Client Alert

April 2020

Practical Tips for Understanding and Managing SBA PPP Risks After Day 1

Perhaps it was to be expected that the Small Business Administration ("SBA") would not be able to deal with the deluge of responsibilities associated with the funneling of hundreds of billions of dollars to businesses to keep them afloat. The SBA was trying to cope with the need to allocate $350 billion toward the 7(a) program in three months when it guaranteed "Only" $17 billion of 7(a) loans during all of 2019. Moreover, the Coronavirus Aid, Relief and Economic Stability Act (the "CARES Act"), which created the Paycheck Protection program ("PPP"), expanded eligibility well beyond both the traditional SBA borrower and traditional SBA lender. As a result, the SBA had to create new rules for such loans in less than a week. It was not surprising that the rules they created are wanting.

Perhaps the SBA could have had more success with continually fine-tuning the PPP if not for the pressure to perform quickly. The SBA made its problem worse when it disclosed that 7(a) loans under the PPP would be on a "first come, first served basis." Treasury Secretary Mnuchin poured gasoline on the raging fire when he hyped expectations. "Treasury and the Small Business Administration expect to have this program up and running by April 3rd so that businesses can go to a participating SBA 7(a) lender, bank or credit union, apply for a loan, and be approved on the same day," he said. The Secretary also announced he expected the $349 billion PPP to run out of funds quickly. Although he committed to going back to Congress for more funding if need be, would-be applicants were now primed. Both the California gold rush and the efforts of the Oklahoma "sooners" would pale in comparison to the hysteria of Day 1 of the PPP.

And why not? The U.S. economy is in crisis. The depth and steepness of the decline are beyond anything the country has experienced in its 244 years. Last week, 6.7 million Americans filed for unemployment. Such figure dwarfed the prior week's 3.3 million claims. In contrast, the week of highest unemployment claims that occurred in 2008 was approximately 500,000 people. Thus, in two weeks, the unemployment rolls increased by 8X the biggest one-week figure from the subprime crisis.

The Federal Reserve Bank of St. Louis has extrapolated such information and now expects second-quarter unemployment to increase to 32%. At the same time, economists are now saying that the second-quarter gross domestic product may drop as much as 20 to 25%. There is no way to tell if such figures are a product of enhanced unemployment benefits and a reasonably strong safety net, or if more likely, they are a harbinger of an economy brought to an abrupt stop with businesses with zero cash flow coming in the door forced to terminate employees. Hopefully, businesses will have just experienced a superficial wound, rather than a mortal blow, from the civil authority policies in response to COVID-19.

In light of such looming economic troubles, Congress, the Administration, the Federal Reserve Board, and other regulators were correct in identifying the need for urgent action. Unquestionably, getting money out the door to keep businesses afloat long enough so that they can hire back staff is a national priority, perhaps only trailing the war on the virus itself.

Congress decided to use the platform of the SBA for funding dollars to large sectors of the U.S. economy. In addition, Congress and the Administration decided that the understaffed and always-short-of-dollars

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SBA could not do what the country needed. Instead, the banking system would need to be brought in to provide hands to administer the checks. Thus, the PPP was designed as a grant program masquerading as a loan program. Any differing views of that were summarily disposed of with the changes to the program announced by the SBA on April 1, 2020 – and no, those changes were no April Fool's Day joke.

The biggest two changes to the PPP were a dramatic drop in the rate on loans from 4% to 50 basis points, and a shortening of the loan term from up to 10 years to two years. Moreover, the SBA rules provide for third parties to get a piece of bank origination fees, which are really the only means to compensate the banks for the time, effort and risk of the program. In response to banks' indicating that they would not participate in the PPP, Treasury and the SBA changed course for the third time in one week. On the eve of the program opening, the SBA announced that the rate would be 1%. More importantly, the SBA changed the PPP to minimize the risks for banks in administering the program and also disclosed the opportunity to jettison the forgiven portion of SBA loans within two months of funding. With such changes, banks grudgingly returned, but many indicated that they would only serve existing customers. One money center bank disclosed that customers would need both a deposit account and credit card to receive funding.

Even such banker willingness to help their customers and the country was sorely tested as the SBA dropped in changes to the documentation (after many applicants had already signed the prior versions). Moreover, the SBA indicated that there would be new documents and that there would be continuing changes to the ETran system used to communicate electronically and receive the all-important customer approvals. Ironically, for a "lending program," the SBA did not even have a form promissory note to use, SBA officials have advised us that they are aware that SBA preferred 7(a) lenders were creating their own notes. The SBA could not tell such lenders to refrain from doing so.

In the face of a program that is recognizable only to a shape shifter, what should banks be doing to address the current issues? Also, how can banks protect themselves from the certainty that the SBA will continue to alter the PPP even after notes are signed and dollars are funded?

Bankers must identify their willingness to engage in such a program. Because the economy and their customers need them, I have no doubt bankers will heed the call to serve. How could a community banker face his or her friends, neighbors, customers and the mirror without doing so? The trick is to participate while reducing the ongoing risks from the PPP. We have identified some of the apparent risks from Day 1 of the PPP and our suggested actions to mitigate them.

- ***Risk – Overall Risk Appetite***: Each bank should identify its risk appetite for the PPP.

  Actions:

  - ✓ The bank should develop the overall risk appetite for the scope of PPP participation. Specific parameters are needed. Management will need to make recommendations to the board. For example, will the bank only allow existing customers to participate, or will the bank open the program to noncustomers? What does it take to be deemed a customer for this purpose? Will the bank avoid certain industries, or will the bank open its program to all industries? Will the bank have a maximum aggregate dollar amount that it is willing to lend a customer under the PPP (preferably not because the borrower can only get one loan – we encourage banks to allow customers to maximize the loan proceeds)?

  - ✓ From a corporate governance standpoint, the Board (via a written consent or electronic/telephonic Board meeting) should approve: (i) these recommendations as part of the bank's overall risk appetite statement, (ii) projected worse case capital and wholesale funding ratios and (iii) any changes to policy and capital plan thresholds. The regulatory expectation is that the board is overseeing the bank's role in the PPP.

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- ✓ As discussed below, bankers should obtain regulatory buy-in for these unusual risk limits and tolerances. Unquestionably, numbers will balloon in the June 30 Call Report.

- ***Risk – Reputation Risk***: For many, if not all, community banks, the PPP presents a challenge to the bank's reputation in its community. Obviously, implementing the PPP when there are many unknowns and variables that are changing can cause significant reputation risk for the bank. The application process is inherently opaque and frustrating with changing requirements and fraught with uncertainty. The PPP is clearly different than advertised. Bankers once again may become an easy punching bag. The modern American pastime is to find a party to blame and bankers, instead of the SBA, could be it.

  Actions:

  - ✓ The bank should considering engaging a PR firm, or discussing with their existing PR firm, the challenges and risks with the PPP program. The bank should explain to its community the hurdles imposed and the basis for decisions the bank is making. The April 3rd 30,000 prospective lender backlog in the ETran systems is indicative. Bankers pulling all-nighters for their customers is an accurate and appropriate storyline.

  - ✓ Banks should seek to manage the expectations of customers to the extent possible. Banks should let customers know the bank is at the whim of the SBA. Banks should let customers know to expect delays and technological issues that are beyond the bank's control. It is appropriate to explain how the SBA is building the plane and flying it – all without any beta testing. In effect, each applicant is an SBA guinea pig. Banks are seeking to implement the PPP with very little (and changing often, at times, conflicting) guidance as an accommodation to customers. There is no profit in an extremely manual 1% interest loan.

- ***Risk – Disclosure***:

  Actions:

  - ✓ Companies should consider their expected loan volumes and liquidity mix as part of earnings disclosure. Presumably, Covid-19 risk is already a part of such analysis. Investors are keenly interested in such information.

- ***Risk – Liquidity and Capital***: Does the bank have sufficient liquidity to fund the PPP? Many banks had high loan to deposit ratios prior to COVID-19. Making sure the bank has access to liquidity sources is essential. Also, does the bank have sufficient capital to support the PPP?

  Actions:

  - ✓ Banks should consider funding the estimated residual program volume from wholesale sources. Some banks appear to be relying entirely on such non-core funding. Funding for these programs can be reassessed after the forgiveness period. It is crucial, however, to obtain staffing information and plans from customers in the application process to project forgiveness levels.

  - ✓ Banks should discuss with regulators the plans for funding and liquidity, so there is regulatory buy-in, because the short-term funding plan will be inconsistent with the bank's policies.

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- ✓ Banks should also discuss with regulators the plan for capital on a proposed worse case capital level in light of the SBA asset growth. For example, if a bank typically maintains a 9% leverage ratio, is an 8% leverage ratio sufficient for the short term to support the PPP? We have heard that some banks are willing to take such ratios below 8% analogizing to the two-quarter grace period under the community bank leverage ratio. The thought is that forgiveness will bring such levels back up, and the bankers are trying to serve the need.

- ✓ Regulators are quickly approving plans on both capital and liquidity.

- ***Risks – Changing Program/Customer Urgency***: There is, unquestionably, a sense of urgency to the PPP. Customers needed the money yesterday. However, there is risk to the bank in starting the program first and thinking through the program later or trying to catch up to the changes in real time.

  Actions:

  - ✓ The bank should have an individual dedicated to repeatedly checking the SBA's website for updated guidance and communicating any updates or changes to the remainder of the management team. Bankers should be capturing screenshots or otherwise recording the input to ETran. Information is indeed power.

  - ✓ The ETran system requires the banker to make judgments. For instance, on Friday to submit a nonprofit applicant, the program would not advance unless ownership was reflected. A list of such issues should be maintained to work through prior to actually funding loans.

  - ✓ Ensure that the bank is asking questions about business affiliations. Guidance was issued on Saturday. Businesses under common control may need to be aggregated and may no longer be deemed "small businesses."

  - ✓ Banks should consider having each customer sign a separate certification, which, among other things, should require the customer to execute any needed documentation to address changes made by the SBA at a later date. We also recommend a hold-harmless provision, so as to minimize bank exposure to the applicant for the applicant's errors and subsequent SBA changes.

  - ✓ Some customers are having others (e.g., accounting firms) prepare the application. Those preparers may then claim that they are owed "agent" fees from the bank under the PPP guidance. If the bank has to pay an "agent," this obviously reduces the bank's origination fee. The bank should consider including in the certification that the customer has not used an agent (if that will be the bank's policy on this issue).

  - ✓ It now may be that the SBA will be providing a specimen promissory note. If the bank proceeds with using its own form of note in the interim (to provide funds to customers), the "loan" may need to be repapered. The note should allow the bank the ability to later unilaterally revise it as needed, for, among other reasons, to harmonize the bank form with the form note produced by the SBA, if any. If the bank prefers to wait until the SBA produces a form, it should advise its customers accordingly.

  - ✓ Because PPP participants can only obtain one loan, the bank should consider obtaining approval for the maximum amount possible. Once the loan is approved, the customer cannot go to another bank and obtain a second loan. The bank can verify

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numbers and information and reduce the loan amount if need be. The ETran system only allows loan amounts to go down. Importantly, banks should centralize document control.

- ***Risk – Operational***: Given the many questions that remain under the PPP and the reliance on technology to implement the PPP, the operational risk is palatable.

  Actions:

  - ✓ The ETran system is a work-in-progress, which is being converted in real time to the new PPP.
  - ✓ Bankers should consider moving customers online to reduce errors and maintain records. It does not take much of an Outline Search to find PPP calculators and application forms. If need be, license the needed software from an out-of-market institution.
  - ✓ For all banks, but especially banks that are not experienced SBA lenders, training of employees (whether lenders or other administrative employees) on the PPP and the ETran system is critical. Banks should implement a procedure to oversee the training and administration of the PPP. There should be a process in place to go back and correct errors.
  - ✓ Banks should consider requiring customers to set up a separate, segregated account to track use of PPP proceeds for forgiveness purposes. Having a separate account will obviously make expenditures easier to track.

- ***Risk – Compliance***: Bankers should recognize that compliance rules apply to the PPP.

  Actions:

  - ✓ If loan customers complete an application, an adverse action notice may be required if the customer does not receive funding (we have asked the CFPB to waive such requirements).
  - ✓ The fair lending laws apply to the PPP. Accordingly, bankers must be careful how they prioritize what, and whether to serve, particular types of customers. Prioritizing customers from largest businesses to smallest is inherently risky.

- ***Risk – Distraction***:

  Actions:

  - ✓ Taking an “all hands on deck” approach to the PPP seems ill-advised. First, there never will be enough short-term capacity for the demand. Second, it mismatches resources. The PPP is a Band-Aid. Bankers should be triaging their loan portfolios, and focusing on workouts with their commercial customers, obtaining guarantees, additional collateral and enhanced loan covenants. Moreover, some customers will need additional credit, *e.g.*, to avoid being primed by a tax lien lender.

This client alert is a partial list of the risks (and it is already plenty long) to be identified and mitigated. In the rush to respond to client demand, bankers should step back, take a breath and set parameters so that customer problems do not become bank liabilities.

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