Lending 101 for Banks

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Banks Authorized to Lend Government's Money to Small and Medium-Sized Businesses Need to Be Reacquainted with Lending 101

Within the last two months, the Treasury Department and the US Federal Reserve, authorized by the Cares Act, have put together an array of programs to help the economy and people survive what is hoped to be a temporary health and business crisis.

Three of the most important programs relating to business and employees are:

- **PPP (Payroll Protection Program)** - this program authorizes $610 billion to be lent and then forgiven to companies if the borrowers use at least 75% of the proceeds to pay employees and have shown a legitimate need for these funds. The intent was to help smaller businesses but as everyone knows, larger companies often using loopholes in the program, grabbed a good deal of the money. This program is intended for small companies.
- **PMCCF (Primary Market Corporate Credit Facility)** - this $750 billion program is for larger, credit worthy companies. The program authorizes an SPV (Special Purpose Vehicle) to purchase investment grade bonds being issued, those already issued, as well as syndicated loans. The Treasury puts $75 billion into the SPV as equity and the Fed lends the SPV $675 billion for a total of $750 billion. Purchased will be bonds and loans which had been investment grade (minimum rating of BBB-) as of 3/22/20 but when purchased could not be rated less than BB-. This program is intended for larger companies.
- **MSLP (Main Street Lending Program)** - this $600 billion program is the focus of this article. The MSLP is designed to encourage banks to lend to smaller and medium-sized companies. To be an eligible borrower, a company needs to show that it is a credit worthy company but which is not able to raise financing on terms that would be readily available to it in "normal" times. The term of the financings under this program would be four years with significant mandatory debt payments beginning annually at the end of year two. The clear intent, based on documents released by the Federal Reserve Bank, is for the banks to provide interim financing to allow "good" companies to ride out the storm. The banks need to make their own credit determination and conduct all necessary due diligence.

There are three different types of lending programs authorized:

- New loans for smaller to medium-sized companies;
- Additional loans for smaller to medium-sized companies; and
- Larger loans for medium-sized companies.

Once a bank makes a loan, it needs to retain 5% to 15% (depending on the particular program under these Main Street Facilities) and can sell the remainder to the $600 billion Special Purpose Vehicle. This

SPV is funded by $75 billion in equity provided by the Treasury Department and $525 billion in loans by the Fed.

For their efforts, the banks would earn Libor + 3% on the loans and also get fees on the full amount of the loan originated. The fees would be anywhere from .75% to 1.25% of the total loan payable up front. A calculation presented later, will show that this could be quite lucrative for the banks.

Summary of Key Requirements in the Main Street Lending Programs

- **Loans Amounts** – from $500,000 to $200 million
- **Eligible lenders** – only banks, bank holding companies including foreign banks in the US
- **Eligible borrowers** – US companies in existence before 3/13/20; commercial and industrial type companies (referred to as "C&I Loans") only which excludes banks, finance companies, hedge funds and private equity companies but can include their portfolio companies
- **Size of borrowers** – no more than 15,000 employees (includes any affiliated companies); or no more than $5 billion in annual revenues
- **Prohibitions on borrower** — no share repurchases, dividends, excess compensation and other capital distributions
- **Leverage tests** – Cannot make any loans where leverage would exceed certain amounts; in one of the programs, the test is 4 times and in the other two including to larger companies, the test is 6 times. Leverage is defined as Total Debt/EBITDA. (EBITDA refers to Earnings Before Interest, Taxes, Depreciation and Amortization, which represents a company's cash flow from its business operations).
- **Lending criteria** – the bank is to use its own lending criteria in determining the credit worthiness of a company; the proposed borrower must have received a "Pass" rating from previous regulatory examinations.
- **Minimum "pari passu" position required** – this means that if the lending bank in this program is not the most preferred lender compared to other creditors in terms of collateral and covenants, it can share this status equally with other lenders. However, mortgages are allowed on specific properties for the benefit of the mortgage lender.

Calculation Illustrating the Profitability of These Loans to a Bank

Because this program has still not been officially launched, this illustration is based on information available to date. It is anticipated that lending will commence in the next week or two.

Assume that a larger bank makes a loan of $50 million and say that it keeps 15% of the loan and sells the remaining 85% to the SPV. The front-end fee is assumed to be 1% of the full loan ($50 million). This means that it earns a fee of $500,000 and has a loan on its books for $7.5 million (while selling the remaining $42.5 million to the SPV). The up-front fee the bank earns is 6.67% of its actual credit

exposure which is quite rich. Recall, the interest spread is 3% which amounts to $225,000/year on the banks $7.5 million exposure. Total income for the year is $725,000.

This hypothetical example shows us that the banks are authorized to do more than most traditional banks which make corporate loans; they are now acting like investment banks arranging financings and making a good deal of money from the fees rather than the interest on the loans. The largest banks in the US (JP Morgan Chase, Bank of America, Goldman Sachs, etc.) are used to making these types of loans which they syndicate to other investors. Under this program, any participating bank lender can syndicate its corporate loans out to the SPV owned by the government. This includes much smaller banks which traditionally do not act like investment banks.

A smaller bank, for example, can make a $1 million loan. It will sell most of it to the government and keep anywhere from $50,000 to $150,000 on its books while earning a front-end fee of about $10,000 in addition to the 3% interest spread on its outstanding loan. As they say in the trade - this is not a bad deal.

Lending 101: An Overview

In recent years, the situation has been one favoring the borrowers over the lenders very simply because there has been much more money available for investments than actual investments. (In a sense, too much money chasing too few deals). Competing for the business, the lenders have gotten lax. This is particularly true of larger banks which have specialized in making loans and then selling them to other banks; but in recent years, the larger banks more frequently have been selling loans to non-bank institutions including funds of certain types. Most worrisome in recent years is that the protections afforded to investors in terms of strong collateral and controls in robust covenants have been abandoned. These days most loans (about 80%) to larger companies are “covenant lite”. There have been warnings from regulators and even from Chief Risk and Credit Officers at financial institutions that this would lead to problems in case of economic difficulties.

That time has come, unexpectedly and quickly. It would be wise for banks to reacquaint themselves with the principles of sound lending in case they have forgotten. The overriding principle should be this - what would a prudent person do in investing his/her own money? In other words, what would you do in terms of credit analysis and loan structuring to protect yourself in the time of extreme economic and financial difficulty? There is no magic thinking involved - what is involved is common sense and a resolve to “do the right thing”.

You, the lender, need to know exactly what the purpose of the loan is and how you expect to get paid back. You need to understand not only the business but also the industry and how that industry is affected by varying economic conditions. You have no business making loans to an industry you do not understand. An intensive business analysis is required including understanding the competition, the power of suppliers and customers, the ease of entry into the industry and the challenge of possible substitute products or services. You need to understand and evaluate the management of the company

and of course you should satisfy yourself on their honesty and integrity. The net result is that you should understand all possible business risks. Isn't this what you would do if your own money were at stake?

The careful lender cannot "fall in love" with the company. It is not his/her job to be thrilled by exciting future prospects of the company. A lender is not going to benefit if the company's stock keeps going up. The lender is not Warren Buffett who is looking to buy shares in undervalued companies. Lending is different - the best that the lender can hope for is to get his/her money back. The lender's job is very simply to evaluate all things that can go wrong and try to best mitigate any acceptable risks.

An evaluation of the risks includes an understanding of the financial aspects of a company. This requires an evaluation of past financial statements and an understanding of future prospects and projections. There should be an understanding of past performance and a clear relationship between past performance and possible future results. Studying financial information includes making certain calculations and computing ratios which are beyond the scope of this article. The result of the financial analysis will acquaint the lender with the financial risks usually associated with a company's liquidity and levels of debt and the ability of the company to service its debt. The financial analysis often leads to questions that need to be answered. This can be done by speaking with management and with the company's accounting firm.

Smaller companies are hardly ever rated by the credit rating agencies. The bigger middle market loans, on the other hand are often rated. If a company is rated, it may be helpful for the lending bank to speak with the analyst who wrote the report at the rating agencies.

Although ratings can be important, they cannot be completely relied upon. They are just another element in the puzzle of understanding a company. Ratings have their limitations. It is known that rating agencies have been slow to downgrade companies when difficulties arise. Also, companies pay rating agencies to rate them and there is always the temptation for a company to pick a "friendly" rating agency. This is a weakness in the rating system which should have been eliminated in the last financial crisis but it was not. A bank which makes a decision primarily on the basis of a rating is not doing its job.

Creating An Appropriate Loan Package

By understanding all acceptable risks, the lender must structure a loan agreement that not only mitigates risks, but also puts the lender in a position to exercise control if problems arise. The idea is to have the senior most position in the capital structure and including the taking of collateral where possible. Common covenants should include the following:

- Limitations on debt.
- Do not allow other creditors to take collateral or to weaken the lender's position in any way.
- The biggest ramification of the M&M Hypothesis and Milken's insight is that solid investment grade borrowers jumped on the bandwagon. They loaded up on debt.

- No mergers or divestitures without permission. No assets to be sold outside the normal course of business.
- No outflow of money including loans, advances and investments to be allowed.
- Any transactions with affiliates and/or insiders to be strictly on an "arms length" basis.
- Certain types of payments to be restricted including stock repurchases, dividends, excess compensation and returns of capital not allowed (as previously noted, this is required under the Main Street Lending Programs)
- Depending on the situation, certain liquidity tests (such as minimum net working capital) may be advisable. In addition, certain leverage tests may be advisable.
- Any modifications to your Loan Agreement and other Loan or Debt Agreement are to be tightly controlled.

The covenants should be chosen with care and should be tailored specifically to the borrower. Unfortunately, in recent years, "Covenant lite" loans have been made whereby much of the foregoing has been forgotten.

In addition, the Events of Default Section should be carefully constructed aside from the "boilerplate" Events of Default. An important one is that any material adverse change in the company's fortunes is a default. There should also be "cross default" clauses so that any default in any debt agreement would constitute a default in the Loan Agreement.

How Do Banks Navigate Between Helping Companies in Distress and Making Prudent Loans?

According to a Wall Street Journal article ("Fed Has Tricky Task with Business Loans," page 2, May 19, 2020) about 19,000 US companies are eligible for these loans and these employ between 30 to 40 million people.

This past week, Secretary of the Treasury Mnuchin and Fed Chairman Powell were grilled by Senators who are anxious for these programs to help companies and maintain employment. Secretary Mnuchin said that the government may lose money on these loans. What came out of the meeting with the Senators is a clear indication that perhaps credit standards have to be relaxed for the common good.

Where does this leave the lending banks? They are instructed under the terms of the Main Street Lending Programs to use their own (supposedly prudent) underwriting standards to make loans. And now, under pressure from US Senators, the government seems to be saying it might be appropriate to relax these standards to make sure that companies get the help they need.

Indeed, not only the Fed but the lending banks have a "tricky task". I am afraid the banks are put in a position where they are damned if they do and damned if they don't.