Client Alert

October 2020

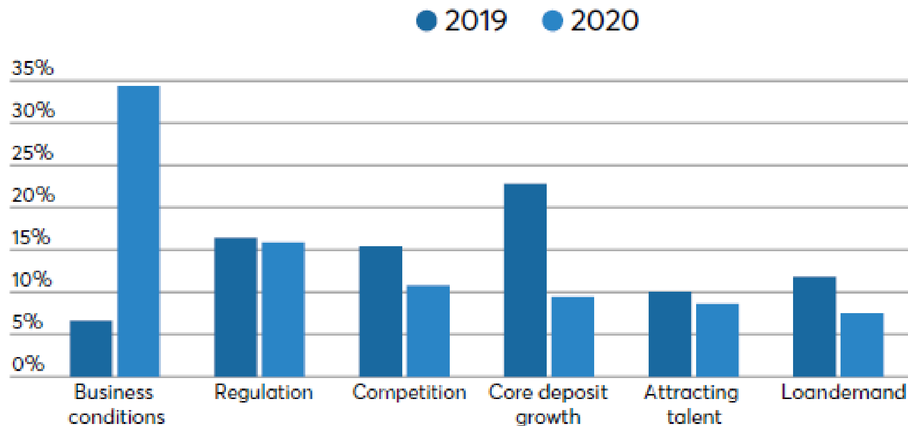
Expanding the Beachhead: Why Banks Should be Using the Main Street Lending Facilities

The Federal Reserve, using CARES Act funding, has created a number of Main Street Lending Facilities ("MSLFs"). The two that should be of interest to most bankers are the Main Street New Loan Facility ("MSNLF") and the Main Street Priority Loan Facility ("MSPLF"). These two facilities should enable banks that have successfully moved business from competitors pursuant to the Paycheck Protection Program ("PPP") to continue such efforts. The MSLF enables banks to continue to enlarge the PPP beachhead by moving other business that may have been neglected by potential customer's existing banking relationship.

The MSLFs come at a welcome time. New lending activity has reached a nadir not seen since 2012. As a result, banks faced with the prospect of anemic returns on investments, and thus, plummeting net interest margins ("NIMs"), are unlikely to be able to loan their way to restored profitability as banks did during the interest rate decline following the last economic downturn.

After the subprime crisis, the Federal Reserve kept interest rates extremely low. As a result, banks had no choice but to expand their lending, perhaps beyond what their risk tolerance would have been otherwise, to make up for the lack of alternative investments. As a result, more than half of the banks with growth rates of 5% or more entered 2020 with a 90% or greater loan-to-deposit ratio. In the current recession, it may not be clear whether borrowers will be able to perform. Despite the current surplus of liquidity, banks are not finding acceptable low-risk opportunities to loan out such funds.

Shifting concerns for small banks:



Thus, banks are flush with cash but have limited places to put it.

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In such an environment, the banking business traditionally becomes a fight for market share. Traditionally, in such an environment, bankers drop interest rates for the clearly good credits as a way to entice business to move to their institution. The MSLFs provide a way to both drop interest rates and soften amortization terms yet still enhance yield on a more limited risk basis.

Yet a Congressional panel overseeing the MSLFs indicated, as of September 7, that participating lenders had issued only approximately $1.07 billion in loans in contrast to the $600 billion available under the MSLFs. The panel noted the possibility that interest was limited because many borrowers tapped the PPP. This is despite the fact that PPP recipients are also eligible to borrow under the MSLFs. Other possibilities noted by the Congressional panel included that lenders had not publicized their involvement with the MSLFs, businesses are not familiar with the MSLFs rules, and eligibility and compliance requirements viewed as complex by some borrowers prevent them from wanting to participate in the MSLFs. The reality may be quite different.

We believe that there are numerous borrowers who would like to participate in the MSLFs. The borrowers are attracted by the 3% margin over LIBOR and the soft amortization terms. Lenders, however, are concerned that only 30% of loan principal may be paid back at the end of five years when the MSLFs mature with a balloon payment equal to approximately 70% of the principal. Typically, loan losses materialize starting around that five-year window. Because the program does not provide a plan for the credits thereafter, lenders are concerned about “peak” exposure.

We are representing over 30 lenders pursuant to the MSLF in over eight states. Obviously the appetite for the program differs. There seems to be a consistent view that the ideal borrower under the MSLF, from a lender’s perspective, is one which the lender would likely renew at the end of the five years of the program. In other words, these are the very borrowers that institutions fight to retain or attract.

In this current environment, however, the MSLF arms lenders with the ability to snatch such business away from their rivals and have borrowers be grateful for the lenders doing so. Thus, there are two approaches to use of the MSLF: one defensive and the other one obviously offensive.

Economic Terms Applicable to MSNLF and MSPLF. The economic terms applicable to borrowers and lenders are largely the same other than the key differences outlined below. For all MSNLF and MSPLF loans, 95% of the principal loan amount will be purchased by a special purpose vehicle administered by the Federal Reserve Bank of Boston. Lenders also receive a 25 basis points servicing fee for administering the servicing on the 95% interest held by the Federal Reserve Bank of Boston.

For borrowers, the MSLF provides a fairly low interest rate (LIBOR plus 3 percent) and deferred payment terms that provide short-term liquidity. No payments are due at all on the MSLF loan for the first 12 months. For the next two years, a borrower is only required to make interest payments. Payments of 15% of the outstanding principal are required at the end of the third and fourth years of the loan term with a balloon payment due at maturity at the end of the fifth year. Borrowers may prepay the loan at any time without penalty.

MSNLF. The MSNLF allows for the smallest maximum loan size of the MSLFs at $35 million. A borrower’s maximum loan size is an amount equal to 4 times their 2019 “adjusted” EBITDA less existing, outstanding debt that will remain in place after the origination of the loan under the MSNLF.

The most advantageous term of the MSNLF is that a borrower can keep pre-existing secured debt in place after the origination of a loan under the MSNLF. The MSNLF debt simply cannot be subordinated (pursuant to a subordination agreement or other instrument) to any of the borrower’s other secured debt. This makes the MSNLF an attractive option for lending to borrowers who already have a relationship with the lending bank.

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Our clients are creatively using the MSNLF to add reserves to cover payments as they arise over the next couple of years. The excess funds are then used by the borrower. From the borrower's perspective, dollars are fungible, and thus, dollars left as payment reserves still free up future dollars for other uses while reducing the risk that payments will not be made.

A borrower is only entitled to one MSLF. Accordingly, a lender's advancing an MSNLF to an existing customer has effectively precluded a competitor from using the MSPLF to take away a good customer.

MSPLF. The MSPLF provides a larger maximum loan size ($50 million) and replaces the 4x "adjusted" EBITDA multiple with a 6x "adjusted" EBITDA multiple in determining a borrower's maximum eligibility. The most critical difference between the MSNLF and the MSPLF is that the MSPLF allows for borrowers to refinance debt with the proceeds of the MSPLF loan at origination. The refinanced debt must be held by a lender other than the lender originating the MSPLF.

Because the MSPLF allows an existing loan to be repaid in full, a bank can move the entirety of a customer's business over. The new bank can do so while potentially leaving existing lines of credit in place or replacing them with its own.

Under the MSPLF, the bank receives not just the servicing fee on the Federal Reserve's piece of the credit, LIBOR plus 3% of the retained 5% of the loan amount and a 1% origination fee, but the spread on moving all of the customer's relationship over. In this way, the new lender can earn fees off of the treasury or cash management function. In addition, the bank would earn funds on the deposits brought over. Of course, currently those deposits do not have much yield to them. Bankers should look mid-to-longer term. After all, "We're buying businesses to own for 20 or 30 years. We buy them in whole, we buy them in parts … and we think the 20- and 30-year outlook is not changed by the Coronavirus," – Warren Buffet.

Changes to the MSLF. The Federal Reserve revised its Frequently Asked Questions ("FAQs") for the MSLFs on September 18, 2020. The thrust of the changes were three-fold:

- In underwriting, lenders are expected to look back to the pre-COVID 2019 performance and the borrower's post-COVID expectations (in doing so, the lender should consider the favorable amortization provided under the MSLFs). In particular, even if the loan would not currently be a pass credit, the regulators will not criticize such loans as long as the "weaknesses stem from the pandemic and are expected to be temporary or if such loans are part of a bank's prudent risk mitigation strategy for an existing customer."
- The FAQs clarify that multi-borrower MSLFs are permitted. For such purposes, co-borrowers may use aggregated EBITA calculations.
- The FAQs also specify that loans from a borrower to its owners, employees or officers, will be deemed to be an impermissible capital distribution. Notably, the FAQs provide an exception if the loan is "bona fide" and repaid according to its terms. In this way, the FAQs provide a clear path for having such loans be considered permissible.

We encourage banks to reconsider the MSLF. In light of its relatively low utilization, it provides a competitive advantage over institutions that are slower to understand its uses. Of course, we would be happy to provide our training materials to help educate those considering such program or looking to maximize its potential.

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