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Fed Adapts As Congress Urges More Credit Risk On Corporate Loans

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Jerome Powell’s dramatic bid to insert the Federal Reserve into protecting private companies from the fallout of the coronavirus is finally underway, but the central bank remains wary about managing the long-term risk.

As the chairman prepares to testify before Congress, starting with the Senate Banking Committee at 10 a.m., the back-story of how the central bank became lender of last resort to Main Street shows the extreme lengths to which officials were ready to rewrite their old crisis playbook to confront Covid-19.

And it’s starting to make Powell wary, as he hinted at a press conference last week, saying that one day, the management of the Main Street program could move out of the Fed, perhaps to Treasury or a third party.

Wind back to March, when policy makers were frantically discussing how to stem the economic destruction from a virus-induced shutdown. Everybody knew it was mom and pop firms and mid-sized businesses that faced the biggest threat.

Their revenues were flattened. They didn’t have access to capital markets. Collectively these firms employ millions of Americans, and if they failed there would be fewer jobs to go back to once the pandemic subsided.

Senior officials at the Federal Reserve, the Treasury Department and on the Senate Banking Committee, which was considering stimulus legislation, agreed that someone would have to find a way to bridge loan America’s mid-size businesses through the crisis.

A consensus developed that the best place to put the program would be the Federal Reserve, according to people familiar with the matter. The central bank could leverage whatever money Congress appropriated and it could partner with the banking system to make loans.

The Fed took a moment to consider the proposal, which is understandable because it took them way outside the normal limits of their emergency lending activities. But as early as February, Fed staff had identified risks to local businesses as they considered coronavirus scenarios.

They endorsed the idea, and announced the Main Street Lending Facility on March 23, even before the $2 trillion CARES Act was approved. That legislation included a whopping $454 billion for the Treasury to leverage through Fed programs, and Treasury Secretary Steven Mnuchin applied $75 billion to the Main Street facility.

‘Man of Integrity’

“The reputation of the Fed is all about Wall Street, but its jurisdiction and it’s ability is much greater,” Senator Sherrod Brown, an Ohio Democrat, said in an interview, noting that the independence and non-partisanship of the Fed also weighed into the decision to place the program there. Powell “is a man of integrity,” he said.

The Main Street facility opened registration on Monday for banks who want to participate and the Fed urged them to start making loans “immediately.”Last time Powell appeared before the Senate panel, both Republicans and Democrats urged him to take risks with the money they appropriated. That message is a difficult one for central banks. Most of the lending they do is for liquidity needs — short term credits backed by good collateral. They don’t have big departments with loan officers specializing in the particular credit risk of the retail or energy industries, for example.Main Street loans will be made by banks that do have that expertise. But banks will sell a large portion of those loans to the Fed, and they could sit on the central bank’s balance sheet for as long as five years. That raises the prospect that the Fed could be in a position of modifying credits or forcing defaulted borrowers into bankruptcy.

Wary Prospect

Powell’s wariness with that prospect was on display at his June 10 press conference.” We don’t really want to be part of the decisions that have to be made to manage such a portfolio,” he said. “So we’d be looking to have that done either someplace else or, you know, by a third party, or at the Treasury Department.” The Fed had a playbook on how to deal with systemic risk and stood up liquidity facilities for the financial system “quickly and aggressively,” said Kathryn Judge, a professor at Columbia Law School.

“I have been concerned about how well suited they are to play these other roles” such as industrial lending, Judge added. “The Fed has no track record of being successful in that space.”

Political Risk

The business lending programs are also rife with political consequences. Risk too little helping mid-sized businesses, and large corporations and Congress could say the Fed didn’t achieve its mission to keep America’s job creators afloat. Risk too much and the Fed could be in a position where the Treasury has to kick in more funds. That could invite more congressional scrutiny, and a desire by lawmakers to have more say over what the Fed does in this area, said George Selgin, a senior fellow at the Cato Institute in Washington.

“Business lending is risky even in normal times,” said Selgin.

“On the one hand, they don’t want to lose more than the $75 billion,” he added. “But they don’t want to have a program that doesn’t loan to capacity.”

Ready for Losses

Mnuchin is prepared to take on all the risk with the loans.

“We could lose all of our capital, and we’re prepared to do that,” he told the Senate Banking Committee last month. However, the Treasury’s base case is that they will only take “some losses.”

There are plenty of signs of the Fed learning by doing and remaining strongly committed to a broad program that takes some risk. The Fed lowered Main Street loan minimums to $250,000 from $500,000. Businesses participating in the program will be able to defer principal payments on their loans for two years, up from the previously announced one year. It also trimmed the required loan retention by banks to 5% from 15% for riskier companies, among other modifications.

Powell is also expanding the program to non-profit organizations.” They know that the potential damage to the economy is very large if they don’t act,” said Laura Rosner, a partner at MacroPolicy Perspectives LLC in New York. “It is important to preserve as much economic infrastructure as possible.”