The Main Street Lending Program: Opportunities for American Businesses Part II: Credit Risk Retention

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On April 30, 2020, the Federal Reserve announced changes to its Main Street Lending Program, to support small- and medium- sized businesses that were in sound financial condition before the onset of the COVID-19 pandemic. As revised, the Program will now operate three loan facilities: the Main Street New Loan Facility (MSNLF), the Main Street Priority Loan Facility (MSPLF), and the Main Street Expanded Loan Facility (MSELF). U.S. businesses are eligible for loans if they (1) have 15,000 employees or fewer, or (2) had 2019 revenues of $5 billion or less. The minimum loan size is either $500,000 (under the MSNLF and MSPLF) or $10,000,000 (MSELF), with terms of 2-4 years and an adjustable rate of LIBOR + 3%.

A key objective for the Main Street Lending Program should be to reach as many viable small- and medium-sized businesses as possible. Supporting viable small- and medium- sized businesses will not only sustain jobs, but also promote the medium- and longer- term recovery of the U.S. economy. Chief among these businesses are the growth- and innovation- oriented companies that will be crucial to lifting the U.S. out of its pandemic-induced recession. On that note, a previous paper in this series commented on the leverage limitations in the Main Street Lending Program that will inevitably leave out many viable companies.

In this paper, I discuss a second issue in the Main Street Lending Program: credit risk retention. Under the revised Program, a Main Street Special Purpose Vehicle (SPV) will purchase participations in eligible loans from lenders. A lender must retain 5% of a loan from MSNLF or MSELF until it matures or the Main Street SPV sells all of its participation, whichever comes first. Likewise, a lender must retain 15% of a loan from MSPLF until it matures or the SPV sells all of its participation. Presumably, the higher 15% risk retention requirement for MSPLF loans is because they are small business loans with higher limitations on leverage.

This requirement that lenders retain a percentage of the loan on their balance sheets is known as credit risk retention, and it was adopted by the Dodd Frank Act in 2010 to address weaknesses in the securitization process. Credit risk retention is intended to align the interests of the lenders with the interests of those who will be purchasing the loan. Notably, credit risk retention requirements put in place by the Dodd Frank Act may have had a significant dampening effect on the credit markets, with costs being passed on to borrowers. In the case of the Main Street Lending Program, credit risk retention could also prove challenging.

The requirement that lenders retain a residual interest in the loans adds additional costs to the Program, thereby discouraging lenders from participation. Particularly for the MSPLF, where lenders are required to retain 15% of the loan, there is a greatly reduced incentive for a bank to extend a loan. Inevitably, higher funding costs imposed on lenders are passed through to borrowers, reducing the potential benefits of the Program. Undoubtedly, then, the impact of high levels of credit risk retention will be felt most by small- and medium- sized businesses.

Loans retained by lenders also count against the lender's bank capital and liquidity treatment. In other words, for every 5% a lender retains in a MSNLP or MSELF loan, generally, it must weight that retained amount at 100% risk weight and retain regulatory capital against it. For a MSPLF loan, the cost is even higher, as a lender must retain regulatory capital against the 15% retained amount. Credit risk retention may also have implications related to other regulatory requirements, such as the Liquidity Coverage Ratio, which requires banks to hold certain levels of liquid assets, and the Leverage Ratio, which requires banks to maintain a certain amount of capital as compared to their leverage exposure. Ultimately, the implications of credit risk retention combined with the capital and liquidity rules adds an additional burden to the Program.

The Main Street Lending Program was created with the stated goal of ensuring that credit flows to small- and medium- sized businesses during a pandemic-induced crisis. Unfortunately, operational, legal and economic challenges in the Program such as credit risk retention requirements may prevent banks from participating, which will in turn leave out a number of viable businesses. The Federal Reserve should reconsider the details of the credit risk retention requirements in the Program and encourage banks to manage their own risk. Rather than discouraging eligible lenders from participating, it should incentivize them to lend, thus enhancing access to credit for small- and medium- sized businesses.