# Client Alert

## “Main Street is the climax of civilization”:[1] The Federal Reserve Issues the Main Street New Loan Facility and the Main Street Expanded Loan Facility

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On April 9, 2020, the Board of Governors of the Federal Reserve System (the “Federal Reserve”) unveiled two new facilities in response to the ongoing COVID-19 pandemic, both pursuant to Section 13(3) of the Federal Reserve Act (“Section 13(3)”).[2] The facilities, seeded with funds allocated to Federal Reserve lending programs under the CARES Act, are directed at facilitating lending to small- and medium-sized businesses: the Main Street New Loan Facility (“MSNLF”) and the Main Street Expanded Loan Facility (“MSELF”) (together, the “Facilities”). Please see our previous client alert, *Federal Reserve Expands Credit Facilities to Aid Economy During COVID-19 Crisis,* for summaries of the Facilities.[3]

These two Facilities represent both a new manner of providing liquidity to the small- and medium-sized companies in the United States as well as a return to a role that the Federal Reserve once played in providing direct liquidity to smaller “main street” companies in the 1930s. Below, we compare the Facilities to one of the primary means by which the Federal Reserve exercises its role as the lender of last resort – the discount window – and highlight a number of open questions and other topics of discussion related to the two Facilities.

### Comparison to the discount window

It is important to note that each Facility contemplates using a special purpose vehicle (“SPV”) to purchase participations from eligible lenders to provide liquidity to eligible borrowers. In other words, the Federal Reserve will not be lending *directly* to any company. We can therefore compare this structure to the discount window, in which eligible lenders that lend to borrowers may pledge those loans to the Federal Reserve in return for advances under Section 10(b) and related provisions of the Federal Reserve Act (the “Discount Window”). Both types of lending ultimately provide liquidity to the same class of eligible borrowers – *i.e.*, U.S. companies.

[1] *Main Street*, Sinclair Lewis, *Preface* (1920).

[2] 12 U.S.C. § 343 (2020).

[3] The Facilities are not yet operational. On April 16, 2020, the Federal Reserve issued its initial reports to Congress regarding the Facilities, which note that the Facilities will be operated by the Federal Reserve Bank of Boston. The reports note that the Federal Reserve has sought input from market participants and other stakeholders regarding the terms of the Facilities, and that the terms and conditions initially unveiled by the Federal Reserve on April 9, 2020, may change in light of that input. The reports to Congress are available at https://www.federalreserve.gov/publications/files/main-street-new-loan-facility-4-16-20.pdf and https://www.federalreserve.gov/publications/files/main-street-expanded-loan-facility-4-16-20.pdf.

What, then, are the primary differences between these two liquidity programs that benefit main street businesses?[4]

| Facilities | Discount Window |
|---|---|
| Eligible lenders include U.S. insured banks, U.S. bank holding companies and savings and loan holding companies, but U.S. branches and agencies of foreign banks are not eligible. | Both insured banks and U.S. branches and agencies of foreign banks are eligible to access the Discount Window. |
| Eligible borrowers are limited by size under the Facilities. | Neither the institutions accessing the Discount Window, nor the borrowers under the loans pledged by those institutions as collateral to the Federal Reserve, are limited by size. |
| Eligible borrowers are limited to U.S. entities that are (i) organized under U.S. or State law; (ii) have significant operations in the U.S. and (iii) have a majority of employees in the U.S. | Borrowers under loans pledged to the Discount Window are generally limited to U.S. entities, although foreign obligors are permitted in limited circumstances. |
| Loan duration: The Facilities contemplate purchasing participations in four-year term loans. | Loan duration: Discount Window advances are generally of shorter duration, for as little as overnight to as long as 90 to 120 days; there are no general restrictions on the duration of the underlying loans pledged as collateral. |
| Loan pricing: The Facilities contemplate the SPV purchasing 95% of new and upsized loans at 100% of the loan origination value. | Loan pricing: The discount window provides a haircut to each loan based on the borrower and collateral. |
| Security: Both Facilities contemplate the SPV purchasing participations in unsecured loans (although the MSELF notes that new tranches should have the benefit of existing loan collateral). Section 13(3) requires that in order to exercise its emergency lending power, Federal Reserve must receive notes that are "indorsed or otherwise secured to the satisfaction" of the appropriate Federal Reserve Bank."[5] As the participations sold to the SPV would be unsecured, the Federal Reserve – in making advances to the SPV – would presumably be able upon a default to acquire the assets held by the SPV and be protected from a portion of credit loss by the equity investment by the Treasury.[6] This appears to be a new interpretation of the aforementioned statutory requirement under Section 13(3). | Security: The Discount Window requires collateral pledged to the Federal Reserve.<br>See https://www.frbdiscountwindow.org/ |

[4] We note that the purpose of the Discount Window is to aid *banks* with liquidity issues, while the purposes of the Facilities are to aid small- and medium-sized businesses with liquidity issues. Nonetheless, both are avenues through which the Federal Reserve ultimately lends money to small- and medium-sized businesses through banks.

[5] *See* https://www.federalreserve.gov/default.htm.

[6] We note that the term sheet does not specify that the Treasury would take first losses; however, this capital structure is consistent with how SPVs set up by the Federal Reserve and Treasury were arranged in the 2008-2010 period. Additionally, the initial reports that the Federal Reserve issued to Congress regarding the Facilities note that due, in part, to Treasury's $75 billion equity investment in the SPV, the Federal Reserve does not expect that the Facilities will result in any losses to the Federal Reserve.

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| Loan size: The Facilities dictate the terms of the new loans or tranches. Among these terms, the Facilities place limits on the amount of funding available (a $25 million maximum individual loan size for the MSNLF and $150 million for the MSELF, subject to certain additional stipulations regarding leverage). The Facilities will presumably purchase the new loans or tranches at par. | Loan size: The Discount Window accepts all loans eligible per category as collateral regardless of loan terms (except those that interfere or otherwise frustrate the Federal Reserve's obligations). The Discount Window generally does not place a limit on available advances, but applies haircuts based on the identity of the borrower and collateral package |
| The Facilities note that the SPV will purchase a 95% participation in eligible loans, while the lender retains a 5% interest. | The Discount Window accepts pledges of eligible loans. |
| The Facilities require that proceeds of eligible loans be used only for certain permitted expenses. In particular, proceeds cannot be used to repay or refinance existing debt. Borrowers of a Facility must attest that they require financing due to the coronavirus pandemic and that they will make "reasonable efforts to maintain ... payroll and retain … employees during the term" of the loan. | The Discount Window has no use of proceeds restrictions, and institutions may pledge a wide range of loan types as collateral. |

**Operational issues for the Facilities**

While much attention has been paid on the financial terms of the Facilities, there are also operational and approval issues for lenders that use them.

1. Eligible lenders are limited to U.S. insured depository institutions, U.S. bank holding companies and U.S. savings and loan holding companies. U.S. branches agencies of foreign banks and non-bank lenders – two groups that have large existing client bases of main street borrowers – are excluded from the Facilities.

This limit on eligible lenders raises issues for the MSELF. If an existing loan facility includes non-eligible lenders, can a new upsized tranche under the MSELF include them?

2. For both Facilities, borrowers with existing relationships with non-eligible lenders will likely have to wait until eligible lenders first service their existing borrowers, as has been the case with the Small Business Administration's ("SBA") Paycheck Protection Program.
3. Both Facilities raise questions of the interplay between new loans (or upsized tranches of existing loans) and existing borrower debt. The Facilities will need to answer critical intercreditor issues before borrowers will be able to take on new loans.

The MSELF raises further issues relating to the existing restrictions in a borrower's current facility. The existing facility to which a new tranche will be added will contain restrictions on additional debt that will need to be negotiated or waived.

4. The Facilities do not contain enforcement provisions. Will the SPV be an active enforcer of its rights, including breaches or representations, warranties and covenants?
5. Will the names of borrowers and terms of borrowings be publicly available?

**Use of the Facilities in combination with additional programs**

The Facilities each state that an eligible borrower may not participate in the other Facility or the Primary Market Corporate Credit Facility. This restriction on "double-dipping" restriction does not apply to the SBA's PPP, so a borrower that is eligible for both the Facilities and the PPP could conceivably benefit from both programs (as well as, indirectly, the Discount Window, to the extent an extension of credit the borrower obtains from a bank is pledged by the bank to the Discount Window).

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**Financial Institutions Regulation Group**

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