan explicitly describes the COVID-19 crisis as one of those serious disturbances and states that the amount of support is to be determined using stress tests.
President-Elect Joe Biden Releases $1.9 Trillion American Rescue Plan

By Sean Fulmer

Original post here.

On January 14, President-elect Joseph Biden released a $1.9 trillion rescue plan that would provide significant assistance to individuals and families, states and localities, schools and universities, and small businesses. The proposal specifically calls for additional direct payments to households, a permanent increase of the federal minimum wage to $15 an hour, extended unemployment insurance benefits, tax relief for households, $350 billion in state and local government aid, $170 billion to schools and universities, $70 billion for COVID testing and vaccine program, and $50 billion for small businesses.

This package expands on the recent $908 billion relief package, passed in December, and the $2.3 trillion Coronavirus Aid, Relief, and Economic Security (CARES) Act, passed in March. The Biden plan is different in that it includes not just short-term “rescue” measures but also longer-term “recovery” initiatives. However, those longer-term initiatives, such as the proposed $15 federal minimum wage, are likely to be open to more debate.

And even though Democrats will control the Senate, House, and Presidency after the inauguration, certain provisions in the Biden proposal are unlikely to pass with a simple majority and will require at least 60 votes in the Senate. See Conclusions below.

While President-elect Biden hopes to achieve bipartisan support for the bill, some of its longer-term provisions could be removed to allow Congress to pass a still sizable rescue plan through budget reconciliation, a process that allows bills focused on spending and revenue to pass the Senate with only a simple majority. The latter path seems more likely, considering the immediate pushback from Senate Republicans.

The proposal does not state a cost estimate for every category of assistance, but the nonpartisan Committee for a Responsible Federal Budget has compiled the following list.

<table>
<thead>
<tr>
<th>Provision</th>
<th>Deficit Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provide $1,400 per person “Recovery Rebates” on top of the $600 already issued</td>
<td>$465 billion</td>
</tr>
<tr>
<td>Provide aid to state and local governments</td>
<td>$350 billion</td>
</tr>
<tr>
<td>Increase Unemployment Insurance supplement to $400/week and extend emergency UI provisions through September</td>
<td>~$350 billion</td>
</tr>
<tr>
<td>Description</td>
<td>Cost</td>
</tr>
<tr>
<td>----------------------------------------------------------------------------</td>
<td>----------</td>
</tr>
<tr>
<td>Provide funding for a national vaccination program, testing, and other COVID containment efforts</td>
<td>$160 billion</td>
</tr>
<tr>
<td>Fund school reopening and increase funding to schools and colleges</td>
<td>$170 billion</td>
</tr>
<tr>
<td>Expand the Child Tax Credit to a refundable $3,000 per child, $3,600 for children under 6 (assuming one year)</td>
<td>~$120 billion</td>
</tr>
<tr>
<td>Provide rental and small landlord support</td>
<td>$30 billion</td>
</tr>
<tr>
<td>Provide support to childcare providers</td>
<td>$25 billion</td>
</tr>
<tr>
<td>Other policy changes</td>
<td>~$200 billion</td>
</tr>
<tr>
<td><strong>Total Reported Cost</strong></td>
<td><strong>$1.9 trillion</strong></td>
</tr>
</tbody>
</table>

Source: [Committee for a Responsible Federal Budget](https://crfb.org)

**Benefits for Individuals and Families**

The proposal provides several direct and indirect benefits to families and households, many who have been struggling through the pandemic due to unemployment or other unexpected costs. Notably, the proposal would provide perhaps the most significant benefits to low-income families who many believe are suffering the most.

**Direct Payments**

The proposed package would provide households authorized to receive a $600 payment per eligible adult and child dependent under the December relief bill an additional payment of $1,400. The payments would likely cost $465 billion. The $600 direct payments authorized in the December relief bill were the subject of much debate and the President delayed signing the bill, arguing that the payments should be $2,000 per individual. The payments began to reach the bank accounts of eligible individuals prior to year-end. The additional payments in the Biden proposal are intended to reach that $2,000 amount for many households.

Under the Biden plan, as under the December relief bill, eligible households may receive up to the maximum payment if they meet certain income criteria. Households with “individual” filing status and “married filing jointly” status are eligible for the maximum payment of $1,400 per individual if their adjusted gross income (AGI) is $75,000 or less for individuals, and $150,000 or less for married couples. AGI calculations are based on 2019 income.

Also similar to the December payments, payments under the Biden plan decreases proportionally as incomes rise. However, Biden’s plan phases out at higher income levels than the December relief bill. Payment eligibility phases out at an AGI of $115,000 for individuals (compared with
$87,000 under the December bill); $206,000 for married couples filing jointly ($174,000); and $262,000 for families of four ($198,000).

<table>
<thead>
<tr>
<th>Category</th>
<th>December Relief Package</th>
<th>Biden Proposal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Max payment/individual</td>
<td>Top AIG for maximum payment</td>
<td>AIG at which payment eligibility phases out</td>
</tr>
<tr>
<td>Individual</td>
<td>$600</td>
<td>$75,000</td>
</tr>
<tr>
<td>Married filing Jointly</td>
<td>$600</td>
<td>$150,000</td>
</tr>
<tr>
<td>Family of 4</td>
<td>$600</td>
<td>$150,000</td>
</tr>
</tbody>
</table>

Source: [Yahoo Finance](https://finance.yahoo.com)

The Biden proposal also widens the eligibility for payments to include certain dependents if their household’s AGI qualifies for the direct payments. The proposal would extend eligibility to 17- and 18-year olds, college students, and adult children with serious disabilities. This group was similarly not eligible for the $1,200 direct payments included in the CARES Act. It does not appear that this inclusion of adult dependents would be retroactive to the earlier rounds of direct payments.

The higher phaseout threshold, as well as including adult dependents, significantly increases the number of recipients that would receive direct payments. Ernie Tedeschi, an economist and former Treasury Department official, estimates that an additional 8.8 million individuals would receive a direct payment as a result of this proposal.

**Unemployment Insurance**

The most recent Labor Department jobs report showed 965,000 new unemployment claims in the first week of January, the largest increase since the beginning of the pandemic. The overall number of people unemployed according to the report is approximately 18.4 million. However, state officials note that this number is likely to be inflated due to administrative and logistical issues.

The December relief package extended $300 per week in enhanced unemployment insurance (UI) benefits through March 14, 2021; the CARES Act had provided an additional $600 per week to those eligible for their state’s UI. The Biden plan increases the weekly enhancement to $400 and extends the benefit through September 2021. This would apply both to individuals who have exhausted their regular state UI benefits and moved onto Pandemic Emergency
Unemployment Compensation, as well as to self-employed and gig workers who are eligible for Pandemic Unemployment Assistance.

Senator Ron Wyden (D-OR) had publicly pressured Biden to restore the $600 per week enhanced benefit included in the CARES Act. Senator Wyden additionally pushed for the inclusion of automatic stabilizers, which would have tied the enhanced UI benefits to underlying economic conditions such as the unemployment rate. The Biden proposal does not include automatic stabilizers; it does say that the administration will work with Congress to consider including automatic stabilizers after September.

Emergency Paid Sick Leave
The Families First Coronavirus Response Act, passed in mid-March, required businesses with 50-500 employees to provide emergency paid leave for workers affected by the COVID-19 pandemic. While the December relief package extended the tax credits for employers who provided such leave through March 2021, it did not extend the requirement for eligible employers to provide the sick leave. The Biden plan would reinstate this requirement. It would also eliminate the workforce limitations, opening up the emergency sick leave program to an additional 106 million Americans.

The CARES Act required eligible companies to provide two weeks of paid sick leave and 12 weeks of paid family leave. The paid sick leave provided full wage replacement, while workers with paid family leave received two-thirds of their wages (up to a daily limit of $200). The Biden plan would instead require companies to provide 14 weeks of fully paid sick, family, and medical leave to help parents and those recovering from COVID-19 or self-isolating. The Biden proposal would also expand the program to federal workers.

The maximum sick leave benefit would be $1,400 a week for eligible employees, the equivalent of full wage replacement for a worker earning up to about $73,000 annually. The proposal would reimburse employers with less than 500 employees for the cost of leave through a refundable tax credit. State and local governments would be reimbursed for the costs of this program. Finally, the program would have an end date of September 30, 2021.

Tax Adjustments
The Biden plan would increase the Child Tax Credit (CTC) in 2021 for families from $2,000 per child to $3,000 per child ($3,600 for children under the age of 6) for a year. It would also make 17-year-olds qualify for the CTC for 2021.

The plan would also attempt to solve an irony under the CTC which results in families with the lowest incomes not being able to benefit from it. Currently, households are eligible to receive up to $2,000 for every child under the age of 17. The CTC is reduced proportionally by five percent of AGI over $200,000 for single parents and $400,000 for married couples. If the size of the CTC is greater than the taxes owed, the difference can be refunded to the household. The refund is limited to 15% of earnings above $2,500. However, the poorest households, those with under $2,500 in earnings, are not eligible for this refund, since they do not make enough to qualify for
the CTC. This phase-out at the low end of the income distribution and phase-out at the top of the distribution has been called the “trapezoid problem.” About 27 million children live in households with incomes too low to qualify for the full CTC benefit, with 25% of households in the lowest income quintile receiving no benefit at all.

Source: Tax Policy Center

The Biden plan would attempt to solve the trapezoid problem by allowing the lowest income households, who are currently shut out of CTC benefits, to receive the entire CTC as a refund. The Center on Budget and Policy Priorities estimates that this expansion of the CTC would bring three million Americans above the poverty line, while increasing the economic well-being of another 13.6 million people below the poverty line. However, the Biden plan only makes the CTC completely refundable for 2021, so it is unlikely to have a significant impact on poverty reduction in the long-term, but is intended to serve as emergency assistance during the current economic downturn. The Committee for a Responsible Federal Budget estimated that this adjustment to the CTC would cost $120 billion in 2021.

The Biden plan also calls for tax relief for low-income childless households. The proposal would raise the maximum Earned Income Tax Credit (EITC) for childless adults from $530 to approximately $1,500, raise the income limit from $16,000 to about $21,000, and eliminate the age cap so that older workers can receive the EITC. Currently, approximately 5.8 million Americans are either taxed into or pushed deeper into poverty since their EITC is not large enough to offset their owed taxes. A Center on Budget and Policy Priorities study earlier estimated that a plan similar to the Biden proposal would reduce the number of individuals so impacted by 96%, to 200,000 individuals. Like the CTC changes, this adjustment to the EITC would only apply for 2021.
Federal Minimum Wage
The Biden plan would permanently increase the federal minimum wage to $15 an hour, up from its current level of $7.25, as well as abolish the tipped minimum wage and sub-minimum wage available to people with disabilities. The increase would apply to all jobs and supersede any state laws that set lower minimum wages.

This provision is expected to be hotly contested. Some argue that Congress should not include it in the budget reconciliation process, since it does not directly affect spending or revenue. Supporters argue that it can be considered a revenue-raising measure: higher wages should cause higher tax receipts, as well as less strain on safety-net spending due to higher earnings. The incoming Majority Staff Director for the Senate Budget Committee, which will be chaired by Senator Bernie Sanders (I-VT), has stated that the committee can pass this provision through budget reconciliation.

Housing and Nutrition
The Biden plan would extend the current federal moratoriums on evictions and foreclosures, scheduled to expire at the end of January, until September 30, 2021. Additionally, the package would extend the application period for payment forbearance on federally guaranteed mortgages until September 30, 2021. The plan also calls for Congress to provide an unspecified amount of funds for legal assistance for tenants facing eviction or foreclosure proceedings.

The December relief package included $25 billion for rental assistance. The Biden plan would add $25 billion for rental assistance, as well as $5 billion to cover utilities costs. An estimated 14 million adults (20% of renters) were behind on their rent in December 2020. Households with children are also more likely to be behind on their rent than households without children. The package would also provide $5 billion in aid to provide housing for unhoused individuals. This would provide stable housing for an estimated 200,000 families.

The December relief package increased Supplemental Nutrition Assistance Program (SNAP) benefits by 15% until June 30, 2021. The Biden plan would extend this through September. For context, approximately 43 million people received SNAP benefits in August 2020, a 17% increase from pre-COVID participation.

State and Local Aid
The Biden plan calls for $350 billion in emergency funding for state, local and territorial governments. Congress debated this provision last year but it proved too politically divisive to be included in the December relief package. A Brookings Institution paper estimated that state and local governments faced a budget shortfall of $500 billion, spread over the next three fiscal years, due to the effects of COVID. The CARES Act and other relief bills have previously provided approximately $250 billion in funding to these governments.

The American Public Transit Association, an industry group, estimated that transit authorities would require $32 billion in aid to return to pre-COVID financial health. The Biden plan calls for $20 billion in funding for transit authorities, in addition to the $14 billion authorized by the December relief package.
Aid to Schools and Universities
The proposal calls for $170 billion in funding for K-12 schools and institutions of higher education, which is intended to allow them to reopen safely without cutting services to students. During the pandemic, educational institutions at all levels have had to spend unplanned amounts to protect faculty and students as they operate in a variety of open, closed, and hybrid conditions.

The Biden plan does not include any mention of potential student loan debt forgiveness or cancellation. President-elect Biden voiced support for the cancellation of $10,000 in student debt in November, stating that it should be done “immediately.” Advocates for cancellation representing 325 nonprofit and community organizations renewed calls for student loan forgiveness in response to the Biden plan.

Aid to Businesses
The Biden plan would provide $15 billion in grants to small businesses, building on the second round of the Payment Protection Program (PPP) implemented in the December relief package. The plan would also invest $35 billion into state, local, tribal, and non-profit small business financing programs, allowing for about $175 billion in additional lending to small businesses. Notably, aid to businesses only comprises about three percent of the overall cost of the Biden plan, as opposed to earlier relief packages and proposals which ranged from 20% to 30%.

The Biden plan would allocate significant resources to limit the spread of COVID-19 and safely reopening the economy. The proposal would allocate $20 billion toward a national vaccination program, focusing on bringing healthcare access to hard-to-reach areas. Additionally, $50 billion would go towards a widespread expansion of COVID-19 testing availability. The Biden plan would create a public health job program, aiming to employ up to 100,000 individuals to perform vaccine outreach and contact tracing.

Conclusions
With the CARES Act and the December relief, government spending to combat the effects of the pandemic totaled approximately $3 billion, significantly more than the $800 billion American Recovery and Reinvestment Act of 2009, the major stimulus legislation passed in response to the Global Financial Crisis. However, with the pandemic still raging and vaccinations just beginning, economists believe that more is needed to steer the nation to an economic rebound. The Biden proposal would add another $1.9 billion to the effort, but the next steps for the Biden proposal and its chances of passage are currently unclear. The impeachment of President Trump threatens to spill into the early weeks of the Biden presidency, which could impede the ability for Congress to quickly pass his proposal. Also, some parts of the proposal, such as the $15 federal minimum wage, can be viewed as longer-term policy and are likely to be subject to more contentious debate.

It is possible that Congress could reach bipartisan agreement for a smaller relief package, avoiding budget reconciliation, with a larger spending bill containing longer-term Democratic
priorities saved for later in 2021. Goldman Sachs predicted that near-term fiscal stimulus would be $1.1 trillion after Biden released the $1.9 trillion proposal, demonstrating a belief that the plan will be watered down. President-elect Biden said that he will unveil a second package in February, with a focus on longer-term recovery, rather than the emergency assistance-focused plan just released.

Budget Reconciliation

Even though Democrats will control the Senate, House, and Presidency after the inauguration, certain provisions in the Biden proposal are unlikely to pass with a simple majority and will require at least 60 votes in the Senate. Under Senate rules, invoking cloture to avoid a filibuster requires 60 votes. Another solution to a potential filibuster is a process called “budget reconciliation,” which allows bills focused on spending and revenue to pass the Senate with only a simple majority. Typically, Congress can only pass one bill per year through this measure. Due to a legislative quirk, there is the possibility that Democrats can pass two bills through budget reconciliation in 2021. The most recent usage of budget reconciliation was the Tax Cuts and Jobs Act of 2017.

The Byrd Rule limits the scope of provisions allowed in budget reconciliation bills. Any provision that is deemed “extraneous” can be stripped from the bill. This rule applies to provisions that are not related to spending, increase the deficit for a fiscal year after ten years, or affect Social Security. Due to this rule, Congress can not utilize budget reconciliation to pass measures like statehood for Washington, D.C., or further voting rights legislation. Some possible solutions to the Byrd Rule include allowing certain provisions to expire at the end of the 10-year window or pairing tax increases with spending provisions to maintain deficit-neutrality. The Senate Parliamentarian decides if a provision is “extraneous” and can order it stripped from the bill.
Congress Passes the $1.9 Trillion American Rescue Plan Act
By Sean Fulmer

Original post here.

On Thursday, President Biden signed the nearly $1.9 trillion American Rescue Plan (ARP) Act into law. The relief package contains additional direct payments to households, enhanced unemployment insurance benefits, tax relief for households, $350 billion in state and local government aid, and $170 billion to schools and universities.

The ARP Act expands on the recent $908 billion relief package, passed in December, and the $1.8 trillion Coronavirus Aid, Relief, and Economic Security (CARES) Act, passed in March. The ARP Act passed through Congress on a party-line vote using the budget reconciliation process.

<table>
<thead>
<tr>
<th>Major Provisions</th>
<th>Estimated Cost over Ten-Year Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Payments to Individuals</td>
<td>$410 billion</td>
</tr>
<tr>
<td>State and Local Aid</td>
<td>$350 billion</td>
</tr>
<tr>
<td>Enhanced Unemployment Insurance Benefits</td>
<td>$206 billion</td>
</tr>
<tr>
<td>Education</td>
<td>$170 billion</td>
</tr>
<tr>
<td>Fully Refundable Child Tax Credit</td>
<td>$110 billion</td>
</tr>
<tr>
<td>Housing Assistance</td>
<td>$27 billion</td>
</tr>
<tr>
<td>Earned Income Tax Credit</td>
<td>$25 billion</td>
</tr>
<tr>
<td>Federal Transit Administration</td>
<td>$30 billion</td>
</tr>
<tr>
<td>Aid for Restaurants and Bars</td>
<td>$25 billion</td>
</tr>
<tr>
<td>Payroll Support Program</td>
<td>$15 billion</td>
</tr>
<tr>
<td>Agricultural Assistance</td>
<td>$10 billion</td>
</tr>
</tbody>
</table>

Source: Congressional Budget Office and Joint Committee on Taxation

The Organisation for Economic Co-operation and Development (OECD) estimates that the ARP Act will increase GDP by 3–4% in the first year after passage, increasing its projected growth rate to 6.5% from the 3.2% included in its November report. Additionally, the ARP Act is expected to raise employment by nearly three million jobs by the end of 2021, while increasing inflation by just under one percent in the next two years. Internationally, the ARP Act is estimated to
increase GDP by 1% in Canada and Mexico, and 0.5% in the euro zone and China. In total, the OECD estimates that the ARP Act will increase global GDP by 1% in 2021.

The Tax Policy Center estimates that the ARP Act will increase the after-tax income of the lowest 20% of households by 20%. The top 20% of households in the income distribution will receive an increase in after-tax income of 0.7%, with the top 1% actually seeing a marginal decrease in income. In total, low-to-moderate income households (those with incomes below $91,000) will receive 75% of the tax benefits in the ARP Act. The Urban Institute estimates that the ARP Act will reduce poverty by over 33%, from 13.7% to 8.7%, as well as lessen the racial poverty gap.

Source: Tax Policy Center

Benefits for Individuals and Families

Direct Payments
The ARP Act provides a third round of direct payments - at $1,400 per person - to both adults and dependents at an aggregate cost of $410 billion, according to the Joint Committee on Taxation. Single filers with adjusted gross income (AGI) of up to $75,000, head-of-household filers with an AGI of up to $112,500, and joint filers with AGI of up to $150,000 will receive the full amount of the direct payments for each adult filer and each dependent claimed. Adult dependents, those over 16, were excluded in the previous rounds of direct payments, but are included in this round. Only individuals with a Social Security number are considered eligible for payments. Mixed-status families (those with some household members not having Social Security numbers) would receive payments with respect to those individuals who have social security numbers. Such families were not eligible for direct payments under the CARES Act, but became eligible after the December relief package.

The ARP Act changes the AGI-phase-out structure used with the first two stimulus payments. Payments now phase out over the $75,000-$80,000 range for single filers, the $112,500-$120,000 range for heads of households, and $150,000-$160,000 for married couples. The Joint Committee on Taxation calculated that this faster phase-out design will save approximately
$12 billion from the overall cost of the direct payments while the Institute on Taxation and Economic Policy estimated that 17 million people who would have been eligible under the earlier rounds would not receive checks as a result of this design change. The direct payments should begin arriving within two weeks after the legislation is signed into law by President Biden.

Unemployment Insurance
The Bureau of Labor Statistics estimated the unemployment rate in February at 6.2 percent, with 41.5 percent of the unemployed having a duration longer than 27 weeks between employment. Over 1.2 million workers filed initial claims for UI benefits during the week of March 6, marking the 51st week that total initial claims have been higher than the worst week of the Great Recession. About 20 million individuals filed continued unemployment insurance (UI) claims in the week ending on February 20.

The ARP Act extends the enhanced unemployment insurance benefits included in the December relief bill, which are set to lapse beginning on March 14. Individuals receiving UI benefits will receive an extra $300 per week until September 6 through the Federal Pandemic Unemployment Compensation program. Similarly, the Pandemic Unemployment Assistance (PUA) program (for individuals not eligible for regular UI benefits, such as self-employed or gig workers) and the Pandemic Emergency Unemployment Compensation (PEUC) program (for individuals that have exhausted their weeks of regular UI benefits) will be extended until September 6. Some Senate Democrats requested that the deadline be extended until October in order to avoid a UI benefit cliff occurring during the August congressional recess period. However, this did not achieve the full support of the caucus, so the extended UI benefits will expire during the recess period.

Different from most government cash transfers, UI benefits are currently considered taxable income. Federal law requires states to give beneficiaries the option of withholding 10% of UI benefits for federal income taxes, but some states did not offer that option to workers receiving CARES Act benefits. Also, some unemployed workers simply cannot afford to have 10% withheld from their benefits, according to a report by the Century Foundation, a progressive think tank. Overall, the Century Foundation estimated that almost 40% of UI payments have not had taxes withheld, possibly creating strains for beneficiaries when such taxes become due. However, the ARP Act will exempt up to $10,200 in unemployment benefits received in 2020 for families that make up to $150,000, which will help prevent surprise tax bills for almost 40 million Americans. At a tax rate of 10%, this would provide up to an additional $1,020 to unemployed workers.

The Internal Revenue Service (IRS) will need to reprogram its software in order to account for this new unemployment benefit exemption. This retroactive change could require a pause in tax filings, with the April 15 tax deadline quickly approaching. As a result of the COVID-19 pandemic, the IRS extended the tax filing deadline to July 15 in 2020, but it has not made a similar extension in 2021, despite congressional requests.
Temporary Child Tax Benefit Expansion

The ARP Act introduces an improvement to the Child Tax Credit (CTC), making it fully refundable for the vast majority of children for 2021. The Joint Committee on Taxation estimates that this provision will cost $110 billion over the next 10 years. Currently, 27 million children do not receive the full $2,000 CTC because their parents do not make enough to qualify for the full benefit, which is known as the “trapezoid problem;” this includes half of all Black, Latino, and rural children.

The ARP Act eliminates the trapezoid problem by removing a lower phase-in for the CTC credit. The ARP Act raises the income phase-out to start at $112,500 for single filers and $150,000 for married couples. The act also increases the CTC benefit to $3,000 per child and $3,600 for children under six years of age, and includes 17-year old dependent children in the benefit.

The ARP Act also directs that half of the CTC be paid out in advance payments on a “periodic” basis to eligible families from July to December 2021. Originally, this provision meant to read “monthly” basis, but arcane budget reconciliation requirements led to the change to “periodic.” The other half of the CTC benefit can be claimed by families when they file 2021 taxes.

Since the advance payments are disbursed based on the previous year’s tax filing status, some households could receive payments even though they are technically ineligible to receive the payments. This can occur if a child lived with one parent in 2019, but moved in with the other parent in 2020. This could result in the first parent receiving the advance CTC payments (rightfully due to the latter parent), but they would be required to repay the IRS for the benefits received when filing their 2021 taxes. This could affect up to three million children. The ARP Act fixes this potential issue by implementing a “safe harbor,” which exempts advance repayments for single filers with an AGI below $40,000 and joint filers with an AGI below $60,000. Above those thresholds, the safe harbor protection phases-out.

The Committee on Budget and Policy Priorities (CBPP) estimates these provisions will result in 4.1 million children raised out of poverty, a decline in child poverty of 40%, and 66 million children receiving a larger CTC benefit. Researchers at the Center on Poverty and Social Policy at Columbia University found that the fully refundable CTC would provide $800 billion in benefits to society, eight times the cost of the credit. However, this estimate assumes that the expanded CTC benefit would not be temporary, as currently planned, but become a permanent feature of the American social welfare system.

Earned Income Tax Credit

The Earned Income Tax Credit (EITC) largely excludes childless adults from receiving benefits, which taxes 5.8 million childless workers into poverty every year, according to the Center on Budget and Policy Priorities. The ARP Act expands the maximum EITC for childless adults from $530 to $1,500, and raises the income cap from $15,000 to $21,000. It also expands the age eligibility to include 19-24 year olds that are not full-time students, as well as people over 65. These changes are temporary and do not extend beyond 2021. This would benefit an estimated 17 million adults and cost approximately $25 billion.
Housing Assistance

The ARP Act allocates $27 billion towards emergency rental assistance and housing vouchers. This comes on the heels of a Consumer Financial Protection Bureau report that found that 8.8 million tenants were behind on their rent as of December 2020, with more than a quarter of tenants with incomes below $25,000 behind on rent. The outstanding payments on rent and utilities by the end of the 2020 totalled over $44 billion. The December relief package provided $25 billion towards rental assistance.

The funds in the ARP Act will be disbursed to state and local governments using the same methodology as the December relief package. Every state will receive a minimum of $152 million; the remaining funds will be distributed across states based on population. This formula resulted in less populous states receiving a much higher ratio of rental assistance to tenant size. For example, Wyoming received the largest amount of aid relative to the tenant population at $3,000 per tenant, while New York received under $400 per tenant, according to one analysis.

The ARP Act includes $10 billion for the establishment of the Homeowner Assistance Fund in the Treasury Department. The Homeowner Assistance Fund will provide states with funds that eligible single-family homeowners can use for mortgage payment assistance, principal and interest rate reductions, utilities payment assistance, and housing stability assistance. The purpose of the program is to limit delinquency, foreclosure and eviction. At least 60% of the funds allocated to states must be disbursed to homeowners with incomes lower than the median of their area or the United States, whichever is greater. Each state will receive at least $50 million, with the remaining funds allocated in proportion to each state’s unemployment rate and number of delinquent and foreclosed mortgages.

Multiemployer Pensions

Multiemployer pension plans provide retirement benefits according to a collective bargaining agreement between an employer and a union, across a single industry. Typically, these plans are found in the transportation, construction, and hospitality industries. Currently, over 10 million people are covered by multiemployer plans. Multiemployer plans were considered inherently more stable than single employer plans, due to the lesser risk that one failing employer could bankrupt the entire pension fund. As a result, multiemployer pensions have historically been underfunded compared to single employer plans.

The Pension Benefit Guaranty Corporation (PBGC), a government entity that backs multiemployer pensions, estimates that it will be insolvent by 2026, leaving retirees with little to no benefits from the pension fund. While the vast majority of the 1,400 multiemployer plans are healthy, there are 130 plans in significantly poor financial health, with 1.3 million individuals covered by these plans. The ARP Act would provide grants from the Treasury Department’s general fund to insolvent plans in return for a mandated reduction in benefits for participants. The CBO estimates that the relief to multiemployer pension plans will cost $83 billion over the next ten years, while keeping the PBGC solvent until the mid-2040s.
ACA subsidies
Under current law, subsidies are provided to individuals for health insurance plans purchased through the Affordable Care Act (ACA) marketplaces if the person has an AGI between 100%-400% of the federal poverty line (up to $51,500 for a single person). The ARP Act removes the upper income limit for subsidy eligibility and sets a cap on health insurance premiums at 8.5% of AGI for individuals in the newly expanded category. For a 64-year-old individual making $58,000, or 450% of the federal poverty line, her monthly premium would decrease from $1,075 to $412, saving her nearly $8,000 a year. These changes will allow 1.3 million uninsured people to access health insurance through the ACA marketplaces. These new requirements will last through the end of 2022 and will cost $34 billion.

Additionally, the ARP Act will increase federal medical assistance to states by $15.5 billion, in order to incentivize states to expand Medicaid. Thirty-seven states and the District of Columbia have already expanded Medicaid, with the ARP Act estimated to speed up expansion in holdout states by a full year.

State and Local Government Aid
The December stimulus package did not include aid to states and municipalities. The ARP Act provides $350 billion in such aid. Every state and Washington D.C. will receive at least $500 million with a further $169.8 billion split proportionally between the states and Washington, D.C., depending on each state's level of unemployed workers relative to the national unemployment level. This calculation will use the three-month period from October to December 2020. Under the CARES Act, Washington, D.C., was classified as a territory and did not receive the same level of aid as states, but the ARP Act makes it whole by providing an estimated extra $755 million. The funds received by states can only be used to respond to the pandemic and its negative economic impacts, in essence disallowing funds from being used to finance tax cuts.
Municipalities and counties will receive $130 billion in aid, with half being disbursed to cities through a modified Community Development Block Grant formula and the other half provided to counties based on population levels.

The total size of state and local government aid caused debate. The Committee for a Responsible Federal Budget noted that catastrophic revenue declines expected at the start of the pandemic never materialized, with some states even seeing a rise in revenue. On the other hand, the Center for Budget and Policy Priorities (CBPP) estimates that total state revenues are six percent below the pre-pandemic trend, with unexpected costs to fight the pandemic added to budgets. The CBPP evaluates the current total state and local government shortfall at $300 billion.
The CBPP also notes that state and local government employment has not recovered, with a current shortfall of 1.3 million jobs. The most recent Bureau of Labor Statistics jobs report on March 5 found a continued decline in state and local government employment in February, with most of the drop centered in education.
Agriculture

The ARP Act will provide approximately $10.4 billion in assistance to the agricultural sector. The Farm Bureau, an industry organization, estimates that about half of that aid will go to disadvantaged farmers, of which a quarter are Black. Four billion dollars of that aid will be disbursed as direct payments to disadvantaged farmers at 120% of their current outstanding debt in order to facilitate debt forgiveness.

This program addresses questions of equity in agricultural transfers. Under the Coronavirus Food Assistance Program (CFAP) initiated by the Trump Administration at the start of the pandemic, white farmers received 97%, or $6.7 billion, of the transfers. The average white farmer received $3,398 in assistance while the average Black farmer only received $422. Similarly, 99% of transfers through the Market Facilitation Plan, created to offset the impact of President Trump’s trade war with China, went to white farmers, who received an average transfer 10 times the benefit allocated to Black farmers.

Education

The legislation provides $170 billion to the Department of Education to disburse in grants to states, local education agencies, and postsecondary institutions. Added to the earlier COVID relief packages, this brings the total education funding to almost $285 billion, with the majority of the previously allocated funds unspent. The ARP Act also makes any student loan forgiveness...
granted in the next five years tax-exempt, setting up a potential executive order from President Biden to complete his promise to forgive $10,000 in student debt.

Miscellaneous

The ARP Act includes a further $15 billion for the Payroll Support Program, which provides grants to air carriers to cover wages in return for halting all furloughs and pay cuts until September 30, 2021.

The bill allocates $25 billion to restaurants and bars that have suffered as a result of Covid-19, as well as $6 billion towards nutrition assistance programs.

The Federal Transit Administration will receive $30 billion to distribute as grants to local transit authorities.
Guest Articles

These have either been written by YPFS authors and published elsewhere, or written by authors external to YPFS and published on the Systemic Risk Blog.
Lender beware: Emergency relief efforts are inherently risky

By Greg Feldberg and Sabeth Siddique

Original post here.

The coronavirus response puts American bankers in a tight spot.

More so than most developed countries, the government has put bankers in charge of life-or-death decisions about private businesses. Banks and nonbank lenders have been allocating what are essentially government grants through the nearly $660 billion Paycheck Protection Program.

They will soon be expected to allocate hundreds of billions more through Fed and Treasury programs that will require them to take more risk.

But banker-as-government-agent is not an enviable role. Lend too conservatively, and the banker will be (or has been) criticized for putting shareholders, or favored clients, ahead of the common good. Lend too freely, and losses may be higher than expected, leading to a need for capital from the government before the end of the year.

To solve this dilemma, bankers and nonbank lenders can rely on the principles of risk management and governance that they relearned the hard way during the last financial crisis.

To protect their institutions, bankers need to, first, provide clear guidance on risk appetite. Even today, bank boards have an important role to play in reconfirming a bank’s strategy and risk appetite — the level of losses that board members can endure and justify to stakeholders — and making sure management prudently follows policies and procedures.

To be sure, risk appetite remains relevant. A bank can do its part to support the real economy even if its board decides it will only extend credit through lending programs in which the government has committed to take much of the risk. Or if it decides not to extend new credit at all, but to focus on helping existing borrowers.

Bank risk managers aren’t epidemiologists. They don’t have special insights into how long the health crisis will last.

However, their expertise should allow them to differentiate between borrowers with persistent foundational issues and borrowers with only temporary issues. Authorities have acknowledged this with clear guidance that banks should not automatically downgrade borrowers who miss payments.

Lending or restructuring decisions should be based on sound underwriting criteria, with a clear understanding of the board’s risk appetite while paying attention to the current environment and the mitigating effects of government assistance.

Management can expect elevated losses and depletion of capital buffers. The challenge is to not allow those losses to put the safety and soundness of the institution at risk. Specifically,
operating at or near the institution’s post-stress capital target should be consistent with the board’s risk tolerance in this environment. Some banks have already warned that capital ratios are likely to decline from recent high levels.

The depth and length of this recession are very uncertain, depending on public-health variables that no one can predict. Banks should be vigilant in identifying, assessing and reporting risks commensurate with the speed and magnitude of the changing-risk environment.

Banks need these ongoing assessments to translate risk appetite into tangible metrics such as exposure limits and underwriting criteria. Risk managers should scrutinize the reliability of model outputs, mitigating model risks with qualitative factors when applicable.

Data on historical loan losses and backward-looking statistical scoring models won’t be very helpful. Judgment will likely play a greater role.

Bankers should also carefully balance “micro” and “macro” pressures. Supervisors have focused increasingly on banks’ responsibilities to the public since the financial crisis.

In its annual stress test, for example, the Federal Reserve says it expects every bank’s management to “establish post-stress capital goals that are aligned with its risk appetite and risk profile, its ability to act as a financial intermediary in times of stress, and the expectations of internal and external stakeholders.”

Governments today are striking a delicate balance between their “microprudential” role (to keep banks solvent), and their “macroprudential” role (to support the real sector). In a crisis, the macroprudential role must take center stage. But bankers, backed by good governance, should know best how to strike the balance.

In the early stages of this crisis, no decision of each bank’s board has been more sensitive than the question whether to suspend the payments of dividends to shareholders. In the U.S., supervisors have so far hesitated to tell banks to suspend. And, so far, banks have not done so.

In contrast, there was a diversity of responses to supervisors’ guidance on the allowance for loan losses. Some banks took advantage of the forbearance to conserve capital by delaying their application of the new “lifetime loss” standard.

Others held to the standard, conservatively reserving for the worst. Both answers may be appropriate, based on each bank’s unique business profile.

Finally, don’t forget reputational risk. Of course, bankers entered this crisis with more goodwill than last time. But, like the liquidity and capital buffers they have built since the 2008 financial crisis, that goodwill can be quickly spent if not managed.

Already, it is clear that the public will be very sensitive to credit allocation decisions that appear unfair or prejudicial, especially when bankers are allocating taxpayer funds. There are also the matters of compensation, bonuses and shareholder dividends while so many are suffering.
In summary, banks have the tools to determine their fate this year. Their public-service role — the justification for both the benefits and the costs of their unique regulatory framework — is never more clear than in the depth of a crisis like this.

Following risk-management principles and knowing when to say “no,” bankers may be able to get through this early phase of the coronavirus-triggered recession intact.

It won’t be easy. It will require hard-headed analysis of risks amidst extreme uncertainty and constant reevaluation of the conflicts and complements between stakeholder and public interests. It will also require the fortitude to make decisions backed by sound judgment and leadership, consistent with each bank’s risk appetite.
No Bank Should Be Paying Dividends Right Now

By Greg Feldberg

Original post here.

This blog was published today in the American Banker.

In the midst of one of the fastest and deepest economic declines in U.S. history, the largest banks are expected to pay out about $14 billion in dividends in the third quarter, while remaining under a cap imposed by the Federal Reserve in response to the coronavirus pandemic.

This comes after the same banks paid out about $17.5 billion in the second quarter, according to an analysis using Bloomberg data.

While the Fed did somewhat restrict shareholder payouts in late June, it has already missed an opportunity to require banks to conserve more than $30 billion in capital that could have proven invaluable if any of its recent economic stress scenarios pan out.

Both the economic scenarios and policy on dividend payouts were included in the results of the 2020 stress test of the 33 largest banks.

The results were not rosy. The Fed forecasted $433 billion in loan losses through March 2022, under a scenario designed prior to the coronavirus lockdown.

But in a rough sensitivity analysis that took the coronavirus into account, projected losses ballooned to $560 billion in a V-shaped economic recovery scenario; $680 billion in a W-shaped scenario; and $700 billion in a U-shaped scenario.

Those would be heavy losses compared to the banks’ aggregate $1.2 trillion of capital. In the worst case, a quarter of banks would be near or below their regulatory minimums, although the Fed did not say which banks or how close they would be.

The Fed admitted that its sensitivity analysis was not as robust as its typical stress test. So it took an unusual additional step: it is calling on banks to reassess their capital needs and resubmit capital plans later this year. Those plans could result in further dividend restrictions.

Still, amidst the extraordinary uncertainty that the coronavirus lockdown has induced, suspending dividends would seem an easy way to conserve capital right now. This is exactly the kind of situation for which these forward-looking stress tests are designed, in order to prevent another collapse of the financial system.

The Fed’s rule normally prohibits banks from proposed capital distributions while it is reviewing capital plans. But the Fed hasn’t prohibited dividends this time.
Note that banks’ capital ratios were already elevated by an average of about 30 basis points in the first quarter because regulators allowed them to delay the capital impact of the new expected credit loss accounting framework.

Regulators reasonably justified that forbearance by the need to promote lending during a crisis. But allowing banks to deplete capital through dividend payments seems counter to that purpose.

Regulators’ reluctance to suspend dividends may elicit some déjà vu. During the last financial crisis, banks were still paying more than $10 billion in dividends per quarter through late 2008, and didn’t cut dividends by more than half until 2009. Regulators raised no objection.

Those same banks ultimately needed hundreds of billions of dollars in government capital through the Troubled Asset Relief Program. One paper showed that all the banks that received TARP capital paid at least 45% of the amount as dividends in 2007 to 2009. The combination of paying dividends and receiving government capital represented a massive transfer of wealth from taxpayers to shareholders.

The Fed did announce some modest measures this time. For example, a bank’s common stock dividends in the third quarter can’t exceed what it paid in the second quarter, or its average net income over the past four quarters. The Fed also banned share repurchases for the third quarter entirely.

But these limits are unlikely to significantly affect banks’ capital decisions. Net income is falling for most banks anyway, and the largest banks suspended repurchases voluntarily in March; share repurchases similarly fell sharply in the last financial crisis.

So why not suspend dividends immediately? The Fed’s peers in Europe quickly called for a temporary halt to bank dividends and share repurchases in this crisis; and later did the same for insurers and other financial companies.

The Fed’s vice chairman for supervision, Randal Quarles, argued that banks are much better capitalized this time. He also argued that banks performed well under the Fed’s rough sensitivity analysis.

But that’s no reason to allow banks to deplete their capital, as Fed Gov. Lael Brainard pointed out in a rare public dissent.

Some argue the Fed has already gone too far, meddling in bank board decisions. But it’s the Fed’s job to set limits in a crisis.

This is simple macroprudential policy — look out for the system as a whole, by providing cover to bank boards to conserve their capital in case things get worse.

Without that cover, bank boards hardly have autonomy right now. Supervisors may hope banks would reach the same decision through their own capital planning and governance, which have improved since the last crisis. But no bank wants to be the outlier while everyone else is paying
shareholders. So, heading into an extraordinary period of uncertainty, most banks are going to maintain dividends.

However, any dividends paid may look frivolous if the recovery from the coronavirus turns more U-ish than V-ish.

Here’s a paper floated by the European Central Bank worth further study: a cyclical dividend prudential target set by regulators as guidance for banks. Such a policy could allow relatively high payouts in good times but automatically constrain payouts in downturns. Arguably, this would encourage banks to meet regulatory capital ratios during downturns by retaining earnings rather than shrinking assets.

Let’s consider ideas like this for next time.

More immediately however, the Fed should require banks to halt dividends until the coronavirus recession has passed, as other central banks have done.

In the very worst case, Fed officials should not want to repeat history by using government funds to recapitalize banks, while justifying in retrospect why they didn’t conserve as much capital as they could when the crisis began.
Monetization of Fiscal Deficits and COVID-19 - A Primer
By Aidan Lawson and Greg Feldberg

Original post here.

Introduction
Governments around the world have introduced huge stimulus programs to combat the economic damage caused by COVID-19. These programs allocate billions of dollars in direct payments, tax breaks, business subsidies, and other relief. The size and scale of these programs have caused many governments to run much higher budget deficits than normal. But how are they going to finance these deficits? One way, which some consider anathema to the price-stability mandate of a central bank, has been thrust back into the spotlight as the crisis rages on: sovereign debt monetization.

What is monetization?
Most of the time, governments have two basic choices for financing their deficits: they can borrow (issue debt) or raise taxes. Monetization represents a third, unconventional choice that governments may consider in crises like the current one.

What is it? Simply put, monetization—also known as “money-financed fiscal programs” or “money-printing”—occurs when the government finances itself by issuing non-interest-bearing liabilities: that is, either currency in circulation or central bank reserves, if the central bank can avoid paying interest on those reserves.

Monetization can solve several problems for a government during the COVID-19 crisis. First, it can directly cover some of the costs of extraordinary recovery programs. Second, it can mitigate deflation and stimulate moderate inflation. Third, by increasing inflation, it can reduce to some extent the value of its outstanding obligations. Stimulating inflation is a necessary part of the plan. A central bank financing government spending—by purchasing government debt directly, or crediting the government the amount needed—is not monetizing that spending unless it also stimulates inflation.

The fact that most central banks now pay interest on bank reserves complicates the process of monetization.

Without interest on reserves, monetizing debt would be easier. The government would issue enough bonds to pay for its fiscal program, and the central bank would then purchase those bonds, committing to hold them in perpetuity or to roll them over forever. The government would spend the “money” that the central bank has created on any short-term stimulus, or COVID relief, that it has identified as necessary. In the short run, that money would end up at banks, as people and businesses deposit their checks from the government. But banks wouldn’t want to keep their excess reserves with the central bank, where it earned no interest. Much of the
money would flow back into the economy through loans, and thereby boost aggregate demand. The stronger demand would, in turn, increase inflation, which would gradually reduce the real value of currency and reserves back to their initial levels. As a consequence, the government would end up having financed its fiscal action through base money: growth in both reserves and currency.

But, in reality, central banks do pay interest on reserves today. The interest rate they pay, even if it is small, gives banks an incentive to keep their excess reserves with the central bank. The interest payments the central bank pays on excess reserves are merely substituted for the interest payments the government pays on its debt, confounding the process of monetization described above. Nonetheless, this method of financing government debt programs works broadly similarly to the above, with a few key differences.

As in a world where banks don’t earn interest on reserves, central banks would still directly purchase and commit to roll over the debt issued by the government to initially finance the fiscal program. But it would also commit to raising prices to a high enough level that the additional demand for nominal currency is sufficient to finance the debt purchase. Essentially, this means that there would be some temporary but moderate inflation (4% annually over five years, say), which would reduce the real value of the currency stock and increase the demand for currency. As a result, seigniorage—the profit generated by the government from printing money—would be used to finance the fiscal action.

For this to work, the public must perceive the central bank’s commitment to expanding base money as credible and permanent, or else the short-run economic impact would be far less (English, Erceg, Lopez-Salido (2020), p. 3). While the central bank could instead communicate that it would only monetize a certain amount in this way, it is preferable for it to commit to raise the price level; not doing so may have unpredictable effects on inflation (English, Erceg, Lopez-Salido (2020), p. 26). Committing to a higher price level alongside expansionary fiscal policy may make it easier to convince the public that the increase is indeed permanent (see here). When modeled, a program that costs about 1 percent of GDP that is fully monetized corresponds to about a 10 percent increase in the price level (see here).

This story is different from the story that some tell about debt monetization. To some, any purchase by the central bank of government debt is monetization. But it really is not, if it is financed through (interest-bearing) reserve creation and the central bank does not intend to raise the price level. Thus, recent attempts to flood financial markets with liquidity via the purchase of government bonds (among others) is not monetization. Nor are the Federal Reserve’s purchases of large amounts of Treasury debt as part of its quantitative easing (QE) programs during both the Global Financial Crisis (GFC) and the COVID-19 crisis (see here).

One of the biggest challenges in determining whether monetization has actually occurred is that it is not immediately clear whether debt purchases by the central bank satisfy the requirements outlined above. The Bank of Japan (BOJ), for instance, has continually purchased Japanese securities proportionate to the amount of the fiscal deficit over the past 25 years, but has never
explicitly stated that monetization is its intent (see here). The size of its balance sheet has only increased and it has made no major efforts to sell its bond holdings. But the BOJ financed these purchases through reserve creation; it has been unable to generate consistent inflation and spur demand for its domestic currency stock. The BOJ in 2016 did say that it would be aiming to overshoot its inflation target while keeping the rates on government debt close to zero, an important step in a seigniorage-based monetization framework. Nonetheless, it has still undershot this target and has been unable to generate the seigniorage needed to pay for fiscal actions.

Why has monetization not been more widely used?

The primary concern about engaging in monetization is the fear that it will lead to excessive and uncontrollable inflation. Since monetization is, by definition, a permanent increase in non-interest-bearing liabilities of the central bank (in this case currency), the policy should be expected to lead to some inflation. However, this increase is intended and necessary in order to generate enough seigniorage to finance the fiscal program in question. The increased inflation generated is not inherently a bad thing if it is moderate, temporary, and communicated clearly by the central bank. Uncontrolled monetization, particularly in less-developed economies, can cause currency crises in fixed exchange rate regimes and lead to excessive inflation. These crises can be exacerbated in countries with a substantial amount of foreign currency-denominated debt, as the increase in domestic currency puts pressure on the exchange rate, weakening the domestic currency and increasing the cost of their debt exponentially.

A central bank in a fixed exchange rate regime under this sort of pressure may find that conventional methods of defending its currency (by raising interest rates, for instance) would create unacceptable economic costs at home. The central bank would have to choose between providing relief at the risk of breaking the peg, or alternatively, defending the peg and allowing the economy to stagnate. In fact, “first generation” currency crisis models discuss this very issue. These models outline a hypothetical country that runs persistent budget deficits while maintaining a fixed exchange rate. Eventually the government will need to monetize its deficit, putting downward pressure on the exchange rate, and the model predicts that the peg will break (see here). Currency crises in both Mexico and Turkey in the 1990s share some of these characteristics.

This phenomenon can also occur if there is widespread circulation and usage of other currencies, as people will flock to these if the domestic currency is under pressure. The risk of excessive inflation depends on the degree of monetization and the characteristics of the economy doing it.

Governments that have access to the printing press as a form of financing may also exercise far less fiscal discipline than otherwise. Issuing debt without the expectation of repayment could lead to governments spending excessively and overheating the economy.

This concern underscores the importance of central bank independence. Adopting monetization as a regular part of a central bank’s toolkit, or even setting a precedent that it is available, could
gradually erode the barriers between monetary and fiscal policy, damaging the central bank’s credibility and limiting its ability to fulfill its mandate. Central bank credibility is a nebulous concept, yet it is absolutely critical when thinking about the impact that monetization can have. There appears to be a general relationship between economic development and central bank credibility, but there are a variety of factors that can affect it. The erosion of credibility could unhinge inflation expectations. A fiscally irresponsible government ultimately puts any central bank in an impossible situation. If it does not monetize the deficits, interest rates on government debt will rise, which could increase the probability of default. Eventually, the central bank will have little choice but to monetize. This phenomenon — when a central bank is forced to monetize an unsustainable, out-of-control deficit to avoid negative economic outcomes — is known as fiscal dominance (see here, pp. 34-37). Thus, long-run fiscal sustainability is key in ensuring that central banks are able to fulfill their price-stability mandates and remain credible. The lack of fiscal discipline ultimately affects the independence of the central bank.

There are other issues. Monetization can circumvent the market-pricing mechanism in secondary markets by allowing the government to issue debt at lower interest rates. The Fed expressed this concern back in 1917, when the U.S. Treasury offered it $50 million in bonds at far below market rates. The cheap credit for the government also led to moral hazard concerns if the central bank commits to low interest rates along the yield curve. Excessive spending could also lead to crowding out, though this may not be an issue if the central bank doesn’t allow interest rates to rise. These are some of reasons why monetization has been generally characterized as a last-resort authority, if anything (see here).

How has monetization been used historically?

Governments have used monetization most often in the past as a mechanism for war financing. Wars are typically financed through some combination of taxation, debt financing, external financing, and monetization. Monetization is typically the easiest option, provided that central bankers are willing to cooperate. It generally is not a politically sensitive policy during wartime, and can be operationalized quickly. To finance huge wartime production needs via monetization, governments issue bonds that are then purchased directly by the central bank. The question of central bank independence does not have to arise in this case, since the incentives of the central bank and government are aligned. Below are discussions of different countries’ experiences - successful or not - when they chose to monetize. In some cases, such as the Weimar Republic or Zimbabwe, the decision to monetize resulted in rampant hyperinflation. In others, like Japan during the Great Depression, monetization proved to be an effective tool.

In the US, Section 14 of the original Federal Reserve Act allowed the Fed to directly purchase government bonds. The earliest use of this authority was in 1917 at the onset of World War I, when Treasury Secretary William McAdoo offered $50 million in 3-month notes to Federal Reserve banks (see here, p. 2). The Board of Governors was not happy, as the interest rates were below market rates, but ultimately acquiesced (see here, p. 3). After World War I, the government continued to use this authority, albeit only for cash-management purposes, until
Congress prohibited it in 1935. At the time, some policymakers expressed concerns about chronic deficits, the erosion of fiscal discipline, and ballooning Federal Reserve balance sheets. Treasury questioned Congress’s decision, arguing that the Fed’s ability to make direct purchases could be crucial in times of crisis (see here, p. 5). Congress eventually accepted this argument, inserting a wartime exception in 1942 that allowed the Fed to underwrite Treasury debt. But the exception was subject to a $5 billion limit (see here, pp. 9-10). It was really just an overdraft privilege for the U.S. government to use when it was cash-poor, most notably around tax-collection dates.

The U.S. government financed World War II and the Korean War very differently. Of the major wars that the U.S. participated in after World War I—that is, after the Fed became a truly independent central bank—it only financed World War II in part through monetization, based on our definition (see here, p. 3). The Fed used the exception to help facilitate Treasury cash balances on tax collection dates during the war (see here, p. 10). Because of the exception’s limited size, however, the U.S. relied primarily on borrowing, and its debt ballooned from $51 billion in 1940 to over $260 billion in 1945 (see here and here).

In doing so, the Fed committed to pegging interest rates at low levels and offered an even lower, preferential rate for loans secured by short-term government obligations (see here). The Fed’s balance sheet grew massively in its effort to keep rates low; its holdings of government securities rose from $2.5 billion at the end of 1939 to $24.3 billion at the end of 1945. Wartime price controls and rationing temporarily mitigated the inflationary effects, but their removal after the war caused a surge in the price level, which prompted the Fed to increase reserve requirements (see here, p. 25). After World War II, the wartime exception was used sparingly until it was allowed to expire in 1981. The Korean War was financed entirely through taxation, due to high post-World War II inflation and broad public support (see here, p. 114). Nonetheless, high inflation in 1951 forced the reintroduction of wage and price controls (see here, p. 8).

Although the Fed did not monetize wartime debt during the Korean War, its independence was tested because it continued to maintain its low interest-rate peg. It attempted to raise rates throughout 1950, believing the peg to be inflationary, but was blocked by the Treasury to keep its debt-service costs manageable (see here). After a meeting between the Fed and President Truman in early 1951, the President committed the Fed, without its consent, to maintaining the peg during the Korean War, just as they had done during the two world wars. This conflict between the mandate of the Fed and needs of the Treasury ultimately resulted in the Treasury-Fed Accord, which stated that the Fed and Treasury remained committed to financing the government’s needs while minimizing outright purchases of the debt (see here).

Governments have been known to continue financing their deficits through monetization even after a war has ended. Such policies led to out-of-control hyper-inflation, with prices rising by factors of two or more per month, in Weimar Germany (1923), Austria (1922), and Poland (1924-27) after World War I.
In the case of Germany, a reduced tax base, increased debt service, unrealistic reparation demands from the victors, and the erosion of tax revenues created huge budget deficits. Germany first attempted to solve this by fixing the exchange rate to slow inflation and hence tax erosion, which worked while the Reichsbank had sufficient reserves to support it. Ultimately, the bank couldn’t defend the peg and abandoned it, which necessitated further reform. The German government passed legislation in October 1923 that created a new currency; under the legislation, the central bank could no longer purchase government debt. The government also raised taxes and reduced outlays (see here, pp. 8-16). The new currency, the Retenmark, had a limited issuance and was backed by claims on industry and agriculture. One of the most important uses of the new currency was a “once and for all allocation” to the government to help it retire its existing debt while it passed fiscal reforms (see here, p. 11). The central bank quickly got inflation and the exchange rate under control by pushing interest rates to extremely high levels, as high as 20% per day in December 1923. In 1924, a substantial reduction in reparations expectations and a large loan from the U.S. helped restore the fiscal and monetary balance.

Similarly, during and after the war, Austria increasingly funded its deficits via the printing press, which led to massive inflation and depreciation. Currency in circulation rose by nearly 1000% from the beginning to the end of the war (see here). The postwar government imposed artificially low price controls on agricultural products and enacted massive food subsidies. Excessive inflation turned into hyperinflation in 1921 and continued into 1922. Inflation in the third quarter of 1922 was at an annual rate of 130,000% (see here, p. 18). To stabilize, the government received a large foreign loan and was required to bring its budget back in line.

It took the Polish government three separate attempts to stabilize its economy from hyperinflation. Military conflict continued in Poland even after the end of World War I, and the government committed over 50 percent of its budgetary resources to defense spending (see here, p. 9). Due to a small tax base, most of these expenses were financed through the printing of Polish marks. As was the case in Germany and Austria, currency in circulation increased quickly, and depreciation followed suit. First, the government introduced austerity measures, which prompted a modest appreciation of the mark, but it did not stick to them and the inflation worsened. Second, the government raised taxes, “valorizing” them, or indexing them to gold, and issuing a new currency that was pegged to the dollar. Initially the measures appeared to work, but budgetary and economic issues forced the central bank to defend the peg, which ultimately broke. The money supply kept growing because the Treasury continued to issue small notes and mint coins, although the central bank was actively removing notes to defend the currency. Stabilization was finally achieved via a large U.S. and British loan and regulatory reforms that prevented the government from issuing treasury notes.

Generally, each of these countries had extremely high postwar deficits that were almost entirely monetized and worsened economic and political turmoil and by punitive reparations (Germany), governmental instability and incompetence (Austria), and generally poor fiscal discipline (Poland). The Reichsbank in Germany purchased any and all government debt that the private
sector did not want, providing the government a seemingly bottomless well of financing (see here, p. 501). The National Bank of Austria had been granted the authority to provide credit to the state, and did so out of “fear for upheaval, social chaos, and anarchy” (see here, pp. 13-14). The Polish National Credit Bank was created during World War I by occupying Germany and functioned as a temporary bank of issue until the Bank of Poland was established. It had financed sky-high war expenditures using the printing press and continued to do so after the war due to a lack of fiscal capacity (see here, p. 10). The degree of separation between central banks and finance ministries that is commonplace today simply did not exist during this time. The central banks or banks of issue in these countries were largely subordinate to the fiscal authorities, making it impossible for them to establish credibility and manage inflation.

In each of these cases, stabilization was achieved through the dramatic reduction of budget deficits, usage or proposal of foreign loans, and pegging the exchange rate. However, solely relying on a strict peg, or even a narrow band of exchange rate targeting, is not sufficient to stabilize the economy since the peg may not be sustainable. Fiscal discipline was necessarily enforced and regulatory reforms or legal restrictions limiting governments issuing money were introduced.

In the 1990s, Turkey experienced a serious economic crisis that had roots in excessive monetization. Turkey’s economy rapidly expanded throughout the 1980s and early 90s; meanwhile, the government relied increasingly on monetization to finance huge deficits (see here, pp. 12-15). This lack of fiscal discipline, coupled with huge inflows of “hot” money from foreign investors and consistent financing conflicts with the central bank, eroded confidence and caused a currency crisis in 1994, and the economy spiraled into recession in 1999. Because of the significant dollarization of the economy, the monetary authority was unable to combat the recession because it had to raise interest rates to ward off downward pressure on the Turkish lira (see here, pp. 276-77). Ultimately, Turkey received a 3-year IMF Standby Arrangement that required the authorities to curb the excessive inflation and reform their institutions and regulations.

Perhaps the most noteworthy and most recent example of monetization-induced hyperinflation is Zimbabwe in the late 2000s. From 1980 to 1999, the country experienced modest growth, but the country’s public debt began to climb as the government spent heavily on bonuses for war veterans, involvements in other conflicts, and debt service to the IMF. The agriculturally focused country also experienced periods of heavy droughts and land reallocation at the turn of the century, depressing output dramatically (see here, pp. 4-5). Instead of financing these costs through taxation or issuing debt, the government – already managing a weak economy – heavily monetized them. By 2008, continuously monetized deficits created a deep currency depreciation that wiped out citizens’ net worth and reduced GDP per capita below its level 50 years earlier (see here, p. 5). In response, the government introduced harsh price controls, which led to rampant shortages of key goods. The U.S. dollar, which was already one of the de facto currencies in the wake of this crisis, became the primary currency.
France’s performance during and after World War I offers a more encouraging example of monetization. It depended heavily on borrowing and money growth to finance its expenditures during the war and saw its price level more than double (see here, p. 5). While the government faced considerable challenges—a large debt-to-GDP ratio, huge budget deficits, damage from the war—its economy rebounded significantly (see here, pp. 6-12). This was because the Bank of France eased monetary policy and allowed the value of the franc to fall significantly before eventually repegging it to gold at a lower level in 1926. This decision increased inflation, which reduced the debt-to-GDP ratio, and also significantly increased output over time (English, Erceg, Lopez-Salido (2020), pp. 27-28). On the other hand, the UK, which adopted a much tighter monetary stance and returned to its prewar peg to gold, saw much more sluggish growth (see here, p. 24).

France, in contrast to Germany, Austria, and Poland, did not exclusively finance its involvement in World War I through monetization. France, as a victor in the war, did not face the same fiscal imbalances that Germany and Austria did. Poland, which was partitioned by Germany, Austro-Hungary, and Russia at the start of the war, faced considerable political and economic turmoil even after the war’s conclusion (see here). The French people may have also seen the Bank of France’s change in monetary policy as credible in the face of its difficult fiscal circumstances (English, Erceg, Lopez-Salido (2020), pp. 27-29). Had France attempted to follow the U.K’s example of re-pegging earlier, it is likely that the adverse economic outcomes would have seriously damaged the government’s credibility (see here, p. 32).

Japan’s performance during the Great Depression offers another encouraging example. Similar to France, its central bank and treasury cooperated in a monetary expansion, allowing it to recover quickly under the “Takahashi economic policy,” named after finance minister Korekiyo Takahashi. Japan experienced double-digit deflation in 1930 and 1931, but Takahashi promoted expansionary exchange rate, fiscal, and monetary policies starting at the end of 1931 (see here, pp. 1-4). The country first moved off the gold standard, prompting a substantial devaluation of the yen; eased monetary policy; and introduced massive fiscal stimulus. All of these measures were explicitly financed by the Bank of Japan. Consumer prices rebounded shortly thereafter and GDP per capita began recovering in 1932. This recovery can be partially attributed to the fact that the Japanese people viewed these policy changes as credible, much in the same way that the French did during their stabilization (English, Erceg, Lopez-Salido (2020), p. 29).

Takahashi, worried about the inflationary consequences of continuing to finance government expenditures in this way, pushed back against further monetization (see here, p. 373, here, p. 130). He was assassinated during a coup 1935 due to his decision to cut government-specifically military—spending. In the words of former Fed chairman and Great Depression scholar Ben Bernanke, Takahashi had “brilliantly rescued” Japan and allowed it to rebound rapidly from the Depression, even while many other nations were still suffering.
It is important to note that, in all of these examples, monetization was the primary, often the only, tool to finance profligate spending—for wars or otherwise. The governments in our modern examples—Turkey and Zimbabwe—followed similar paths. Turkey financed rapid economic expansion via monetization and saw large foreign capital inflows, leading to an increased debt burden, further monetization, and less confidence, which culminated in a currency crisis. The government of Zimbabwe faced a mixture of problems with key sectors (agriculture), spent frivolously and chose to not rely on conventional methods of financing. While external factors, such as crushing war reparation burdens in the case of Weimar Germany or a turbulent period of interwar occupation, in the case of Poland, contributed to postwar economic hardship, the consistent lack of fiscal discipline and the partial or complete subordination of the central bank to the government across all the examples were the catalysts to extremely damaging economic crises.

In contrast, the French and Japanese experiences offer more hopeful lessons. They did not have to rely exclusively on the printing press to finance expansionary monetary and fiscal policy; they had stronger, more credible central banks; and they made attempts to curtail excessive spending and depreciation after they were on the road to recovery. France re-pegged to gold at a lower level and Takahashi made the mistake of attempting to cut government spending in an attempt to rein in inflation.

**Are Central Banks Monetizing Government Debt in 2020?**

It’s not clear that any country is conducting monetization in response to COVID-19, based on our definition. Many central banks, including several in emerging markets, have established or reinstated asset purchases and QE programs in 2020; and debt levels are only rising, especially in developing countries. But no central bank, to our knowledge, has explicitly labeled its programs as monetization. On the contrary, several have taken measures to make clear that monetization is not part of their strategy.

One example is the Banko Sentral Ng Pilipinas (BSP) in the Philippines. The BSP purchased about $6 billion in securities from the government in March, but with the understanding that the government would repay after six months. This explicit exit target, as well as the absence of a commitment to increase the price level, suggests that the central bank, while cooperating with the fiscal authority, does not intend to monetize this spending.

In Indonesia, government debt has tripled in the fight against COVID-19. The government first issued a regulation that allowed Bank Indonesia (BI) to directly purchase newly issued government debt as a last resort. It later proposed auctioning off about $30 billion in “pandemic bonds,” most of which would be purchased by BI. But the government never issued the pandemic bonds, saying it could obtain financing through traditional auctions. BI can still participate in other auctions if needed. Foreign demand for Indonesian debt has fallen, but domestic lenders and banks, supported by BI’s liquidity measures, have increased their holdings. The finance minister predicted on June 8 that the budget deficit would rise as high as 6.34% of GDP this year. More recently, the government and BI agreed to a proposal under which BI will
purchase about $40 billion in government bonds; the interest rate will be at market levels, rather than zero as originally proposed. It is likely that BI will hold on to these bonds through 2021 (see here). It is doubtful that these debts will be monetized, as BI did not issue any guidance signaling that it was committing to a higher price level following these purchases.

There has also been some discussion about monetization in China. The People’s Bank of China (PBOC) is not permitted by law to directly buy sovereign debt or provide an overdraft facility to the government. However, the country still has significant monetary and fiscal space that it could use to enact other forms of relief, without monetizing those costs.

India has kept the door to monetization open, but it has not yet acted. Like many central banks, the Reserve Bank of India (RBI) is actively purchasing government bonds. However, it is only doing so in secondary markets and for limited amounts, as direct purchases were outlawed in 2003. In the early days after India's independence, its government could achieve monetization automatically by issuing ad-hoc treasury bills “on-tap” directly to the RBI. A series of reforms in the 1980s and 1990s set some limits on this explicit form of fiscal dominance. The government adopted a market-based pricing system for auctions of sovereign debt, phased out the usage of ad-hoc treasury bills, and completely outlawed primary market purchases of debt by the RBI (see here). Some direct government finance occurred during the GFC through the use of Special Market Operations (SMOs), which allowed certain public companies (namely in the oil sector) to sell bonds directly to the RBI to meet foreign exchange requirements. These were used sparingly, however. A former RBI governor has said that monetization is “inevitable” as calls for further stimulus continue. However, many in the government remain concerned about the potential for excessive inflation and the return of fiscal dominance (see here). India has seen a record number of COVID-19 cases recently but has not opted to reinstate lockdowns (see here). The country’s healthcare infrastructure is already strained. However, an escape clause in the law allows the central bank to purchase government debt during times of crisis. This allows the government to borrow from the RBI for temporary, cash-management needs and for the RBI to purchase government debt on primary markets during periods of significant economic stress, national emergency or war (see here, pp. 5-6).

The Bank of England (BoE) expanded the scope of its standing overdraft facility, called the Ways and Means facility, for COVID-19-related expenditures. Historically, the facility has been used for cash-management purposes, similar to the wartime exception in the U.S. during the world wars. It was drawn on for nearly £20 billion in 2008 during the Global Financial Crisis. The BoE justified this decision by stating that the facility was necessary to support the economy and meet its inflation target. It also stated that doing so does not subordinate the BoE to the government; a member of its monetary policy committee noted that this freedom of action is what separates the BoE’s use of monetization today from the historical monetary disasters of the Weimar Republic or Zimbabwe (see here, p. 14). Despite the government ramping up debt issuance to finance COVID-19 relief, the facility has not yet been used.
The BoE’s Asset Purchase Facility has dramatically increased its purchases of government debt over the last few months as HM Treasury continues to issue more (see here and here). Despite this, BoE governor Andrew Bailey has repeatedly stated that governments should not become reliant on central banks buying their debt through extensive asset purchase programs. He said these programs have more in common with QE programs—they are crisis-focused and temporary by design. Additionally, he stated that the BoE would be looking to reduce its balance sheet before raising interest rates (see here). This is a departure from previous thinking. Bailey’s predecessor, Mark Carney, argued for just the opposite after the GFC. The BoE under Carney viewed interest rates as a policy tool that could be more easily adjusted. Bailey, however, has said he does not wish for huge central bank holdings of government bonds to become the norm.

None of these examples meet our definition of monetization, although many observers have used the word to describe them. We have yet to find an example of any monetary authority that is explicitly engaging in monetization (see here, p. 63). Many central banks are purchasing government debt, including through QE programs, alongside large fiscal expansions. Those are aggressive, even unprecedented crisis-fighting measures. But they are not monetization. In none of these cases is the central bank using non-interest-bearing liabilities or seigniorage to finance the purchase of government debt. In none of these cases is the central bank committing to a higher price level.

For instance, even though the BoE has been aggressively purchasing newly issued government debt, the Bank of England says it remains confident that it will be able to continue to fulfill its mandate while increasing its involvement in the government bond market. Additionally, the BoE has not coordinated with the fiscal authorities by issuing forward guidance to raise its inflation targets, suggesting that it is not monetizing.

**Do Central Banks Have the Scope to Monetize their Debt?**

If central banks wanted to monetize their debt to support their COVID-19 response, would they be able to?

Based on our analysis, a country’s capacity for “safe” monetization depends on its level of economic development, the central bank’s credibility, and the current economic environment. However, there is no clear tipping point where the inflationary and governance issues discussed above suddenly occur. Countries that have persistently low inflation, credible central banks, and strong economic fundamentals could potentially monetize some of their COVID-19 spending without excessive inflation or a loss of central bank independence. These countries generally have undershot their inflation targets and have central banks that are well-equipped to handle changes in the price level. A country like Japan, which has struggled more than any other country to generate enough inflation to hit its target, might actually find it difficult to convince the public of its commitment to a higher price level.

Traditional debt financing, particularly for countries that already have high levels of debt, could still be an issue, with investors potentially questioning a sovereign’s ability to fulfill its
obligations and influencing expected future default probabilities. Deficits are rising rapidly in
2020, raising questions about which nations will be able to reliably pay back what they owe.
This creates a difficult situation for developing countries that do not have a large amount of fiscal
space and are struggling to obtain external financing or issue debt. It may be tempting for such
countries to monetize, as they would be more likely to do so, and to do it for longer. But their
risks are also much greater. Continued monetization, as discussed above, could lead to a de-
anchoring of inflation expectations and excessive inflation. Central banks in these countries may
also be more susceptible to governmental influence and fiscal dominance.

Tables 1 and 2 below break these concerns down. Table 1 charts the capacity that various types
of countries have to engage in “conventional” (in other words, tax-based or debt-based)
financing. Table 2 charts countries’ varying capacity to conduct monetization. It is clear from this
rough analysis that the financing capacity is quite disparate across countries. Countries that could
potentially benefit the most from monetization due to a lack of conventional financing capacity
may also be most susceptible to its risks.

Table 1: Characteristics of conventional financing capacity

<table>
<thead>
<tr>
<th>Level of Economic Development</th>
<th>Central Bank Credibility</th>
<th>Fiscal Capacity</th>
<th>Borrowing capacity</th>
<th>Reliance on external finance</th>
<th>Overall “conventional” financing capacity</th>
</tr>
</thead>
<tbody>
<tr>
<td>High income</td>
<td>High</td>
<td>High</td>
<td>High</td>
<td>Generally low</td>
<td>High</td>
</tr>
<tr>
<td>Medium income / emerging market</td>
<td>Mixed</td>
<td>Mixed or low</td>
<td>Mixed, cyclical</td>
<td>Mixed or high</td>
<td>Mixed</td>
</tr>
<tr>
<td>Low income / developing economy</td>
<td>Generally low</td>
<td>Low</td>
<td>Low, cyclical</td>
<td>Generally High</td>
<td>Generally low</td>
</tr>
</tbody>
</table>

Source: Authors' analysis

Table 2: Characteristics of monetization capacity

<table>
<thead>
<tr>
<th>Level of Economic Development</th>
<th>Risk of fiscal dominance</th>
<th>Risk of excessive inflation</th>
<th>Procyclicality of capital flows</th>
<th>Currency strength</th>
<th>Overall monetization capacity</th>
</tr>
</thead>
<tbody>
<tr>
<td>High income</td>
<td>Low</td>
<td>Low</td>
<td>Low</td>
<td>High</td>
<td>High</td>
</tr>
<tr>
<td>Medium income / emerging market</td>
<td>Mixed</td>
<td>Mixed or low</td>
<td>Mixed, cyclical</td>
<td>Mixed, cyclical</td>
<td>Mixed or low</td>
</tr>
</tbody>
</table>
Low income / developing economy

High  High  High  Generally low  Low

Source: Authors’ analysis

Despite these risks, some have argued that developing countries may be able to monetize a portion of their debts, provided they have a flexible exchange rate regime and are issuing debt mostly in their local currency. Foreign ownership of local-currency government bonds in many countries has steadily increased. Investors usually have U.S. dollar-based liabilities, which increases the risk of a fire-sale of local government debt. However, their central banks are positioned to function as purchasers of last resort if this occurs.

Operationalizing monetization requires some additional thought. Using reserve creation for monetization assumes a world in which there is no interest paid on reserves, which is not the world we live in. The aid extended by a fiscal program will inevitably end up in the banking system, which will increase the amount of bank reserves at the central bank. In times of stress banks are reluctant to lend, so they are likely to keep these excess reserves at the central bank and earn interest on them (see here). The central bank, by paying for the program initially using reserves, has simply substituted interest payments that the government would pay on debt for interest paid on reserves.

Central banks could opt to pay very low, or even zero interest on the bank reserves created in this way, which would discourage banks from parking their cash, encourage lending, and ensure that the exercise is costless to both the central bank and the government. Another method involves the central bank levying an adjustable charge on banks—one on total liabilities, for instance—that would be sufficient to offset the interest paid on reserves (see here). This, however, amounts to a tax on the banking system and has its own issues. Concerns about fiscal dominance and central bank independence could potentially be alleviated by the government opening a permanent account at the central bank that would be filled only when the central bank deemed monetary financing appropriate (see here).

As for the problem of interest on reserves, a longer-run solution for central banks would be for them to gradually reduce their reserves and return to an environment where they no longer pay interest on them. However, this would be exceptionally time-consuming and require major central banks to coordinate amongst one another about how to unwind their balance sheets. Given these limitations, it would be much more effective to finance a fiscal program with reserve creation initially and seigniorage in the long run, rather than reserve creation.

There are reasons to be cautious, but as the costs of COVID-19 continue to mount, so too have the sizes of government deficits and with them, the calls for monetization. It is a powerful emergency tool, capable of providing substantial stimulus and a dramatic reduction in real interest rates if it is communicated successfully and seen as credible (see here, pp. 30-
However, it is unclear how much monetization developing countries could safely conduct, if any.

**What are some alternatives to monetization?**

For developing countries for whom monetization appears difficult, debt relief may be the only alternative in the COVID-19 crisis. On April 15, the G20 announced the Debt Service Suspension Initiative (DSSI). It provided relief from sovereign debt payments to G20 members for International Development Association (IDA) countries and least developed countries (LDCs). A total of 77 countries are eligible for the DSSI, which would suspend debt service payments through the end of 2020 for participating countries. Approximately $11 billion could be freed up this way.

There are some challenges, however. Debt relief may be too small or too narrow in scope to effectively reduce massive debt stocks. Many of the DSSI-eligible countries need relief from private-sector creditors coordinating with sovereign ones for debt relief, as they owe a collective $13 billion to them through the end of the year. But negotiations with the private sector is being done on a case-by-case basis, and there are likely to be some holdouts, which could mean that countries will have to pay those creditors in full (see here). There are also a number of middle-income countries that have higher debt burdens and are expected to run much higher deficits this year. These countries also tend to rely more on private creditors, which can exacerbate holdout issues. See the following YPFS blog for more information on the DSSI.

Another alternative is financial repression. This typically takes the form of policies that allow the government to “tax” savers, such as through interest-rate caps, capital controls, and other policies. Financial repression can help a country reduce nominal interest rates, alleviating the debt service burden and ultimately reducing the debt-to-GDP ratio (see here). The U.S. used financial repression extensively after World War II, and real interest rates during this time were negative about half the time (see here). Ultimately, financial repression “played an instrumental role in reducing or liquidating the massive stocks of debt accumulated during World War II” (see here, p. 5).

As with debt relief, financial repression is not without its challenges. Enforcing low interest rates can lead to inefficient allocation of savings, and successful implementation may require a level of coordination between fiscal and monetary authorities that may call into question the independence of the central bank.

Another option is a combination of tax increases and spending cuts, or austerity. These appear to be unlikely options, as they are politically unpopular and can harm economic recovery. Spain’s efforts at fighting the virus were initially hamstrung by austerity measures they adopted in the wake of the GFC, which led to a number of shortages of equipment, doctors, and hospital beds. The government of India circulated a memorandum that stated that it would suspend the commencement of all new publicly funded programs aside from those in their approximately $260 billion pandemic response package. Ecuador announced austerity measures in May, which
will result in the closure or merging of several public companies and potentially thousands of layoffs. The decision sparked massive protests across the country, similar to the reaction that occurred after the government negotiated an austerity-laden $4.2 billion agreement with the IMF in March 2019 for economic support. The IMF and Ecuadorian government cancelled this agreement in May and have begun working towards a more sustainable aid package (see here, p. 2).

**Is there a difference between war financing and pandemic financing?**

Much of the criticism of monetization centers around the fear that, if it is extended, it will prevent the central bank from fulfilling its price-stability mandate—through excessive inflation, loss of independence, or some combination of the two. But some forget that this type of monetary-fiscal cooperation is typically seen in times of war.

Wars typically entail dramatic but temporary increases in government spending and borrowing to adequately address the conflict. In the case of World War II, for instance, the United States ran budget deficits in excess of 27 percent of GDP (see here). The Federal Reserve relinquished some of its independence to cooperate with the U.S. government during both world wars, but it was always able to return to its mandate and retain independence once they ended.

Something to consider is that, historically, pandemics and wars have impacted economies very differently. The real “natural” rate of interest in the decades following a major pandemic is 1.5 percentage points lower about 20 years later (see here, pp. 6-7). Pandemics, which often result in massive losses of life, and thus, labor, rebalance the relative returns to labor and capital. Wars, on the other hand, cause the destruction of both portions of the capital and labor supply. The added destruction of capital during a war then has the opposite effect as a pandemic on the natural interest rate for about the same amount of time. While these differences exist, academics have suggested that the potential decline in real interest rates may not be as severe, as the deaths from COVID-19 make up a smaller proportion of the total population. Those that have lost their lives are generally older, and thus not in the labor force, and that aggressive fiscal policies, which lead to higher debt burdens, will put upward pressure on interest rates (see here, p. 15). We do not yet know the full extent of the damage caused by COVID-19, and monetization would also depress real interest rates for a time, so the potential stagnation described above may still be a concern now.

Wars often necessitate more monetary-fiscal cooperation than what convention suggests is wise, but it’s helpful to have the central bank backing the government to ensure it has everything it needs to address the conflict. The sharp but temporary increase in deficit spending during a war mirrors what countries are having to do currently to combat COVID-19. If we assume that the current crisis is temporary, as wars are, and necessitates large temporary increases in government spending to combat it, then is allowing monetary-fiscal cooperation to the degree that some of these deficits may be monetized as harmful as some argue?
Concerns about excessive and uncontrolled inflation would still remain, but could be combated with conventional tools or potentially through some form of financial repression. Some additional inflation is necessary to both counteract the deflationary nature of the COVID-19 crisis and to pay for fiscal programs, but it must be proportionate, controlled, and temporary. It is true that the independence of the central bank may be damaged, but the benefits from having the objectives of the monetary and fiscal authorities temporarily align in the face of a truly damaging crisis may outweigh the harms. We are not suggesting that monetization would produce no negative impacts, but that the similarities between the COVID-19 crisis and times of worldwide conflict, from a public financing standpoint, are strikingly similar.

**Conclusions**

Monetization, that is, financing government expenditures through issuance of non-interest-bearing central bank liabilities, poses real risks—potentially excessive inflation and encroachment on central bank independence. Some paint monetization as a relic of a bygone era. The onset of the COVID-19 crisis, however, has forced governments to spend heavily to combat the considerable economic and public-health impacts. As deficits continue to climb and external investors remain cautious about where to place their capital, monetization has re-entered the conversation as a potential avenue to avoid massive debt burdens that some nations, particularly those in the developing world, may face.

However, much of what many are calling monetization today is not really monetization. In particular, many central banks are conducting extensive purchases of government bonds -- but they are financing these purchases with newly created, interest-bearing reserves rather than through a temporary commitment to increase the price level. Without committing to raise prices, they aren’t creating currency demand, so they aren’t generating seigniorage—and aren’t really monetizing, even though they could hold the bonds until maturity and roll them over indefinitely. The characteristics of debt securities purchased via quantitative-easing programs can make it difficult to tell if the purchases are permanent; it could be up to 30 years before some of the debt matures and needs to either be retired or rolled over. To our knowledge, no central bank during the COVID-19 crisis has explicitly stated that it is conducting monetization.

The extent to which a country is able to conduct either explicit or even “implicit” monetization depends on its level of economic development, the credibility and independence of its central bank, and the general economic environment. This makes monetization more attractive for countries that may not be able to obtain sufficient financing through debt issuance, taxation, or external finance (such as through the IMF).

However, these countries are often much more vulnerable to the inflationary and governance risks associated with the practice. A counterargument is that not fighting the crisis forcefully enough could have medium or long-run economic effects that are worse than the risk of some inflation. Central banks are well-equipped to deal with inflation, but the historical examples of excessive inflation, spurred by a loss of central bank credibility and a de-anchoring of inflation expectations, serve as a cautionary tale.
Monetization has primarily been used in the past to help finance wartime expenditures. The Fed financed deficits as high as 27% of GDP during World War II. Central banks may sacrifice some of their independence and ability to manage inflation in favor of fiscal objectives in such situations, albeit for a very limited period to avert a crisis. From a public financing standpoint, a substantial, but temporary economic shock, whether through war or disease, could be a dangerous enough emergency to demand similarly substantial and temporary cooperation between monetary and fiscal authorities. As World Bank Chief Economist Carmen Reinhart said recently: “This is a war. In a war, you worry about winning the war, and then you worry about paying for it.”
A New Index of Bank Resolution Reforms
By Matteo Aquilina, Krishan Shah, Costas Stephanou and Jonathan Ward (FSB Secretariat)

Original post here.

At the end of June, the Financial Stability Board (FSB) published a consultation report on its evaluation of the too-big-to-fail (TBTF) reforms for systemically important banks. The TBTF reforms\(^1\) were endorsed by the G20 in the aftermath of the 2008 financial crisis and have been implemented in FSB jurisdictions over the past decade. The report examines the extent to which the reforms are reducing the systemic and moral hazard risks associated with global and domestic systemically important banks (G-SIBs and D-SIBs), as well as their broader effects on the financial system.

The evaluation carried out an extensive review of the literature and relied on published results where possible. It also carried out several new pieces of analysis, which are summarised in an extensive Technical Appendix. To support this analysis, following the approach of Beck et al. (2019), the FSB developed a resolution reform index (RRI). The index measures progress in the implementation of resolution reforms across FSB jurisdictions and has been used in two ways:

1. As a descriptive statistic to show progress in implementing bank resolution reforms over time (2010-19) and across FSB jurisdictions.
2. As an independent variable in regression analyses, to help provide insights on the credibility and effects of those reforms.

In this article, we present the design of the RRI and insights that it has produced so far. The underlying data for the index can be found here and we hope that researchers will use it in future analysis.

Developing the index:

The RRI captures a mixture of legislative and regulatory reforms and policy guidance on bank resolution. It does not include all of the reforms set out in the global standard (the FSB’s Key Attributes of Effective Resolution Regimes for Financial Institutions), as it is intended to be an explanatory variable and not a compliance tool. The index is also not a benchmark of the resolvability of individual SIBs in each jurisdiction, nor does it reflect authorities’ considerations in deciding whether and how to use different resolution tools.

The evaluation followed four design principles when determining which items to include in the index:

---

\(^1\) The TBTF reforms have three components: (i) standards for additional loss absorbency through capital surcharges and total loss-absorbing capacity requirements; (ii) recommendations for enhanced supervision and heightened supervisory expectations; and (iii) policies to put in place effective resolution regimes and resolution planning to improve the resolvability of systemically important banks (SIBs).
1. Items should capture progress across the main areas of resolution reform introduced since the global financial crisis.

2. Items should provide unique information, in order to facilitate the identification of the effects of resolution reforms. This involves selecting items that tend to have more variability and lower correlation across jurisdictions and over time.

3. Items should be based on consistent and accurate data. The data was based on FSB progress reports and additional information collected from (and verified with) FSB jurisdictions.

4. The relative weight of items within the RRI should reflect expert judgment. All weighting systems involve implicit assumptions about relative importance, so this index reflects what resolution authorities in the FSB consider to be important elements of an effective and credible resolution regime.²

The RRI comprises three sub-indices:

1. The first sub-index covers resolution powers and recovery and resolution planning.

2. The second sub-index covers operational policies and guidance of resolution regimes (as opposed to the legal framework).

3. The third sub-index covers loss allocation, in particular whether authorities have powers to bail-in the creditors of failing SIBs and whether they impose external loss absorbing capacity (LAC) requirements on those banks.

A number of conclusions emerge from the RRI panel data. First, there has been good overall progress by FSB jurisdictions in implementing bank resolution frameworks. Figure 1 shows the increase in the RRI over this period. A similar pattern, although with more divergence across jurisdictions, emerges in the sub-indices, which are shown in the consultation report. Most jurisdictions have created additional resolution powers and introduced recovery and resolution planning for SIBs. But progress in operationalising the resolution process – including loss allocation – is less advanced, as noted in the FSB’s latest resolution progress report (November 2019) and its thematic peer review on bank resolution planning (April 2019).

² As a robustness check, the FSB also developed an alternative index in which all components are equally weighted. The main results, described below, were not significantly affected.
Second, Figure 2 shows that progress is most evident for jurisdictions that are home to G-SIBs. The progress made by these jurisdictions is not surprising, considering that most of them were among those most affected by the 2008 financial crisis and had good reasons to implement resolution reforms quickly.

The effects of resolution reforms

The index has been used in various analyses to assess how progress in the implementation of resolution reforms is related to indicators of systemic risk and moral hazard associated with SIBs. However, it is not always possible to attribute observed outcomes to the reforms. The evaluation has sought to establish a causal link between the reforms and observed outcomes using statistical techniques to the extent possible. However, some reforms were only recently implemented, while
other reforms and unconventional monetary policies over the same period are confounding factors.

Resolution reforms and funding subsidies

Banks that are too big to fail enjoy an implicit funding subsidy. Creditors expecting to be bailed out by the government if the bank fails may be willing to fund such banks at lower rates than other banks. Such subsidies represent an undesirable economic distortion. They are, by definition, not observable. However, funding cost advantages of SIBs, compared to (for example) other banks or non-financial firms, can be used as a proxy for implicit subsidies.

A review of the literature suggests that SIBs’ funding cost advantages peaked during the 2008 financial crisis, remained high for a number of years, and then fell. In addition, the funding cost advantages are negatively correlated with the RRI. More comprehensive implementation of resolution reforms is associated with a reduced funding cost advantage for SIBs, and hence with less economic distortion. A number of approaches point towards this result.

First, by comparing the return on a portfolio of SIB equities with the return on a portfolio of equities of banks that are not SIBs, while accounting for other risk factors, the evaluation finds that the funding cost advantage of SIBs diminishes when there is progress in the implementation of resolution reforms.

Second, by comparing how CDS spreads have evolved for SIBs compared to other banks or large firms during the period in which reforms were implemented the evaluation finds some evidence that a higher value for the RRI is correlated with a larger decline of the funding cost advantage across all specifications.

Third, focusing on bond spreads in Canada, the evaluation finds that the overall effect from the index on spreads is insignificant, but the sub-component attributed to recovery and resolution powers (sub-index 1) is negative, indicating that Canadian SIBs’ funding costs increase when these reforms are implemented.

Fourth, using bond spreads in Europe, the evaluation finds a negative relationship between the funding cost advantage of SIBs and the RRI. This result is mainly driven by D-SIBs.

Finally, using equity-implied CDS spreads the evaluation finds that the RRI is negatively correlated with funding cost advantages.

Broader effects of resolution reforms

One important question in the evaluation is whether the reforms have affected the supply of credit to the economy. The evaluation examined the hypothesis that, following the introduction of tighter prudential requirements, G-SIBs reduced their supply of credit as a proportion of GDP. This was the main concern about “unintended consequences” that was mentioned by some external stakeholders in their response to the call for public feedback.
The evaluation found that the level of G-SIBs’ domestic credit relative to GDP is negatively related to the RRI. The more advanced is the implementation of the resolution reforms the lower is the level of G-SIBs’ contribution to credit-to-GDP. The results are economically significant. A one standard deviation increase in the RRI (0.26 on average) is associated with a 1 percentage point lower ratio of G-SIBs’ domestic credit to GDP.

However, when using credit from other firms (D-SIBs, other banks, and non-bank financial intermediaries) as a dependent variable, the coefficient on the RRI is not significant. This suggests that there is no relationship between such firms’ aggregate credit supply and the resolution reforms.

It should be noted that the welfare consequences of a reduction or increase in credit supply are ambiguous. If credit falls relative to GDP, in an environment where the level is not above the optimum, it could be detrimental for growth unless other sources of credit pick up the slack. If lending is higher than optimal – a feature of the period that preceded the global financial crisis – a gradual reduction in credit would actually be beneficial from a welfare and financial stability perspective (Cecchetti et al., 2011).

The last piece of analysis performed with the RRI relates to the degree to which SIBs are similar. Holding common or correlated assets may expose banks to the same type of shocks, exacerbating losses in the system should such shocks occur. A key question in the evaluation is therefore whether the reforms have caused G-SIBs’ asset allocation to converge. The evidence suggests that G-SIBs’ asset similarity increased gradually from the early 2000s. The increase, though statistically significant, is small and probably has no material economic consequence. However, the estimated coefficient on the RRI is always significant and negative: advances in implementation of the resolution framework are associated with more heterogeneity in G-SIBs’ portfolios. This casts doubt on the hypothesis that it was resolution reforms that caused bank asset portfolios to converge.

**Conclusions**

The RRI is a powerful tool for measuring progress in the implementation of resolution reforms. It can also be used in empirical analyses to understand the effects of resolution reforms on various indicators of bank performance. The TBTF evaluation provides several examples of how such an index can help provide answers to the question on whether resolution reforms have achieved their intended objectives. We hope that the index will be used in future research by other researchers. Questions to be analysed include the political economy of resolution reforms: when and why did authorities initiate the reforms and whether causality between resolution reforms and outcome variables of interest can be established.
War Finance and Bank Leverage: Lessons from History
By Antoine Martin (NY Fed) and Joshua Younger (J.P. Morgan Chase & Co.)

Original post [here](#).

Congress’s legislative response to the coronavirus pandemic is expected to lead to a dramatic increase in government debt that, as a fraction of GDP, could reach levels not seen since World War II (WWII). Who will buy that debt and what could be the consequences of this indebtedness? How could it reshape the banking system and how might regulators respond? In this post, we take a look at U.S. government debt over the last 100 years to draw some lessons.

**Congress’s Response to the Pandemic**

Fiscal policy has evolved almost as fast as the pandemic, with a slate of legislation passed in March and April designed to offset the negative economic impact of the public health emergency. As of June, the Congressional Budget Office (CBO) [estimated](#) that the cost of this response will total $2.4 trillion, roughly 79 percent of which will be new spending. With revenues likely to decline at the same time, the CBO in a separate report said it [expects](#) a budget funding gap of $3.7 trillion in FY2020 and $2.1 trillion the following year. As a result, government outlays and deficits relative to GNP are both nearing levels last seen during WWII, as shown on the next chart.

![Figure 1: Federal outlays and deficits as a share of GNP increase dramatically](image)

**War financing: what happened to government debt around WWII?**

There are several intuitive reasons to look back to the historical example of war financing when considering the economic impact of the COVID pandemic. In both cases, an urgent national project required a level of coordination of activity that generally cannot be achieved by the private sector. This often leads to fiscal policy that generates a large increase in the stock of Treasury debt. That was clearly the case in the 1940s, during which the marketable debt outstanding grew from 30 percent to 98 percent of GDP from Pearl Harbor to Victory over Japan (V-J) Day. The impact of COVID-19 on federal finance will likely not be quite as dramatic as WWII, in part because the debt-to-GDP level was already high before the pandemic. Nevertheless, CBO
projections suggest that the stock of Treasury debt relative to economic output will reach comparable levels in the coming years.

**How was all that government debt financed?**

Much attention has been paid to the role of the Federal Reserve after WWII. Of the roughly $230 billion increase in interest-bearing Treasury debt (or 216 percent of 1940:Q4 GNP) between 1940 and 1945, more than 70 percent (or $163 billion, or 153 percent of 1940:Q4 GNP), was sold on the open market (that is, as marketable debt). A recent Liberty Street Economics [post](https://libertystreet.economists.org) by Kenneth Garbade (and a related [publication](https://www.the-federal-reserve.com/)) examines in detail the implementation and impact of yield curve control measures enacted during those years to support the financial aspects of the War effort. However, it should be noted that though Fed purchases were an important piece of the story and central to capping yields, they were not the primary source of demand. The private sector purchased more than 87 percent of the marketable debt sold from 1940-45, with commercial banks in particular absorbing 31 percent of net issuance, as compared to only 13 percent by the Fed, over that period. As a consequence, the percentage of marketable Treasury debt held by commercial banks increased to nearly 50 percent during the War Years, while the Fed never breached 12 percent over that period, as seen in the following chart.

![Figure 2: The share of marketable Treasury debt owned by commercial banks during WW II was consistently much higher than the share owned by the Fed](https://example.com/figure2.png)

These purchases led to rapid growth in the balance sheets of both the Fed and of the U.S. banking system. Over 1940 to 1945, total assets held by commercial banks more than doubled in absolute terms and reached nearly 80 percent of GNP, as seen in the next chart.
Most of the increases in commercial bank assets were driven by the expansion of the Fed’s balance sheet, and the associated increase in bank reserves, as well as acquisitions of Treasury securities. By the end of the War, these two assets accounted for nearly 80 percent of their balance sheets, as seen in the next chart.

The large increase in Treasury holdings by commercial banks had striking implications for their leverage ratio. Total leverage ratios, measured as equity capital to total assets, among commercial banks started the 1940s around 10.3 percent, but declined to a low of 5.5 percent by 1945, as seen on the next chart.
The drastic reduction in the leverage ratio eventually led to a dilemma for regulators. Capital adequacy requirements put in place by the Federal Deposit Insurance Corporation (FDIC) during the 1930s set a 10 percent minimum for equity relative to all balance sheet assets, including cash and Treasuries. This was a change from minimum capital-to-deposit ratios, which prevailed prior to the Great Depression. The new equity-to-asset ratio rule was not binding for several years after its creation, but this changed quickly with the rapid expansion of commercial bank balance sheets in response to the massive increase in government debt. To avoid a disorderly reduction in assets that would likely harm the war effort, the Federal Reserve revised its requirements, defining a new equity-risk asset ratio that excluded cash and Treasuries and setting a 20 percent minimum requirement. (More detail about these events can be found in papers by Malcolm Alfriend, Karlyn Mitchell, John Walter, and Joseph Haubrich.)

The immediate post-War years are also an instructive epilogue to this story. Neither total nor risk-based leverage ratios recovered as quickly as debt-to-GDP in the years immediately following V-J Day. In fact, risk-based leverage ratios declined in the late 1940s and 1950s as strong growth led to increased private sector demand for credit. This development led the Federal Reserve to revise capital adequacy requirements again in 1952, this time assigning capital requirement to specific assets on the basis of their perceived risk. The Fed also added new liquidity requirements that considered the liability side of the balance sheet in 1956. These rules were designed to maintain the stability of the banking system without restricting the system’s ability to facilitate the post-War economic recovery—and the requirements did not return to total leverage-based constraints.

To sum up

The last time the United States had levels of debt to GDP as high as those expected in the coming years was during WWII. Among other things, the 1940s show that, though the Fed certainly played an important role, private market participants were instrumental in financing the war effort. Commercial banks in particular played a key role, which lead to large increases in the sizes of their balance sheets and a dramatic decline in the leverage ratio, as measured by capital over assets. These changes required a more dynamic approach to capital adequacy, and regulators
adapted to this unprecedented situation by excluding the safest assets, such as cash and Treasury securities, from the leverage ratio.
Fixing Financial Data to Assess Systemic Risk

By Greg Feldberg

Original post here.

This post is a report, which was produced by the Brookings Center on Regulation and Markets.

The coronavirus-induced market stress in March provided new evidence that the public and the authorities still don’t have the data they need to track and analyze risks in the financial system. Authorities were unable to answer basic questions as markets spun out of control. Who was selling billions of dollars’ worth of U.S. Treasuries, which many believe are the safest assets in the world? Who had too much short-term leverage in repurchase agreements (repos)? Who was exposed indirectly through their debtors and counterparties?

Answers to these questions would have been useful. But the Treasury market, the most liquid fixed-income market in the world, remains surprisingly opaque. Broker-dealers now report their transactions in the market to the authorities, but banks still don’t, and the authorities share little information with the public. Data remain limited on the uncleared bilateral segment of the repo market and on the activities of hedge funds, whose selling of Treasuries was significant but difficult to evaluate with existing data.

To be sure, the Federal Reserve quickly restored confidence this Spring. But it did so through massive credit operations and a commitment to buy securities, like corporate bonds and exchange-traded funds, that it has never bought before, not even during the 2007-09 financial crisis. Better information may have allowed for a more targeted response in March and a more fruitful assessment afterward.

It wasn’t supposed to be this way. Regulators have much more data now. Since the last crisis, they have pulled derivatives trading out of the shadows; introduced reporting for hedge funds, private equity funds, and money market funds; and asked a lot more of banks.

Congress created an Office of Financial Research (OFR) in 2010 to identify risks and fill blind spots so regulators would have a broader view of “who owes what to whom” across the financial system. The OFR has mandates to improve the quality of data collected, promote data-sharing, and improve public disclosure. It has subpoena power to collect data from financial companies to enforce these authorities. It is also expected to conduct cutting-edge research and create models and monitoring tools that they and the regulators can use to identify potential systemic risks.

But, despite these initiatives, financial data today remain incomplete and often not fit for purpose. Legacy data-collection technologies, old-school thinking, and bureaucratic turf fights continue to hinder the authorities’ ability to monitor systemic risks. Moreover, U.S. regulators have fallen behind the private sector and many of their peers overseas in the adoption of technologies that could revolutionize the collection, management, sharing, and dissemination of financial data.
This paper first describes the unique challenges that financial data present. It then describes a strategy to bring financial data into the 21st century. That strategy would set a timeline for identifying and closing data gaps; improving standards; sharing data, both among authorities and with the public; and accelerating the adoption of new technologies. Finally, it describes the role the OFR should play in driving that strategy, working closely with regulators on the Financial Stability Oversight Council (FSOC).

To implement this strategy, the new Biden administration will have to first remove the roadblocks that have gotten in the OFR’s way for the past 10 years. Those roadblocks include a lack of support from Treasury, where it sits organizationally; sometimes aggressive undermining by private industry and even other FSOC member agencies; and defunding and silencing under the Trump administration.

The presidential transition period provides a unique opportunity to remove such roadblocks in the vetting process for heads of regulatory agencies. The administration should make sure every appointee understands that financial regulatory data management is broken and FSOC member agencies have the responsibility to fix it. Every FSOC Principal should also know that the Evidence Act of 2018 requires them to appoint a Chief Data Officer (CDO) and draft a data strategy. Most importantly, the Treasury Secretary, as chair of FSOC, needs to unify the regulators to support an independent OFR and head off the turf issues that will inevitably arise as it executes its mandates.

There are reasons for cautious optimism that the OFR can lead FSOC toward common data goals. Most FSOC member agencies now have appointed CDOs, each tasked with championing better use of data. Recent laws require federal agencies to improve their collection, management, and dissemination of data. Some agencies have already taken steps to improve the data they collect. The Federal Deposit Insurance Corporation launched a competition to modernize the century-old call report that banks file. The Commodity Futures Trading Commission recently took action to fix derivatives data.

In short, the elements are in place. We still need leadership. This paper argues that the new administration should make it a priority to fix financial regulatory data, starting during the transition. The incoming administration should, first, emphasize data when vetting candidates for top financial regulatory positions. Every agency head should recognize the problem and the roles they must play in the solution. They should recognize how the Evidence Act of 2018 and other recent legislation help define those roles.
Introduction

The residential housing bubble has been identified as one of the main culprits of the global financial crisis (GFC), partially fueled by securitization, bank risk taking behavior, and lax financial regulation. More than a decade later, there are still unanswered questions about the mechanisms that drove the housing market misalignment and key lessons learned.

Various theoretical arguments suggest that fundamental factors such as credit supply, interest rates, income and population growth cannot fully explain the house price process. One compelling hypothesis is that the residential housing market resembled an asset bubble in the run-up to the GFC, primarily driven by subprime lending (Mian and Sufi, 2009; 2010). When interest rates jumped, a large share of subprime borrowers defaulted and their homes were subsequently foreclosed upon, triggering the house price bust.

In contrast, others have argued that differences among investor types have significantly contributed to house price dynamics, primarily due to heterogeneous preferences and expectations. For instance, housing speculation (such as short-term investments) can be a source of shock amplification, which in turn can lead to systemic risk. One mechanism through which speculation works as a shock amplifier is fire sales. If speculators are highly leveraged, owning multiple properties and being dependent on rental income, any exogenous shock can trigger a rapid deleveraging and potentially drive fire sales of their properties. This mechanism can also have important economic consequences (Gao et al., 2020). Other investors perceive housing as a financial asset, with their expectations mainly anchored in the future price appreciations while rental income acts as a dividend. This phenomenon has led to the rapid growth of REITs (Real Estate Investment Trusts) and the synchronization of house price cycles across the globe. Global cities such as London, New York, and Hong Kong have experienced substantial international capital inflows into their real estate markets. These capital flows are typically driven by global financial conditions. Conversely, when risks increase in emerging markets, international capital flows are searching for safer assets in advanced economies, with housing in global cities representing one asset class.

Conceptually, one of the main drivers of housing markets is the credit supply. Prior to the GFC, shadow banks were heavily involved in mortgage intermediation, heavily relying on the “originate and distribute” model. However, during the GFC, the appetite for private securitization plummeted and shadow banks experienced a sudden stop on the funding side. In the aftermath of the crisis, regulatory changes in the banking industry and the use of new technologies to screen borrowers have significantly contributed to the rebound of shadow banking activity, particularly in the mortgage market.
The relationship of non-Primary Home buyers to house price cycles and rents

In a recent paper, we document the evolution of different types of housing investment demand, using a proprietary and comprehensive dataset covering nearly 90 million US residential transactions over 1998-2018. In the run-up to the GFC, second-home purchases represented a significant share of total transactions, exceeding 15 percent of total transactions in some areas. When the transaction volume collapsed, the fraction of short-term investors (i.e., within-year resales) surged, helping to improve market liquidity. Interestingly, corporate purchases in cash jumped as well after 2008, more than tripling the pre-crisis levels. Overall, non-primary home buyers were involved in more than 30 percent of transactions during 2008-12 period, suggesting their relevance in the residential real estate market (Figure 1).

**Figure 1. Non-primary Home Buyers and Transaction Volume**

![Graph showing non-primary home buyers and transaction volume](image)

Note: Each type of non-traditional investments is depicted as a share of total transactions, weighted by the sales price. Total transactions include both primary and non-primary home buyers. Total transaction volume (in logs) is plotted on the RHS axis.

More importantly, non-primary home buyers have had an important contribution to the house price cycle over the past two decades. Relying on an instrumental variable analysis, we identify causal effects of non-primary home demand on the housing market. Starting in 2009-10, government sponsored enterprises (GSEs) implemented the First Look initiative to encourage home ownership by allowing owner occupant homebuyers to purchase foreclosed properties.
owned by GSEs, during a window of up to 30 days, before other investors could make a bid on
the property. Similar to Lambie-Hanson et al. (2019), we exploit the geographical variation in
foreclosure sales owned by GSEs as an instrument to quantify the effect of housing investors.

Zooming in the distribution across zip codes over time, the share of First Look sold properties
peaks around 2010 and then gradually declines after 2011 (Figure 2, top panel). In terms of
geographical distribution, higher percentage shares are observed in the coastal areas, particularly
in the South West. Importantly, areas with a high exposure to First Look properties saw a
relatively steeper drop in the share of second-home buyers, when compared with less exposed
areas (Figure 2, bottom panel). This finding is consistent with the purpose of the program which
achieved its objective of reducing the share of investors in areas where the GSEs’ owned most of
the foreclosed properties.

**Figure 2. First Look Properties and Non-Primary Home Demand**

*Share of First Look Properties*

*Share of Second-home Buyers*
In economic terms, the second-home investment demand has statistically significant impact on house prices and rents. For instance, a one percentage point increase in the instrumented share of second-home buyers is associated with 0.66 percent higher house prices, amplifying the boom periods. At the same time, a one percentage point rise in investment demand can lead to 0.5 percent lower rents in the subsequent period. This evidence is consistent with a buy-to-let logic of investment demand whereby investors purchase properties and subsequently increase the supply in the rental market.

**Shadow banking**

Naturally, with more than 60 percent of housing transactions being financed by loans, credit supply and credit shocks play a key role in housing market dynamics. First, housing investment is highly leveraged, creating risks for both homeowners and their lenders. This aspect has important implications for financial stability. Second, the housing cycle and household indebtedness have historically moved in tandem. This co-movement has been strengthened by the rapid growth of securitization and shadow banking activity in the early 2000s. After plummeting during the GFC, shadow banking activity has strongly rebounded over the past
decade (Figure 3). Its rapid growth was partially driven by tighter banking regulation and the emergence of new technologies which allowed the arrival of online FinTech lenders (Buchak et al., 2018; Greenwood and Scharfstein, 2013).

In our analysis, we find that in areas with a high share of shadow bank lending, a one percentage point increase in second-home buyers is followed by a 0.5 percent increase in house prices during boom periods. In contrast, the effects are not statistically significant in the areas dominated by traditional banks. Similarly, a one percentage point increase in the fraction of second-home buyers in areas with a larger penetration of shadow banking activity is associated with about 5 percent slump in house prices during bust periods. At the same time, the effects of second-home purchases are much weaker in areas less exposed to shadow bank lending, leading to a 1.3 percent fall in house prices during recessions. The effects of various types of investments on house prices are consistently found 3-4 times larger in areas dominated by shadow banks, particularly during boom periods (Alter and Dernaoui, 2020).

**Figure 3. Shadow Banking Activity across US Counties**

In 2008

In 2018
Note: “Shadow banking” refers to non-deposit taking financial institutions such as mortgage, finance, leasing and insurance companies.

Concluding remarks

In summary, we study the dynamics of investor composition using a unique and comprehensive dataset and document the peak of non-primary home investments in the aftermath of the GFC. Interestingly, areas with a higher share of investments experienced an amplified boom-bust housing cycle. More importantly, areas with a higher share of shadow bank lending have been associated with riskier mortgages and a more amplified house price cycle due to the presence of non-primary home transactions.

Our findings have several policy implications. Macroprudential, monetary, and fiscal policies can serve as key levers to mitigate excessive house price appreciation, housing affordability, and potential financial stability risks. In particular, our results are consistent with the development of a complete macroprudential policy toolkit for non-bank financial intermediaries, which can be appropriately utilized to limit risk-taking behavior and potential policy leakages.
Should Governments Print Money to Make It through the Pandemic?

By Greg Feldberg and Aidan Lawson

Original post [here](#).

Most of the time, governments have two basic choices for financing their deficits: they can borrow (issue debt) or raise taxes.

In a recent paper in the *Yale Journal of Financial Crises*, we discuss a third, unconventional option that has reentered the discussion lately: printing money.

Money-printing—more technically known as monetization or “money-financed fiscal programs”—occurs when the government finances itself by issuing non-interest-bearing liabilities. Those liabilities could be currency or they could be reserves that banks hold at their central bank.

By monetizing debt, the government uses inflation to finance some of its spending. But that’s OK. With economies shrinking by as much as one-third on an annualized basis in 2020, central banks have had more cause to worry about deflation than inflation. The Federal Reserve last year said in unprecedented guidance that it could allow inflation to exceed its 2% target to escape the pandemic-induced recession; it won’t rush to raise rates to head off inflation.

Several experts have called for cautious monetization during the pandemic. Some have even promoted the idea for emerging-market central banks, so long as they have flexible exchange rates and well-anchored inflation expectations. Of course, any money-printing would require controls and careful messaging about the extent and duration (see page 63 of this report from the Bank for International Settlements).

How would monetization work? The central bank could buy government bonds and cancel them, or similarly, promise to roll the debt over indefinitely. Either way, the result would be the creation of money at no direct cost to the government. Central banks would purchase those bonds by crediting newly created reserves to the government’s account at the central bank. The government could then use the reserves, which would be a liability of the central bank, to pay for its fiscal programs. Alternatively, the central bank could simply create accounts for the public at the central bank with new money, an idea with growing support.

A complication is that most central banks now pay interest on the reserves that banks hold with them. So buying government debt would carry a cost to the central bank, as it would replace interest on debt with interest on reserves. Removing interest on reserves could make it harder to tighten monetary policy — that is, to raise interest rates — when the time comes. A central bank typically sets the rate on reserves as a floor for its target interest rate.

But even a central bank that is legally bound to pay interest on reserves could put monetization in its toolbox. It would have to combine its government debt purchases with convincing guidance.
that it has temporarily raised its inflation target. If the guidance is credible—that is, if consumers and businesses expect more inflation in the future—then they will consume and invest more in the present, pushing prices up. The higher inflation reduces the real value of existing currency; as a result, consumers and businesses need to hold more of it, which allows the government to finance the fiscal action with non-interest-bearing currency over time.

The challenge is to not let inflation get out of hand. A country’s capacity for monetization is related to the amount of money (currency plus non-interest-bearing reserves) in its economy. When modeled, a program that costs about 1% of gross domestic product (GDP) that is fully monetized corresponds to about a 10% increase in the price level.

Of course, the mere hint of monetization conjures fears of government overreach and excessive inflation. Many countries don’t allow their central banks to buy government debt at all. Some allow limited amounts to cover short-term cash needs. Others require the government to repay the central bank quickly.

But it was Milton Friedman himself, conservative economist and historian of the Great Depression, who first proposed using “helicopter money” to escape a deep deflationary recession, 50 years ago.

Critics wagged at former Fed chair Ben Bernanke when he mentioned Friedman’s suggestion in 2002, but he still hasn’t backed down from his view that “governments should never have to give in to deflation.”

Some of the same critics made apocalyptic warnings about potential inflationary effects when the Fed and other central banks introduced quantitative-easing programs after the global financial crisis (GFC) of 2007-09. In our view, these were not monetization programs. Indeed, despite trillions of dollars of debt purchases by central banks, inflation hardly stirred. Banks held the new cash in reserves, the broader money supply grew moderately, and the money multiplier—the ratio of commercial bank money to central bank money—shrank. Monetization is thus not inflationary as long as banks are reluctant to lend. As Treasury secretary and former Fed chair Janet Yellen recently said, central banks know how to subdue inflation; it is deflation that continues to puzzle them.

Monetization only works if there is a respected and responsible central bank ready to turn off the taps when inflation threatens to exceed its targets and a responsible government. If the government believes the central bank has a limitless appetite for its debt, it could spend beyond the point at which the central bank can still control inflation. Such “fiscal dominance” is real. For example, the central bank had an explicit obligation to buy government debt in India before reforms in the 1980s and 1990s.

Questions about central bank independence could be mitigated by capping the amount of spending that can be monetized. Bernanke has proposed that Congress create a Treasury account at the Fed that the Fed could fill up to a limit. Congress would retain the authority to decide where to spend any funds the Fed created.
The theory of central bank independence, Bernanke has argued, allows for such close cooperation between a country’s central bank and Treasury during difficult times, when their interests are clearly aligned. During the world wars, for example, the Fed temporarily monetized portions of an expansive fiscal policy at the expense of its independence. After World War II, the Fed artificially kept interest rates low—a policy known as “financial repression”—so the government could more easily repay its debts. But the Fed ultimately recovered its independence. Recent papers suggest that monetization may need to be accompanied by some financial repression to significantly affect debt burdens.

Since we published our paper, President Joe Biden’s $1.9 trillion American Rescue Plan has rekindled this debate. Notable economists like former Treasury Secretary Larry Summers have raised concerns about inflation. It would be fine, Summers says, if the government simply plugged the output gap—the difference between current and potential GDP. But he argues that the proposed relief is much bigger than that. In contrast, he argues that the $840 billion stimulus package of 2009, of which he was a chief architect, was not nearly large enough to address the output gap during the GFC.

To be sure, the Fed now says it will accommodate higher inflation than in the past. Investors seem to have noticed. Ten-year Treasury yields—a market proxy for inflation—have crept higher in recent weeks.

But that doesn’t mean we are in for excessive inflation.

First, the GFC is the wrong historical analogy. It was a balance-sheet crisis, stemming from exposure to highly risky assets and unsustainably high leverage. During the pandemic crisis, financial balance sheets are fine; the shock came from outside the financial system. This makes it more like a war, as economist Paul Krugman has argued and World Bank chief economist Carmen Reinhart recently suggested. Wars, like the pandemic crisis, require huge amounts of government spending, industrial reorganization, and monetary-fiscal coordination. Despite massive, debt-financed spending by the U.S. during both world wars, inflation never got out of hand. Indeed, Fed Chair Jay Powell recently said (page 10) that he does not expect the combined Fed and Treasury measures will lead to “troubling inflation.”

Second, the critics’ argument partly rests on their view of the fiscal multiplier, which measures the effectiveness of a particular fiscal policy program on output. The higher the multiplier, the greater the effect on output. Olivier Blanchard, a former IMF chief economist, estimates that the multiplier of the Biden package will be 1.2, which means that the $1.9 trillion ARP would have an estimated effect of $2.3 trillion on output.

But there is an argument that multipliers could be much lower, both because many sectors of the economy are shut down or operating at reduced capacity and because fear of catching COVID will make people more cautious about completely returning to normal.

Third, the Federal Reserve now has a long track record of well-communicated, timely, and measured monetary policymaking. Consumers and businesses may trust that the Fed can allow
prices to rise moderately without risking excessive inflation. Some moderate, controlled inflation would also allow the Fed to begin gradually raising interest rates, which have hovered close to zero since the global financial crisis. Some inflation also could give the Fed some more room to manipulate rates during downturns. Instead of signaling a coming inflationary spiral, increases in 10-year Treasury yields may simply be a sign of markets willing to take more risks. Sound monetary policymaking in the past gives central banks the necessary capacity to effectively combat negative shocks in the present while preserving credibility.

In short, monetization is a powerful tool that countries with strong, independent central banks can use to finance large rescue programs and pay down existing debt.

We may soon have firsthand experience with monetization, with the passage of the latest relief bill and the Fed’s increased tolerance for higher inflation. Only time will tell how the Treasury and Fed will navigate these challenges.