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September 8, 2020

The Honorable Mike Crapo
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

Dear Chairman Crapo, Ranking Member Brown, and Members of the Committee:

My name is George Selgin. I'm a professor (emeritus) of economics at the University of Georgia and the Director of the Cato Institute's Center for Monetary and Financial Alternatives. I thank your committee for allowing me to comment upon the Status of the Federal Reserve Emergency Lending Facilities.

My remarks here concern the Federal Reserve's Main Street Lending facilities. So far, those facilities have lent only a very small fraction of the $600 billion quota assigned to them by Congress and the U.S. Treasury. The proximate reason of this low uptake consists of strict lending terms that either exclude or are uninviting to many struggling firms. But a more fundamental cause consists of the government's belief that, by having the Fed "lever up" a smaller quantity ($75 billion) of funds appropriated to support Main Street loans, the Government avoids much of the burden the public would have to bear were Congress to fund Main Street lending to the full extent of its assigned $600 billion limit.

I plan to explain why that belief is mistaken, and how setting it aside would allow the Treasury and the Fed to offer truly effective Main Street support.

The Main Street Lending Facilities

The Federal Reserve's Main Street facilities are supposed "to support lending to small and medium-sized" businesses and nonprofits "that were in sound financial condition before the onset of the COVID-19 pandemic." To qualify for this assistance, businesses must either have fewer than 15,000 workers, or they must have earned less than $5 billion in 2019 revenue. The Main Street facilities complement the Fed's Primary and Secondary Corporate Credit facilities, which only assist companies large and well-established enough to have issued investment-grade securities prior to the pandemic. They both complement and supplement the SBA's "Paycheck Protection Program" (PPP), for which only single-establishment companies of 500 or fewer employees, or some chains with 500 or fewer employees per location, are eligible. Whereas the maximum PPP loan is for $10 million dollars, a Main Street loan can be for as much as $35 million. Small companies that have secured PPP funding may also borrow from the Fed's Main Street facilities provided they can demonstrate a need for further aid.

Almost 30,000 companies employ between 500 and 15,000 employees (henceforth "midsize companies") in the U.S. today. Many were sound until the outbreak of the pandemic, but cannot secure needed emergency support from either the Fed's Corporate Credit facilities or the PPP program. The Fed's Main Street facilities are therefore their principal if not only potential source of emergency support.

So far, however, the Main Street facilities have fallen well-short of fulfilling that hope. Since they became fully operational two months ago, those facilities have processed fewer than 100 loan applications, and the Fed has purchased only $1,172 million in loans. At this rate it would take *over 85 years* for the programs to reach their planned capacity! This limited uptake doesn't reflect any lack of need for support among qualifying businesses. Instead, potential applicants complain that, although Main Street loans are less burdensome than ordinary bank loans, their terms either disqualify, or appear too burdensome to make borrowing worthwhile.

Without some sort of assistance, many of these firms, though viable until the crisis, are likely to fail. And while some might fail even with help, owing to permanent changes in post-COVID business conditions, the failure of others will result in a regrettable waste of firm-specific capital, a longer-than necessary post-COVID recovery, and a greater than necessary welfare losses—the very results Congress sought to avoid by passing the CARES Act. In short, cracks have appeared in that measure; and many mid-size firms are in danger of falling through them.

The Argument for the Fed's Involvement

The strategy Congress and the Treasury have chosen for aiding Main Street depends on the Fed's willingness to serve, not merely as a conduit for Congressionally-appropriated aid to small and medium sized businesses, but as the chief source of funding for such aid. Speaking on March 22nd of the Treasury's broad reliance upon the Fed to supplement CARES Act funding, Treasury Secretary Mnuchin remarked that the Fed could "lever up" the $454 billion in Treasury backstop funding to over "$4 trillion to help everything from small business to big business get through."[1] With that plan in mind, the Treasury has devoted $75 billion in CARES Act funding to the Fed's Main Street facilities case, its implicit assumption being that the Fed would be willing and able to lend as much as 12.5 times that amount**.**

Unfortunately, in reaching this conclusion, Congress and the Treasury either underestimated the potential riskiness of emergency Main Street lending, or they assumed that the Fed would be willing to risk incurring losses exceeding its Treasury-provided backstop. Neither assumption has been born out in practice.

[1] See Jeanna Smialek and Alan Rappeport, "Fed Could Bolster Groups of Businesses and Localities With Funds in G.O.P. Bill," *The New York Times*, March 22, 2020, https://www.nytimes.com/2020/03/22/business/economy/fed-bailout-congress.html

13(3) Limitations on Fed Loss Taking

Section 13(3) of the Federal Reserve Act spells-out the rules for its emergency lending to nonbank individuals, partnerships, and corporations. It allows the Fed to lend on such borrowers' "notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal Reserve bank." They stipulate, furthermore, that "the security for emergency loans" must be "sufficient to protect taxpayers from losses."[2]

The ultimate aim of these rules is that of safeguarding Congress' "Power of the Purse," as enshrined in Article 1, Section 9 of the Constitution, which provides that "No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law." Because losses incurred by the Fed are deducted from its obligatory Treasury remittances, they are legally equivalent to money "drawn from the Treasury." By a special, long-standing arrangement, the Fed is allowed to deduct from remitted interest earnings no more than what's required to cover the system's ordinary operating expenses. *These provisions incline the Fed to err on the side of caution rather than risk breaking the law.*

Treasury Backstops are Insufficient

Even in ordinary times, the risks of business lending are considerable. Consequently, commercial banks generally exercise considerable due diligence in arranging and overseeing business loans. During a major economic crisis, the risks of business lending become much greater. When loans are offered only to struggling firms that that are "unable to secure adequate credit accommodations from other banking institutions," the risk is greater still: in practice, the targeted firms will lack anything resembling "good banking collateral," and most will lack *any* sort of collateral sufficient to fully secure their loans.

For these reasons, it has proven impossible to design a Main Street lending facility that strictly conforms to the Federal Reserve Act's 13(3) provisions. Indeed, far from requiring that all of its Main Street loans be fully secured, the Fed only requires security for "expanded" Main Street loans, and then only when the underlying loans are themselves secured. These facts explain why the Fed could not possibly help Main Street on its own: Treasury backstopping of Main Street lending has been absolutely necessary.[3]

But while it may be necessary, the $75 billion in equity has not been *sufficient* to protect the Fed from the kind of risks to which Main Street lending might expose it. Because of this, the Fed has resorted to other precautions, including various strict lending terms, and the requirement that commercial Main Street loan originators retain 5 percent of the loans they originate. It is owing to these risk-control measures that both the uptake of Main Street loans and commercial banks' interest in participating in them have been so limited.

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[2] See https://www.federalreserve.gov/aboutthefed/section13.htm

[3] See George Selgin, "The Constitutional Case for the Fed's Treasury Backstops." *Alt-M*, April 13, 2020, https://www.alt-m.org/2020/04/13/the-constitutional-case-for-the-feds-treasury-backstops/

Nor would a larger but still limited Treasury backstop necessarily fix things. Between 1934 and 1957, the Federal Reserve made business loans, both directly and through commercial bank partners, on terms not unlike those of its current Main Street New Loan facility. One difference with today's program was that the Fed's 13(b) lending, which was capped at $280 million dollars, relied on a Treasury backstop equal to a full 50% of that limit. Yet, owing in part to loss sharing with its partner banks but also to its own determination to limit losses despite its fat equity cushion, the 13(b) program also proved to be a major disappointment.[4]

The "Lever Up" Fallacy

As I've noted, Congress's decision to rely on the Fed not merely as an administrator but as a source of Main Street support, despite all the risk-avoidance behavior that invites, rests on its desire to "lever up" its CARES Act appropriations. That desire in turn reflects the view that such leveraging-up is fiscally advantageous. But that view is false. Having the Fed lend $600 billion using a $75 billion Treasury backstop, or no backstop at all for that matter, doesn't guarantee a fiscal burden lower than that which would result from having the Treasury fully-fund a $600 billion lending program by issuing new debt for the purpose.

The expected fiscal burden of these alternative financing arrangements is instead roughly equivalent, because both ultimately involve similar interest expenses. When the Treasury borrows $600 billion, that expense consists of the interest paid in the securities it issues. When the Fed instead creates the necessary credit, it adds $600 billion to the outstanding quantity of bank reserves, which also bear interest. That interest is earned by banks, and deducted from the Fed's Treasury remittances. The result is much as if the Treasury itself were responsible for paying interest on banks' reserves. The difference between the interest burden of a Main Street program fully-funded by Congress, and financed by Treasury security issues, and one funded entirely by Fed credit creation, is simply the difference between the interest paid on reserves and the interest on securities. Although the rate paid on reserves can differ at any moment from the rate on securities, there is no reason to suppose that one option will be less burdensome than the other. As I write this, for example, the 3-year Treasury bond yield is 18 basis points, while the interest rate on reserves is only 10 basis points. But because the rate on reserves is a floating rate, it might rise enough in three years to make the longer-term financing option worthwhile.[5]

A Revised Main Street Program

To conclude: in choosing to rely on the Fed to "lever up" its CARES Act support for struggling small and mid-sized businesses, Congress tied its hands unnecessarily. By exposing the Fed to risk, this strategy invited it to build risk-control arrangements into its Main Street facilities that have prevented them from supplying more than a small fraction of the aid Congress intended to make available. Yet having the Fed "lever up" Congressional appropriations doesn't actually

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[4] See idem., "When the Fed Tried to Save Main Street," *Alt-M*, March 30, 2020, https://www.alt-m.org/2020/03/30/when-the-fed-tried-to-save-main-street/
[5] For more details see idem, "The Treasury's Helicopter Cop-Out," *Alt M*, March 20, 2020, https://www.alt-m.org/2020/03/20/the-treasurys-helicopter-cop-out/

offer any clear fiscal savings. Consequently, the strategy has been not only unsuccessful but unnecessary.

It is not too late for Congress to correct matters on time to assist many struggling firms. It can do so by (1) having the Treasury fully fund the Main Street programs, using its remaining CARES Act funds and, perhaps, by providing additional funds, and (2) having the Treasury and the Fed revise the Main Street facilities' terms in view of the fact that the Federal Reserve Banks will no longer be extending their own credit to businesses or assuming any credit risk. Possibilities the Treasury and Fed might consider include lower Main Street lending rates; conditionally forgivable loans; loans of longer duration; and less or no reliance upon commercial bank risk sharing.

Respectfully,

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