Client Alert

May 2020

The Paycheck Protection Program Liquidity Facility

At the end of the second round of the Paycheck Protection Program (the "PPP") administered by the Small Business Administration (the "SBA") there will be up to $659 billion in loans on the books of participating lenders. Of course, the idea is that these loans will be forgiven to the extent the proceeds are used by borrowers for eligible uses over the 8-week forgiveness period, and thus, will soon be paid off by the SBA. However, there is a meaningful possibility that a significant portion of the loans will remain on the books of lenders for much longer than the forgiveness period—especially considering the forgiveness process is still being developed. It is also important to note that the approach of the end of PPP funding does not yet signal the end in the deluge of changes.

In the SBA's Inspector General Report released on Friday, May 8th, it was noted that the initial interim final rule did not align with the allowable use requirements for PPP loan proceeds under the CARES Act.[1] Two specific areas of deviation include the requirement that 75% of PPP loans be used for eligible payroll expenses and that borrowers have to repay amounts not eligible for forgiveness within a 2-year term. The CARES Act does not contain any restrictions on the portion of loan proceeds that need to be used for payroll. There has been a lot of ink spilled over the possibility that changes to the PPP might be made to lower the 75% payroll requirement and when borrowers need to take their funds. Of lesser note is that the CARES Act allowed for a maximum maturity of up to ten years for PPP loans. While unlikely, it is theoretically possible that changes will be made so that loan terms are extended beyond the current 2-year term. This is especially the case as more economists are now predicting a longer economic downturn.[2]

To ensure lenders do not suffer from liquidity constraints due to participation in the PPP, the Board of Governors of the Federal Reserve System (the "Federal Reserve") is providing what is billed as "non-recourse" liquidity through the Paycheck Protection Program Liquidity Facility (the "PPPLF"). In this client alert, we assess the PPPLF and why all PPP lenders should be mindful of risk issues when taking advantage of this source of liquidity during the current economic crisis.

Background

The CARES Act originally appropriated $349 billion for PPP loans to small businesses, nonprofits and certain other entities. The Paycheck Protection Program and Health Care Enhancement Act, authorized an additional $310 billion for PPP loans and $60 billion for Economic Injury Disaster Loans.

The SBA's PPP, as part of the 7(a) loan program, is designed to provide loans principally to small businesses, nonprofits and religious organizations in order to encourage those entities to keep workers on their payroll. Borrowers that use loan funds for eligible purposes during the applicable period may have principal and interest forgiven on a tax-free basis—thus converting the loans to grants. Loans are

[1] The CARES Act is formally titled the "Coronavirus Aid, Relief, and Economic Security Act."
[2] For example, Nariman Behravesh, chief economist at IHS Markit, said "This is the dilemma of the disease and the economy. To limit and control the disease you basically have to kill the economy. It's a tradeoff." Los Angeles Times Online edition (March 10, 2020).

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fully guaranteed by the SBA and any loans that are not forgiven carry a fixed interest rate of 1% per annum. Eligible lenders may sell PPP loans on the secondary market to eligible purchasers.

The Federal Reserve established the PPPLF using its emergency lending powers under section 13(3) of the Federal Reserve Act to bolster the effectiveness of the PPP. Under the PPPLF, each of the Federal Reserve Banks will extend nonrecourse loans at a fixed rate of 35 basis points to lenders that pledge SBA-guaranteed PPP loans. To facilitate use of the PPPLF, the Office of the Comptroller of the Currency (the "OCC"), the Federal Reserve, and the Federal Deposit Insurance Corporation (the "FDIC") adopted interim final rules to neutralize the regulatory capital and liquidity, including pursuant to the Liquidity Coverage Ratio rule, impacts associated with accessing liquidity through the PPPLF.[3] The Federal Reserve later expanded the PPPLF to allow banks to also pledge PPP loans purchased in the secondary market.

PPPLF Overview

Under the PPPLF, a Federal Reserve Bank will make nonrecourse loans to eligible lenders, secured by PPP loans, without any haircuts. All lenders (including non-bank lenders) that are eligible to originate PPP loans are eligible to borrow from the PPPLF, this is the first time in history that the discount window has been opened up to non-banks. Both regulated financial institutions and non-depository institutions are required to complete and submit certain legal documents to qualify for the PPPLF.[4]

The PPPLF, while operated under the discount window, differs in a number of ways. Primarily, the PPPLF only accepts PPP loans as collateral. Additionally, primary credit loans under the discount window are made with full recourse to the borrowing institution, while extensions under the PPPLF are theoretically non-recourse—we explain the *theoretically* qualifier below. Extensions of credit under the PPPLF are at a slightly higher rate than primary credit loans (fixed rate of 35 basis points versus 25 basis points), are for a significantly longer term (up to two years versus 90 days), and the amount of extensions are determined based on the principal amount of the underlying PPP loan (or pool of loans). No extension of credit will be made under the PPPLF after September 30, 2020.[5] The Federal Reserve changed its stance recently. Now PPP loans that have been purchased in the secondary market may be pledged to the PPPLF.

Section 13(3) "Adequate Credit" Certification

Because the PPPLF is established under Section 13(3) of the Federal Reserve Act, it therefore requires a financial institution borrowing thereunder to "certify that it is unable to secure adequate credit accommodations from banking institutions." The foregoing certification is based on the requirement in Section 13(3) of the Federal Reserve Act that, prior to providing a discount to any participant in any program or facility, a Federal Reserve Bank must "obtain evidence that such participant in any program or facility with broad-based eligibility is unable to secure adequate credit accommodations from other banking institutions."[6] Because such language cannot be modified, the Federal Reserve issued Frequently Asked Questions that address what a PPPLF participant may rely upon in certifying that it lacks adequate credit accommodations from other banking institutions. The Frequently Asked Questions explicitly state that "a PPPLF participant is not required to certify that credit is unavailable. Rather, … a PPPLF participant may rely on the fact that the Board of Governors authorized the establishment of the PPPLF to improve the ability of PPP lenders to obtain reasonably priced long-term financing for PPP Loans."[7]

[3] On April 9, 2020, the OCC, FDIC, and Federal Reserve issued the interim final rule neutralizing the capital effects for participating in the PPPLF (comments on the interim final rule are due by May 13, 2020). On May 5, 2020, the OCC, FDIC, and Federal Reserve issued the interim final rule neutralizing the treatment of PPPLF funding impact on the Liquidity Coverage Ratio.

[4] Required documents include, but are not limited to, a letter of agreement and a borrower certification.

[5] The Federal Reserve and U.S. Department of the Treasury may determine to extend this date.

[6] 12 U.S.C. 343(3)(A).

[7] Frequently Asked Questions, Paycheck Protection Liquidity Facility.

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In addition, we confirmed with contacts at the Federal Reserve, that banks can make the required lack of adequate credit certification, not because a bank does not have access to other sources of adequate credit, but because there are no more favorable options to support participation in the PPP. Considering the long-term fixed-rate funding and the favorable capital treatment available under the PPPLF, it is unlikely that banks will be able to find more favorable options to support participation in the PPP. In light of the guidance released by the Federal Reserve, a bank's board of directors may deem it reasonable to conclude that the bank can make the required certification as to lack of adequate credit accommodations in order to participate in the PPPLF. We have assisted a number of institutions with resolutions and documentation reflecting board of directors' approval for the banks to access the PPPLF on this basis.

Certainly, nonbank lenders will not be able to find 35 basis point credit elsewhere.

Nonrecourse with Strings Attached

As we discussed in one of our recent client alerts, the Federal Reserve's PPPLF has been "billed" as a nonrecourse arrangement. That is how it is described in the Federal Reserve's FAQs and interim final rules. Lenders should be aware that the arrangement can become recourse if the lender "has breached any of the representations, warranties, or covenants made under the PPPLF agreement." We refer to this as the Federal Reserve's "side door" for revoking the nonrecourse status with regard to loans that lose the Small Business Administration ("SBA") guarantee.

Specifically, the Federal Reserve has stated that "[f]ailure by the Borrower to meet any of the requirements of the PPPLF Agreement (including if any PPPLF Collateral fails to satisfy the requirements of the PPP) may, at the sole discretion of the Reserve Bank, void the nonrecourse provisions and any related provisions, i.e., the Reserve Bank's rights shall be full recourse with respect to that portion of any Advance equal to the amount of the PPPLF Collateral Valuation (on the date of the Advance) of any non-conforming PPPLF Collateral, and may, at the sole discretion of the Reserve Bank, result in the Borrower's disqualification from participating in the PPPLF." This is a long way of saying that the Federal Reserve may void the nonrecourse provisions if a lender fails to comply with the requirements of the PPPLF or if *any of the pledged PPP loans fails to meet the SBA's requirements for such loans*.

To provide some assurance, the Federal Reserve did go on to state that "[t]he discretion to revise the nonrecourse provision, while essential to prevent fraud and abuse of the program, is not meant to be used as a method to arbitrarily disqualify PPP loans as collateral." The Federal Reserve expects banks to establish policies and procedures that ensure compliance with the SBA rules and guidance—this implies that lenders participating in the PPPLF should ensure they have comprehensive policies and procedures in place to support the soundness of PPP loan administration. The Federal Reserve acknowledges that the assessment of a bank's policies and procedures will be based upon the rules then in effect. This guidance is a welcome acknowledgement, although incomplete, in light of the constantly shifting PPP landscape.

Although policies and procedures are a core tenet of a compliance management system, the pace of change and all-consuming nature of loan demand have created difficulties in applying basic regulatory requirements to the PPP. Nonetheless, the regulators have made it clear that the "rulebook" is still in effect regarding the PPP.[8]

Lenders should put in place the structure required for any new product albeit with recognition of where events are in the process and timeline. Accordingly, lenders should have a risk assessment covering both the PPP and the PPPLF. Policies and procedures covering both should be adopted. Training and internal controls should also be put in place to ensure that lenders can monitor and test for compliance with the PPP and PPPLF requirements. Board reporting and oversight should also be put in place. Such steps are expected by examiners but may also be critical to preserving the SBA guarantee and nonrecourse status under the PPPLF.

[8] See, e.g., OCC Bulletin 2020-45.

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Other Considerations

Nonbank lenders, primarily fintechs, may have been late to the PPP party, but they certainly came ready. While the figures have not yet been reported publicly by the SBA, it is estimated that over $20 billion in PPP loans were originated through fintech lenders since they became eligible to participate—right around the time the second round of PPP funding was approved. While these fintech lenders should be able to participate in the PPPLF, some are entering into arrangements where they sell pools of PPP loans to banks who in turn pledge the loans to a Federal Reserve Bank. The fintechs retain servicing obligations in exchange for a cut of the spread earned by banks pledging the PPP loans.

This may be a very reasonable strategy for all players considering the low risk, provided the nonrecourse nature of the PPPLF, forgiveness and the SBA guarantee on PPP loans can be preserved. Banks are certainly comfortable with the process of accessing the discount window. Nevertheless, banks are cautioned to evaluate all of the risks before entering into any such arrangement.

We have worked with a number of banks to develop comprehensive risk assessments as required by federal regulators as well as board resolutions designed to ensure the proper authorizations are in place. Due to the risk that exists surrounding the Federal Reserve's ability to void the nonrecourse provisions of the PPPLF, lenders should be exceedingly diligent in ensuring that loans purchased in the secondary market meet all of the SBA's requirements for PPP loans.

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