

Clients & Friends Memo

COVID-19 Update: The Paycheck Protection Program and the Secondary Market

April 13, 2020

Last week, the Board of Governors of the Federal Reserve System (the “Federal Reserve”), the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively, the “Banking Agencies”) adopted two measures to facilitate aid to small business employees under the CARES Act. First, the Federal Reserve announced the formation of the Paycheck Protection Program Loan Facility (the “PPPLF”), a program established under Section 13(3) of the Federal Reserve Act which enables insured depository institutions to obtain financing from the Federal Reserve Banks collateralized by Paycheck Protection Program (“PPP”) loans. The Federal Reserve’s announcement stated that the PPPLF would later be expanded to include PPP financing for loans held by nonbank lenders.¹ Second, the Banking Agencies announced that PPP loans held by banking organizations are assigned a zero-percent risk-weight for purposes of U.S. risk-based capital requirements, essentially making PPP loans exempt from risk-based (but not leverage) capital requirements when held by a banking organization subject to U.S. capital requirements.² The imposition of a zero-percent risk-weight requirement was mandated by Section 1102(a) of the CARES Act.

Considerable confusion remains, however, regarding how PPP loans may be transferred in the secondary market. Until this confusion is resolved, banking entities and other entities with regulatory or internal funding constraints may be unwilling to originate PPP loans without a clear path for obtaining financing or otherwise transferring such loans into the secondary market. This confusion must be addressed promptly to promote the smooth working of the PPP and the delivery of economic aid to small businesses.

This confusion exists due to the nature of the PPP loans and how they are regulated. Section 1102(a) of the CARES Act provides that PPP loans “shall be eligible to be sold in the secondary market consistent with this subsection.” This statement regarding sales in the secondary market

¹ <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200409a.htm>

² <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200409a1.pdf>

was echoed in Treasury Department releases describing the PPP. “This subsection” refers to Section 7(a) of the Small Business Act.³ As explained in our prior Clients & Friends memo, “[COVID-19 Update: The SBA's Paycheck Protection Program Explained](#)”, PPP loans are a form of SBA Section 7(a) loans, a traditional form of SBA guaranteed loan. Although not addressed in the CARES Act, the SBA's existing regulations implementing the CARES Act restrict the ability of Section 7(a) loan to be transferred in the secondary market. In particular, whole loan sales, participations, securitization (referred to as pooled certificates arrangements), and pledges require the consent of the SBA and the involvement of the SBA's designated fiscal and transfer agent (Colson Services Corp.), and generally require the transferee to be SBA licensed. Given that such loans are guaranteed, these requirements are designed in part to ensure that the SBA is aware of the identity of the holder to whom the SBA owes an obligation under the guarantee.

PPP loans are not only 100% guaranteed but are subject to forgiveness provided that certain conditions were satisfied by the borrower, and thus it is not unreasonable for the SBA to ensure that the entity claiming a right to payment from the SBA holds valid title to the SBA loan and that proper procedures were followed to determine whether the PPP's forgiveness requirements were fulfilled by the borrower. Unrestricted transfer of PPPs in the secondary market could result in chaos when the PPP loans are later presented to the SBA by the holder for reimbursement for forgiveness or guarantee. In addition, unrestricted transfer could mean that natural persons become direct owners of small business loans, which would be a highly unusual outcome for any credit market. On the other hand, prior approval requirements for loan transfers inhibit the ability to transfer newly originated PPP loans into the secondary market. Given that the PPP entails a massive amount of loans – \$349 billion – to be originated in a very short period – less than three months,⁴ transfer restrictions could have a material impact on the ability to get much needed funding to small business quickly. Some compromise is required. It would not be unreasonable to permit PPP loans to be transferred once without prior SBA approval, if transferred to a federal regulated entity (such as an insured depository institution) that provides after the fact notice to the SBA (or Colson). The originating SBA lender could be required to retain responsibility for servicing the loan and for performing the very important role of determining whether the forgiveness conditions have been met (and both the SBA and the transferee bank should be entitled to rely on such originating lender's determinations).

As for the PPPLF and the capital relief measures, questions remain regarding exactly what type of loan interests are eligible. For example, neither the terms sheet nor the capital relief regulation addresses whether participation interests or pooled certificates are encompassed, or whether these measures instead apply only to whole loans. Likewise, some confusion exists as to whether these measures apply solely to PPP loans originated by the banking organization or whether the measures

³ 15 U.S.C. 636.

⁴ Note that \$349 billion is more than the prior decade's worth of SBA 7(a) loan origination.

also include loans acquired by the banking organization. With respect to this last point, the capital relief regulation contains statements that are somewhat inconsistent with each other. To enhance support for the PPP, the Federal Reserve should consider including participation and securitization interests, as well as acquired whole loans, into the PPPLF.

* * *

If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

Scott Cammarn	+1 704 348 5363	scott.cammarn@cwt.com
Joseph Beach	+1 704 348 5171	joseph.beach@cwt.com
Gregg Jubin	+1 202 862 2485	gregg.jubin@cwt.com
Peter Morreale	+1 202 862 2258	peter.monreale@cwt.com
Lorien Golaski	+1 704 348 5331	lorien.golaski@cwt.com