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## How to Help Small Businesses Survive COVID-19

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## How to Help Small Businesses Survive COVID-19

Todd Baker\* & Kathryn Judge\*\*

*Small businesses are among the hardest hit by the COVID-19 crisis. Many are shuttered, and far more face cash flow constraints, raising questions about just how many will survive this recession. The government has responded with a critical forgivable loan program, but for many of these businesses, this program alone will not provide the cash they need to retain workers, pay rent, and help their business come back to life when Americans are no longer sheltering in place. This essay calls on regulators to find new and creative ways to work with existing intermediaries, including banks and online lenders, who have the infrastructure and tools needed to help small businesses get the additional loans they need to survive and thrive. Leveraging existing institutions could enhance the speed, scale, and scope of the government's response, all critical virtues in the efforts to support small business.*

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The public health crisis posed by COVID-19 may soon be overshadowed by the massive economic disruption that lies in its wake. A severe recession is certain, but questions remain about just how deep it will sear, how long it will last, and how it will reshape the economy that emerges. Among the critical questions policy makers are facing are how best to support small businesses and how to reduce the number of otherwise viable businesses that will be forced into bankruptcy as a result of COVID-19 and efforts to slow its spread.

We argue that in order to minimize the adverse impact on small businesses, lawmakers should harness existing mechanisms for extending credit to companies with the potential to succeed and renegotiating the terms of existing loans. The core idea is that grants to support small business, such as the Paycheck Protection Program (“PPP”), are a critical but insufficient response to the cash flow needs of small businesses. No one yet knows just how long the threat posed by COVID-19 and associated activity constraints will last, and whether a second or even third wave will arise after this one. Nor can anyone foresee what the economy will look like when people emerge from their shelters. The government lacks the means to provide full support to all of the people and businesses that will suffer; so, over the longer term, it must consider how best to leverage the money it is investing to get the economy back on track and to help people in need. Banks and other lenders, particularly the new breed of online lenders, can help.

Banks and online lenders have the relationships, information, expertise, and infrastructure needed to help get cash into the hands of the small and mid-sized businesses that need it. Providing appropriate support to banks and online lenders could also go a long way in softening the blow that small and mid-sized businesses suffer, as obligations to pay outstanding loans can be among the more significant ongoing liabilities these business face. Further, making an effort to work with a diverse array of intermediaries could expand the pool of businesses that receive help and could also reduce the tendency for the government’s needed interventions to further distort the an already uneven playing field.

The challenge is that banks and online lenders face their own liquidity and capital constraints, limiting their capacity to provide the type of aid small businesses so desperately need. We provide an overview of why these institutions are critical and how the government can best leverage them to maximize the impact of governmental support on the long-term success of the small businesses threatened by recent developments. The aim is to provide a frame for understanding efforts underway and further steps that could be taken. Much of what is called for could be implemented through facilities authorized by the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), including the PPP administered by the Small Business Administration (“SBA”), but we also point to additional interventions policymakers should consider as they contemplate new legislation or other regulatory efforts to support small businesses through these difficult times. Finally, we point to policies that may be needed to reduce the systemic risks created by the recent rise of online small business lenders.

## Background

COVID-19 has quickly evolved into the greatest global economic threat of the century. These challenges arise in part from the suffering and sometimes passing of those who contract COVID-19, but even more so from the type of government interventions and behavioral changes needed to stop its spread. Among the hardest hit are small and mid-sized businesses,

often defined as those businesses that have less than 500 employees. According to the Census Bureau, there are roughly six million such businesses currently operating in the United States. These businesses have been a central focus of the government's interventions.<sup>1</sup> One reason is the critical role these firms play in the economy. Small businesses are a key driver of economic activity. They support the growth and vitality of our neighborhoods, spark innovation, and provide a proven pathway for many people — particularly women and minorities — to achieve financial success and independence. In recent years, almost one-half of the U.S. workforce worked in a small business, and small businesses collectively produced 45% of U.S. GDP.<sup>2</sup>

A related reason for the emphasis on small businesses, also reflected in the CARES Act, is that small businesses embody and reflect certain American ideals. Particularly given concerns that the United States has become excessively dominated by large businesses, and that those businesses exercise too much influence over policy making, many see small businesses as critical to the long-term vibrancy of democratic institutions.<sup>3</sup> Finding ways to help these businesses get the cash they need to survive, while also ensuring their owners do not end up saddled with excessive personal debt in the process, is at the forefront of the current economic policy challenges.

In its early efforts to minimize the economic costs of COVID-19, Congress passed a series of laws that provide extensive fiscal support to businesses and individuals. The CARES Act is the most important of the interventions to date, although further congressional action appears likely as the economic toll of COVID-19 becomes apparent. In broad terms, the CARES Act seeks to help small businesses in two ways. One is through forgivable loans under the PPP, which effectively operate as grants to help small firms weather the short-term challenges they face and retain most of their employees. Although a critical first step, these loans alone are unlikely to satisfy the medium and longer-term cash-flow and other needs of these businesses.<sup>4</sup> Given the fluidity of the situation, we spell out here in broad terms why it is so critical for policy makers to harness existing institutions to meet these needs, and some of the ways they can do so. Longer term, we encourage policy makers to think creatively about the country's reliance on powerful middlemen, in finance and elsewhere, but, for now, we believe the focus must be on finding the most viable avenues possible for supporting small businesses. We make some specific recommendations to illustrate what is possible and how, even for these proposals, the tradeoffs at stake will need to be evaluated in context.

#### A. Lessons on the Importance of Harnessing Existing Institutions

History, both recent and distant, suggests that harnessing existing institutions can be key to enabling the government to achieve particular policy goals. During the 2008 financial crisis, for example, then Treasury Secretary Paulson asked Congress for \$700 billion to buy mortgage-

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<sup>1</sup> Nellie Liang, The Federal Reserve, which already has moved aggressively, can do more for small businesses (March 30, 2020, Brookings Inst. Paper), <https://www.brookings.edu/blog/up-front/2020/03/30/the-federal-reserve-which-already-has-moved-aggressively-can-do-more-for-small-businesses/>

<sup>2</sup> JPMorgan Chase & Co., Small Businesses are an Anchor of the US Economy, <https://www.jpmorganchase.com/corporate/institute/small-business-economic.htm>.

<sup>3</sup> Thomas Philippon, *The Great Reversal: How America Gave Up on Free Markets* (2019).

<sup>4</sup> Although much uncertainty remains, preliminary survey results show that both service and manufacturing firms are facing meaningful financial challenges as a result of the COVID-19 crisis.

backed securities and other troubled assets, with the aim of putting a floor under the price of those assets. After being given this authority, however, Treasury quickly changed course, as it came to recognize that the impossibility of erecting its own facilities for valuing and buying up those assets quickly enough to calm markets, particularly given the liquidity strains and informational challenges of the time.

Less than two weeks after EESA became law, the Treasury Secretary interpreted the Department's authority to buy "troubled assets" as sufficient basis for a massive recapitalization of the banking system. These interventions proved to be an effective and timely way to restore market functioning and helped enable the banking system to play a role in the recovery that followed.<sup>5</sup> Other programs to stabilize markets, such as the Term Asset-Backed Securities Loan Facility, or TALF, were established by the Federal Reserve and enabled to grow by virtue of Treasury providing TARP funds to absorb possible losses. Under the TALF program, the Federal Reserve issued nonrecourse loans with a term of up to five years to holders of eligible asset backed securities, or "ABS". TALF financing was intended to support new ABS issuance and increase the flow of credit to consumer and business borrowers. Any U.S. company that owned eligible ABS collateral was able to request a TALF loan. In the words of the Federal Reserve: "While TALF borrowers benefited from the leverage provided by the facility, they served primarily as conduits.... The [] issuers and sponsors of newly issued ABS were the beneficiaries of the program."<sup>6</sup> This is a great example, and one being used again, of the Federal Reserve and Treasury working together to harness existing institutional capacity to promote the extension of credit needed to support the real economy. The most relevant lesson is that it is very hard for the government on its own to develop the expertise and infrastructure to do what private financial institutions specialize in—assessing the value of financial instruments and the creditworthiness of potential borrowers. An additional lesson is that a well-capitalized banking system is key for economic recovery.

Looking further back, we see that the Federal Reserve has attempted to make loans directly, but with very mixed results. Between 1934 and 1958, pursuant to what was Section 13(b) of the Federal Reserve Act, the Federal Reserve was authorized to provide working capital loans directly to nonfinancial firms.<sup>7</sup> In a recent analysis of Section 13(b), George Selgin provides a close analysis of just how difficult it was for the Fed to determine who should get funds—resulting in widespread denials of applications—and how poorly those loans nonetheless performed. When Congress took away the Fed's power in 1958, it was acting in accord with, not contrary, to the wishes of respected Fed Chairman William McChesney Martin, who testified that the program was not well aligned with "good government" or "good central banking," both of which pushed for a Fed that was more focused on its core mandates.

None of this is to belittle the value of government-run programs. Just the opposite, public options can be a critical way to provide services and can spur private activity.<sup>8</sup> Depending on

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<sup>5</sup> For more information on the passage of EESA and how the Treasury Department interpreted its authority, see Eric A. Posner & Adrian Vermeule, *The Executive Unbound: After the Madisonian Republic* (2011).

<sup>6</sup> <https://www.federalreserve.gov/regreform/reform-talf.htm>

<sup>7</sup> George Selgin, *When the Fed Tried to Save Main Street* (Alt-M, March 30, 2020), <https://www.alt-m.org/2020/03/30/when-the-fed-tried-to-save-main-street/>.

<sup>8</sup> Ganesh Sitaraman & Anne L. Alstott, *The Public Option: How to Expand Freedom, Increase Opportunity, and Promote Equality* (2019).

how the next few months play out, a critical re-assessment of the country's reliance on financial middlemen may well be warranted. For now, however, the government's capacity to extend credit and provide other aid to businesses in need will likely depend on how successfully it harnesses and directs existing intermediary structures. Failure to grapple with institutions specifically well designed to aid small business could result in a post-Covid-19 world with far more large and powerful businesses, and far fewer of the small businesses critical to the vibrancy of our economy and society.

## B. Banks Remain Critical

That banks are critical is reflected in many of the legislative and regulatory interventions to date. The challenges here will be finding new ways to harness bank capacity and ensuring banks remains sufficiently well capitalized to work with existing small-business borrowers and extend new loans.

The difficult balance in ensuring banks have the capital cushions needed to survive and lend while also the flexibility to make accommodations when appropriate is already leading to heated debates. One aspect of the challenge is in the need to maintain a long-term perspective that reflects the genuine uncertainty of the public health crisis the country and world is facing, and hence the possibility of greater losses ahead. So far, there has been a tendency to focus on ways that banks can help their clients and themselves at the same time. But the more difficult and important decisions entail tradeoffs between these groups. If Congress wants to do more to help small businesses, and more effectively leverage banks in that process, it must to find ways to encourage banks to act even when it is costly for them to do so. This requires far more than moral suasion, will be counterproductive longer term if banks become under-capitalized in the process. Figuring out ways both through and beyond the CARES Act to provide targeted subsidies to reward banks for costly modifications or the extension of certain new loans to small businesses could be a critical complement to the efforts already underway.

A more troubling development is that in addition to encouraging banks to work with customers, Congress and regulators are giving banks the freedom to renegotiate loans without adhering to appropriate accounting standards and are otherwise weakening capital standards.<sup>9</sup> On the one hand, capital and liquidity requirements can act as a buffer, so modest relaxations during finite periods of distress may at times be justified. Similarly, excessively rigid adherence to existing and new rules may discourage precisely the type of long-term value creating workarounds that all want to see. On the other hand, these developments can lead in dangerous directions. Banks, for example, may opportunistically use these temporary relaxations in accounting and other standards to restructure loans that are problematic for other reasons; and the weakest and worst-run banks may be most likely to engage in such behavior. More broadly, an undercapitalized banking system could inhibit recovery in the real economy, as vividly illustrated by Japan's lost decade. Additionally, by softening standards in ways that reduce the informativeness of banks' financial statements, these developments could breed the type of

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<sup>9</sup> E.g., CARES Act, Sections 4102 – 4014.

unknowns that can exacerbate market dysfunction. Take away the credibility of the information available, and that too could lead to doubt about the banking sector and a prolonged crisis.<sup>10</sup>

Apart from these dynamics, there are questions about whether the Treasury and Federal Reserve could do more to harness banks' infrastructure for making loans. The big problem, again, is that banks' incentives and society's interests are not well aligned. Banks cannot be expected to do what needs to be done without financial incentives to do so. This is an important area for further exploration for Treasury and the Federal Reserve, and finding ways to encourage the extension of new loans to small businesses, with terms that are friendlier than what a bank could make on its own, by finding a way for banks to quickly unload such loans could be a good way to help small businesses without threatening bank health.

Overall, the evidence suggests that better capitalized banks do a better job lending through the cycle.<sup>11</sup> Excessively relaxing capital requirements or allowing troubled banks to opportunistically renegotiate with weak borrowers is unlikely to pave the road to long-term success. Instead, the aim should be to devise tools that utilize bank expertise and provide appropriate incentives for helping businesses in need.

### C. Online Lenders are a Critical and Growing Part of the Small Business Credit Ecosystem

The situation with online small business lenders is significantly more complicated. Online small business lenders are the main source of credit for a large and highly vulnerable part of the small business ecosystem that the banks can't or won't serve effectively.<sup>12</sup> Due to their capital markets-dependent business model as nonbank finance companies, online small business lenders will be forced out of the market just when the liquidity they provide is needed most. Online lenders have already curtailed or ceased lending entirely as their asset-backed securities (ABS) are downgraded and funding costs rise precipitously.<sup>13</sup> That means that unless the government finds a way to utilize and support these lenders, a wide swathe of small business borrowers may face a dire cash shortage. As a longer-term matter, it may be advisable to consider reducing the systemic risks created by small business lenders that are dependent on the capital markets and thus disabled in a crisis. It may be more prudent to force these lenders into the regulated banking system where access to deposit funding and effective capital and liquidity rules will prevent lending paralysis.

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<sup>10</sup> Kathryn Judge, Information Gaps and Shadow Banking, 103 Virginia Law Review 411 (2017); Kathryn Judge, The Role of a Modern Lender of Last Resort, 116 Columbia Law Review 843 (2016).

<sup>11</sup> Gambacorta & Shin, *supra* note 7.

<sup>12</sup> Online lenders include the new breed of standalone non-bank "fintech" small business lenders like FundingCircle, OnDeck, Fundation, Kabbage, BlueVine, Can Capital, StreetShares, Lendio, and Biz2Credit, as well as more established tech and fintech companies like Square, PayPal, Stripe, Intuit, and Amazon, which include lending as part of their service.

<sup>13</sup> Robert Armstrong, Online lender stops making loans to small US businesses, Financial Times, April 1, 2020.

<https://www.ft.com/content/c31a20cf-cb17-4958-9454-73763302b5dc>

Kroll Bond Rating Agency, 10 U.S. Small Business ABS Deals on Watch Downgrade Due to COVID-19 Concerns (March, 2020), <https://www.krollbondratings.com/documents/report/32339/abs-u-s-small-business-abs-watch-downgrade-surveillance-report>.



It is important to be clear-eyed about how the small business credit market has changed since 2008. Banks aren't the only source of credit for true small businesses anymore, especially the type of very small “Mom & Pop” corner stores, laundromats, beauty salons, and coffee and sandwich shops that line main streets. Over the last decade, the smallest enterprises have increasingly turned to online lenders for their credit needs. The most recent Federal Reserve Banks' Small Business Credit Survey indicated that, in 2018, nearly one-third of small businesses that applied for credit sought it from an online lender.<sup>14</sup> For less traditionally credit-worthy businesses, the number was closer to one-half.<sup>15</sup> Despite an average loan size much smaller than a typical bank's<sup>16</sup>, online lenders extended more than \$20 billion in loans to small businesses in 2019, overwhelmingly to very small enterprises. Combined with the approximately \$12-15 billion in aggregate merchant cash advances made to small retail businesses in 2019, nonbank lenders provided somewhere between a quarter and a third of all credit to the smallest businesses.

All this growth has brought systemic fragility with it. If you peel back the skin of an online lender, what you find underneath is a finance company, which is simply a nonbank lender that gets all of its funding from the capital markets. Leading finance company names from the past like Household, GE Capital, CIT, MBNA, Countrywide, Money Store and GMAC all relied on the same liquidity model: borrow in the capital markets and lend that money to customers. In good times, this model works well. But when funding in the capital markets is unavailable or prohibitively expensive, a finance company quickly hits the wall. That's why the finance companies of the past moved, though not always voluntarily, into the banking system to get access to the stable deposit funding they needed to survive and prosper, or they failed.<sup>17</sup>

Because they are so important to the small business credit ecosystem and because they are liquidity-challenged relative to banks, online small business lenders will need both short and medium-term assistance from the Federal government to play a meaningful role in any small business credit and economic recovery. The most immediate short-term solution for these lenders and their customers is direct participation by online lenders in the PPP, as authorized by

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<sup>14</sup> Federal Reserve Banks, Small Business Credit Survey (2019), <https://www.fedsmallbusiness.org/medialibrary/fedsmallbusiness/files/2019/sbcs-employer-firms-report.pdf>.

<sup>15</sup> According to the Federal Reserve's 2018 study, “[m]edium- and high-credit-risk applicants seeking loan or line of credit financing were as likely to apply to an online lender as to a large bank (54% and 50%, respectively), and more likely to apply to an online lender than to a small bank (41%), CDFI (5%), or credit union (12%).” Federal Reserve Banks, *supra* note 17 at iii.

<sup>16</sup> Maddie Shephard, Average Small Business Loan Amounts, Broken Down and Explained, Fundera (March 2020), <https://www.fundera.com/business-loans/guides/average-small-business-loan-amount>.

<sup>17</sup> Unfortunately, some of today's online small business lenders—the so-called “marketplace lenders”—are even more fragile in a crisis than their more traditional predecessors. A marketplace lender has to keep issuing loans to survive. It can't slow down lending and slash operating costs to stay afloat while collecting cash from existing loans, like a traditional finance company, because it typically doesn't own many loans and relies on transaction fees or “gain on sale” for its main source of revenue. If the capital markets stop buying its loans and securitizations, or charge too much for the privilege, the music stops and the lender stops lending. Todd H. Baker, Marketplace Lenders Are a Systemic Risk, *American Banker* (Aug. 2015), <https://www.americanbanker.com/opinion/marketplace-lenders-are-a-systemic-risk>; Todd H. Baker, OK, Marketplace Lenders, I'll Say It: Told You So, *American Banker* (May 2016), <https://www.americanbanker.com/opinion/ok-marketplace-lenders-ill-say-it-told-you-so>.

the CARES Act.<sup>18</sup> The speed and simplicity of online lenders' processes would be a significant advantage relative to the often more bureaucratic loan origination practices of banks. Recent actions and statements by the Treasury, SBA and Federal Reserve indicate strong support for online lender participation in the PPP.<sup>19</sup>

The problem becomes more complex in the medium term when the immediate COVID-19 crisis begins to abate but loan performance and economic activity are still depressed. Additional term loans and other types of credit will be needed as small businesses begin to emerge from lockdown and contemplate a return to more active operations. But loan losses in the online lenders' historical books (the credit risk of which was largely transferred to the capital markets) will remain very high. The loan-secured "warehouse" facilities from banks typically used by these lenders as a source of cash to fund loans in good times, which are tied to quickly funded loan sales/securitizations into the capital markets, are unlikely to be available so long as historic portfolio losses remain a problem, and the capital markets will not provide funding for new loans in an amount and at a price which is adequate to support non-guaranteed lending by online lenders until the economy is fully recovered and credit risks return to a more normal range. Government solutions will be needed for an indeterminate amount of time. We suggest two potential solutions to this problem: one involving direct support to online lenders and one supporting capital markets funding as markets recover.

One way the Fed and Treasury could help the small business customers of online lenders secure the financing they will need would for the Fed, at the direction of, and with loss absorption provided by, the Treasury, to provide for a limited period a direct secured line of credit facility with a fixed advance rate and a concessionary interest rate available to any online small business lender that meets the SBA 7(a) lending test noted above, which the online lender can use to make small business loans to its existing customers.<sup>20</sup> This should help online lenders keep credit flowing to existing borrowers who would otherwise be cut off because of the lenders' inability to access market capital. It is important to recognize that the Fed normally should not engage in lending of this type, which involves the central bank in what could fairly be called the amelioration of business model failure rather than market failure. However, the emergency circumstances, and the Treasury loss absorption guarantee, make this the best immediate solution.

Another way that Treasury and the Fed could utilize their current authority would be to expand the category of loans eligible for the TALF to include investment grade non-SBA guaranteed small business loans, which are currently not included in the program. Adding these loans to the TALF will increase capital markets' confidence in the ABS issued by online small business lenders and improve pricing and funding availability, especially as the economy revives

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<sup>18</sup> The CARES Act permits "other lenders" to become licensed to make 100% guaranteed PPP SBA loans. [cite] The Interim Final Rule sets out the terms and conditions on which such lenders may participate in the PPP program [cite].

<sup>19</sup> See, e.g., SBA Interim Final Rule [cite] and the Federal Reserve's April 6, 2020 decision to establish a facility to provide term financing backed by PPP loans.  
<https://www.federalreserve.gov/newsevents/pressreleases/monetary20200406a.htm>

<sup>20</sup> To avoid unanticipated competitive effects, we believe that this facility should be limited to existing customers of the online lenders, defined as any small business that has had a loan from the lender at any time within the last 2 years.

and credit outcomes become more predictable. Specifically, the TALF would need to be changed in three ways:

- Non-SBA-guaranteed small business loans would be included in the loan types eligible for TALF ABS lending. The current list includes SBA loans, auto loans, student loans, credit cards, and even insurance premium finance loans (a tiny business in relative terms), but not normal small business loans. This provision would also help banks, credit unions and other small business lenders who make such loans.
- All investment grade consumer loan ABS would become eligible for lending. The TALF rules only allow AAA-rated ABS rated by two rating agencies. For many reasons, the ABS issued by nonbank small business lenders typically don't reach that type of rating. That means none of those ABS would be eligible. It may even be necessary to add some non-investment grade securities to the program, especially those ABS that were investment grade but subsequently were downgraded as a result of the crisis.
- The TALF program would need to clarify that privately (Rule 144A) issued and institutionally traded ABS are eligible. TALF in 2008 was limited to buying the publicly traded ABS securities which dominated the market. That's no longer the case today.

These changes would alter the nature of the current TALF significantly by adding an element of credit risk that, theoretically, does not exist for today's TALF-eligible ABS and may arguably be beyond the Fed's 13(3) authority. For this reason and to protect future Fed independence, it would be preferable for the Treto create a new, parallel Fed lending facility specifically for small business loans (and perhaps for consumer installment loans, where there are similar issues)<sup>21</sup> with funding and/or a loss absorption layer provided by the Treasury.

Finally, policymakers need to come to terms with the systemic risks associated with allowing fragile, capital-market dependent lenders to play a significant role in the provision of credit to small businesses.<sup>22</sup> There can be little question that allowing a large portion of lending to a critical area of the economy to be provided by companies (a) beyond direct federal control and (b) doing business in an inherently fragile and procyclical manner creates systemic risks. We are seeing these risks play out today.

It may be time to insist that lending to critical areas of the economy belongs in regulated banks, where funding is stable, and a regulatory regime intended to support lending in crises and recessions is in place.<sup>23</sup> While the COVOD-19 crisis situation is unprecedented and there are cogent innovation-based arguments to the contrary, it is hard to understand why government should be responsible for stepping in to rescue lenders that could have designed their businesses to be more resilient to liquidity and credit shocks. One might, and should, also ask why the

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<sup>21</sup> Todd H. Baker, Fed's new TALF has a major gap, *American Banker* (Mar. 2020)

<sup>22</sup> This is just one aspect of a larger problem involving the resiliency of capital markets in the face of major crises. In recent weeks, commercial paper, fed funds and mortgage and other markets have struggled to function effectively, requiring intervention from the Fed and Treasury.

<sup>23</sup> This same argument could be made about other areas of financial markets, such as money-market mutual funds, that have repeatedly required government assistance in crises.

Financial Stability Oversight Council, or FSOC, was blind to the now obvious systemic risks presented by the rise of online small business lending.

There are no easy way for the government to readily provide just the perfect amount of support and credit to small businesses. Every path forward is fraught. But failing to provide sufficient access to credit has a much greater downside risk than the complications that will inevitably arise in efforts to harness the infrastructure embedded in banks and online lenders. This paper presents just a few of the ways that the government could more effectively use existing intermediaries to help small businesses get the credit they need to survive this unprecedented shock.

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