April 16, 2020

To: Staff Groups for Primary and Secondary Market Corporate Lending Facilities, Main Street Lending Facilities, Municipal Lending Facility, and Term Asset Lending Facility

From: Americans for Financial Reform Education Fund

Re: Comments on Primary and Secondary Market Corporate Lending Facilities, Main Street Lending Facilities, Municipal Lending Facility, and Term Asset Lending Facility

To Whom It May Concern:

The Americans for Financial Reform Education Fund ("AFR") appreciates the opportunity to comment on the term sheets of the Federal Reserve facilities referenced above. Members of AFR Education Fund include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups.[1]

On April 9th the Federal Reserve announced six new facilities, financed by taxpayer equity investment, that could support potentially $2.3 trillion in "real economy" lending. Below, we offer specific comments on terms offered in six of those facilities: the two facilities supporting corporate securities markets, the two Main Street lending facilities, the Municipal Liquidity Facility, and the Term Asset Lending Facility (TALF).

Before offering these specific comments, we offer the following general observations on three areas in which these lending interventions need substantial improvement.

- **Conditions and requirements for receipt of funding**: The facilities are notably lacking in requirements or conditions that would link funding to the creation of social benefit, the maintenance of employment, or response to the Coronavirus pandemic. This is most evident in the case of the two secondary market corporate credit facilities. Public financing from these facilities could apparently be used for deal funding such as leveraged buyouts or dividend recapitalizations, and there are apparently no requirements whatsoever for companies that benefit from these facilities to maintain employment or payroll or limit executive compensation. Even conditions on the Main Street Lending Facilities are inadequate and fall short of statutory CARES Act requirements. Since there are no limits on the types of entities that could use these facilities, we expect that highly aggressive and sophisticated entities such as large private equity firms will seek out opportunities to channel funding to reward capital owners instead of supporting workers and the pandemic response.

[1] A list of coalition members is available at: http://ourfinancialsecurity.org/about/our-coalition/

We appreciate that the Board faces some practical barriers in monitoring and enforcing requirements for lending facilities. But we believe that much stronger conditions could be put in place and offer specific recommendations below.

- **The importance of disclosure**: Under the CARES Act, disclosure requirements for these programs are governed by Section 13(3)(C) and (D) of the Federal Reserve Act. We understand that under a common interpretation of this statute, the seven day disclosure requirement in Section 13(3)(C) requires only a general statement as to the rules of the facility, its general terms, and the type of borrowers that would be eligible, with no transaction-level disclosures of the identity of actual borrowers or the terms of specific loans. The thirty day disclosure requirement in Section 13(3)(D) would appear to require only updates on the total collateral, revenues, and risks of the facility, again with no information on specific transactions. ***We believe it would be a grave error for the Federal Reserve to attempt to withhold transaction level information on the identity of borrowers and the details of specific loans.*** Instead, detailed transaction-level disclosures should include the identity of borrowers (including beneficial owners of legal entities), the terms of the loans, and copies of the underlying deal documents. A failure to disclose how taxpayer dollars and other benefits are being used would severely undermine public trust in the Federal Reserve as an institution. Further, making such information public is one of the best ways to ensure that borrowers use the funds to genuinely support the economy rather than simply seek profits for capital owners. Public transparency will help limit the extent to which companies can misuse funds. We provide specific disclosure recommendations for each facility below.

- **Moral hazard and incentive effects of misdirected support for high-risk credit**: These facilities will provide funding to a much wider range of borrowers and credit quality than the Federal Reserve has ever interacted with before. Multiple facilities will lend to companies or support credit that is below investment grade, either at the time the loan is made or even before the current pandemic crisis began. We believe it is consistent with the intent of Congress that the Federal Reserve support a wide range of credit quality for the purpose of maintaining employment and, where appropriate, business operations during the current pandemic crisis period. However, an unconditional subsidy to high-risk credit could easily result in the use of public funds to further inflate a corporate credit bubble that was already identified by experts and regulators as a major source of systemic risk before this crisis began. Especially given the lack of conditions for funding, this can act as a subsidy to the same parties that created conditions of excessive corporate leverage, leading to obvious issues of moral hazard, systemic unfairness that contributes to growing economic inequality, and future risk to the economy. Preventing corporate bankruptcy should not be an end in itself. U.S. Chapter 11 bankruptcy is intended to support the ongoing operations of a company and maintain employment while debt is renegotiated.

Taking operational steps to impose conditions on the use of loans and avoid creating long-term moral hazard and systemic risk will require the Board to make policy choices concerning the social goals of lending programs. Unfortunately, Congress in the CARES Act did not always provide clear guidance on those goals. But Section 2A of the Federal Reserve Act did provide such guidance through its mandate that:

> "The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

These programs will have clearly have an enormous impact on the growth of monetary and credit aggregates in the economy. It is the clear statutory responsibility of the Board to manage such increases in a manner that effectively promotes maximum employment and stable long-term economic growth. This cannot be done without making substantive policy choices concerning the distribution of this credit.

Several of the recommendations above, especially stronger conditions on receipt of funds and increased public disclosure, are likely to be opposed by some potential borrowers. Companies may claim that they will be reluctant to access credit if they are required to use funding in particular ways, or the nature and extent of their funding is made public. We urge the Federal Reserve to resist such claims. If a company feels that using funding to maintain the employment and benefits of its workforce, or revealing the existence of funding to the public, are too high a price to pay to receive public support, then perhaps it does not actually need such support.

Below, we provide comments on specific facilities. Because of the extremely deadline (one week) provided for these comments, they are not exhaustive as to our views regarding potential shortcomings in the facilities. They may be supplemented at a later date.

Comments on Specific Facilities

Municipal Lending Facility

The Municipal Lending Facility is an important step that we strongly support. We are particularly supportive of the high cap on total borrowing (up to one-fifth of 2017 revenues) and the fact that the list of permissible uses for funds in the Term Sheet include addressing "all potential reductions of tax and other revenues or increases in expenses related to or resulting from the COVID-19 pandemic". We note that this range of uses exceeds traditional narrow definitions of revenue anticipation borrowing and recommend that this be reflected in the definition of "eligible notes" elsewhere in the term sheet.

However, we have the following recommendations for improvements to the facility. We believe that these recommendations are very important to permit the facility to properly support state and local activity that will be crucial both to containing the health impacts of the pandemic and allowing for a faster and more widespread recovery.

First, eligibility criteria are much too narrow. Current rules limit direct lending to only 76 total eligible borrowers. There are no sub-state borrowers at all eligible for the facility in large, populous, and diverse states like e.g. Ohio, Michigan, Wisconsin, and Massachusetts. It would be a mistake for the Federal Reserve to rely exclusively on state governments to on-lend these funds rapidly and efficiently to all areas of need in the state. The racial equity implications of these limitations are also disturbing. According to the Brookings Institution, none of the 35 cities in the country with the highest proportion of black residents are directly eligible for this program under the current rules.[2] The program should be opened directly to a much larger set of participants.

Second, the two year maturity maximum for the loan should be extended, or, alternatively, the facility should provide a low-cost mechanism for rolling over loans well past the two year point. It is likely that the economic fallout from this crisis will still be felt two years from now. The need to refinance or repay loans at that date will put significant fiscal stress on governments at a time when the economy is still recovering. This could contribute to states and localities acting as a drag on economic growth. The simultaneous private refinancing of all loans from this facility just two years from now could also create significant stress on municipal finance markets. We note that the other private sector programs discussed in this comment provide four year financing, even though private sector borrowers are historically riskier than states and localities.

Third, loan pricing should reflect at most the very low spreads over the Federal Funds rate that were available in the municipal markets in early 2020. Pricing should not rely primarily on NRSRO ratings, but on historical default rates. Ratings agencies have been shown to discriminate against public borrowers by issuing ratings that do not reflect the extremely low (almost non-existent) default probabilities of general obligation municipal credit as compared to private credits.[3] It has also been shown that these ratings significantly increase credit costs for municipalities.[4] Loan pricing should be based on the actual past default rates of general obligation municipal borrowers, which justifies rates at or close to the Federal Fund rate.

A mechanism should also be found to give access to this facility for U.S. territories, especially Puerto Rico. It is true that Puerto Rico presents unique underwriting and governance issues due to its current quasi-bankruptcy situation, in which it is not accessing general debt markets. However, Puerto Rico is like any other jurisdiction in that it may be impacted by the revenue interruptions and other financial and human costs of the Covid-19 pandemic. Further, Puerto Rico is within the district of the Federal Reserve Bank of New York which is the largest and most sophisticated regional bank and the best equipped to manage and analyze issues associated

[2] Klein, Aaron and Camille Bussette, "Improving the Equity Impact of the Federal Reserve's Municipal Lending Facility", Center on Regulation and Markets, Brookings Institution, available at https://brook.gs/2VF6NSu
[3] Jess N. Cornaggia, Kimberly J. Cornaggia, John E. Hund, Credit Ratings Across Asset Classes: A Long-Term Perspective, *Review of Finance*, Volume 21, Issue 2, March 2017, Pages 465–509, available at https://doi.org/10.1093/rof/rfx002
[4] Jess Cornaggia, Kimberly J. Cornaggia, Ryan D. Israelsen, Credit Ratings and the Cost of Municipal Financing, *The Review of Financial Studies*, Volume 31, Issue 6, June 2018, Pages 2038–2079, available at https://doi.org/10.1093/rfs/hhx094

with assisting Puerto Rico. It is not equitable or appropriate to simply omit Puerto Rico and its population of over 3 million people from all support for revenue anticipation borrowing.

Regarding disclosure, we believe that the Federal Reserve should publicly disclose its reasoning and supporting evidence in cases where municipal applications to borrow from the facility are rejected upon review.

Beyond this facility, we also believe that additional assistance is needed through a future municipal facility financed through a share of remaining CARES Act money. An additional facility should support issuance of more conventional longer-term municipal finance during the period of economic recovery from the current downturn, in order to ensure that municipal fiscal pressures do not act as a drag on long term economic recovery.

Primary and Secondary Market Corporate Credit Facilities

The Primary and Secondary Market Corporate Credit Facilities (PMCCF and SMCCF) will purchase debt securities issued by corporations, both new issues and existing secondary market instruments, as well as shares in Exchange Traded Funds (ETFs) backed by corporate credit and shares of syndicated corporate loans.

PMCCF

There are no apparent conditions placed on the use of proceeds from the PMCCF facility, and no attempt to limit or even prioritize lending based on the use of proceeds. This means that bonds could be issued to finance pure financial engineering transactions such as leveraged buyouts or dividend recapitalizations, and they would be financed on an equal basis with issuances intended to support needed investment, maintenance of employment, or support for ongoing operations. There are also no requirements for companies benefiting from selling new issuances to this facility to maintain their employment or business operations, or to rehire workers.

The PMCCF should require any corporations financed by the facility, whether through purchase of new bond issuances or syndicated loans, to clearly state and attest to the intended use of proceeds from the loan. The PMCCF should aggressively prioritize lending where the proceeds are intended to support employment or payroll, ongoing operations, and pandemic-related investment including in worker safety or in response to new health or economic needs related to the pandemic. Such prioritization should be reflected in both the ease and rapidity of obtaining loans and the pricing of the loan. Lending that will go to finance unproductive financial engineering should not be financed at all.

In addition, at minimum companies benefiting from PMCCF funding should be required to maintain their workforce and payroll as of the time the loan was received. As discussed in the section on Main Street Lending Facilities, it should be possible at a later date to obtain a fairly accurate estimate as to whether employment was maintained. This could be done by simply using payroll tax data as reported through the payroll tax system, with individual wages capped at a reasonable level, and comparing total payroll after the loan was funded to total payroll before it was funded.

We are also puzzled as to why the PMCCF does not include the restrictions on capital distributions and executive compensation that are attached to the Main Street Lending Program. The purchase of a new bond issuance is similar in economic substance to a loan, so it appears that it should also be subject to similar restrictions on diverting proceeds to capital distributions or increases in executive compensation. We urge the Board to extend these restrictions to the PMCCF. Since the PMCCF will likely have a smaller number of users than the Main Street Lending Facilities, and more will be public companies, it should be easier to monitor and enforce such restrictions. Finally, similar to our recommendation for the Main Street Lending Programs, to prevent diversion of funds we recommend that private equity companies making use of the program be required to stop charging dividends and monitoring fees to portfolio companies.

We appreciate that the CARES Act did not grant the Federal Reserve new enforcement or monitoring tools to pursue penalties for violating conditions on the use of financing, and that the Federal Reserve may lack the administrative capacity to perform all of these tasks. However, simply having legally binding attestations and requirements on record will significantly impact company behavior and greatly facilitate any future effort, including by other government agencies, to penalize the misuse of public monies. Requiring attestations as to the use of proceeds in advance should not be administratively challenging, since such information is routinely included in new bond issuance documents. Similarly, informing companies that they are responsible for maintaining their payroll employment and avoiding layoffs while in receipt of public money is not administratively challenging. While some companies may refuse loans if required to follow these straightforward requirements, the financing of such companies is unlikely to bring large social benefits.

In terms of disclosure, the PMCCF should publicly disclose:

- The identity of the borrower, including the legal entity and beneficial owner.
- The terms of the loan, including price, repayment provisions, covenants, penalties, and time period.
- Copies of the underlying deal documents.
- The stated/intended use of the proceeds.

SMCCF

The SMCCF will purchase secondary market corporate credit, including ETF shares. There is a lack of clarity in the term sheet as to the goals of these purchases. This is particularly concerning since the purchase of some of these instruments, such as ETF shares backed by high-yield bonds or corporate bonds rated below investment grade, will expose the public to significant credit risk. It is appropriate to take such credit risks to address the real effects of the current pandemic crisis, but it is unclear exactly how supporting prices in secondary bond and ETF markets contributes to this goal. This is especially true since the PMCCF will support new issuance, making secondary market prices less significant to the real economy in the short run.

The lack of clarity as to goals makes it difficult to assess how or why funding from the SMCCF will be allocated. In its April 9th press release the Board stated that the goal of both the PMCCF and SMCCF is to "increase the flow of credit to households and businesses through capital markets". But secondary trading markets do not directly provide credit to households and businesses. If the goal is to protect the payments system by ensuring that price shocks for longer-term corporate credit do not somehow impact short-term credit markets in ways that are not addressed by the existing Commercial Paper, Money Market, and Primary Dealer credit facilities, then this would call for only narrow, selective, and targeted interventions.

We urge the Board to clarify the goals of the SMCCF. These goals should prioritize clear assistance to the real economy and avoid supporting secondary market prices in a way that could contribute to long-term moral hazard and capital misallocation. Interventions that benefit already wealthy investors and fund managers without effectively addressing the impact of the crisis for ordinary workers and communities must be avoided.

We also recommend that the following information be disclosed for SMCCF transactions:

- The identity of the issuer of any secondary market instruments purchased.
- The CUSIP of any bonds purchased.
- The portfolio holdings of any ETF purchased.
- The owner ("authorized seller") of any bonds or ETF shares purchased, including both the legal entity and the beneficial owner.

Main Street Lending Facilities

Main Street New Loan Facility (MSNLF)

This facility supports bank loans to companies with fewer than 10,000 employees or $2.5 billion in revenues, who are not also benefiting from the Paycheck Protection Program (PPP). The loans are supported by purchasing 95% of the loan from the originating bank, leaving 5% of the loan with the bank as an underwriting incentive. Loan sizes are capped at $25 million and may not cause the borrower's leverage to exceed four times Earnings Before Taxes Interest and Depreciation and Amortization (EBITDA).

The conditions on MSNLF loans are significantly more extensive than conditions in the various corporate credit facilities. We particularly support the restrictions on refinancing transactions and capital distributions during the term of the loan.

However, MSNLF restrictions still fall far short of the conditions laid out in the CARES Act. In particular, the CARES Act has a numerical requirement to maintain at least 90% of the current workforce through September 30th 2020, and to rehire at least 90% of the workforce that was on payroll as of February 1, 2020 by a date no later than four months after the end of the pandemic emergency is declared. The MSNLF term sheet replaces these concrete requirements with a much vaguer requirement to for the borrower to attest that “using the proceeds of the Eligible Loan, it will make reasonable efforts to maintain its payroll and retain its employees during the term of the Eligible Loan.” These employment requirements are inadequate and are not justified by administrative or implementation concerns. It is unclear what is meant by “reasonable effort”. It is also unclear whether the qualification “using the proceeds of the eligible loan” means that a business could lay off or cut salaries of a significant portion of its workforce so long as the full proceeds of the loan were used to pay salaries for the remaining workers.

We urge the Board to restore the clear and concrete employment requirements in the CARES Act as a precondition for receiving MSNLF loans. The extent to which these terms were met could easily be checked at a later date through the use of payroll tax records. The Board may not be the appropriate entity to monitor for compliance with employment terms or levy penalties for breaking employment commitments. But simply having on record an attestation to abide by these clear and specific terms would greatly improve company compliance and greatly facilitate any later effort by government entities to monitor compliance or charge penalties for lack of compliance. (For example, Treasury would have the technical capacity to check compliance through IRS access to employment tax records). Simply requiring agreement to these terms as a precondition for the initial loan would not be an administrative burden on the Board.

We are also concerned that the lack of restrictions on users of the program means that very sophisticated and aggressive entities such as private equity firms may make use of these funds. A private equity firm using this program could divert ordinary portfolio firm revenues to pay dividends or monitoring fees to the general partners of the parent fund, while using loan proceeds for payroll. This tactic would effectively divert public financing away from workers and business operations to general partners of the fund. But it may not technically be covered by current restrictions on use of funds for capital distributions and loan refinancing, although it achieves similar goals. Such behavior should be banned, by requiring that any private equity funds using the program cease charging dividends, monitoring fees, or similar expenses to portfolio companies for any period in which credit is outstanding.

It also appears possible that the MSNLF could be used to obtain funding for a leveraged buyout by a private equity firm. This use of funds should be banned.

The following information should be publicly disclosed for MSNLF transactions:

- The identity of the borrower, including legal entity and beneficial owner.
- The identity of the lending bank.
- The terms of the loan, including price, repayment provisions, covenants, penalties, and time period.
- The text of any attestations made in connection with the loan.
- The intended use of loan proceeds.

Main Street Extended Loan Facility (MSELF)

The MSELF supports banks in expanding existing loans to mid-sized companies. Except for the requirement that an upsized tranche of a pre-existing loan be financed, instead of an entirely new loan, the MSELF is similar to the MSNLF and raises similar issues. All of our substantive and disclosure recommendations above for the MSNLF also apply to the MSELF.

Another way in which the MSELF differs from the MSNLF is that companies may be levered at up to six times EBITDA through the MSELF, while the MSNLF is capped at four times EBITDA. We have significant concerns regarding the use of EBITDA as an underwriting mechanism for this program and the MSNLF, and our concerns are still greater for this program because of the higher level of leverage permitted. The EBITDA measure is a model-based estimate which can be manipulated through model assumptions. It is particularly difficult to accurately forecast earnings at times of high economic uncertainty such as the present. In addition, EBITDA has notoriously been manipulated by the private equity industry as it is a non-GAAP figure not subject to audit. Private equity firms have frequently used adjustments known as "EBITDA add-backs" to add pro-forma projections following a leveraged buyout to artificially boost earnings higher. A six times EBITDA limit, calculated under significant economic uncertainty, may lead to a situation where numerous small and medium sized companies are excessively leveraged on emergence from the pandemic crisis.

It may be appropriate in certain situations to finance high levels of leverage when such leverage is necessary to maintain payroll, finance safety precautions, or undertake important new investments. However, the presumption should be for lower levels of leverage. In addition, leverage should be checked by a mechanism less susceptible to model manipulation than EBITDA. We thus recommend that the Board institute a rebuttable presumption that MSELF leverage be limited to four times EBITDA and allow banks and borrowers to apply for higher leverage based on a specific set of background circumstances and planned uses for the proceeds. We further recommend that companies be required to meet both an EBITDA cap and a cap based on a simple multiple of free cash flow during a period prior to the pandemic crisis.

Term Asset Lending Facility (TALF)

The TALF supports securitization of consumer and business loans through purchase of senior tranches of such loans. TALF credit is extended to a number of sectors involving high-risk credit, including subprime auto loans, leveraged corporate loans, and commercial real estate loans. An underwriting restriction in the program, which we strongly support, is that no underlying securitization collateral may consist of other securitizations or synthetic securitizations (derivatives). Synthetic securitizations and re-securitizations have performed very poorly in periods of economic stress. In addition, such securitizations do not directly support real economy lending. We urge the Board to maintain the restriction that synthetic securitizations and re-securitizations are not supported by the TALF. We also support the exclusion of single-asset, single-borrower commercial real estate transactions from TALF financing, and the restriction to static CLOs.

We believe that it is important that the underlying loan collateral for securitizations include borrower protections. The facility is to some degree protected from losses through the limitation to purchases of senior securitization tranches, but the end borrower is not protected from the fallout from excessive leverage or exploitative lending. Guaranteed purchase of the senior tranches effectively subsidizes the issuance of the underlying loans, and exploitative credit should not be subsidized. We recommend that the Board take the following steps:

- The TALF should not permit support for subprime auto loans, student loans, and credit card loans that are designed without regard to consumer ability to repay.
- Lenders and loan originators benefiting from TALF support for consumer loans should agree to not garnish wages or seize property during the pandemic crisis period.
- Limit excessive leverage it facilitates at companies receiving the leveraged corporate loans that underlie new issuances of Collateralized Loan Obligations (CLOs). These leverage limits should be similar to the leverage limits in the Main Street Lending Facilities, and should incorporate the recommendations made above regarding leverage in those facilities.

The following information should be publicly disclosed for TALF transactions:

- All securitization disclosures for all tranches of the securitization (including the junior tranches).
- Look-through disclosure of the identity of end borrowers for the loan collateral for any securitization that provides business loans, in particular CLOs and CMBS / commercial real estate securitizations.
- The financing terms for senior tranches and the specific tranches financed.
- The identity of the securitization manager and / or arranger selling to the facility.

Thank you for the opportunity to comment on these facilities. Should you have questions, please contact Marcus Stanley, the Policy Director of the AFR Education Fund, at 202-674-9885 or marcus@ourfinancialsecurity.org.

Sincerely,

Americans for Financial Reform Education Fund