Office of the Special Inspector General for Pandemic Recovery
Office of Audits

Audit Memorandum: The Main Street Lending Program's Loan Losses' Effect on Treasury's Investment in the Program

Report Number SIGPR-A-23-002-7
December 16, 2024

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TO:	Dini Ajmani Deputy Assistant Secretary for Capital Markets U.S. Department of the Treasury
FROM:	Kevin Gallagher Acting Assistant Inspector General for Auditing Special Inspector General for Pandemic Recovery (SIGPR)
SUBJECT:	Audit Memorandum: The Main Street Lending Program's Loan Losses' Effect on Treasury's Investment in the Program SIGPR-A-23-002-7

The SIGPR Office of Audits has the mission to conduct audits of loans, loan guarantees, and other investments made by the U.S. Department of the Treasury (Treasury) under any program established by the Treasury under Division A of the CARES Act. Section 4003(b)(4) authorizes the Secretary "to make loans and loan guarantees to, and other investments in, programs or facilities established by the Board of Governors of the Federal Reserve System…." On April 9, 2020, the Board and Secretary of the Treasury announced the establishment of the Main Street Lending Program (MSLP) under the authority of Section 13(3) of the Federal Reserve Act, with approval of the Secretary. Treasury made a $37.5 billion equity investment in support of the MSLP. SIGPR conducted this audit to determine if loan losses experienced by the MSLP have hindered Treasury's ability to recoup its $37.5 billion investment into the MSLP.

Although Treasury has been reimbursed all but $4.9 billion of its $37.5 billion investment into the MSLP, increases in program loan losses make a full reimbursement uncertain. MSLP 5-year term loans do not become due until July 2025 through January 2026. Without extension to SIGPR's currently scheduled March 2025 statutory sunset date, it will not exist to definitively determine whether Treasury will recover all its investment into the program. Program loan losses continue to increase, exceeding more than $1 billion as of September 30, 2024. MSLP borrowers currently are making their second 15 percent principal payments and facing 70 percent principal balloon payments next year, in addition to variable loan interest rates that have increased significantly since loan origination. These are contributing factors to the MSLP's high loan loss allowance, which indicates that the program may experience nearly $1 billion in additional loan losses by program's end. These factors, in addition to expected increases in program support costs over the last year of the program, cast doubt on the likelihood that Treasury will be made whole on its MSLP investment.

Background

The CARES Act authorized the Federal Reserve to establish the MSLP to aid small and medium sized businesses during the COVID-19 pandemic. In total, 319 lender banks participated in the MSLP issuing 1,830 commercial loans. The total value of the loans issued was approximately $17.5 billion. The Federal Reserve Bank of Boston (FRBB), which manages the program, set up MS Facilities 2020 LLC (MS Facilities), a Special Purpose Vehicle, which took out a loan from the FRBB to purchase 95 percent of loan participations from lender banks. These purchases were backed by Treasury's equity investment in the program. The lender banks retain the remaining 5 percent of the risk associated with making a loan.

Payment terms for MSLP loan borrowers are for five years. No payments were due in the first year. After the first year of the loan, interest payments became due in accordance with the loan agreement. No principal was due in the first or second year of the loan. The loans are amortized over the remaining term of the loan with 15 percent of principal due at the end of year three, 15 percent due at the end of year four, and a balloon payment of 70 percent at the end of year five.

All MSLP loans were issued between July 2020 and January 2021. Therefore, most borrowers still have the second 15 percent principal payment due, and all borrowers with outstanding loans still have the 70 percent balloon payment due on their loans.

As of September 30, 2024, 823 of the 1,830 MSLP loans are outstanding. The total loan balance of the outstanding loans is approximately $5.2 billion.

Treasury's Equity Investment and Agreements with the FRBB

In May 2020, the FRBB and Treasury entered into a Limited Liability Company Agreement of MS Facilities LLC (the LLC Agreement) to both become members of MS Facilities, the Special Purpose Vehicle which purchased the loan participations of the MSLP. As part of the LLC Agreement, the FRBB is the Managing Member, and Treasury is the Preferred Equity Member. As Preferred Equity Member, Treasury contributed $37.5 billion to protect the FRBB from potential loss on the loan participations purchased by MS Facilities. As the Managing Member, the FRBB has the exclusive right to manage the business of the MS Facilities, meaning that Treasury, although it contributed the equity investment into the program, does not have the right to take part in the management or control of the MS Facilities' business.

Treasury's investment into the MSLP is maintained by MS Facilities in a "Preferred Equity Account." The Preferred Equity Investment Agreement between the FRBB and Treasury directs the FRBB to invest 85 percent of the Preferred Equity Account funds into Treasury non-marketable debt securities that earn MS Facilities interest paid out by the Treasury. As of September 30, 2024, these securities have earned MS Facilities over $700 million in interest paid out by the Treasury. The other 15 percent of the Preferred Equity Account is intended to provide a cash buffer for the liquidity needs of the SPV.

As MSLP loans are paid down by borrowers and the balance of outstanding loans decreases, the amount of Treasury's equity needed to secure the program's loans also decreases. As such, the LLC Agreement directs MS Facilities to make interim distributions to Treasury. These interim distributions come from the funds Treasury invested that reside in MS Facilities' Preferred Equity Account.

Status of Treasury's Equity Investment in the MSLP

Treasury made its initial $37.5 billion equity investment into the MSLP in May 2020. In January 2021, once the MSLP program had closed to new borrowers, MS Facilities made an initial interim distribution of $20.9 billion to Treasury to align with the amount of loan participations purchased by MS Facilities (approximately $16.6 billion). Since then, as MSLP borrowers pay down their loan balances, the MS Facilities has made interim distributions to Treasury to reimburse portions of the equity investment no longer needed as collateral. MS Facilities made its next interim distribution to Treasury in November 2021, and every May and November since then. *Figure 1* shows the history of interim distributions made by the SPV back to Treasury:

Figure 1 – Interim Distributions to Treasury

Date	Amount	Outstanding Equity Investment
May 2020	-	$37,500,000,000
Jan 2021	$20,927,945,289	$16,572,054,711
Nov 2021	$897,649,095	$15,674,405,616
May 2022	$1,783,474,054	$13,890,931,562
Nov 2022	$2,438,231,374	$11,452,700,188
May 2023	$1,768,376,089	$9,684,324,099
Nov 2023	$2,245,845,236	$7,438,478,863
May 2024	$2,480,128,817	$4,958,350,046

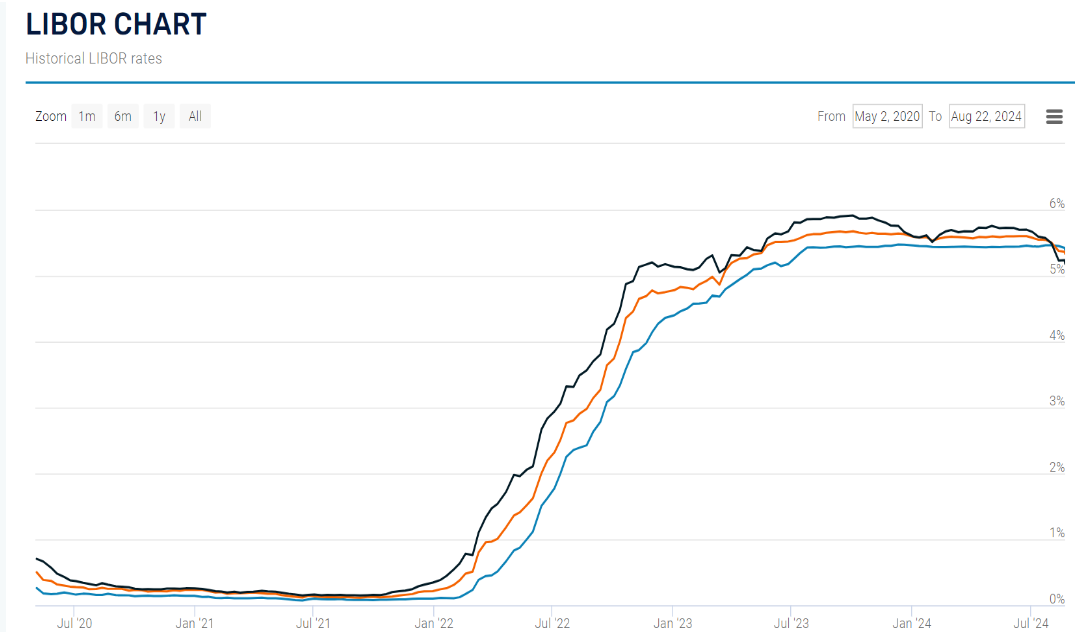
Per the LLC Agreement, interim distributions will continue until the balance of the Preferred Equity Account is down to $1 billion. At that time, the $1 billion will be kept in the Preferred Equity Account as collateral until all MSLP loans have been settled.

MSLP Financial Performance

Income

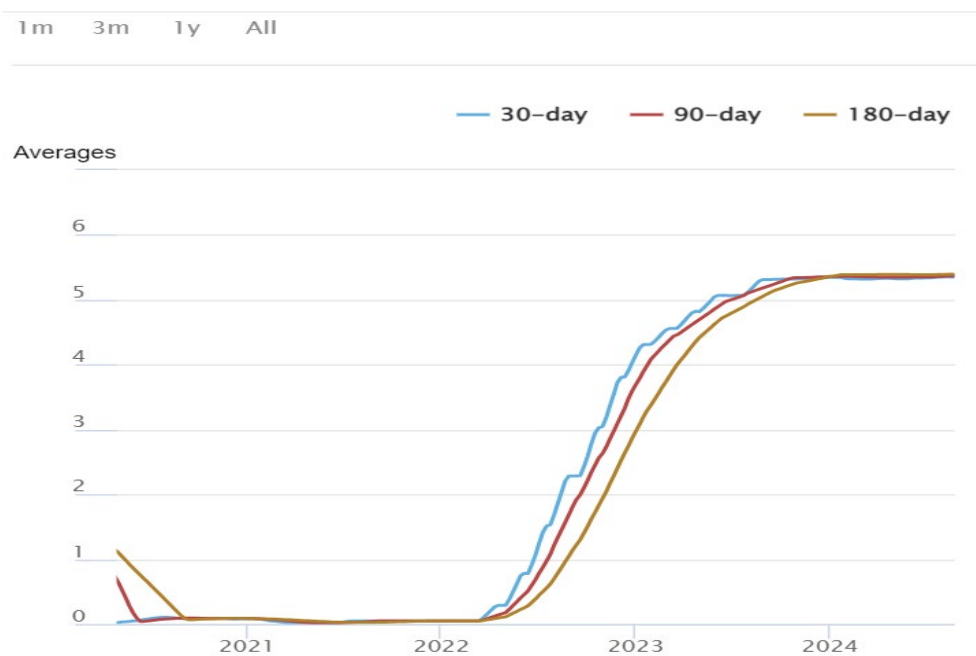
MS Facilities has three main sources of income associated with the MSLP: 1) interest collected from borrower loan payments; 2) interest earned from non-marketable securities investments from the Preferred Equity Account; and 3) transaction fees/late fees collected from borrowers. Borrowers paid interest on their MSLP loans at a rate of LIBOR (London Interbank Offered Rate) plus 3 percent. The LIBOR rate has increased significantly since MSLP interest payments initially became due. *Figure 2* displays changes in LIBOR from July 2020 through July 2024.

Figure 2 – LIBOR from July 2020 through July 2024



In June 2023, LIBOR was decommissioned, and lenders were required to change from LIBOR to a comparable rate. Most lenders (96 percent) changed to the SOFR (Secured Overnight Financing Rate). Differences between the LIBOR and SOFR have been minimal, by comparing LIBOR in *Figure 2* with SOFR as shown in *Figure 3*.

Figure 3 – SOFR From July 2020 through July 2024



Both LIBOR and SOFR have increased from rates that were tenths of a percentage at the beginning of the program, up to over 5 percent as of July 2024. Because borrowers incurred interest at a rate of LIBOR (now SOFR) plus 3 percent, borrowers are incurring over 8 percent interest on MSLP loans in 2024.

Even with the year over year decrease in number of loans outstanding, these increases in borrower interest rates have resulted in increases in interest income earned by MS Facilities. *Figure 4* shows increases in interest income (from borrower incurred interest) from 2020 through 2023.

Figure 4 – Interest Income 2020 through 2023

Year	Interest Income
2020	$59,300,000
2021	$438,500,000
2022	$546,900,000
2023	$797,000,000
TOTAL	**$1,841,700,000**

As explained earlier in this memo, MS Facilities also earns interest by investing Treasury's Preferred Equity Account holdings into Treasury's non-marketable securities. These securities earn interest paid by the Treasury. As of September 30, 2024, Treasury had paid over $700 million in interest to MS Facilities.

Lastly, MS Facilities earned transaction fees paid by MSLP lender banks for each loan the banks originated. Banks had the option to pass this fee on to the borrower. For each loan over $250,000, MS Facilities collected a transaction fee of 1 percent. MS Facilities also earns 95 percent of all late fees and penalties paid by MSLP borrowers. MS Facilities has recognized approximately $142 million in transaction and other fees as of December 31, 2023.

<u>Expenses</u>

To fund its purchase of 95 percent participations in MSLP loans, MS Facilities borrowed from the FRBB. The loan totaled $16.6 billion. The LLC Agreement states that MS Facilities at the end of the program must pay back its loan from the FRBB before Treasury receives any investments back from the Preferred Equity Account or shares in the program's net income. Therefore, MS Facilities' ability to repay its loan to the FRBB is important in determining whether Treasury can be made whole on its investment into the MSLP. MS Facilities is required to pay interest on its loan from the FRBB and do so at a rate of 0.1 percent. As of December 31, 2023, MS Facilities has incurred approximately $41 million in interest expense on the loan payable to the FRBB.

MS Facilities' loan payments to the FRBB are due monthly and made using the proceeds from MSLP borrower principal and interest payments. If principal and interest proceeds are not sufficient to make its monthly expense and loan repayment amounts due, MS Facilities will transfer an amount from the Preferred Equity Account to address the shortfall. In subsequent monthly periods following a withdrawal from the Preferred Equity

Account, MS Facilities must reimburse the Preferred Equity Account an amount equal to the withdrawn shortfall amount as proceeds are available. From June 2000 through November 2023, MS Facilities made three withdrawals from the Preferred Equity Account totaling $11.4 million and reimbursed the withdrawals in full. However, from December 2023 through July 2024, MS Facilities has made six withdrawals to cover shortfalls totaling $265.1 million and has only reimbursed $91.3 million of this amount as of September 30, 2024.

In addition to interest expense, MS Facilities has other expenses such as legal fees and loan servicing costs associated with the MSLP. MS Facilities has a variety of professional services fees it pays vendors to assist running the program. There are legal and accounting firms performing credit administration and custodial services, loan workout services, external legal counsel, and independent auditing. Participating MSLP banks also collect fees from MS Facilities for servicing the loans. As of December 31, 2023, MS Facilities has incurred approximately $112 million in professional services fees, and $107 million in loan servicing costs.

Figure 5 – MS Facilities' MSLP Expenses (as of December 31, 2023)

Expense	Amount
Interest incurred on FRBB loan	$40,942,000
Professional Services	$110,341,000
Loan Servicing	$107,409,000
TOTAL	**$258,692,000**

Credit losses on loans that default or are sold at a discount are the largest expense for MS Facilities. Credit losses have steadily increased over the past year and are the biggest variable when determining the outlook of MS Facilities' loan from the FRBB and Treasury's likelihood of getting its $37.5 billion equity investment fully returned. As of September 30, 2024, the program has experienced $1.19 billion in actual credit losses, net of subsequent recoveries. *Figure 6* shows the increase in credit losses over the past 12 months.

Figure 6 – MSLP Loan Loss History

As of Date	Loss Amount	Loan Loss Allowance
10/31/23	$301 million	$820 million
11/30/23	$359 million	$820 million
12/31/23	$564 million	$820 million
1/31/24	$572 million	$841 million
2/29/24	$582 million	$841 million
3/31/24	$695 million	$841 million
4/30/24	$746 million	$1.1 billion
5/31/24	$788 million	$1.1 billion
6/30/24	$878 million	$1.1 billion
7/31/24	$899 million	$923 million
8/31/24	$1.01 billion	$923 million
9/30/24	$1.19 billion	$923 million

Net Income

We reviewed the audited financial statements of MS Facilities from the inception of the program in 2020 through the end of calendar year 2023. The financial statements show that MS Facilities has experienced a net income of nearly $900 million in that time. This net income figure takes into account revenue earned from MSLP borrower interest, interest earned though MS Facilities' investment in non-marketable securities (with interest on these investments paid by the Treasury), and transaction and other fees. The net income figure also accounts for expenses incurred by MS Facilities, including interest expense on its loan from the FRBB, loan participation servicing costs, professional fees due to vendors in support of the program, and a provision for credit losses. *Figure 7* captures a summary of the income statements of MS Facilities from 2020-2023.

Figure 7 – Summary of MS Facilities' Net Income 2020-2023

Income	Amount
Interest Income – MSLP Loans	$1,841,700,000
Interest Income – Non-Marketable Securities	$545,000,000
Other Interest Income	$26,761,000
Transaction Fees and Other Income	$142,037,000
Total Income	**$2,555,548,000**
Expenses	**Amount**
Interest expense on FRBB loan	$40,942,000
Professional Fees	$110,341,000
Loan Servicing	$107,409,000
Provision for Credit Losses	$1,379,452,000
Loss on Sale of Loan Participations	$25,254,000
Total Expenses	**$1,663,398,000**
NET OPERATING INCOME	**$892,100,000**

Final Distributions to Treasury and the FRBB

At the end of the MSLP, once MS Facilities has repaid its loan to the FRBB and all its obligations are complete, funds from the Preferred Equity Account and any net income earned over the course of the program are distributed to FRBB and to Treasury. Treasury is entitled to the full balance remaining in the Preferred Equity Account, and 90 percent of any remaining net income earned by MS Facilities. As of July 2024, there is $5.47 billion in the Preferred Equity Account. This $5.47 billion balance consists of the remainder of the initial $37.5 billion investment made by Treasury ($4.958 billion), plus interest MS Facilities earned through its investment of non-marketable securities ($688 million), minus the unreimbursed withdrawals made by MS Facilities ($173.8 million).

Conclusion

Because there are over 15 months until all borrowers' MSLP loans become due, it is impossible to determine if Treasury will be made whole in its investment into the program. There are over $5 billion in loans outstanding, and borrowers with outstanding loans still owe a 15 percent principal payment in year 4 and a 70 percent balloon payment in the last year of the 5-year term loans.

Because Treasury had to borrow to finance its initial equity investment into the MSLP (see *Figure 8* below), the program must operate at a net income for Treasury to be made whole on its total cost of investment. Although MS Facilities has experienced a net income of approximately $892 million through the first three and a half years of the program, growing numbers of loan charge-offs, and expected increases in program administration costs at program's end make it unclear whether the program will maintain a net income through the end of the program. And while increases in borrower interest rates have resulted in subsequent increases in interest income to MS Facilities and the FRBB, there are signs that these rate increases may also be creating financial stress for the borrowers and contributing to borrower defaults and increases in loan losses. *Figure 8* provides a summary of Treasury's investments into the MSLP.

Figure 8 – Treasury Investment Summary and Status

	Amount
Treasury's Initial Investment	$37,500,000,000
Add: Estimated Total Cost of Financing Initial Equity Investment	$513,000,000[1]
Treasury's Total Cost of Investing into the MSLP	**$38,013,000,000**
Less: Initial Investment Returned to Treasury	($32,548,446,793)
Treasury's Total Investment Cost Outstanding	**$5,464,553,207**

To be made whole on its true investment into the MSLP, we estimate that the program must operate at a net income of approximately $570 million by program's end. Although the program already reported a net income of $892 million through the end of 2023, uncertainty around borrowers' ability to repay outstanding MSLP loans make it impossible to project whether this figure will be met.

[1] Treasury pays interest on any outstanding debt from borrowings at the Single Effective Rate. This estimate of Treasury's cost of financing is based on the MSLP concluding in calendar year 2026.

Memorandum Distribution

Chief Recovery Officer – U.S. Department of the Treasury

Office of General Counsel – U.S. Department of the Treasury

Federal Reserve Bank of Boston

Federal Reserve Board of Governors

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Appendix A – Scope and Methodology

Scope and Methodology

Our objective was to determine if loan losses experienced by the MSLP have hindered Treasury's ability to recoup its investment into the program.

To accomplish our objective, we:

- Interviewed Treasury's and the Federal Reserve's program officials involved with the program;
- Reviewed audited financial statements of MS Facilities from calendar years 2020 through 2023;
- Reviewed Federal Reserve Board Periodic Reports for updates on outstanding lending facilities authorized by the Board under Section 13(3) of the Federal Reserve Act;
- Reviewed MSLP documentation such as the MSLP Limited Liability Corporation Agreement between Treasury and the FRBB, the MSLP Frequently Asked Questions document, the MSLP Credit Agreement between MS Facilities and the FRBB, monthly Preferred Equity Account statements, and semi-annual interim distribution letters from the FRBB to Treasury.

We conducted this audit between February 2023 and October 2024 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives.