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A government-private structure for small business loans in the Recovery Phase of COVID-19

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The point of this note is to lay out how I would design a small business recovery loan program, subsidized by the government at some level, in the Covid-19 recovery summer of 2020.

Contents:

Section I: Structure of lending program based on economic "truths"

1) Not Enough Government Capital

My first truth is there is not sufficient government capital to provide subsidized loans for all the demand. Now that we are starting to see openings from shelter-in-place rules, governments should use public funds to de-risk other capital, not to provide loans directly. The capital will reach manifold more small businesses and provide more sustaining loan sizes.

2) Expected Default

The second truth is that the expected default rate of a small business recovery loan today is way too high for loans to be priced at their true costs. Many small businesses simply may not survive. Thus, the "fair rate" of interest that a lender must charge is way above normal times. My guess is that the "fair rate" is in the order of 25%, if not a lot more. A twenty-five percent interest rate implies a very large debt payment burden on companies, such that the debt itself may tip the company into failure and bankruptcy. Therefore, a small business recovery loan program must be at least partially subsidized by government or philanthropy backstops.

3) Backstops

Backstops in this context are financial contract mechanisms whereby governments or philanthropies put up "walls" to protect private investors from at least some of the defaults. They can set up these backstops as guarantees or, preferably, as tranches or waterfall cash flow structures. My third truth is that governments, especially local governments, must be careful about guarantees. If the virus re-emerges and we go into more shelterings, the default rates might be much higher; locking a government in to untenable liabilities. Thus, my preferred way for governments to subsidize loan programs is to use their capital as "loss capital" in debt tranches or waterfall distributions to de-risk the loans. Importantly, such structures allow for leveraging-up government loss capital.
For example, consider a simple waterfall mechanism, commonly used in private equity. All payments coming in from borrowers (in sum, not on a loan-by-loan basis) go to the private investors until they are repaid their investment. Governments and philanthropist get no loan repayments until the water falls to the next level down. Variants of this mechanism through tranching is easily designed. Using waterfalls or tranches is marginally harder to set up ex ante for loan programs, as it requires an ex ante structure to pool funds, rather than just a lending platform to originate and service the loans.

4) Government & Bank Skin-in-the-Game

The fourth truth is that governments and banks are depending on recovery for their revenues into the future, and thus they have a monetary incentive tied to loan programs. Banks hope the programs will help support existing loans to struggling small businesses. Governments hope the programs will restore the bases for sales, income, property, and other taxes that support the entire system of public goods. These implications mean not only are they going to be biased toward any programs that help their future revenues (i.e., toward their customers and constituents), but also that they should be most willing to participate in the subsidy. Note, however, that all of these entities should be willing to put skin-in-the-game. Thus, programs should take subsidizing capital, in proportion, from all those with local exposure. This further implies a benefit for building local programs under some organizing larger structure.

5) Underwriting to Viable Businesses

Even with a subsidized loan, not all businesses are going to recover. As much as I would like to write that we should give everyone a chance to try, government capital is limited; society needs to apply this money to businesses which have a reasonable prospect of survival. (Note that when governments go into debt in crises, spending on education and safety are two of the first big cuts. The government money must be effective at recovering main street.)
Because of this, my fifth truth is that loan program must develop an underwriting program to direct funds into small businesses most likely to be viable. These underwriting standards need to be simple and automatable. Errors will be made in excluding some viable small business. I will lay out my suggestion for one such simple underwriting standard below.

6) Underwriting to Different Size Businesses

I have recently completed a manuscript on small business resiliency (with Robert Bartlett of the UC Berkeley Law School), using the innovative survey conducted by the City of Oakland. As a preamble to our analysis, we write about the prior academic literature on small businesses and why one might care about the small enterprises in addition to the micro-businesses:

> *"Non-employing and micro-businesses (under five employees) account for the majority of main street establishments ensuring community vibrancy…. In contrast, small enterprises with greater than ten employees create future job growth even past the formative years (Decker, et al, 2014)."*

Thus, from a government point of view, the nonemployer and micro-businesses ensure storefronts, preventing zombie main streets. These benefits preserve property and income tax bases in the communities. Small enterprises provide for jobs growth, essential for government revenues and community economic wellbeing. Therefore, I advocate not eliminating small enterprises of any size in programs, but rather to set tougher underwriting standards to truncate the excess demand to the level of the capital in the program.

Section II: Underwriting / eligibility standards for a loan fund

The below is set out as suggested terms and viability criteria to guide a more formal term sheet.

Eligible Borrowers:

- [Adopt standard location, business registration, and conflict of interest terms]
- Business must be established prior to January 1, 2019
- Tax form business net income > 0 for 2019
- Debt Eligibility tests
- Business revenue tests:
    - Positive income recovery (stability test);
    - Negative shock (COVID-19 test)
- Business has 50 or fewer employees

Optional Criteria:

- Business location be in Community Reinvestment Act zone or that a certain portion of funds (funds, not loans) be dedicated to these areas

Loan Terms (adopting ideas from the Fed's Main Street Lending Program):

- 3-year term
- Interest-only monthly payments six months. Full amortization thereafter.
- Loan proceeds cannot be used to make anything other than current payments on debt by lender issuing the loan. Loans cannot be used to refinance or bring current existing-lender outstanding loans.
- Max loan size = min ($50,000, 2019 1st quarter revenues per tax form documentation)