Financial Services Management

Emergency Liquidity Support

Cite
CARES Act, Sections 4003 and 4004

Recommended Distribution:
CEO, CFO, Treasury, Policy, Legal, Government Relations

Websites:
https://www.congress.gov/116/bills/hr748/BILLS-116hr748enr.pdf

Impact Assessment

- More than $4.5 trillion is added to U.S. emergency loan and liquidity support facilities, supporting ongoing funding for targeted industries, eligible businesses, and state/local governments.
- The speed with which these funds are disbursed will determine their impact on macroeconomic and financial stress in the ongoing pandemic. Oversight programs are intended to ensure mission compliance, but Treasury is subject to few upfront restrictions on its discretion. Fed discretion is similarly unparalleled, although it may act only with the concurrence from Treasury needed to receive an ESF backstop. 13(3) restrictions appear to be slightly tightened by virtue of reinforcement in new law.
- Direct beneficiaries of loans, guarantees, and Fed assistance must be U.S. domiciled. This will not prohibit foreign financial institutions or their branches and agencies from participating in programs in which they are not the direct recipients of Fed support.
- None of these facilities purchases corporate assets – i.e., loans being serviced or troubled debt held by a lender – instead authorizing direct loans, guarantees, and investments in the businesses themselves. However, Fed facilities may still provide targeted liquidity to troubled sectors – e.g., mortgage servicing – if numerous conditions are met. The most problematic of these for some firms is demonstrable solvency.
- The Treasury and Fed will, at least for the duration of the pandemic crisis, play an unprecedented role as lenders, guarantors, and investors in businesses and even non-profits. Liquidity facilities for state and local governments will also involve the federal government in local fiscal policy in an unprecedented way. The extent to which these powers are exercised – e.g., how much Treasury directly invests in firms, terms and conditions on corporate policy, how the Fed structures its support – may set long-lasting precedents with implications not only for economic development, but also credit allocation and even Fed independence.

Overview

Landmark U.S. law seeking to counter coronavirus macroeconomic effects authorizes $500 billion in direct Treasury funding on its own and, in concert with the Federal Reserve, as much as $4.5 trillion in Fed facilities backing liquidity for businesses and state/local governments. Programs for non-profits and mid-sized businesses are also possible. Prior to enactment, the Fed in fact established several innovative facilities that it once would have viewed as far beyond its statutory authority (e.g., the facility making direct extensions of corporate credit).[1] Now, the Fed has express authority to make these loans and, indeed, to engage in a wide range of business- and municipal-finance activities. Although prior statutory restrictions on emergency-liquidity facilities remain in force,[2] new conditions apply to direct recipients (i.e., borrowers of funds flowing through the Fed) such as restrictions on stock buy-backs and compensation. The same restrictions apply and in some cases are greater for direct Treasury loans and guarantees, but both the Treasury and Fed programs are open only to U.S. companies. Part of an extensive, hurriedly-drafted, and very controversial bill, these terms and conditions and the powers the Fed and Treasury enjoy are often inconsistently applied or otherwise unclear. Nonetheless, the new liquidity and loan windows will be opened in early April to at least some extent.

Impact

The Treasury's Exchange Stabilization Fund (ESF) is, as its name implied, meant to give Treasury the resources with which to address imbalances in the value of the U.S. dollar or other sovereign-obligation matters. In 2008, Treasury deployed it as an unprecedented way to rescue a relatively small money-market fund (MMF).[3] In the midst of the pandemic crisis, it did so again to back an array of new Federal Reserve facilities, taking a first-loss position of $10 billion ahead of risk taken by the Fed to support the MMF, corporate bond, municipal-finance, and asset-backed securities markets.[4] With these relatively small precedents before it, Congress has now granted Treasury the authority to use $500 billion for loans, guarantees, and other investments. $46 billion of this is authorized for direct loans and guarantees to large businesses and, perhaps, non-profits and somewhat smaller firms. The remaining $454 billion will backstop Fed facilities. Chairman Powell has estimated that this will leverage as much as $4.5 trillion in Fed liquidity or more direct support to large and mid-size businesses and municipal issuers. Statutory barriers – already fragile in the face of recent Fed action – have now been completely removed for identified sectors.

This authority is, as noted, temporary and conditional. The Federal Reserve also remains subject to the limits established in 2010 after Congress concluded that rescues during the 2008 crisis went too far. These limits generally require that support be broad-based, meaning that the Fed remains barred from supporting fewer than five entities. Penalty rates and collateral are also required, but the Fed's

1 See *Client Report* **COVID6**, March 23, 2020.

2 See **RESCUE65**, *Financial Services Management*, August 3, 2010.

3 See *Client Report* **MMF**, September 29, 2008.

4 See *Client Report* **COVID6**, March 23, 2020.

implementing rules give its considerable authority to define these restrictions generously.[5] Further, several of the Fed's COVID facilities are founded on other statutes that do not require any of these limits; should the Fed decide to use these powers instead of those in the emergency-liquidity sections of the Federal Reserve Act, it could intervene with still more flexibility and greater or lesser risk depending on how much ESF support Treasury chooses to provide.

Even so, neither the Fed's nor Treasury's authority is wholly unbounded. Firms receiving loans, guarantees, or other support – including Treasury stakes in equity or debt instruments – come with conditions on domicile, compensation, corporate governance, and worker rights. These are not, however, binding on recipients for more than the period of outstanding support and, in certain cases, limited times thereafter. Democrats had sought permanent bans on practices such as stock buy-backs, but failed to achieve these along with still broader social-policy objectives (e.g., emissions controls). The CARES Act's impact, the manner in which firms make use of support, the depth of the pandemic's economic downturn, and resulting political alignment will determine the extent to which these restrictions are converted into the broader "stakeholder capitalism" framework under active discussion by large corporations and some Members of Congress before the pandemic.

Although the Fed broke the barrier to direct lending in the noted facility put in place ahead of the Act for large companies, the new law is still stunning in the powers it gives the central bank to take a direct, hands-on role as a provider not only of far-reaching liquidity facilities, but also as a lender and guarantor. These programs are time-limited, but still so far afield from what the Fed believed it could do just a week or so before the law that they may well force a fundamental re-examination of the role of central banking. In fact, Democrats have already proposed legislation to be advanced in future pandemic bills or other vehicles to create a new U.S. digital currency that would supplement or even replace traditional deposit-taking.[6]

What's Next

The CARES Act was passed 96-0 by the Senate on March 25; the House approved it by voice vote on March 27, when it was also signed into law by the President. The provisions described here are effective on enactment. Procedures for applying for Treasury ESF assistance must be in place as soon as possible but no later than ten days after enactment. Reflecting this speed, the statute gives Treasury the authority to revise these procedures going forward. The law also establishes special procedures for investigating the grants, loans, guarantees, and facilities to identify fraud, conflicts of interest, or diversion from the recovery intended by so massive a fiscal-policy stimulus. However, funds will be expended ahead of any controls determined to have been necessary. President Trump has

5 See *Client Report* **RESCUE69**, November 30, 2015.

6 See forthcoming FedFin Analysis.

also signaled that the Administration will not comply with some of these *post hoc* controls.

Analysis

A. Treasury Authority/Exchange Stabilization Fund

1. Activities

The ESF is generally authorized to make loans, issue guarantees, and take positions (e.g., warrants) in and to eligible businesses, states, and municipalities up to $500 billion, using the Federal Credit Reform Act to judge the actual cost of this program. Amounts are as follows:

- $25 billion for passenger air carriers and other air-travel companies. Treasury intends to use much of this to take investments in these companies rather than to extend loans;
- $4 billion for cargo air carriers;
- $17 billion for critical companies, which media suggests may principally be the Boeing Company; and
- $454 billion plus any amounts unspent from the above sums to backstop loans, guarantees, and other investments undertaken by Federal Reserve liquidity facilities for eligible businesses and state/municipal issuers.

2. Powers

Treasury is given very broad authority to set the rates, terms, and conditions on which its assistance is provided. It may also design financial instruments and otherwise conduct itself as the Treasury sees fit, including with regard to hiring personnel, issuing rules or guidance, and taking other actions. However, it must ensure that:

- a recipient cannot reasonably receive credit elsewhere at the time of the transaction;
- the intended obligation is prudent;
- a loan or guarantee is sufficiently secured or (the law does not say “and”) carries a rate reflecting risk and, to the extent practicable, is not less than market rates prior to the pandemic. This drafting suggests that security or collateral could be waived if pricing satisfies the Treasury.
- loans and guarantees are short duration and no longer than five years;
- during the loan or loan guarantee and for twelve months thereafter, the obligor and its affiliates do not repurchase stock except as required under prior contractual agreement, pay dividends, or make any other capital distributions. Obligors of loans and guarantees must also maintain employment until at least December, 2020 to the extent possible and in no case reduce employment compared to March 24 by more than ten percent;
- agreements include certification that the entity is created or organized in the U.S. or under U.S. law with significant operations and a majority of employees in the U.S; and
- the obligor experienced COVID-19 related loss threatening continuing operations.

Loan forgiveness for these obligations is prohibited. Treasury may not make a loan or guarantee to a business unless it takes out a warrant in a publicly-traded company or otherwise obtains an investment stake. Terms and conditions appear designed to ensure sufficient return to the government as an investor, although voting rights related to common stock may not be exercised.

B. Fed Authority

1. Powers

Funded by the ESF, the Fed may support eligible entities through:

- purchasing obligations directly or in secondary markets; and
- making loans, including loan secured by collateral.

These loans are to be made available for eligible businesses and state/local issuers, working through banks to the greatest extent possible. Treasury is also to work with the Fed to establish programs for non-profits and businesses with 500 to 10,000 employees. Rates on any loans to non-profits or these medium-sized businesses (and perhaps others) may be no more than two percent a year, with no principal or interest due for at least six months. Direct-loan borrowers must also make a good-faith certification that they need the funds due to the pandemic's effects and will retain ninety percent of employees at full compensation until the end of September, restoring their workforces to February levels and compensation and benefits to prior levels no later than four months after the emergency's end. Borrowers must also be U.S.-based, not in bankruptcy proceedings, refrain from capital distributions (including stock buy-backs) absent contractual commitments, not outsource jobs, not abrogate existing collective-bargaining agreements during the term of the loan, and remain neutral in union-organizing efforts.

For the period in which Treasury/Fed assistance is provided and one year thereafter, no officer or employee of the covered company whose compensation exceeded $425,000 in 2019 (except when this occurs due to a prior collective bargaining agreement) may receive a raise or golden parachute. Officers or employees with salaries above $3 million may not receive total compensation higher than $3 million plus half of the additional financial benefits received in 2019.

Nothing in the provisions involving direct lending binds the Fed when it establishes the planned "Main Street" lending program or similar programs for smaller businesses even if Treasury backs it. However, these programs must comport with Section 13(3).

2. Additional Restrictions

The CARES Act reiterates the restrictions applicable to Fed emergency lending under Section 13(3) of the Federal Reserve Act as amended by Dodd-Frank (e.g., collateralization, taxpayer protections). Borrowers must be solvent.

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone: (202) 589-0880
E-mail: info@fedfin.com Website: www.fedfin.com