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Relief or Risk?: The Hidden Costs of Government Lending

The rollout of the Paycheck Protection Program may serve as a cautionary tale. The program was designed to minimize, if not eliminate, default and liability costs to financial institutions, but in practice demonstrated the many risks institutions face when participating in government lending programs.

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There is no longer any question that the economy will take years, not months, to fully recover from COVID-19, and additional funding for government and government-backed loans seems inevitable at some point. Examining the programs from the initial COVID-19 relief package provides context for financial institutions considering their role in the next round of relief.

The rollout of the Small Business Administration's Paycheck Protection Program—a prominent pillar of the initial CARES Act that allowed lenders to offer struggling businesses government-backed loans—may serve as a cautionary tale. The program was designed to minimize, if not eliminate, default and liability costs to financial institutions, but in practice demonstrated the many risks institutions face when participating in government lending programs.

In contrast, the SBA's less publicized Economic Injury Disaster Loan Program provided government grants and loans administered directly by the SBA. Financial institutions only became involved when the SBA deposited those funds into the recipient's account. And yet, what appears to be widespread potential fraud in the EIDL has increased compliance costs and risk exposure for financial institutions.

The EIDL also evidences the inevitable weaknesses of a program implemented in just days that distributed hundreds of billions of dollars in just weeks—and discredits the argument that program fraud results from lender negligence, misconduct or noncompliance. The PPP and EIDL are fresh reminders of the hidden costs of government lending.

Costs of the Paycheck Protection Program to Financial Institutions

The PPP provided emergency assistance to small businesses affected by COVID-19 by allowing financial institutions to process and originate program loans to borrowers with delegated authority from the SBA. The SBA set a 1% interest rate, fully guaranteed the loans, and will eventually forgive loans and remit the forgiveness amounts to lenders with accrued interest if borrowers satisfy certain criteria. The design, in theory, insulates lenders from the cost of collecting the debt if a borrower cannot pay.

Like other government loan programs, lenders submitted certifications to the SBA as a prerequisite to obtaining its guaranty. But the SBA substantially eased lenders' certifications and underwriting obligations, allowing them to rely on the borrowers' certifications and representations. They seemingly did so at

least in part to respond to lenders' concerns about False Claims Act liability.

This mitigated, but did not eliminate, risk and related costs.

For example, in May, the Department of Justice reportedly sent grand jury subpoenas to big banks as part of a broader investigation into potential PPP fraud. The banks are not an apparent target but bear the expense of responding to each subpoena regardless. Predictably, at least one civil FCA investigation concerning the PPP has also been launched, and the possibility of future enforcement also still looms. Lenders of Federal Housing Administration-insured loans originated during the 2007-08 financial crisis, for example, didn't face related DOJ litigation until 2011. Since then, the government has obtained more than $7 billion under the FCA from FHA lenders.

Federal regulators have also focused on PPP lenders. For example, the Financial Crimes Enforcement Network issued PPP-related guidance on the Bank Secrecy Act, and the Consumer Financial Protection Bureau on the Equal Credit Opportunity Act. And both the CFPB and Office of the Comptroller of the Currency have expressed potential fair lending concerns, signaling the possibility of targeted reviews.

Private litigants have also targeted PPP lenders. Within days after SBA began accepting applications, unsuccessful applicants filed class action lawsuits against national banks that limited loans to existing customers or allegedly prioritized certain applications. Purported agents for successful applicants have also filed at least 50 class actions in federal district courts over lenders' failure to pay their fees. Initial rulings have favored lenders, but the discretionary nature of the PPP leaves ample room for creative plaintiff's lawyers to try other approaches.

In addition, public sentiment quickly sided against lenders and successful applicants when underfunding led to application denials, bringing reputational costs. Lenders were an easy scapegoat for government officials looking to pass blame and media organizations searching for a news angle that would resonate with an audience predisposed to skepticism of financial institutions and uninterested in the nuances of a complicated government program.

Costs of the Economic Injury Disaster Loan Program to Financial Institutions

A less-publicized component of the CARES Act authorized the SBA to issue $10,000 advances to loan applicants under its existing EIDL program. Unlike the PPP, the SBA itself processed EIDL applications and disbursed approved grants and loans to recipients' depository accounts at financial institutions. Those institutions incurred costs for, among other things, ongoing BSA compliance.

For example, a report of potential widespread fraud in the EIDL program from SBA's Office of the Inspector General in late July indicated a combined $187.3 million in suspected fraudulent transactions was reported by just nine financial institutions. It also reported other instances of institutions freezing funds and contacting the SBA for assistance resolving the transfers. To date, there have been no allegations of impropriety, but the institutions have nonetheless incurred significant costs monitoring, identifying and reporting the potential fraud.

Ways for Institutions to Minimize Costs

There is no foolproof way to avoid these costs. Even an institution that opts out can face reputational costs of dissatisfied customers and government regulators who may view participation as compulsory for good corporate citizens. Moreover, as the EIDL demonstrated, customers may involve institutions without their prior consent, or even knowledge. Fortunately, institutions can take steps to minimize the costs of participation.

First, institutions can build a record of compliance by documenting their practices in policies and procedures, providing adequate training, monitoring and auditing the program, and appropriately tracking and addressing borrower complaints.

Second, institutions should consider requesting clarification or modification from the government if the program's requirements seem vague, contradictory, or unduly burdensome.

Finally, institutions should add their voices to the public narrative. Institutions should consider publicizing their success stories and point out where flaws in program design, rather than lender implementation, created many of the challenges lenders worked to overcome.

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