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The Fed's $600 Billion Challenge: Lending Directly to Businesses

The central bank's Main Street Lending Program is shaping up to be one of the trickiest things it has ever done

Fed officials are working to fine-tune the program. 'We're learning as we go,' said Fed Chairman Jerome Powell.

By Nick Timiraos
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The Federal Reserve is preparing to lend directly to middle-market businesses, filling a hole left by the government's economic crisis relief efforts, and it is shaping up to be one of the trickiest things it has ever done.

The risk for the Fed is that it goes where the central bank has rarely ventured and that not many businesses seek help, creating both financial and political headaches.

The program is designed to assist companies like LMI Aerospace, a St. Charles, Mo.-based maker of airplane parts that is too large to get help under the Small Business Administration's loan program but too small to benefit from the Fed's other corporate-lending backstops.

Under the Fed's middle-market program, a company would get a loan from a bank, which would then sell up to 95% of the debt to the Fed. This leaves the bank with less additional debt on its books and free to make more loans to other borrowers.

LMI, which has cut its workforce by 600 employees since the start of the year to 1,600, has spoken to its lenders in recent weeks about participating in the program, and found them hesitant. "They're not saying, 'No, we don't want to do it,' but they don't want to do this when their balance sheets may have a lot of borrowers that are going to be underperforming for some time," said Ed Dickinson, the company's chief executive.

After credit markets started seizing up amid the coronavirus pandemic, the Fed responded in March and April with promises to backstop them—including corporate and municipal debt markets—reducing borrowing costs and lifting stocks. Now, “its biggest challenges are making these programs work,” said former Fed Chairman Ben Bernanke in an interview.

With the midsize business program, a key challenge is setting the terms so the Fed doesn’t become a dumping ground for bad loans—but not so onerous that companies don’t want to participate.

“The Main Street program is going to be tremendously complicated,” said former Fed Chairwoman Janet Yellen. “One of the problems with this program is that it may turn out to be insufficiently generous.”

The Fed is very sensitive to political blowback such as the criticism that surfaced after the 2008 financial crisis, when Washington’s rescue of Wall Street avoided a deeper economic downturn but was assailed by lawmakers for not doing more to help Main Street. “It’s very important if you’re going to engage in this, that you get take-up,” said Chicago Fed President Charles Evans.

Fed officials say they are working to fine-tune the program, including extending it to nonprofits. “We’re learning as we go,” said Fed Chairman Jerome Powell in an online forum last week.

The middle-market lending program grew out of discussions in March between Mr. Powell, Treasury Secretary Steven Mnuchin and lawmakers including Sen. Mark Warner (D., Va.), who proposed using the Fed to reach midsize businesses through the banking system that the central bank regulates.

The Fed is using special powers granted by Congress and the Hoover administration during the Great Depression to make loans in times declared to be “unusual and exigent.” Between 1932 and 1936, the Fed lent $1.5 million to 123 businesses, or around $28 million adjusted for inflation. The largest loan—of $300,000—was made to a typewriter manufacturing company.

The $2 trillion coronavirus relief legislation enacted in March, the so-called Cares Act, provided $454 billion for the Treasury to invest in different lending programs run by the Fed; as a rule, the central bank won’t make loans that puts its own capital at risk.

Mr. Mnuchin agreed last month to provide $75 billion to cover losses in the Main Street Lending Program, and the Fed says that will allow the central bank to extend up to $600 billion in loans. Mr. Mnuchin has said the Treasury would put up more funds if they are needed.

The Main Street program is open to companies with up to 15,000 employees or less than $5 billion in revenue last year. More than 19,000 U.S. firms had between 500 and 15,000 employees in 2017, and they collectively employed between 30 million and 40 million Americans, according to Census Bureau data.

Banks can lend up to $25 million in new loans or refinance up to $200 million in an existing loan if a firm's total debt, relative to its 2019 earnings, is below certain thresholds. Borrowers face restrictions on executive compensation and distributions to shareholders.

Sen. Warner said he urged Mr. Powell to incorporate loan forgiveness into the program, but that Mr. Powell said the Fed isn't legally able to turn its loans into grants. Mr. Warner said he has also urged the Treasury Department to consider its $75 billion investment as money that won't be repaid.

"Most of my colleagues presumed that all of the Cares money would be spent and not recouped," said Mr. Warner. "What happens if this facility is set up and nobody comes? It's a valid concern."

Outside economists have said the Fed could loosen eligibility terms or lower the rate it charges borrowers, providing somewhat more in subsidy, if the Treasury Department signaled greater willingness to absorb losses.

The Fed modified the initial terms of the program last month to allow larger firms and those with somewhat larger debt loads to qualify.

While those are positive steps, "they still have left in place a default bias against assuming too much risk in this program, and as long as that bias is in place, they're sending the wrong signal to banks about making these loans," said David French, senior vice president of government relations at the National Retail Federation, a trade group that counts thousands of retailers as members.

Mr. Mnuchin said the mere announcement of the Fed's lending programs has already succeeded in opening up lending markets. "I don't view the success of Main Street as whether we originate $50 billion or $500 billion. The measure of success is, 'Do companies have access to capital, either through the facilities or the banks?' " he said in an interview.

Mr. Mnuchin said the Treasury has modeled scenarios in which it makes a return on the taxpayer's investment and scenarios in which it loses money. "We're not investing money the way a pension fund would invest money," he said. If the economy deteriorates, "of course we would expect to lose money in those cases."

For aircraft-parts maker LMI, the Fed's terms—up to $25 million at a rate of 3 percentage points above short-term interbank lending rates—are "reasonably attractive," said Mr.

Dickinson. That is much less than the manufacturer would have to pay to take a loan from a private investment company.

“We recognize nothing would be forgiven out of this, but right now, what we need is some capital to build inventory and keep our workforce engaged,” said Mr. Dickinson.

Other businesses say the proposition of adding more debt isn’t attractive right now. “It just wouldn’t make sense in this environment,” said Bill Hutton, president of Titan Steel Corp., a Baltimore-based distributor and processor of steel products. The company received assistance under the small-business program and if that hadn’t happened, “we’d be hungrier” to participate in the Main Street program, he said.

Dan Eberhart, a Phoenix-based entrepreneur who invests in industrial companies that include utility construction, trucking and oil-field services, said the Main Street program could be a lifeline for several of his companies.

Fed Chairman Jerome Powell explained the Fed’s new round of $2.3 trillion in lending programs in an online forum Thursday but underscored the limits of the central bank’s powers to halt the economic impact of the coronavirus pandemic.

“For the foreseeable future, new credit is pretty much nonexistent,” he said. "Absent the Fed program, we’re going to see very, very little commercial and industrial lending for the next 120 days or so.”

Difficulty getting bank loans could freeze any normal capital spending or equipment replacement, such as regular maintenance on his fleet of refrigerated food-hauling trucks. That kind of capital spending “is the lubricant that keeps the economy moving,” said Mr. Eberhart, and the business has “taken a lot of blows” from virus-related closures of meatpacking plants.

Still, he said the program won’t help businesses that have too much debt or where revenues aren’t poised to rebound, such as the oil-and-gas industry. “Banks don’t even want to talk about that sector,” he said.

Mr. Powell has cautioned the Fed cannot help businesses that aren’t viable, a problem that could deepen if the economy takes longer to recover from the virus. “The Fed has lending powers, not spending powers,” he said last week.