Chairman Jay Powell
Board of Governors of the Federal Reserve System
20th St. and Constitution Ave. NW
Washington, DC 20551
ATTN: Staff of Main Street Lending Facilities, Primary and Secondary Market Corporate Credit Facilities

Dear Chairman Powell:

The Americans for Financial Reform Education Fund ("AFREF") is writing this letter because we are concerned that the rules of various Federal Reserve lending facilities could permit lending to insolvent companies. [1] Not only would this be illegal under Section 13(3) of the Federal Reserve Act, the combination of lending to insolvent companies plus the lack of strong conditions for use of the funds to support employment or meaningful investment means that funds could be diverted to financial insiders seeking to use public money to recoup a failed investment. We are particularly concerned about the possibility of lending that supports insolvent private equity firms and lending to insolvent firms in the fossil fuel sector.

As you know, in recent months the Federal Reserve has established new emergency lending interventions, which could deploy in total several trillion dollars in credit. The authorization for all of these interventions is in Section 13(3) of the Federal Reserve Act which allows "broad-based programs and facilities that relieve liquidity pressures in financial markets" but also that "the Board shall establish procedures to prohibit borrowing from programs and facilities by borrowers that are insolvent." In its 2015 Final Rule regarding emergency lending facilities, the Board defined insolvent borrowers to include both borrowers currently in bankruptcy and also "potential borrowers that are generally not paying their undisputed debts as they become due during the 90 days preceding borrowing from the program, and potential borrowers that are otherwise determined by the Board or the lending Federal Reserve Bank to be insolvent."[2]

The recently established credit facilities would provide loans to a very broad range of borrowers, including borrowers who are rated below investment grade or who can qualify for loans using underwriting standards that are based solely on non-GAAP measures of credit quality such as "Earnings Before Interest, Taxes, Depreciation, and Amortization" (EBITDA).

We are sympathetic to the fact that the revenues of otherwise solvent businesses may be severely impacted by the current pandemic crisis and accompanying public health driven shutdowns, so that they may require temporary credit assistance due purely to the crisis. We support lending to

1 Members of AFR Education Fund include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups.A list of coalition members is available at: http://ourfinancialsecurity.org/about/our-coalition/
2 Extension of Credit by Federal Reserve Banks, 80 Fed. Reg. 78959 (December 18, 2015) https://bit.ly/305uxml

such "solvent but for the pandemic" firms, although we believe there should be conditions attached to this lending to make sure there is a public benefit. However, we are very concerned that credit standards being used in these facilities may result in lending on a significant scale to borrowers who are insolvent not simply due to crisis-related revenue interruptions, but due to their underlying financial prospects and amount of leverage. We are particularly concerned regarding two such categories of borrowers. The first is heavily leveraged firms owned by private equity, where loan proceeds may be transferred up to the private equity owner. The second is companies within the fossil fuel industry, which faced major financial difficulties for an extended period before the crisis occurred, and face little prospect for medium-term recovery, especially if adequate policy measures are taken to address climate change.

Such support for insolvent borrowers would be illegal, and in addition, given the lack of conditions on Federal Reserve lending, it would fail to serve a clear public policy purpose. While the Board's Main Street Lending Program term sheets do include language that participating firms make "commercially reasonable efforts to maintain its payroll and retain its employees," this language does not require any attestation by the borrower and is non-binding.[3] Without firm commitments on payroll retention or hiring as a precondition for loans, lending to insolvent firms clearly does not support employment. The owners of a firm that is insolvent for longer-term structural reasons also have little or no incentive to invest in the productive capacities of the firm. They will be motivated to seek to transfer loan proceeds away from the company to capital holders or creditors, thus converting the loan from support for an operating business to a payoff for financiers. In the case of private equity firms, such transfer will be particularly simple, since current facility rules would permit fees to be paid up from the borrowing company to the private equity parent, and the parent fund would not be liable for paying back the government loan.

Below, we review reasons to believe that under current rules Federal Reserve facilities may support lending to functionally insolvent firms, and then discuss the particular cases of private equity owned firms and fossil fuel companies. We urge the Board to put in place much more meaningful protections against lending to insolvent companies, and to establish much stronger conditions on firm behavior as a pre-requisite to lending, in order to ensure that lending serves a legitimate public purpose and avoid the risk of a pure bailout to the owners or debt holders of potentially insolvent firms.

<u>Current Protections Against Lending to Insolvent Firms are Inadequate</u>

Attestations in the Main Street Lending Programs

The Main Street Lending Program requires a borrower to attest that:

> "it has a reasonable basis to believe that, as of the date of origination of the Eligible Loan and after giving effect to such loan, it has the ability to meet its financial obligations for at least the next 90 days and does not expect to file for bankruptcy during that time period."

Since this attestation only refers to the company's ability to meet financial obligations after it receives and can spend the loan, and only refers to the next 90 days, an effectively insolvent company borrowing sufficient funds to support itself for the next few months could truthfully

3 Saleha Mohsin, Catarina Saraiva, and Laura Davison, "Fed Rebuked Over Loan Terms That Don't Explicitly Bar Layoffs," Bloomberg, May 1, 2020. https://bloom.bg/304MRfk

make this attestation. Making a loan under such circumstances could be a reasonable public policy measure for a company that was temporarily insolvent solely due to coronavirus-related shutdowns. But the Board has removed any requirement for companies to attest that their borrowing needs are related to the Covid-19 related issues, meaning that Main Street Lending assistance will hardly be limited to those cases.

Companies who are in dire straits and have little ability to borrow elsewhere could be incentivized to tap Main Street lending facilities to shore up their liquidity. This will be especially attractive because the Main Street Lending Facilities do not require loan repayments for the first two years in which the loans are outstanding, making them particularly useful for potentially insolvent companies. Underwriting banks would benefit from origination and servicing fees for such loans while holding only 5 percent of the risk of loan default.

Underwriting Protections in the Main Street Lending Programs

The other major protection against lending to insolvent companies are the underwriting requirements for the loans themselves. All three Main Street programs require that a company looking to borrow meet a threshold of debt to earnings as measured by adjusted EBITDA. In the case of new loans under the Main Street New Loan Facility this limit is 4.0x 2019 adjusted EBITDA while it is 6.0x adjusted 2019 EBITDA under the other two facilities.

The adjusted EBITDA financial metric is not reliable. It is common knowledge that this metric can be easily manipulated.[4] Since EBITDA is not a Generally Accepted Account Principle ("GAAP") figure, there is no standard method of calculating the figure, leaving it highly open to manipulation. Even though use of EBITDA is common, its potential for abuse and for underestimating true levels of leverage has also been widely noted.[5]

In the FAQ document for the Main Street Lending Facilities, the Board clarifies that banks are required to use the same methods for calculating adjusted EBITDA that they used prior to April 24, 2020. But this stipulation hardly provides protection. Since it excludes interest and depreciation costs EBITDA is structurally biased to favor highly indebted and capital-intensive companies. In addition, the use of "adjusted" EBITDA opens up enormous space for manipulation. For many years private equity firms have been artificially inflating earnings through the subtraction of so-called "one-time" costs that may in fact be recurring, in addition to pulling forward future projected cost savings to give the appearance of less indebtedness. As Standard and Poor's stated in a recent study of how EBITDA adjustments artificially deflate leverage, these add-backs make adjusted EBITDA a fundamentally unreliable metric of company leverage:

> "As noted in our recent study on add-backs, companies and deal arrangers have become increasingly creative in presenting what qualifies as an add-back, resulting in an increase in both the number and types of adjustments. In some of these cases, S&P Global Ratings views the act--expanding the definition of management-adjusted EBITDA to inflate "marketing EBITDA" (EBITDA plus add-backs) -- as an artificial deflation of leverage. The absence of a uniform and commonly accepted definition of EBITDA is the key issue

[4] Schelling, Christopher. Institutional Investor. "When EBITDA Is Just BS". Oct 11, 2019. https://bit.ly/3014Y5M

[5] Natarajan, Sridhar and Porzecanski, Katia. Bloomberg News. "Fake EBITDA to Worsen Next Slump, $33 Billion Debt Maven Warns". Dec 5, 2019. https://bloom.bg/301Qjaw

> here. In practice, it is and has always been a negotiated definition, varying from (credit) agreement to agreement."[7]

Such maneuvers have already been used to get around the Leveraged Lending Guidance promulgated by banking regulators in 2013. In an effort to get around the 6.0x debt-to-adjusted EBITDA limit on corporate loans, banks and private equity firms would reverse engineer enough adjustments to boost EBITDA and get the leverage ratio below the threshold.[8] Two of the three Main Street programs set the EBITDA leverage threshold at 6.0x, which is the same level used as the cutoff for unsustainable levels of leverage in the 2013 Guidance. Thus, any unreliability in the EBITDA metric will boost actual levels of leverage above this maximum limit.

Even if the adjusted EBITDA metric was completely reliable, the use of 2019 adjusted EBITDA does not speak to the current economic situation of the company. While help for temporarily insolvent firms might be appropriate given coronavirus related economic disruptions, it is not clear that the Federal Reserve is attempting to distinguish those companies where insolvency is a temporary result of the crisis from other firms. It is notable in this regard that the Main Street Lending Program initially included a requirement for a company attestation stating that the financing is needed for coronavirus related reasons, but that requirement has been dropped.

Potential Support for Insolvent Entities in Other Federal Reserve Lending Programs

Beyond the Main Street Lending Programs, several other programs provide at least indirect support for potentially insolvent entities. Perhaps the clearest example is the Secondary Market Corporate Credit Facility. This facility has opened the door to Federal Reserve support of insolvent companies through the Fed's decision to allow BlackRock to purchase high yield bond ETFs such as the iShares iBoxx High Yield Corporate Bond ETF (HYG). Officially, the Federal Reserve is not directly purchasing the securities of these insolvent companies on its balance sheet. But the purchase of ETFs which invest in these insolvent companies essentially makes credit available to companies at one remove, since asset managers know that they will have Federal Reserve credit support if they invest in company debt.

Examples of insolvent private equity companies already in the HYG ETF include Neiman Marcus which is owned by Ares Management and defaulted on debts on May 7, and satellite company Intelsat which was purchased by BC Partners and Silver Lake in 2008 and filed for bankruptcy on May 14. Ares has already been accused of transferring away $1 billion worth of Neiman Marcus's MyTheresa online shopping business for next to nothing.[9] Intelsat borrowed $15 billion in debt over the years while at the same time paying hefty dividends to its private equity owners.[10] To make matters worse, both BC Partners and Silver Lake sold sizeable

7 Honeyman, Olen and Zhang, Hanna. S&P Global Ratings. "When the Cycle Turns: The Continued Attack of the EBITDA Add-Back". September 2019. https://bit.ly/2OXiD7P

8 Indap, Sujeet and Platt, Eric. Financial Times. "Hot leveraged loan market puts 'ebitda add-backs' under scrutiny. Feb 9, 2017. https://on.ft.com/301ypVw

9 Unglesbee, Ben. Retail Dive. "Neiman Marcus sued again over MyTheresa transfer". August 12, 2019. https://bit.ly/2CIr8Bb

10 Pressman, Aaron. Fortune. "Why satellite communications company Intelsat filed for bankruptcy". May 14, 2020. https://bit.ly/3fZNyw1

portions of those shares as the company tumbled further into insolvency.[11] These are examples of how, as discussed above, unconditional support for insolvent companies risks subsidizing transfers to executives and ownership groups who have no incentive to invest in the business and will not be responsible for repaying the public for these loans. Other insolvent companies currently held by the HYG ETF include Frontier Communications and Whiting Petroleum, in addition opioid producer Mallinckrodt (Caa2), AMC Entertainment Holdings (currently rated CCC-), and commercial real estate property operator CBL & Associates (CCC+) have either already filed for Chapter 11 bankruptcy (Whiting Petroleum) or are precariously close.

The Secondary Market Corporate Credit Facility also recently announced it will purchase bonds from individual companies to track a specified Broad Market Index.[12] This index includes only companies that meet a ratings threshold, but a recent Barclay's report pointed out that the lack of any requirement for a company to attest to solvency could permit debt from effectively insolvent energy companies to be purchased during the window prior to downgrade of the company.[13]

Another Federal Reserve program that could subsidize insolvent firms is the Term Asset Lending Facility or TALF. The TALF program makes low interest rate loans to funds in order to purchase the senior-most AAA rated classes of static, non-reinvesting CLOs. That senior most class makes up the majority of a CLO's financing costs (usually around 60% of the total). As a result, programs such as TALF which help to bring down the cost of financing senior tranches of the security will support the overall CLO vehicle in purchasing more leveraged loans.

This kind of subsidy to the CLO market supports further investment in hundreds of different non-investment grade leveraged loans that those CLOs can purchase, many of which are also at the cusp of being rated CCC+/Caa1. Many of those loans will also be going to heavily leveraged companies owned by private equity.

Particularly Concerning Examples of Potentially Insolvent Borrowers

Private Equity-Owned Firms

We are particularly concerned that the Main Street Lending Facilities may permit potentially insolvent firms backed by private equity to take advantage of public credit on a large scale. Private equity owners are likely to be particularly sophisticated in both manipulating EBITDA underwriting standards for such loans (as discussed above) and in channeling Main Street funds away from supporting employment and investment in the borrowing company and up to the private equity fund that owns the portfolio company.

The majority of companies that are at the brink of defaulting are owned by private equity. According to January, 2020 data from Moody's private equity portfolio firms accounted for 80% of the borrowers who were rated Caa, just notches above a default..[14]

11 Kosman, Josh. New York Post. "Intelsat's biggest investors sold shares just before massive stock plunge". Mar 4, 2020. https://bit.ly/2By5IWD

12 Composition of the SMCCF Broad Market Index. Federal Reserve Bank of New York. Jun 5, 2020. https://nyfed.org/2DdXbbL

13 Chambers, Paul and Christian DeSimone, "Fallen Angel Eligibility for Fed's Broad Market Index Purchases", Barclays Credit Research, June 29, 2020.

14 Idzelis, Christine. Institutional Investor. "Private Equity Is a Big Part of a Growing Pool of Risky Companies". Institutional Investor, Jan 16, 2020. https://bit.ly/2BELRW0

The Main Street Lending Programs are thought to exclude many private equity firms and their portfolio companies. This is due to aggregation rules that require consideration of a borrower's ultimate owner and all of its affiliates in determining whether the company meets the size limits for program eligibility(private funds themselves are also excluded from direct borrowing).[15] These limits restrict the program to firms with under 15,000 workers and $5 billion in revenue.

However, potential loopholes still exist which the Fed needs to clarify and close, particularly as it relates to private equity firm use of shell companies. Private equity firms frequently take control of portfolio firms through an intermediary shell company.[16] It appears that in cases where a private equity firm owns less than 50 percent of an intermediate shell company, the aggregation rules would not apply and the company would not be required to aggregate its employment and revenues with other companies owned by the PE firm. In cases where there are multiple shareholders, we believe the PE general partners could easily have effective control of a firm with less than a 50 percent share of ownership. Such shell companies are frequently foreign owned companies. As it stands, US companies that are subsidiaries of a foreign company are eligible to borrow under the Main Street programs. Thus, private equity firms may be able to use their partial ownership to evade aggregation rules through offshore shell companies as we have already seen with the Paycheck Protection Program.[17]

Permitting access to large amounts of public credit for the portfolio firms of large and sophisticated private equity firms is problematic on many levels. Private equity firms have many mechanisms for conveying and transferring borrowed funds from their portfolio companies up to the private equity fund parent or to another bankruptcy remote entity that would not be responsible for paying back the funds. The ban on dividends under the Main Street Lending Program closes off some, but not all, of these mechanisms.

For example, "monitoring fees" and other kinds of payments from the portfolio firm up to the private equity fund parent would not technically be a dividend but would transfer loan proceeds from the portfolio company that is responsible for repayment up to a private equity parent that might not be. Beyond these fees, in an increasing number of bankruptcy cases involving failing private equity backed businesses, the private equity owner has been able to transfer valuable assets away from the failing companies to a bankruptcy-remote company.[18] In the case of Neiman Marcus, which had about 13,500 employees at the end of 2019, amidst a decline of sales across its brick-and-mortar business, both Ares and CPPIB in September 2018 transferred the MyTheresa online shopping business, estimated to be worth up to $1 billion, for a minimal sum, to other funds they control.[19] Neiman Marcus officially filed for bankruptcy on May 7 2020.

Another program through which private equity funds could directly access funds is the Primary Market Corporate Credit Facility (PMCCF), which appears to allow deal funding such as bonds

15 See E.11 and E.12 of June 20th FAQ document available at https://bit.ly/2BzzAlD

16 Levin, Jack and Light, Russell. Structuring Venture Capital, Private Equity, and Entreprenurial Transactions. 2015. https://bit.ly/3cFZy3v

17 Schwellenbach, Nick and Szakonyi, David. Project on Government Oversight. "Inside the Pandemic Cash Bonanza for Private Equity-Backed Firms". Jul 15, 2020. https://bit.ly/3f878Vw

18 Coy, Peter. Bloomberg News. "In Finance, 'J. Crew' Is a Verb. It Means Stick It to a Lender." Jun 17, 2019. https://bloom.bg/3301dzm

19 Unglesbee, Ben. Retail Dive. "Neiman Marcus sued again over MyTheresa transfer". August 12, 2019. https://bit.ly/2CIr8Bb

issued to finance leveraged buyouts. The PMCCF has some meaningful protection against lending to insolvent firms through the requirement that firms be rated at least BB- by a major rating agency. However, this requirement could be gamed through manipulation of EBITDA metrics. In addition, even if a firm is technically solvent when the loan is made, a private equity firm may drain value from the company once taken over in manner that renders it quickly insolvent.

To take one example of such a transaction, bonds used to finance the leveraged buyout of Nine West by Sycamore Partners in 2014 were rated single-B due to EBITDA addbacks, but investors have asserted that the company was insolvent upon taking out the loan, and Nine West indeed declared bankruptcy a few years after the buyout.[20] It is true that the single-B would be one notch below the PMCCF credit rating limit, but the ease with which this rating was obtained shows the potential vulnerability of the PMCCF to an aggressive private equity firm seeking to finance leveraged buyouts.

Fossil Fuel Companies

Years of unprofitable drilling combined with declining oil prices raised serious questions about the viability of many energy companies even before the pandemic. The Federal Reserve facilities were not designed to pick and choose between corporate sectors, but the Fed does have a responsibility to not lend to insolvent firms.

Many oil companies as a result do not qualify to borrow under both the Primary and Secondary Market Corporate Credit Facilities due to their non-investment grade ratings. No such ratings criteria exist under the Main Street Lending Facility, opening a door for firms rejected from the Corporate Credit Facilities as long as they can show they meet the other criteria of the Main Street programs. This is especially true since borrowers are allowed to use their adjusted 2019 EBITDA, which for many energy companies, predates the sharp selloff in crude oil prices in early March. For example, Chesapeake Energy's 5.5x debt-to-adjusted EBITDA at the end of 2019 would qualify the company for the program, even though the company is going bankrupt.[21] More generally, the energy sector is also inappropriately advantaged by the reliance on EBITDA at all. The exclusion of interest payments and amortization/depreciation in the EBTIDA calculation is particularly advantageous to a highly indebted and capital intensive sector such as energy, particularly fossil fuel production and drilling. A more realistic metric of company ability to service its debts would exclude insolvent energy companies from public support.

Issues in the energy sector significantly predate the current pandemic crisis. In Q3 2019 some 91 percent of defaulted U.S. corporate debt was due to oil and gas companies.[22] Before the coronavirus shock in March, the energy industry had been the largest issuers of high yield corporate debt for a decade, and accounts for 13 percent of the bottom tier, CCC rated corporate

[20] Ronalds-Hannon, Eliza. Bloomberg News. "Aurelius Renews Feud Over Sycamore's Nine West Payday". Feb 27, 2020. https://bloom.bg/308vElr
[21] Spector, Mike et al. Reuters. "Shale gas pioneer Chesapeake Energy taps restructuring advisers". Mar 16, 2020. https://reut.rs/300RI18
[22] McLean, Bethany. New York Times. "Coronavirus May Kill Our Fracking Fever Dream. Apr 10, 2020. https://www.nytimes.com/2020/04/10/opinion/sunday/coronavirus-texas-fracking-layoffs.html.

bonds.[23] The energy sector has been plagued by overleverage and oversupply for years and investors have exited the sector in droves.[24] As recently pointed out in an analyses by the accounting firm Deloitte and Touche, the American shale industry never earned a profit in the aggregate, registering a net negative cash flow even before the current pandemic, and given current declines in energy prices is now poised to see a massive wave of bankruptcies.[25]

With demand for crude oil now falling significantly following the pandemic lockdown, combined with an oversupplied market, oil prices will not recover easily. The Energy Information Administration expects crude oil prices to remain at least 20% below their 2019 levels for at least the next year and a half, and this assumes that OPEC consistently restrains production over the forecast period.[26] By allowing companies to borrow using outdated financials that reflect a far different picture, the Fed is exposing taxpayers to a potentially large amount of non-performing debt from insolvent energy companies.

This is not only true for the Main Street Lending Programs, but also for the various corporate credit facilities that are purchasing corporate debt without any effort to apply a forward-looking screen. For example, 9.48% of the SMCCF's Broad Market Index guiding Federal Reserve individual company bond purchases is made up of energy debt, even though the weighting of the energy sector in the S&P 500 has dropped from 7.5% in 2016 to 2.8% today as investors foresee radically lower profits.[27] A recent report by InfluenceMap found that bond purchases under the SMCCF were consistently overweighted to the energy sector by any reasonable metric -- they made up more than twice as much as would be expected based on outstanding debt, more than three times as much as would be expected based on equity valuation, and more than four times as much as would be expected based on employment.[28]

As a result of resting its lending programs on outdated pricing data and easily manipulated leverage metrics, and failing to institute adequate safeguards against lending to insolvent firms the Federal Reserve will be putting the public at risk of seeing loans go unpaid, as well as violating the required limitations on their facilities, and subsidizing the fossil fuel industries. The failure to put in place effective conditions that prevent loan funds being channeled to executives and shareholders instead of operations also means that failing energy firms may use public funds for executive bonuses while failing to perform environmentally necessary remediation and cleanup of inactive wells. As recently documented by the New York Times, exactly this scenario is occurring today in failing energy firms.[29]

In the specific case of energy companies the failure to prevent funding for insolvent companies will also be providing inappropriate support for firms that are major contributors to climate change, and are at continuing risk of sharp losses in value if and when policy action is taken to

[23] Rennison, Joe and Ablan, Jennifer. Financial Times. "US energy 'junk' bonds hammered by oil plunge". Jan 29, 2020. https://on.ft.com/39umCCc

[24] Sanzillo, Tom. Institute for Energy Economics and Financial Analysis. "Federal lending to the oil and gas sector would be a complete waste of money". Apr 27, 2020. https://bit.ly/2P0YX2I

[25] Dickson, Duane et al. Deloitte. "Implications of COVID-19 for the US shale industry". 2020. https://bit.ly/39xjXHL

[26] U.S. Energy Information Administration. "Short-term Energy Outlook". July 7, 2020. https://bit.ly/3hLWXId

[27] Siblis Research. "U.S. Stock Market Sector Weightings". June 30, 2020. https://bit.ly/32XDzUb

[28] Influence Map, "Is the Fed Being Sector Neutral?", July 2020; available at https://bit.ly/332cCyK

[29] Tabuchi, Hiroko, "Fracking Firms Fail, Rewarding Executives and Raising Climate Fears", New York Times, July 12, 2020. https://nyti.ms/2X3fd7X

address climate change. As former Federal Reserve Governor Sarah Bloom Raskin recently wrote:

> "The decision to bring oil and gas into the Fed's investment portfolio not only misdirects limited recovery resources but also sends a false price signal to investors about where capital needs to be allocated. It increases the likelihood that investors will be stuck with stranded oil and gas assets that society no longer needs." [30]

Suggested Reforms

To address the dangers of illegally lending to insolvent companies and improve the targeting and impacts of Federal Reserve programs, we would suggest the following four policy changes.

Strengthening employment and other conditions for borrowing companies*:* The Federal Reserve's failure to place meaningful restrictions on the activities and behavior of companies receiving public credit assistance is particularly dangerous in the case of potentially insolvent companies. Such companies have no incentives to maintain employment or to invest in the firm, and every incentive to seek mechanisms for transferring loan proceeds to insiders. A strong requirement to maintain employment will lower their incentive to seek credit from the Federal Reserve. Further, in the absence of any requirement to maintain employment loans will not serve the public interest in economic recovery. We have previously recommended that the Federal Reserve place stronger conditions on lending to all companies.[31] These conditions should include binding requirements to maintain employment and to keep resources in the firm to support employment, production, and safe working conditions, rather than pay them out in dividends, stock buybacks, or excessive executive compensation. Not only will such conditions better preserve employment and economic value, they will also enhance protections against lending to insolvent firms.

Capping EBITDA adjustments for underwriting lending programs and using backstops based on cash flows*:* Limits need to be set in order to stop the adjusted EBITDA metric from being artificially inflated. At minimum, leverage should be capped at a percentage of unadjusted EBITDA. This would be consistent with the views of the Federal Reserve's own bank examiners who have expressed alarm in the past over borrowers being able to take on more debt, reducing their margin of safety in an economic downturn as we are now seeing.[32]

Although this is the minimum, the Board should go further by eliminating corporate management's discretion over its earnings figure altogether by lending instead at a multiple of Free Cash Flow (FCF). Free Cash Flows are an audited GAAP figure that show how much cash is left for a business after all expenses and taxes have been paid and provides a better assessment of the true economic situation of a company

Significant declines in Free Cash Flow may also indicate trouble for a company before EBITDA. An analysis by the American Bankruptcy Institute of 42 companies in the year leading up to their

[30] Raskin, Sarah Bloom. New York Times. "Why Is the Fed Spending So Much Money on a Dying Industry?". May 28, 2020. https://nyti.ms/2DekwdK

[31] Americans for Financial Reform Education Fund. Apr 16, 2020. https://bit.ly/3f5x2ZW

[32] Hoffman, Liz and Wirz, Matt. Wall Street Journal. "The Ultimate Ebitda Fighting Championship" Oct 16, 2016. https://on.wsj.com/3360fl8

Chapter 11 bankruptcy found that 33% of those companies still had positive EBITDA, yet all of them had negative free cash flows.[33]

Restrict private equity access to Main Street Lending programs by basing aggregation policies on a control determination – Currently the aggregation determination is based on a mechanical application of a 50% ownership threshold. To capture cases where control is exercised through a shell company with less than 50% ownership, companies should be asked about effective control if there is a substantial and meaningful private equity stake that falls short of the 50% threshold.

Require private equity parent funds to accept full liability for loans made to portfolio companies*:* Private equity firms are shielded in bankruptcy from liability for debts incurred by their portfolio companies. This means that they would not be liable for repaying Federal Reserve loans made to a failed portfolio company, even if they had transferred considerable funds from the portfolio companies through monitoring fees or other types of quasi-dividends not addressed by restrictions on capital distributions under Federal Reserve programs. For that reason, all such lending to private equity backed companies need full disclosure of all payments between the company and its controlling firm to ensure funds are not excessively flowing to their owners that way. The incentive to drain funds from portfolio firms in this manner could also be addressed by extending liability for loan repayment from the portfolio firm to the private equity parent that exercises control over the firm. Extended liability would also guarantee repayment to taxpayers. While conditions for lending should in any case require that resources be kept within the firm, the extension of liability to the private equity parent will align incentives by establishing that those who control the company are also liable for its debts.

Ensure that lending to energy companies is based on realistic forecasts of future energy prices and realistic estimates of future company solvency*:* Lending to energy companies should be based on realistic forecasts of future energy prices, not on energy prices from 2019 that are now radically out of date. Such forecasts should also include the possibility of significant policy action against climate change over the near to medium term. Further, it is particularly important that leverage metrics like EBITDA which exclude interest payments and capital costs not be used to determine lending criteria for heavily indebted and capital-intensive sectors such as energy.

Ensure that policies do not inappropriately overweight lending to the fossil fuel sector: As noted above, Federal Reserve secondary market bond purchases have been significantly overweighted to the energy sector so far. It is unclear why policies in the Secondary Market Corporate Credit Facilities, which are totally discretionary on the part of the Board and do not involve applications from companies, would lead to this result. In any case, they should be changed. As regards other facilities, we believe that the revisions to policies outlined above regarding energy price forecasts and EBITDA determination will act to limit lending to insolvent energy companies. However, if lending in other facilities also becomes significantly overweighted to fossil fuel companies, the Board should examine whether companies that are effectively insolvent and have little chance of recovery given the likely future direction of energy prices and climate regulation are receiving inappropriate assistance.

[33] Sciametta, Joe et al. American Bankruptcy Institute. "EBITDA vs. Free Cash Flow – A Study in Viability and Value Indicators." Mar 1, 2003. https://bit.ly/2D5rly1

Thank you for your attention to these matters.

Sincerely,

Americans for Financial Reform