Targeting the Paycheck Protection Program to those Most in Need

Viral V Acharya and Manasa Gopal[1] (March 29, 2020)

Goal – Provide cash assistance to small businesses affected by COVID-19 to enable them to retain workers and continue operations.

Program – The Paycheck Protection Program (PPP), part of the Coronavirus Aid, Relief and Economic Security (CARES) Act signed into law on March 27, 2020, provides non-recourse, forgivable, 100 percent federally-guaranteed loans of up to $349 billion in aggregate, with up to $10 million per business with fewer than 500 employees[2] to cover payroll costs, mortgage payments, rent/lease obligations, utilities, and interest on debt obligations existing prior to February 15, 2020. Expeditiously announced as necessary, some of its salient features are:

- Eligible entities may apply with Small Business Administration (SBA)-approved lenders, who are granted authority to make loans under PPP without SBA review.
- Loans are available for up to a 10-year term (amortized) at 4 percent interest, with six months (and up to one year) deferral of principal and interest payments.
- Loans are available with no personal guarantees of shareholders, members or partners; no collateral; no requirement to prove the recipient cannot obtain funds elsewhere; no SBA fees; and, no prepayment fee.
- The amount of the loan used for the covered expenses for a duration of eight weeks will be eligible (if the employer maintains payroll) for loan forgiveness.
- Borrowers must apply for forgiveness with the lender servicing the loan. Lenders have 60 days to review and make a determination.
- Zero risk weight and relief from TDR (troubled debt restructuring) disclosures have been provided on these loans for federally regulated banks and national credit unions.

Recommendations to Ensure the Program is Effective[3] –

1. **Target the program to those most in need** –Hubbard and Strain (2020)[4] estimate the *"cost of replacing 80 percent of the revenue for three months of private-sector firms with fewer than 500 employees, excluding the manufacturing, health, education, and finance industries, to be $1.2 trillion"*. Currently, $349 billion has been earmarked for the PPP.[5] Given the limited size, the program must be targeted towards businesses with the greatest financing need to help reduce the potential level of unemployment and business failures. Perhaps in the interest of delivering the program swiftly, the current proposal does not prioritize businesses by the extent of economic distress due to COVID-19. However, given that loans are no-recourse and forgivable, as well with a variety of traditional SBA requirements being waived, there is a high chance of their being sought even by firms not in need, crowding out, in turn, firms in the greatest need. Hence, without better targeting the PPP, its impact on the real economy may be significantly weaker. To address this objectively:

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[2] Size limit may vary by industry. Sole proprietors, eligible self-employed, contractors, gig economy workers, nonprofits, veterans' organizations, certain tribal business concerns, and businesses in the accommodation and food services industry (NAICS 72) that have less than 500 employees per physical location, are also included.
[3] Similar programs are being offered in other countries (for example, U.K. and Italy). Even within the United States, the Federal Reserve will be announcing soon its "Main Street Business Lending Program." Our recommendations are more broadly applicable, beyond the PPP, to these other programs.
[4] Hubbard, Glen and Michael Strain, "A Business Fiscal Response to COVID-19 Recession", 2020
[5] Our recommendations assume that almost the entire amount of the loan made under the PPP will be forgiven. Under a conservative estimate that small businesses have a 10% profit margin (even large, publicly traded businesses in the U.S. only have a 6.35% margin) and 90% of the business costs are operating costs, replacing eight weeks of expenses for small businesses would require replacing over 80% of business revenue and a budget of $810 billion.

a. One possibility is to (first) prioritize "non-essential" businesses that have discontinued operations in the wake of COVID-19 (say since Feb 15, 2020).
b. Another possibility is to (next) prioritize small businesses in sectors most affected by the economic effects of COVID-19. A classification of businesses into fraction of jobs that can be done from home as in Dingel and Neiman (2020)[6] could help quantify the impact of COVID-19 on the business.

2. **Expand the set of SBA-eligible lenders** – Currently, only SBA-certified lenders (around 1700 - nearly all only banks or credit unions but also few non-banks) are permitted to make PPP loans. Many small businesses rely on smaller banks (over 5,400 in number in the U.S.), non-bank, and FinTech lenders for their financing needs. In particular, the total volume of small business loans originated by banks under the Community Reinvestment Act (CRA) was $242 billion in 2018. In 2018, finance companies originated $397 billion in business loans[7] and FinTech lenders originated $26 billion of loans in 2017. To address this,

    a. SBA should expand the set of eligible lenders, certainly to all banks and credit unions but perhaps even more broadly. Non-bank and FinTech lenders are equipped to disburse loans more quickly than traditional banks which could be beneficial at this juncture. All eligible lenders should be subject to governance and regulatory oversight (see 3. below).
    b. The expanded list of SBA-certified lenders should be made available on the SBA website for easy borrower accessibility.

3. **Require and enforce lender governance and oversight**– Under the PPP, lenders have been delegated the authority to make loans without SBA review as well as to make a determination on loan forgiveness. Normally, the non-repayment of SBA-guaranteed loans is considered to be a black mark on the lender's performance; however, non-repayment on loans appears to be an intention of the PPP. Even if such latitude has been granted in the interest of expediency, without adequate oversight and well laid-out governance standards, sweeping discretion could potentially be abused by lenders, especially as loans are federally-guaranteed. In particular, lenders may prioritize insiders, friends, influential borrowers, or pre-existing relationships whose survival may be the most beneficial to the lender even if these borrowers aren't the most affected by the COVID-19 outbreak. Hence,

    a. Targeting the program to sectors most in need, as suggested in 1a.-1b. above, seems critical, also to limit the scope for cherry-picking by lenders for private gains at the expense of federal guarantees and out of line with PPP's goals.
    b. *"Sunshine is said to be the best of disinfectants"* [8] - The SBA/ bank regulator should collect and publish data on all PPP loan applications received by the lender along with their approval and forgiveness decisions on a daily basis. Such data can then be scrutinized by outsiders (including forensic scholars) with analytics to determine poor allocations[9] and whether fair lending practices / PPP guidelines were followed by the lender. Finally, appropriate fines can be imposed on the lender for egregious allocations and glaring violations, including ineligibility in the future for SBA loans. Such transparency and external scrutiny would be essential to keep lenders in line, especially as the set of eligible lenders needs to be expanded.

[6] Dingel, Jonathan and Brent Neiman, "How Many Jobs Can be Done at Home?", BFI White Paper, 2020
[7] https://www.federalreserve.gov/releases/g20/current/ ; https://crsreports.congress.gov/product/pdf/R/R44614
[8] Louis D. Brandeis, "What Publicity Can Do", 1914
[9] For instance, researchers can map employment data (say, using weekly unemployment claims) to each loan and thereby construct a "loan efficiency" measure that summarizes the impact of the policy in terms of achieving its legislative intent. The relative efficiency of lending by lender type, geography, etc., could be readily determined.