IN THE TRENCHES: OPERATING DURING THE CRISIS—THE MAIN STREET LENDING PROGRAM

$600 Billion in Relief for Midsized Businesses

OUR AGENDA FOR TODAY:

Lending Programs under Title IV of the CARES Act

- $500 billion in direct lending and other programs by Treasury
- Specific authorization for Assistance to Mid-Sized Businesses
- Specific authorization for Fed's Main Street Lending Program

Federal Reserve Main Street Lending Programs

- Main Street New Loan Facility (MSNLF)
- Main Street Expanded Loan Facility (MSELF)

Eligibility and Restrictions

Application Process

Lender Implementation

TITLE IV OF THE CARES ACT

Additional Relief for Businesses

OVERVIEW OF TITLE IV PROGRAMS

Title IV of the CARES Act set aside $500 billion for direct lending and other loan and guarantee programs by the Treasury

- $25 billion for passenger airlines and related industries
- $4 billion for cargo air carriers
- $17 billion for businesses "critical to maintaining national security"
- $454 billion for lending "to provide liquidity to financial system that supports lending to eligible business, States or municipalities"
  - To include Assistance for Mid-Sized Businesses (500-10,000 employees)

TITLE IV: ASSISTANCE TO MIDSIZED BUSINESSES

CARES Act directed Treasury and Federal Reserve to create a lending program for Mid-Sized Businesses (500-10,000 employees)

The CARES Act had statutory terms and criteria:

- Interest rates less than 2%
- No principal or interest due for at least 6 months
- Loan forgiveness is prohibited
- Until one year after the date the loan is no longer outstanding, any officer or employee with 2019 total compensation of over $425,000 cannot receive increased compensation for any 12-month period or receive severance pay or other termination benefits of more than twice his or her 2019 total compensation. Any officer or employee whose 2019 total compensation was more than $3,000,000 cannot receive compensation greater than $3,000,000 plus 50% of the amount by which his or her 2019 total compensation exceeded $3,000,000
- Applicants “required” to make significant certifications (**see next slide**)

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SIGNIFICANT CERTIFICATIONS

Express Requirements of the Program (included in April 9, 2020 guidance):

- Economic conditions make loan necessary to support ongoing operations
- Domiciled in US with significant US operations
- Majority of employees in US
- Not in bankruptcy (***not included, but expected***)
- No dividends or stock repurchases while loan is outstanding
- “Reasonable efforts to maintain [the borrower’s] payroll and retain its employees during the term of the [loan].”

Unclear if Requirements of the Program (not announced to date, but applicable to a hypothetical Treasury Program that has not been announced):

- Will retain 90% of workforce at full compensation until September 30, 2020
- Intends to restore at least 90% of workforce as of February 1, 2020 within 4 months of end of emergency
- No offshoring or outsourcing jobs for 2 years after loan is outstanding
- May not abrogate collective bargaining agreement for 2 years after loan
- Neutral in union organizing for term of loan

TITLE IV—FEDERAL RESERVE'S MAIN STREET LENDING PROGRAM

Section 4003(c)(3)(D)(ii) of the CARES Act specifically granted the Board of Governors of the Federal Reserve the discretion to determine the terms of its previously announced Main Street Lending Program consistent with Section 13(3) of the Federal Reserve Act, which requires generally that any emergency lending program have:

- Broad-based eligibility (cannot benefit a single or specific company);
- Borrowers cannot obtain adequate credit accommodations from other banking institutions;
- Purpose of providing liquidity to the financial system and not to aid a failing financial company;
- Security is sufficient to protect taxpayers from losses; and
- No insolvent or bankrupt borrowers.

MAIN STREET LENDING PROGRAM

Mechanics and Eligibility

FEDERAL RESERVE PROGRAMS

Existing Federal Reserve Programs

- Market-based programs
  - Primary Market Corporate Credit Facility
  - Secondary Market Corporate Credit Facility
  - Term Asset-Backed Securities Loan Facility
  - Money Market Mutual Fund Liquidity Facility
  - Commercial Paper Funding Facility
- Main Street Lending Program first announced March 23, 2020
  - Main Street New Loan Facility (MSNLF)
  - Main Street Expanded Loan Facility (MSELF)

Section 13(3) of the Federal Reserve Act applies, including requirements relating to loan collateralization, taxpayer protection, and borrower solvency

Other than the Primary Market Corporate Credit Facility, which provides loans to investment grade businesses experiencing economic distress, and the Main Street Lending Program, most of these programs appear to be aimed at stabilizing the credit markets rather than providing direct loans to mid-sized businesses

MAIN STREET LENDING PROGRAM

Main Street Lending Program first announced March 23, 2020, with term sheets released Thursday, April 9, 2020. Comments were due April 16, 2020.

General terms of Program:

- Main Street New Loan Facility (MSNLF) and Main Street Expanded Loan Facility (MSELF)
- Federal Reserve will purchase 95% of participations in loans/upsized tranche (lenders retain 5%)
- Treasury will send $75 billion for the MSNLF and MSELF, and the combined size will be $600 billion

Eligible lenders will be US insured depository institutions, US bank holding companies and US savings and loan holding companies

Eligible borrowers: businesses with up to 10,000 employees or up to $2.5 billion in 2019 annual revenues

- Created or organized in the US with significant operations in the US and a majority of employees in US
- Borrowers may not also participate in the other Main Street Lending Facility or the Primary Market Corporate Credit Facility
- **Can also participate in PPP**

Program ends September 30, 2020 unless further extended

MAIN STREET LENDING PROGRAM—NEW LOAN FACILITY

New Loan Facility Terms:

- Loans originated on or after April 8, 2020
- 4 year maturity
- Amortization of principal and interest deferred for one year
- SOFR + 250-400 basis points
- Minimum size – $1 million
- Maximum size – lesser of
  - $25 million or
  - An amount, when added to outstanding and committed but undrawn debt, does not exceed 4x 2019 EBITDA
- No prepayment penalty

New Loan Facility Fees:

- "Facility Fee" from lender to SPV of 100 basis points of principal amount purchased by SPV. Lender may require borrower to pay this fee.
- "Loan Origination and Servicing Fee" from borrower to lender of 100 basis points of the principal amount of the loan. SPV will pay lender 25 basis points of its participation per annum for loan servicing.

MAIN STREET NEW LOAN FACILITY—AN EXAMPLE

MSNLF Example: Company A has bonds outstanding of $20 million dollars, an undrawn credit line of $30 million dollars, and 2019 EBITDA of $15 million:

Outstanding and committed but undrawn debt equals $50 million	4x 2019 EBITDA equals $60 million	EBITDA formula is $60 million minus $50 million, or $10 million

Loan amount is $10 million (the lesser of $25 million and the EBITDA formula)

MAIN STREET LENDING PROGRAM—EXPANDED LOAN FACILITY

Expanded Loan Facility Terms:

- Term loans between eligible lender and eligible borrower originated before April 8, 2020
- Upsized tranche has following features:
  - 4 year maturity
  - Amortization of principal and interest deferred for one year
  - SOFR + 250-400 basis points
  - Minimum size – $1 million
  - Maximum size – lesser of:
    - $150 million;
    - 30% of existing outstanding and committed but undrawn bank debt; or
    - An amount, when added to outstanding and committed but undrawn debt, does not exceed 6x 2019 EBITDA
  - No prepayment penalty

Expanded Loan Facility Fees

- Borrower will pay lender a fee of 100 basis points of the principal amount of the upsized tranche at time of upsizing.
- SPV will pay lender 25 basis points of its participation in the upsized tranche per annum for loan servicing.

MAIN STREET EXPANDED LOAN FACILITY—AN EXAMPLE

MSELF Example: Company B has term loan outstanding of $20 million dollars with an eligible lender, an undrawn credit line of $30 million dollars, and 2019 EBITDA of $15 million:

Outstanding and committed but undrawn debt equals $50 million	6x 2019 EBITDA equals $90 million	EBITDA formula gets us $90 million minus $50 million, or $40 million

Loan amount is $15 million (the least: (i) of $150 million, (ii) $40 million (the EBITDA formula), and (iii) $15 million (30% of outstanding and committed but undrawn debt))

MAIN STREET LOAN PROGRAM—REQUIRED ATTESTATIONS

From Borrower:

- Financing is required due to exigent circumstances presented by COVID-19, and it will make reasonable efforts to maintain payroll and retain employees
- May not use proceeds to repay other loan balances
- May not repay other debt of equal or lower priority, other than mandatory principal payment, until Main Street Loan repaid in full
- Will not seek to cancel or reduce any existing lines of credit
- Must follow statutory restrictions: stock repurchase, dividends, and executive compensation

From Lender:

- Proceeds will not be used to repay or refinance pre-existing loans or line of credit made by the Lender to the Borrower
- Will not cancel or reduce any existing lines of credit of Borrower

MAIN STREET LOAN PROGRAM—POTENTIAL ISSUES

Some potential issues to consider:

- Entity-level financials
- Foreign ownership
- Counting employees
- Term loan versus other extensions of credit
- Problems with EBIDTA

BANK IMPLEMENTATION

Preparing for the next wave of business applications

BANK OBLIGATIONS

The bank, acting as the "Lead Lender" is responsible for underwriting the loan and is the legal "holder" of the debt.

The Lead Lender is responsible for the documentation of the loan (T.B.D. if the Federal Reserve will require model forms).

The Lead Lender is responsible for properly servicing the loan, disbursing payments to the Federal Reserve, and monitoring the borrower.

THE APPLICATION PROCESS

THE PARTICIPATION AGREEMENT TERMS

BANK PITFALLS

The bank must be able to properly underwrite the loan, obtain documentation from the borrower, and retain documentary evidence in an enforceable way. (*Lessons learned from the PPP Loan Program*).

Generally, a failure to adhere to the terms of the participation can lead to claims by the participating lender (may or may not be a real risk with the Federal Reserve).

The bank may be exposed to new or uncommon lines or risk associated with:

- Servicing loans on behalf of participants
- Accounting for participation interests
- Maintaining books and records sufficient to satisfy the participation standards
- New credit types or lack of sophistication with this type of lending

FDIC EXAMINATION OF PARTICIPATIONS

- Does the bank have clear policies and procedures for loan participations?
- What is the internal assessment of credit quality?
- Have facts and concerns relative to the loan been communicated to the participating lender (the Federal Reserve)?
- Are there servicing weaknesses requiring management's attention?
  - Failure to fulfill servicing obligations place the selling bank at risk.
  - Failure to fulfill servicing obligations may exposed the bank to new and different claims.
- Does participation qualify as a sale, or must it be accounted for as a secured borrowing?
- Does the bank have a loan-loss allowance policy specific to participation interests?

CONCERNS EXPRESSED BY BANKERS

The current minimum loan size is $1 million.

- Some community and smaller regional banks have clients that would not seek this size loans. The average PPP Loan size was $240,000.
- Similarly, these banks may not have lending capacity for a large volume of $1 million plus loans.
  - ICBA: "The minimum loan amount should be no higher than $100,000. Otherwise, Main Street businesses and community banks will not participate."
  - ABA: loans as small as $50,000 should be eligible.

The loans are indexed to SOFR, instead of traditional LIBOR.

- Due to the potential cessation of LIBOR, the Federal Reserve has tied MSNLF and MSELF to the Fed's new SOFR rate.
- Traditionally, LIBOR has not mirrored SOFR due a "rate gap."
- Similarly, SOFR has been more volatile compared to LIBOR.

The term cannot exceed 4 years.

- This would limit the flexibility to structure loans for businesses in greater need.

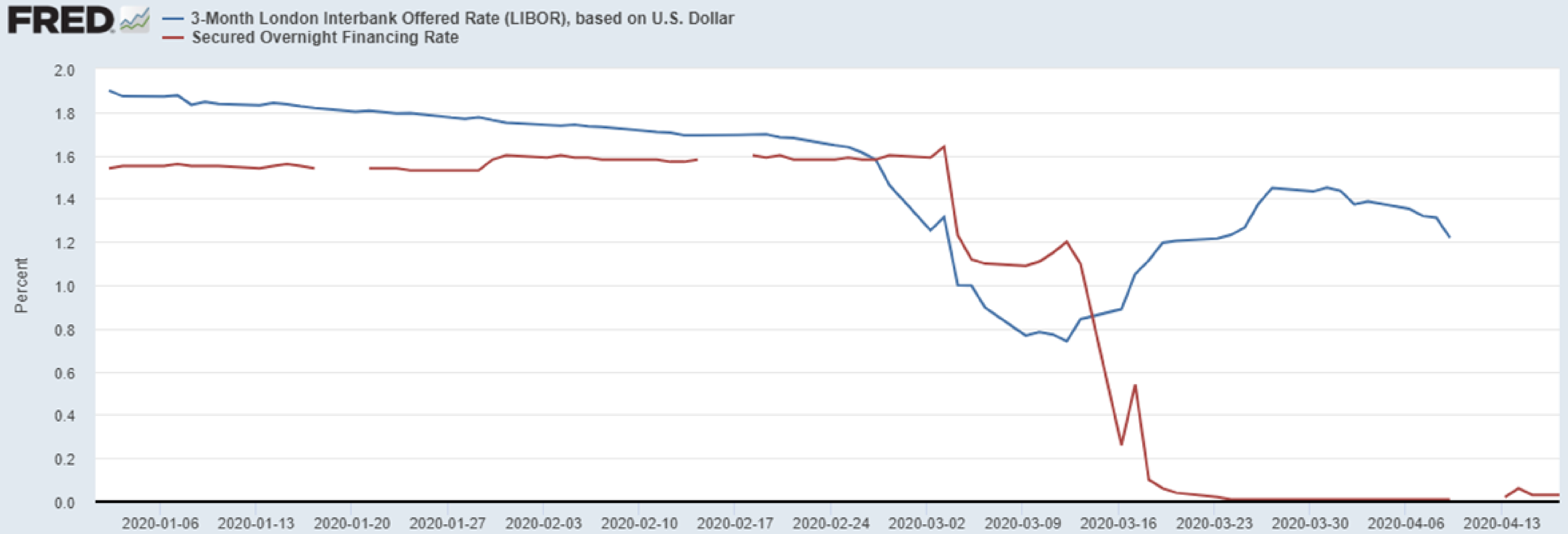
EBITDA restrictions will exclude borrowers.

- Highly-leveraged borrowers may, in fact, be better credit risks.
- A number of groups have requested sector-specific guidance, such as for manufacturers and commercial real estate, for which EBITDA may not be the best predicator of business health.

LIBOR – SOFR COMPARISONS

It is still unclear which SOFR rate the Federal Reserve will use for the program. It may be that the reference to SOFR means the base SOFR reflected by the Federal Reserve, as opposed to SOFR Compounded in Advance, SOFR Compounded in Arrears, or Daily Simple SOFR in Arrears.

LIBOR—SOFR 2020 DIVERGENCE



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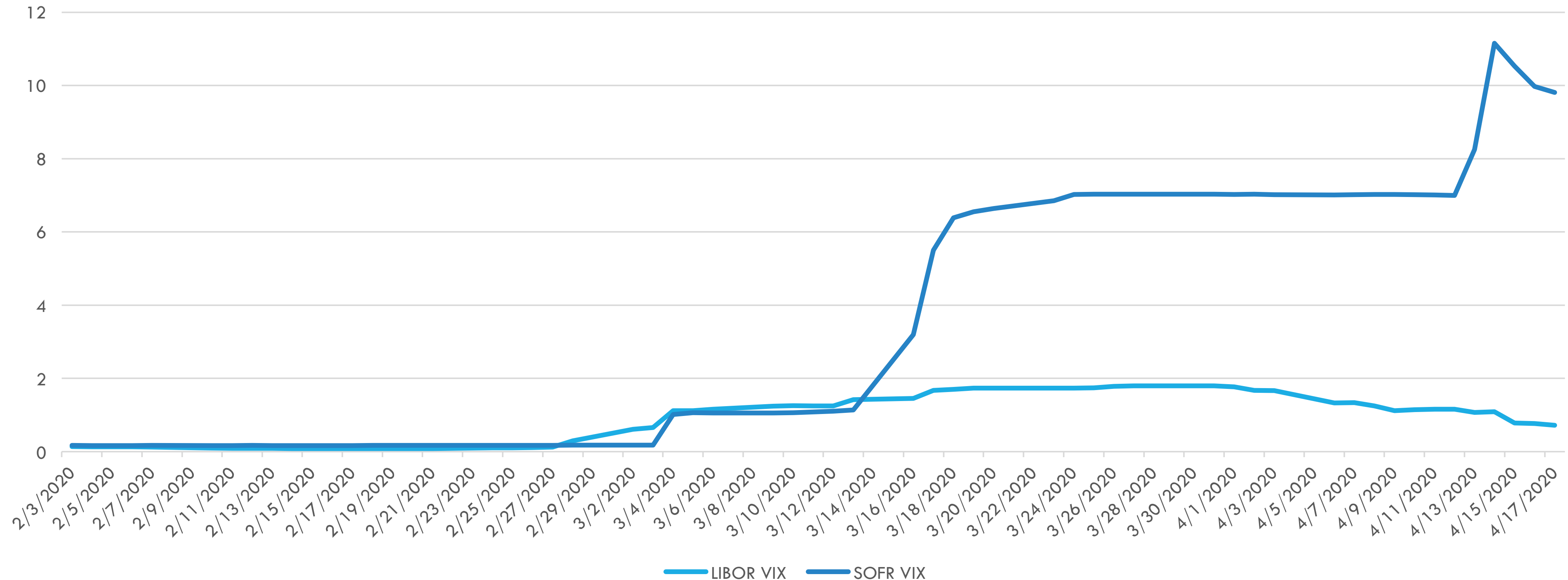
NOT JUST SPREAD—VOLATILITY



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THE CHALLENGE WITH THE 5 PERCENT PARTICIPATION

Banks, because of the 5% retained interest in the loan, will have to account for the loan on the bank's books.

- ASC Topic 860 (formerly FASB 166, *Accounting for Transfers of Financial Assets*, an amendment of FASB Statement No. 140), *Transfers and Servicing* (ASC 860).
- ASC 860/FAS 166 modified the financial components approach in FAS 140. Importantly it limits the circumstances in which a portion of a financial asset is eligible for derecognition. The transferred portions of financial assets are eligible for derecognition only if the transferred portions mirror the characteristics of the original financial asset. The revised topic introduces concept of a "participating interest" for transfers of portions of an entire financial asset.

In addition, to qualify as a participation, <u>no party</u> may have the right to pledge or exchange the entire asset unless all participating interest holders agree. <u>Generally</u>, both parties can transfer the respective interest without restriction.

Cannot use First-In, First Out ("FIFO") or Last-In, First Out ("LIFO") payments. All payments are split in proportion to participation.

PRACTICAL ISSUES WITH THE 5 PERCENT PARTICIPATION

Banks choosing to participate in the program are unlikely to engage in significant underwriting given the minimal retained interest in the loan.

However, it becomes difficult to sell, secondarily, the 5 percent interest to a secondary purchaser (particularly for a smaller bank not accustomed to these models).

Similarly, the bank must engage in more complex participation accounting given the risk-sharing mechanism. These may be uncommon or new for smaller banks.

THE COSTS OF SERVICING AND COSTS TO THE BORROWER

The bank will receive, annually, 25 bps of the principal amount of the lender's participation retained.

In exchange for this amount, the bank must service the loan and, depending on future Federal Reserve guidance, enforce compliance with the borrower restrictions:

- **Restrictions on Dividends and Stock Repurchases.** The borrower may not (i) pay dividends or make other capital distributions on its common stock or (ii) repurchase an equity security listed on a national securities exchange while the loan is outstanding except to the extent required under a contractual obligation existing on March 27, 2020, for the term of the loan and for a period ending one year after the loan is repaid.
- **Compliance with CARES Act Compensation Restrictions.** Borrower must comply with the executive compensation limitations set forth in section 4004 of the CARES Act:
  - No employee who earned over $425,000 in 2019 may receive (i) an increase in annual compensation for any 12-month period or (ii) severance payments in excess of two times 2019 total compensation.
  - An employee with 2019 compensation over $3 million is limited to total annual compensation of $3 million plus 50% of the amount by which the employee's 2019 total compensation exceeded $3 million.
- **Workforce Retention.** Reasonable efforts to maintain the borrower's payroll and retain its employees during the term of the loan.
- **Workforce Retention.** Borrower must use the loan proceeds to retain at least 90% of the recipient's workforce at full compensation and benefits through September 30, 2020.
- **Restoration of Workforce.** Borrower must restore more than 90% of its workforce that existed as of February 1, 2020, and to restore all compensation and benefits to its workers no later than four months after declaration of the termination of the public health emergency by the Secretary of the Department of Health and Human Services.
- **No Outsourcing.** It will not outsource or offshore jobs for the term of the loan plus two years after completing repayment.
- **Honoring of Collective Bargaining Agreements.** It will not abrogate existing collective bargaining agreements for the term of the loan and for a period of two years after completing repayment.
- **Neutral in Union Organizing Efforts.** It will remain neutral in any union-organizing effort for the term of the loan.

In addition, the bank faces restrictions on what it can do vis-à-vis other loans to the borrower:

- **Debt.** The bank may not use proceeds of the loan or upsized tranche to repay or refinance preexisting loans or lines of credit. The borrower will not use the proceeds of the eligible loan or upsized tranche to repay other loan balances and may not repay other debt of equal or lower priority, with the exception of mandatory principal payments, unless the borrower has first repaid the eligible loan or upsized tranche in full.
- **Lines of Credit.** The lender will not cancel or reduce any existing lines of credit outstanding to the borrower, and the borrower will not cancel or reduce any of its outstanding lines of credit held with any other lender.
- **Covered Entity.** Lenders and borrowers will each be required to certify that the entity is eligible to participate in the facility, in light of the conflict of interest prohibition for covered entities under the CARES Act.

*Not included in April 9, 2020 regulations but concepts found in other provisions of the CARES Act.

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