Americans for Financial Reform Education Fund

Review of New Federal Reserve Facilities

On April 9th the Federal Reserve announced six new facilities supporting potentially $2.3 trillion in "real economy" lending.

While there are a few positive elements – most notably direct Federal Reserve lending for states and municipalities – in general these facilities present an open door for massive support to the financial and corporate sector, with little or no conditionality attached to ensure that this funding serves public needs. The announced terms for these facilities would seem to permit public financing of leveraged buyouts, public financing of share buybacks to enrich already wealthy executives, public support for corporations that are simultaneously engaged in laying off their workers, and a range of other highly problematic outcomes. Coming after a decade which has already seen significant increases in wealth inequality, these facilities could further enrich the wealthiest in our society and further entrench the power of Wall Street over the economy. The Fed should act to prevent this by greatly increasing conditions attached to these programs and providing full disclosure regarding their recipients and the terms of loans.

Two broad pieces of context:

- These facilities involve Treasury equity commitments of only $195 billion out of the $454 billion in equity capital provided in the CARES Act to support Federal Reserve programs, so there is a great deal of ammunition left in the money cannon.

- The facilities outlined in this memo are the "real economy" CARES Act related facilities only, capitalized by the Treasury, in which the Fed is acting as the "government's bank". Other actions in which the Fed is acting as liquidity lender of last resort, are not covered in this memo. These include most of the facilities announced by the Fed on March 23rd that replicate measures taken in 2008, including the primary dealer credit facility, the commercial paper financing facility, and the money market fund financing facility, as well as the large-scale bond purchases undertaken last month which substantially increased the Fed's balance sheet.

The specific facilities are all briefly described in a chart added as an appendix at the end of this memo. In general, they provide support for four major categories of credit and lending markets that combined touch all elements of the economy.

- Securitized consumer and business lending (the Term Asset Lending Facility supporting auto loans, credit cards, commercial MBS, and business leveraged loan securitizations).

- Capital market transactions supporting the corporate sector (the Primary Market Corporate Credit Facility supporting new corporate bond issuances and the Secondary Market Corporate Credit Facility supporting existing corporate debt).

- Bridge loans to states and localities to cover delays in tax receipts and pandemic related costs (Municipal Liquidity Facility).

- Direct bank lending to mid-size corporations (up to 10,000 employees), supporting either new bank loans or expansions of existing loans or credit lines to businesses (the two Main Street Lending Facilities).

Together, these facilities represent an unprecedented expansion of Federal Reserve direct lending. Two other "real economy" areas not addressed in these facilities are liquidity support for non-bank mortgage lenders (which may happen through FHFA or FHLB rather than the Fed) and support for true small business loans through the Paycheck Protection Program (PPP) backed by the Small Business Administration. The Fed does not set policy for PPP loans but has already announced that it will purchase such loans directly from banks.

Discussion

The facilities include a handful of positive elements. Most notable is the willingness to lend directly to states and localities through the municipal liquidity facility. We have advocated strongly for something along these lines as a complement to grant aid to states and localities, which are on the front line in the response to the pandemic crisis. The Municipal Liquidity Facility is a major step, though it should be altered in a number of significant ways to effectively make funds available where they are needed.[1] This step is important both because of the assistance in crisis response it could make available to the entities on the front lines of fighting the pandemic, and because it is an instance of the Fed supporting public and democratically accountable entities, rather than just corporations and banks.

There are, however, very serious problems with what the Fed plans to do in the rest of the facilities.

- First is the striking lack of conditions placed on what companies can do with the funds they receive through these programs. In the absence of any effort to specifically direct funds to the needs of workers and communities, companies can receive assistance while laying off workers, can spend funds on rewards to executives while failing to provide safe work environments for their essential workers, or use funds for financial engineering schemes that benefit insiders and wealthy shareholders at the expense of other stakeholders. Funds could even be used for corporate mergers and acquisitions, thus increasing economic consolidation and the power of large corporations and finance.

- Second is the lack of underwriting protections to avoid the use of the programs for large-scale bailouts of bad credit. Such bailouts prop up non-functional companies instead of appropriately restructuring their credit obligations. They contribute to long-term corporate moral hazard by creating incentives for insiders to profit from extreme leverage

[1] The Municipal Lending Facility is not discussed in detail in this memo, but is analyzed in depth in another AFR Education Fund memo available at https://ourfinancialsecurity.org/wp-content/uploads/2020/04/AFR-Ed-Fund-Memo-Re-muni-facility.pdf

and other irresponsible risk-taking during good times, while putting costs on to the public during downturns or crises such as the one we see today. They are also simply unfair in that they could give large and undeserved windfalls to wealthy people who are (supposedly) paid to take risks, with no clear public benefit.

- Finally, the facility term sheets do not address the issue of public transparency or reporting. There is a vast amount of money at stake, and full public disclosure at the individual transaction level should be a minimum condition under these circumstances. Unfortunately, the disclosure requirements currently in statute are extremely inadequate, and do not require disclosure of the identity of specific borrowers or the terms of specific loans. The Federal Reserve has discretion over the level of disclosure provided.

If these very serious problems were addressed, and there were a much greater effort to actively channel funding to support a fair, efficient, and equitable crisis response, these facilities *could* be of significant value in that they can reach elements of the economy that were not reachable by government credit support in 2008. Very significant changes would be required to do this.

Absence of Requirements or Conditions Regarding the Use of Funds

Most of the funding provided through these facilities has few or no strings attached. Businesses benefiting from support for their credits through any capital market mechanisms, including bond purchases, purchases of syndicated loan shares, or securitization of new business borrowing through the TALF, appear to face no significant restrictions at all. This includes no requirements for retention of workers / maintenance of payroll, for safety equipment or paid sick leave for workers exposed to the Coronavirus, no restrictions on use of proceeds for capital distributions, and no restrictions on executive compensation. The only restrictions tied to capital market facilities are that companies may not benefit from other CARES Act funding and lending must adhere to the conflict of interest restrictions in Section 4019 of the CARES Act involving support for companies owned by government officials or legislators.

Programs in the Main Street Lending Facilities supporting bank loans to small and medium sized enterprises must meet somewhat more conditions, but it is striking that these conditions still fall far short of the conditions listed in Section 4003(c)(3)(D) of the CARES Act, which outlines a facility to support midsize businesses.

The Main Street Lending facilities do require attestations by businesses and the lending bank that proceeds will not be used for refinancing debt. period. The borrowing business is also banned from any capital distributions until 12 months after the loan is repaid and must follow CARES Act restrictions on executive compensation.

But employment conditions are weaker than the CARES Act. The CARES Act Section 4003(c)(3)(D) requires that 90% of payroll be maintained at full compensation and benefits, and 90% of the pre-crisis workforce be restored to employment at full compensation after the crisis is over. But in the Main Street Lending Facilities, the borrowing business must only attest that they will make “reasonable efforts” to use loan proceeds to maintain their workforce through the crisis The requirement to make a “reasonable effort” would seem to permit substantial layoffs or wage cuts so long as the business uses loan proceeds to support payroll costs in some way. While the CARES Act executive compensation restrictions do apply fully, these requirements are weak. They permit executives at assisted companies to receive $3 million plus half of their 2019 compensation in excess of $3 million – e.g. a CEO who received $13 million in 2019 could receive an $8 million payday while his company was benefiting from public support during the current crisis.

There is also a long list of CARES Act 4003(c)(3)(D) requirements that are entirely missing from the Main Street Lending Facility conditions laid out by the Fed. Specifically, requirements involving outsourcing or offshoring of jobs, neutrality in union organizing, and maintenance of collective bargaining obligations are entirely absent.

Both the capital market facilities and the Main Street Lending Facilities would also appear to be open to private equity firms and their portfolio companies, without restriction. Tough and comprehensive restrictions on the use of funds are particularly important for private equity firms, which are structured to extract benefits for general partners at the parent fund at the expense of other stakeholders. Private equity firms are likely to be highly aggressive and sophisticated in seeking to maximize their own profits from these programs, including by taking funds to increase their own returns while slashing jobs or compensation at portfolio companies.

Bailouts

The underwriting criteria in these facilities are very loose. Even with strict underwriting guidelines in place, it is likely that programs of this size taking place during a period of extreme economic uncertainty, especially with no conditionality on corporate activities, would lead to some inappropriate bailouts of poor credit risks. With loose underwriting criteria, the danger is particularly great. The primary and secondary corporate credit facilities support issuers rated as low as BBB- as of late March, so long as their current rating is at least BB- (a "junk bond" rating). The reliance on ratings in both those programs is problematic, as many borrowers still have ratings qualifying them for the facilities that do not reflect the reality of their credit risks in this economic environment. Examples include cruise liner Carnival Corporation which is still rated investment grade by S&P (BBB-) and Moody's (Baa3) as well as oil & gas producer Noble Energy which is still rated Baa3 and BBB by Fitch. Such entities could be downgraded further and still be eligible for assistance. The secondary market corporate credit facility will actually purchase exchange traded funds (ETFs) that hold junk bond / high yield debt. This could transfer some of the worst credits in the economy on to the Federal balance sheet.

The TALF facility will support CLO securitizations of new loans to highly leveraged corporations (although it will not apparently bail out old leveraged loans in existing CLOs). The Main Street lending facility will cap leverage at six times EBITDA, a very high level, for expansions of existing loans or lines of credit. (Company leverage is capped at four times EBITDA for entirely new credits). It's also worth noting that EBITDA itself is a model-based estimate that can be manipulated higher in order to make leverage look lower. Many companies have used a variety of adjustments in order to give the appearance of staying below EBITDA leverage guidelines laid out by banking regulators.

These underwriting issues are particularly troubling in light of the lack of conditions on the funds that could force companies that took them to direct financing to workers, production, and customers. The combination of poor conditionality and loose underwriting leaves the door open to the use of this financing to prop up companies that were drowning in debt before the crisis due to leveraged buyouts and share buybacks. In this manner, Federal Reserve support is available to serve as a bailout of the corporate credit bubble that existed before the pandemic crisis, which scholars and regulators have warned for years posed significant risks. The energy sector, for example, stands to benefit disproportionately, as they have been the single largest junk bond borrower in recent years, and currently account for over 10% of the U.S. high yield market.

Such a bailout will greatly benefit entities and executives who enriched themselves through high-risk or predatory behavior before the current crisis, potentially helping to socialize their losses even as they have benefited from large gains in their private wealth. Moreover, it is unclear why such funding is needed to support employment or corporate functioning. Many corporations have access to a revolving line of credit with a bank which they can draw upon to support business operations even without government assistance. It is also vital to distinguish the question of corporate bankruptcy from its real-world impacts on the economy. A core principle of U.S. Chapter 11 bankruptcy is that the company should continue to operate as a going concern while its debt and ownership arrangements are restructured in court. Preventing corporate bankruptcies through financial assistance should therefore not be an end in itself. Instead, the priority should be given to supporting workers, communities, and where needed ongoing business operations, and public funding should be directed to those goals.

Reporting and Public Disclosure

Section 4026 of the CARES Act says that in the case of these facilities, the Federal Reserve must comply with disclosure requirements under Section 13(3) of the Federal Reserve Act. However, the 13(3) disclosure requirements do not mandate that the Federal Reserve disclose the identity of specific borrowers from Federal Reserve facilities or the terms of specific loans that are given to these borrowers. This raises the possibility that the Federal Reserve will disburse multiple trillions in credit assistance without informing the public as to the identity of the borrowers, the use of the proceeds, or the nature and terms of the loans.

It would be completely inappropriate to keep such information confidential in the case of these programs. Unlike banks, the corporations and businesses benefiting from these programs do not face the possibility of a bank run by creditors or depositors if their identity becomes known, nor would such a creditor run threaten the payment system. The identity of recipients and the terms of assistance should be made public in a rapid, clear, and direct manner. Indeed, there appears to be no reason why all of the core deal documents of these transactions should not be made public. Particularly in the absence of effective conditions on the use of the loans, without full public information as to who benefits and how it will be impossible to hold participants in these programs accountable to use their funding in a responsible manner.

List of Federal Reserve Facilities and Terms

Facility	Equity and Leverage	Target Credits	Key Term Sheet Elements
Term Asset Backed Lending (TALF)	$10 billion in equity; total lending unclear	Senior ABS tranches backed by new loans for floor plans, auto, credit card, SBA, student loans, leveraged lending, CMBS. Rated highest investment grade by two NRSROs. 3 year non recourse loans.	Haircuts are around 10% for auto, 20% for leveraged loans. Spreads also seem low. No synthetic or resecuritized collateral. To qualify for loans CLOs must be "static" (no portfolio shifts). CMBS may be legacy.
Primary Market Corporate Credit	$50 billion in equity; levered 10-1 for investment grade credit, 7-1 for non investment grade. $750 billion in lending across primary and secondary corporate credit facilities	Newly issued corporate bonds or syndicated loans, including refinancings, by U.S. non-bank issuers rated BBB- as of 3/22 and BB- as of date of purchase. 4 year loans.	Max $10.7 billion per issuer; max 20% of syndication; must not have received other CARES Act funding, meets COI requirements in 4019 of CARES Act. Issuer-specific pricing. Few other apparent conditions.
Secondary Market Corporate Credit	$25 billion in equity; 10-1 investment grade, 7-1 non IG	Existing corporate bonds with under 5 year maturity from U.S. non-bank issuers rated BBB- as of 3/22 and BB- as of purchase; or ETFs backed by corporate bonds	Same CARES Act restrictions as PMCC. Max 10% of outstanding bonds or 20% of ETF shares. ETFs include both investment grade and junk bond ETFs. Purchase corporate bonds at secondary market pricing, ETFs at price that "does not materially exceed" NAV
Municipal Liquidity	$35 billion in equity; $500 billion lending	Direct purchase of revenue anticipation notes of up to 24 months issued by U.S. states, cities over 1 million population, counties over 2 million. One issuer per jurisdiction	Capped at 20% of 2017 tax revenues. Excludes territories. Notes to manage cash flow shortfalls due to pandemic or income tax deadline change. Legal review by Fed limiting to this purpose.

Main Street Lending	$75 billion total equity; $600 billion lending across both programs		
Main Street New Loan Facility		New bank loans of from $1 million to $25 million in size made to companies with under 10,000 employees or under $2.5 billion in revenues. Leverage capped at 4 times 2019 EBITDA. Up to four year term for loan. Originating bank retains 5% of loan risk, Fed takes 95%. Interest rate SOFR + 250 to 400 BP.	Required business and bank attestations include that loan will not be used for refinancing other credit, loan is needed due to pandemic, business will make "reasonable efforts" to maintain workforce. CARES Act capital distribution and exec comp restrictions apply as to direct loans. However attestations here fall far short of requirements in CARES 4003(c)(3)(D) for mid size business program.
Main Street Expanded Loan Facility		Expansions of existing bank loans made prior to 4/8/20. Expansions can be from $1 to $150 million but are capped at 30% of existing but undrawn bank debt or leverage capped at 6* EBITDA whichever is smaller. Terms otherwise identical to new loan facility.	Terms and attestations identical to new loan facility, with similar issues.