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Main Street Lending Program morphs from lifesaver to anchor

The Federal Reserve Board's Main Street Lending Program (MSLP) emerged as a critical lifeline for many small and medium-sized businesses and nonprofits during the COVID-19 pandemic in 2020.

But while initially successful in getting money into the hands of Main Street businesses, rising interest rates and loan maturities are leading to high levels of defaults.

The program's early performance was encouraging, with roughly $16.4 billion distributed across 1,830 loans. The Federal Reserve of Boston established a Special Purpose Vehicle (SPV) to distribute risk and provide much-needed liquidity, holding a 95% participation in each loan made through the program.

The loans had a floating interest rate of LIBOR plus 3%, with no principal or interest due in the first year. The second year required interest-only. Years three and four required amortization of 15% of the principal (plus interest), with the remaining 70% due in a balloon payment at the end of year five.

The loan structure offered temporary relief at first, but became a tremendous burn as the loans aged.

CURRENT LANDSCAPE, BORROWER CHALLENGES

As you would expect, default rates remained low in the first two years of the program. However, defaults rose significantly in 2023 (year three) due to two main factors. First, borrowers began grappling with amortization payments on top of ongoing interest obligations. Second, a significant hike in interest rates since the loans were issued led to much higher payments than anticipated. The 1-month LIBOR rate jumped from 0.18301% in June 2020 to 5.21929% in June 2023, and to 5.45752% in June 2024.

As of August 2024, the Federal Reserve reported just over $1 billion in MSLP loan losses. The delinquency rate for MSLP loans stands at nearly five times that of comparable non-MSLP loans. It will get worse throughout 2024, and especially in 2025 when the remaining 70% of the principal is due.

While MSLP loans are not forgivable and remain full-recourse obligations, the program may offer some flexibility for workouts in distressed situations.

SPV'S ROLE IN WORKOUTS AND BANKRUPTCY

In the event of a missed payment or bankruptcy filing, the SPV has the option to convert its participation in the loan to an assignment. However, the Federal Reserve generally expects it will not pursue assignment and will rely on lenders to follow "market-standard workout processes."

The program's relative novelty means there's little established precedent for interpreting these workouts or the level of care expected from lenders. This ambiguity creates uncertainty for all parties involved, particularly as defaults are likely to rise.

That said, there is a growing body of evidence as defaulted MSLP loans go through workouts.

To borrowers needing to sell the business (or its assets), the MSLP throws another curveball — the SPV requires the buyer to assume the entire loan obligation unless the sale proceeds fully repay the loan. This presents a challenge, as distressed companies often need to sell assets at a discount on their secured debt to attract buyers.

Negotiating with the Federal Reserve can be an arduous process, particularly regarding loan modifications. My team and I have successfully negotiated for the SPV to accept sales in which they received less than par value on the MSLP loans, both in and out of bankruptcy court.

To ensure a successful and transparent sale, you must keep the Fed informed through the participating lender, their counsel, and the SPV's financial adviser, demonstrating that the market was adequately tested, and the proposed transaction is meaningfully better than any alternatives.

However, time is running out on any negotiated payment terms — the MSLP expires on Dec. 31, 2026, meaning all agreed-upon payments must be made by that date.

The MSLP undoubtedly provided much-needed assistance to many businesses during the darkest days of the pandemic. However, the program's current state presents significant challenges for borrowers facing rising rates and looming maturities.

The complexities and limitations of the program can make workouts difficult. Borrowers and lenders should be aware of these challenges and approach potential modifications with a clear understanding of the program's guidelines and limitations.

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