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Memorandum

UPDATE: Federal Reserve's Paycheck Protection Program Lending Facility Expands Eligible Lenders and Collateral

May 4, 2020

On May 1, 2020, the Federal Reserve updated the terms for its Paycheck Protection Program Lending Facility (the "PPPLF"),[1] which commenced operations on April 16, 2020. Under the revised PPPLF, Federal Reserve Banks will lend to all SBA-approved lenders, including non-depository institutions such as credit unions, Community Development Financial Institutions, members of the Farm Credit System, small business lending companies licensed by the SBA, and some financial technology firms. Lenders will originate Paycheck Protection Program ("PPP") loans on a non-recourse basis, taking the PPP loans as collateral. As before, only PPP loans guaranteed by the Small Business Administration ("SBA") are eligible to serve as collateral under the facility. The Federal Reserve's updated terms also expanded the collateral that can be pledged; now, lenders can pledge PPP loans that they have both originated *or* purchased from an originating institution. The Federal Reserve also outlined the Reserve Bank through which the newly eligible lenders will access the program, as indicated in the table below. The Federal Reserve is extending the PPPLF under its emergency lending authority under section 13(3) of the Federal Reserve Act and the facility is intended to facilitate lending to small businesses under the Paycheck Protection Program. The Federal Reserve also released the relevant documentation for banks seeking to access the PPPLF[2] and posted a new set of FAQs.[3] An earlier summary of the PPPLF key terms is available here.

Aside from expanding eligible lenders to include non-depository institutions and expanding collateral to include purchased loans, the Federal Reserve did not otherwise change the PPPLF's terms.

[1] The term sheet for the PPPLF, as of April 30, 2020, is available here.

[2] All documents, along with samples of each document and guides for completing them, can be found at the Federal Reserve's PPPLF site (managed by the Federal Reserve Bank of Minneapolis): https://www.frbdiscountwindow.org/generalpages/emergency%20credit%202020.

[3] Available at https://www.frbdiscountwindow.org/pages/general-information/faq.

Lending Reserve Banks

Eligible Borrower Type	Reserve Bank
Depository institution or credit union	The Reserve Bank in whose District the eligible depository institution is located[4]
Community development financial institution[5] (that is not a depository institution or credit union)	Reserve Bank of Cleveland
Member of the Farm Credit System (that is not a depository institution or credit union)	Reserve Bank of Minneapolis
Small business lending companies[6] (that are not depository institutions or credit unions)	Reserve Bank of Minneapolis
Other eligible borrower type not listed above	Reserve Bank of San Francisco

PPPLF Mechanics

BORROWER ELIGIBILITY

A borrower[7] applying to the PPPLF must (1) execute a PPPLF letter agreement and (2) certify that it is not insolvent and cannot otherwise secure adequate credit, in the forms available on the Federal Reserve's PPPLF website.[8] If the borrower does not already have access to the Federal Reserve's discount window, it must deliver certified copies of authorizing resolutions in the form available on the PPPLF website.[9]

A borrower that is a PPP lender does not need to have a master account at a Federal Reserve Bank in order to obtain an extension of credit under the PPPLF. If a borrower does not have a master account, however, the borrower needs to have a correspondent relationship with an institution that does have a master account into which the proceeds of PPPLF extensions of credit are credited and repaid. A non-accountholder borrower (that has not already designated a correspondent for discount window purposes) and its correspondent will need to execute the relevant documentation required by the Reserve Bank extending PPPLF credit to the borrower. A

[4] To determine location *see* Regulation D, 12 C.F.R. 204.3(g)1–2.

[5] As defined in 12 U.S.C. § 4702 and certified by the U.S. Treasury.

[6] As defined in 13 C.F.R. 120.10.

[7] At this time, the PPPLF is only available to depository institutions (*e.g.*, commercial banks, savings and loan associations or credit unions), but the Federal Reserve is working to expand eligibility to PPP lenders that are not depository institutions in the near future.

[8] *See* https://www.frbdiscountwindow.org/generalpages/emergency%20credit%202020.

[9] Note that a borrower is not required to establish ongoing access to the discount window to participate in the PPPLF, but if it would like to, it must submit the other standard documents required by Operating Circular No 10 (Lending), a Letter of Agreement and a Certificate attaching copies of the institution's organizational documents: https://www.frbservices.org/assets/resources/rules-regulations/071613-operating-circular-10.pdf.

borrower that has an existing correspondent relationship for discount window purposes must use that same correspondent relationship for extensions of credit under the PPPLF.

POSTING COLLATERAL, REQUESTING ADVANCES AND USE OF PROCEEDS

To pledge PPP loans as collateral and request an advance under the PPPLF, a borrower must assemble all of the PPP loans (which must have an SBA loan number) into separate pools grouped by maturity date[10] and, for each pool, submit a separate collateral transmittal form and a listing of individual loans for each pledged loan pool by email to its local Federal Reserve Bank.[11] Both the transmittal form and a template for the loan listing are available on the PPPLF website. The form and loan listing must be submitted by an authorized individual, as named in the borrower's letter agreement mentioned above.

Proceeds of a PPPLF extension of credit will generally be available on the business day following the submission date. There are no restrictions on a borrower's use of proceeds, as the Federal Reserve's sole stated purpose of the PPPLF is to bolster the effectiveness of the PPP by providing liquidity against PPP loan collateral. Information on PPPLF extensions of credit will be disclosed periodically to the public as required by section 13(3) of the Federal Reserve Act.

Notable Terms

- **Lowered Standard for Lack of Adequate Credit Accommodations**: The Federal Reserve is restricted under 13(3) to only lend to borrowers that are not insolvent and that cannot obtain adequate credit accommodations from other banks. Notably, for this 13(3) facility, borrowers "need not establish that credit is unavailable, rather that credit accommodations may be available, but *at prices or on conditions that are inconsistent with a normal, well-functioning market*." This clarifying language should facilitate borrowers' ability to make the lack-of-adequate-credit certification and more readily access the PPPLF. We may expect to see a similar lack-of-adequate-credit certification reflected in the Federal Reserve's other liquidity facilities.

- **PPP-Eligible Loans**: Even though the SBA clarified in its interim rule of April 2[12] that lenders are held harmless for borrower certifications, a borrower under the PPPLF must represent, warrant and covenant that, among other things, each loan pledged as collateral is a "covered 7(a) loan" under the terms of the PPP and that it complies "with all requirements of the PPP, including without limitation any rules or

[10] A single extension of credit will be made for PPP loans with the same maturity date. As such, a PPPLF borrower should ensure that it simultaneously pledges all PPP loans with the same maturity date.

[11] For each request of PPPLF credit and pool of PPPLF collateral, a separate collateral transmittal form and individual loan listing must be submitted in its own email. Federal Reserve Discount Window, https://www.frbdiscountwindow.org/pages/select-your-district. *E.g.*, New York's PPPLF Email is ppplfcredit@ny.frb.org and California's is ppplfcredit@sf.frb.org.

[12] Business Loan Program Temporary Changes; Paycheck Protection Program, 85 Fed. Reg. 20812 (April 15, 2020), available at https://www.sba.gov/sites/default/files/2020-04/PPP%20Interim%20Final%20Rule_0.pdf.

guidance issued by the SBA implementing the PPP, and any requirements set forth in any agreement the Borrower is required to execute by the SBA in connection with the PPP."

- **Zero Capital Requirements**: PPPLF extensions of credit are excluded from a borrower's total leverage exposure, average total consolidated assets, advanced approaches total risk-weighted assets, and standardized total risk-weighted assets. PPP loans receive a zero percent risk weight for purposes of risk-based capital rules; however, only PPP loans that are pledged to secure PPPLF extensions of credit (and not those PPP loans pledged to secure primary credit funding) may be excluded from leverage ratio calculations.
- **Secondary Market Purchases Not Eligible**: If a borrower purchases an interest in a PPP loan in the secondary market, it cannot pledge that interest as collateral for a PPPLF extension of credit; only the borrower that originated the PPP loan may pledge it to the PPPLF. Relatedly, if a PPPLF borrower later decides it wants to sell a PPP loan in the secondary market, it must notify its lending Reserve Bank that it is requesting to prepay a PPPLF extension of credit, and must pay its Reserve Bank the full amount of the outstanding balance of the PPP loan that the borrower wishes to sell into the secondary market.

On April 17, the Federal Reserve announced[13] that it would temporarily modify its insider lending restrictions to bolster the effectiveness of the PPPLF, in keeping with the SBA's recent modification of its insider lending restrictions. Normally, both the Federal Reserve and the SBA limit the types and quantity of loans that bank directors, shareholders, officers and businesses can receive from their banks. However, on April 14, the SBA loosened these restrictions, stating they would not prevent an otherwise eligible business owned by an outside director or holder of a less than 30% equity interest in a PPP lender from obtaining a PPP loan from the PPP lender on whose board the equity owner holds an interest so long as (1) the business follows the same process as any other customer of the lender and (2) the outside director or holder is not also an officer or key employee of the PPP lender or the authorizing official that approves the loan.[14] Three days later, the Federal Reserve followed suit.[15]

FHLBank Advances

In guidance released on April 23, 2020, the FHFA confirmed that PPP loans are allowable collateral for purposes of securing FHLBank advances under certain conditions. FHLBank advances are a credit product offered by FHLBanks to provide members with liquidity. These advances serve as a funding source for a variety of mortgage products and help members originate mortgages. In order to be allowable collateral, PPP loans must meet a series

[13] "Federal Reserve Board announces rule change to bolster the effectiveness of the Small Business Administration's Paycheck Protection Program," April 17, 2020, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200417a.htm.

[14] Small Business Administration Interim Final Rule, April 14, 2020, available at https://www.sba.gov/sites/default/files/2020-04/Interim-Final-Rule-Additional-Eligibility-Criteria-and-Requirements-for-Certain-Pledges-of-Loans.pdf.

[15] Federal Reserve System, "Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks," available at https://www.govinfo.gov/content/pkg/FR-2020-04-22/pdf/2020-08574.pdf.

of FHFA-established conditions relating to (i) the financial condition of the member and (ii) discounts, caps, and dollar limits.

MEMBER-RELATED CONDITIONS

- Members must have a CAMELS rating of "3" or better, or a member credit rating in the top 60 percent, or top three quintiles, of the FHLBank's member rating system, *e.g.*, 6 out 10 or 3 out of 5, using the lower (more severe) credit risk rating.
- If a member is subsequently downgraded after pledging PPP collateral to the FHLBank, the member is not required to replace the PPP collateral, but such collateral will be subject to other limitations.
- In the event the member does not immediately replace the PPP collateral with other eligible collateral, the FHLBank must take possession of the PPP collateral and implement higher haircuts based on the rating of the member. If the member is downgraded to a CAMELS rating of "4" or a rating under the FHLBank's rating system in the fourth quintile (greater than 60 percent to 80 percent), the FHLBank must implement a 60 percent haircut. If the member is downgraded to a CAMELS rating of "5" or a rating under the FHLBank's rating system in the lowest quintile (greater than 80 percent to 100 percent), the FHLBank must implement a 90 percent haircut.

DISCOUNTS, CAPS, AND DOLLAR LIMITS

- At a minimum, the FHLBanks shall have a collateral discount of at least 10 percent that is applied to no more than 100 percent of the unpaid principal balance ("UPB"), *i.e.*, PPP loans with a market value above 100 percent of the UPB are capped at the UPB.
- The FHLBank shall establish a 20 percent cap on the amount that PPP loans can constitute of a member's lendable pledged collateral, *i.e.*, after haircuts and market valuations.
- Finally, the FHLBank shall limit the dollar amount of PPP loans that a single member may pledge to no more than $5 billion in lendable collateral.

We offer a dedicated team of advisors to help businesses weigh available options and seek assistance under one or more of the liquidity and support programs established under the Coronavirus Aid, Relief, and Economic Security Act (CARES Act). Whether in the form of direct funding from Treasury, loans or other credit support from a Federal Reserve lending facility or participation in Small Business Administration loan programs, our team has the expertise to help navigate the complex political and legal challenges associated with obtaining government financial assistance and the experience to help access the programs if a decision is made to do so.

Led by Lee Meyerson, who guided the Firm's financial crisis team that advised Treasury in developing, structuring and documenting its $250 billion TARP program for purchasing equity in U.S. financial institutions and related programs, and Keith Noreika, who recently served with Treasury Secretary Mnuchin as acting Comptroller of the Currency, a role in which he also acted as a director of the FDIC and member of the Financial Stability Oversight Council, the cross-disciplinary team also includes financing and governance lawyers, as well as former Treasury and Federal Reserve counsel.

See our Accessing Emergency Government Support Programs webpage for further information.

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