Evaluation Report
2023-FMIC-B-017
October 18, 2023

Board of Governors of the Federal Reserve System

FRB Boston Followed Its Processes for Monitoring the Credit Quality of Main Street Lending Program Loans

Office of Inspector General
Board of Governors of the Federal Reserve System
Consumer Financial Protection Bureau

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Executive Summary, 2023-FMIC-B-017, October 18, 2023

FRB Boston Followed Its Processes for Monitoring the Credit Quality of Main Street Lending Program Loans

Finding

To monitor the credit quality of the Main Street Lending Program (MSLP) loans, the MSLP special purpose vehicle (SPV) team established processes for quarterly credit scoring, including monitoring payment performance, as well as processes for workout loan management. The SPV followed its processes for quarterly credit scoring and workout loan management for all of the loans in our sample.

Recommendations

Our report does not contain recommendations. The Federal Reserve Bank of Boston (FRB Boston) chose not to provide an official response but concurred with the contents of the report.

Purpose

The objective of our evaluation was to assess the MSLP's processes for monitoring credit quality, including execution of the credit scoring process and management of workout loans. As of March 31, 2022, the MSLP had 1,601 loans outstanding, totaling $14.8 billion. To assess the quarterly credit scoring process, we tested a judgmental sample of 30 of the 427 loans scored in the quarter ending March 31, 2022, and tested the MSLP's continuous monitoring of payment performance for all 8 loans in the MSLP portfolio that were 45 or more days delinquent as of March 31, 2022. Finally, we tested all 16 loans in the MSLP portfolio that proceeded through the workout loan process as of March 31, 2022.

Background

The COVID-19 pandemic disrupted economic activity in the United States. To support lending to businesses and nonprofits, the Board authorized the MSLP using section 13(3) of the Federal Reserve Act, with prior approval of the secretary of the U.S. Department of the Treasury. The MSLP is administered by FRB Boston, which established an SPV to manage the MSLP loan portfolio.

Office of Inspector General
Board of Governors of the Federal Reserve System
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Recommendations, 2023-FMIC-B-017, October 18, 2023

FRB Boston Followed Its Processes for Monitoring the Credit Quality of Main Street Lending Program Loans

Finding: The SPV Followed Its Established Processes for Monitoring Credit Quality of MSLP Loans

Number	Recommendation	Responsible office
	No recommendations.	

Office of Inspector General
Board of Governors of the Federal Reserve System
Consumer Financial Protection Bureau

MEMORANDUM

DATE: October 18, 2023

TO: Joe Lynch
Vice President and Main Street Operations Director
Federal Reserve Bank of Boston

FROM: Cynthia Gray
Deputy Associate Inspector General for Audits and Evaluations

SUBJECT: OIG Report 2023-FMIC-B-017: *FRB Boston Followed Its Processes for Monitoring the Credit Quality of Main Street Lending Program Loans*

We have completed our report on the subject evaluation. We conducted this evaluation to assess the Main Street Lending Program's processes for monitoring credit quality, including execution of the credit scoring process and management of workout loans.

We provided you with a draft of our report for review and comment. An official response was not required because our report did not contain recommendations; therefore, Federal Reserve Bank of Boston (FRB Boston) officials verbally concurred with the report and thanked our office for the collaborative effort.

We appreciate the cooperation that we received from FRB Boston and the Board of Governors of the Federal Reserve System during our evaluation. Please contact me if you would like to discuss this report or any related issues.

cc: Kenneth Montgomery
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Introduction

Objective

The COVID-19 pandemic disrupted economic activity in the United States, which heightened the need for businesses to obtain credit to manage cash flows and sustain operations until economic conditions normalized. To support lending to businesses and nonprofits, under section 13(3) of the Federal Reserve Act and with prior approval by the secretary of the U.S. Department of the Treasury, the Board of Governors of the Federal Reserve System authorized the Main Street Lending Program (MSLP). The Coronavirus Aid, Relief, and Economic Security (CARES) Act also authorized the Treasury secretary to make loans to, loan guarantees to, and other investments in the MSLP and other emergency lending facilities authorized by the Board.[1] The Board authorized the Federal Reserve Bank of Boston (FRB Boston) to administer the MSLP, which includes conducting credit monitoring activities to measure and manage the MSLP loan portfolio.

The objective of this evaluation was to assess the MSLP's processes for monitoring credit quality, including execution of the credit scoring process and management of workout loans. Our scope focused on loan portfolio performance as of March 31, 2022, when the majority of initial interest payments were due but principal payments were not yet due. The majority of loans had initial interest payments due starting between December 2021 and January 2022 and principal payments due a year later. As of March 31, 2022, the MSLP had 1,601 loans outstanding, totaling $14.8 billion.[2]

To assess the design of the MSLP's processes for monitoring credit quality, we reviewed MSLP documents and conducted interviews with relevant officials. To assess compliance with the quarterly credit scoring process, we tested key controls for a judgmental sample of 30 of the 427 loans scored for the quarter ended March 31, 2022, and we tested the MSLP's continuous monitoring of payment performance for all 8 loans in the MSLP portfolio that had payments past due for 45 or more days as of March 31, 2022. To assess the workout loan management process, we tested key controls for all 16 of the loans that proceeded through this process as of March 31, 2022. Details on our scope and methodology are in appendix A.

Background

MSLP Overview

Section 13(3) of the Federal Reserve Act permits the Board of Governors, in "unusual and exigent circumstances," to authorize the Federal Reserve Banks to extend credit to participants in any program or facility with broad-based eligibility, with the prior approval of the secretary of the U.S. Department of the Treasury. In addition, the CARES Act authorized, among other things, the Board's ability to extend

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[1] The Consolidated Appropriations Act, 2021 (Pub. L. No. 116–260) prohibited the Board and the Federal Reserve Banks from reestablishing any emergency lending programs that received CARES Act funding.

[2] As of July 31, 2023, the MSLP had $9.3 billion in loans outstanding.

liquidity to support lending to businesses, as well as Treasury's investment in certain emergency lending facilities established by the Board.

The MSLP was designed to help credit flow to small and medium-sized for-profit businesses and nonprofit organizations that were in sound financial condition before the onset of the COVID-19 pandemic but needed loans to help maintain their operations until they recovered from, or adapted to, the effects of the pandemic. The MSLP comprises the following five emergency lending facilities: the Main Street Expanded Loan Facility, the Main Street New Loan Facility, the Main Street Priority Loan Facility, the Nonprofit Organization Expanded Loan Facility, and the Nonprofit Organization New Loan Facility.

The MSLP enabled lenders to issue loans to eligible borrowers. The MSLP purchased a 95 percent participation in eligible loans, and the lender retained a 5 percent interest in the loan's value, thereby creating shared credit risk. Lenders—who have a direct relationship with MSLP borrowers—also act as loan servicers on behalf of the program.

MSLP Key Stakeholders

FRB Boston created a special purpose vehicle (SPV)—a separate legal entity—to manage the MSLP's loan portfolio.[3] The SPV team works with FRB Boston staff and vendors to conduct ongoing loan portfolio management activities. Key stakeholders in the credit monitoring process include the following:

- Credit administrator—The SPV contracted with an external vendor to assist with quarterly credit scoring of the loan portfolio. The credit administrator is responsible for executing the credit scores calculation on a quarterly or annual basis and providing the credit scores output to the SPV team for review.
- Workout advisor—The SPV contracted with an external vendor for problem loan administration, such as proposing disposition plans, risk ratings, impairment analyses, and charge-off recommendations, which are provided to the SPV team for review.
- Oversight committees—FRB Boston established two committees that oversee MSLP credit monitoring activities: the Executive Oversight Committee (EOC) and the Credit Subcommittee. The EOC oversees MSLP strategic policy and operational matters and makes key decisions to support the MSLP's implementation and ongoing operations. The EOC comprises 13 voting members who are leaders from various FRB Boston divisions and offices, such as the Office of the President; the Legal Department; Corporate Strategy and Risk; and Supervision, Regulation, and Credit. The EOC also includes nonvoting members, such as representatives from FRB Boston's General Auditor and the Board's Division of Reserve Bank Operations and Payment Systems. The Credit Subcommittee, which is composed of EOC members, oversees and advises on a wide range of issues related to the extension and management of credit, including credit monitoring, vendor engagement, and management's response to audit reports pertaining to credit-related issues. The Credit Subcommittee reviews and endorses SPV-recommended credit quality monitoring decisions, including the quarterly credit scores and workout recommendations for the MSLP loan portfolio. The EOC reviews and approves these credit monitoring decisions.

[3] An SPV is formed by an organization as a separate company with its own legal identity, assets, and liabilities. Typically, SPVs are used to isolate financial risks from the parent organization.

Credit Monitoring Processes

The SPV team established the following credit quality monitoring processes for the MSLP loan portfolio:

- Quarterly credit scoring—On a quarterly basis, the SPV team works with the credit administrator to assign credit ratings to a subset of individual loan participations in the MSLP loan portfolio based on the principal balance and availability of updated financial statements.[4] The credit administrator uses a statistical model—which was reviewed by FRB Boston and is aligned with commonly used commercial credit scoring practices—to calculate and provide a credit score to the SPV team for each individual loan participation scored that quarter. The SPV team reviews the credit scores and downgrades credit scores for loans that (1) are 60 days or more delinquent or (2) have stale financial statements. The SPV then obtains approvals from the oversight committees. Additionally, to support the quarterly credit scoring process, the SPV team continuously monitors portfolio payment performance to identify delinquent loans and follows up with lenders on loan participations with payments that are 45 days or more past due.
- Workout loan management—The SPV team works with lenders to renegotiate, restructure, or modify the terms of the MSLP loan participation. The MSLP workout process is initiated when a lender requests that the SPV team modify loan terms because of a credit risk event for an individual borrower, such as payment delinquency, bankruptcy, or business closure. Requests for modifying MSLP loan participation terms can be managed by either the workout advisor or by the SPV team with the help of lenders. The oversight committees approve the workout terms.

MSLP Loan Portfolio Performance

The Board reports monthly on the repayment history of the MSLP loan portfolio, including actual loan losses and the estimated loan loss allowance.[5] The loan loss allowance is driven by the credit quality of the loans, which was initially assessed based on the availability of borrowers' financial statements because interest payments were deferred for a year.[6] As payments became due, the SPV began using both the payment history and borrowers' financial statements to assess the credit quality of each loan. According to an SPV employee, this update to the process contributed to the decrease in loan loss allowance and overall portfolio improvement.

From March 2021—the first quarter after loan purchases ended—to June 2023, the loan loss allowance decreased from $2.7 billion to $1 billion, and the MSLP reported actual losses of $164 million. The Board does not expect the Federal Reserve System to incur any losses.

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[4] The credit administrator scores loans with a principal balance under $5 million annually. Any loan without updated financial statements maintains the previously assigned credit score until a lender provides updated financial statements for the respective loan or the SPV requests that the credit administrator reassesses based on additional information.

[5] Loan loss allowances are used to estimate credit losses within a loan portfolio and are representative of the current amount of loans that are likely to not be collected based on current information about the loan portfolio.

[6] The MSLP purchased loan participations between July 2020 and January 2021, with 64 percent of all MSLP loan participations purchased between December 1, 2020, and January 8, 2021. MSLP loan participations have a 5-year maturity in which interest payments are deferred for the first year and principal payments are deferred for the first 2 years. Therefore, the majority of loans had their first interest payment due between December 2021 and January 2022.

Finding: The SPV Followed Its Established Processes for Monitoring Credit Quality of MSLP Loans

To monitor the credit quality of MSLP loans, the SPV team established processes for quarterly credit scoring, including monitoring payment performance, as well as processes for workout loan management. The SPV followed its processes for (1) quarterly credit scoring for the 30 loans in our sample, including continuous monitoring of all 8 loans in our scope that were delinquent 45 days or more, and (2) managing workouts for all 16 loans that proceeded through the workout process as of March 31, 2022.

The SPV Followed Its Established Processes for Quarterly Credit Scoring

To monitor the credit quality of MSLP loans, the SPV team established a quarterly credit scoring process in its *Main Street Lending Program Quarterly Credit Scoring Procedure*. For all 30 loans in our sample, the SPV followed its quarterly credit scoring process as outlined in the procedure document. Further, to support the quarterly credit scoring process, the SPV team established a process to continuously monitor portfolio payment performance in the *Main Street Lending Program Portfolio Monitoring Process Framework*. For all 8 loans in our scope that had payment delinquencies of 45 days or more, the SPV team followed up with lenders as required. Table 1 provides an overview of the quarterly credit scoring requirements and our results.

Table 1. Overview of the MSLP's Compliance With the Quarterly Credit Scoring Processes

Process component	Completed
The SPV team reviews the credit administrator's proposed loan credit scores.	✓
The SPV team downgrades loans with a payment delinquency of 60 days or more.	✓
The SPV team downgrades loans with financial statements 13 months or older.	✓
The EOC and Credit Subcommittee review, provide input on, and approve loan portfolio credit scores.	✓
The credit administrator uploads the final credit scores into the MSLP information system after the SPV team notifies the credit administrator that the credit scores have been approved by the oversight committees.	✓
The SPV team follows up with lenders on loan participations with payments that are 45 days or more delinquent.	✓

Source: OIG analysis of MSLP-provided documents.

The SPV Followed Its Established Process for Managing Workout Loans

To monitor the credit quality of MSLP loans, the SPV established a process for managing workout loans in the *Main Street Lending Program Portfolio Monitoring Process Framework.* For all 16 loans that proceeded through the workout process as of March 31, 2022, the SPV team followed its established workout process. Table 2 provides an overview of the workout process requirements we tested and our results.

Table 2. Overview of the MSLP's Compliance With the Workout Loan Process Components

Process component	Completed
Workout advisor–managed loans	
For workout activities that will cost more than $50,000 or 50 percent of the loan balance, the SPV team obtains approval to engage the workout advisor from the oversight committees through either email or votes during a meeting.	✓[a]
The workout advisor prepares an assessment memorandum on the workout loan using information such as borrower financial information, collateral and guarantor information, and background on the credit risk event.	✓
The workout advisor submits the assessment memorandum, along with recommended next steps (such as charging off the loan balance or modifying loan terms), to the SPV team for review.	✓
SPV-managed workout loans	
A lender requests that the SPV team modify loan terms because of a credit event.	✓
The SPV team reviews the lender's request for a workout and recommends the next steps to the oversight committees.	✓
Oversight of all workout loans	
The SPV team provides the oversight committees with a workout analysis and recommends workout terms.	✓
The oversight committees review the recommended workout terms, provide input, and approve the workout terms.	✓

Source: OIG analysis of MSLP documents.

[a] The SPV team assesses the need to use the workout advisor based on anticipated complexity, cost of workout advisory services, and the subject-matter expertise required.

Conclusion

Following established policies and procedures provides the SPV team with assurance that their processes for monitoring credit quality are operating as intended. Further, having established policies and procedures protects the SPV against operational risks related to losing institutional knowledge if key personnel leave the organization. Based our review, we found that the SPV team established and followed its process for monitoring credit quality, including execution of the credit scoring process and management of workout loans. As a result, we do not have a recommendation.

Management Response

Since our report does not contain recommendations, an official response was not required. FRB Boston management chose not to respond but concurred with the contents of the report and thanked our office for the collaborative effort.

Appendix A: Scope and Methodology

Our objective was to assess the MSLP's processes for monitoring credit quality, including execution of the credit scoring process and management of workout loans. Our scope focused on the loan portfolio performance as of March 31, 2022, when the majority of initial interest payments were due but principal payments were not yet due; the majority of loans had initial interest payments starting between December 2021 and January 2022 and principal payments due a year later. As of March 31, 2022, the MSLP had 1,601 loans outstanding, totaling $14.8 billion.

To assess the design of the MSLP's processes for monitoring credit quality, we reviewed applicable laws, policies, and guidance. We also conducted interviews with relevant officials and employees from the SPV team as well as FRB Boston's Legal Department.

To assess the quarterly credit scoring process, we judgmentally selected a sample of 30 of the 427 loans scored in the quarter ending March 31, 2022. To judgmentally select our sample, we selected loans in each of the three different categories that required review by the SPV team and approval of credit scores by the oversight committees—loans less than $5 million, loans between $5 million and $15 million, and loans more than $15 million—and had corresponding credit scores that indicated a heightened risk of default. We also tested the SPV's continuous monitoring of payment performance for all 8 loans in the MSLP portfolio that were 45 or more days delinquent as of March 31, 2022. Finally, to assess the workout loan process, we tested all 16 loans in the MSLP portfolio that proceeded through the workout loan process as of March 31, 2022.

The sample of loans to test the quarterly credit scoring process was a nonstatistical sample; therefore, we are unable to project the results to the population of the MSLP's quarterly credit scores. We tested 100 percent of the population of loans that were subject to the continuous monitoring of portfolio payment performance and the workout loan process for the testing period; therefore, we can conclude on the overall continuous monitoring of portfolio payment performance and workout loans population.

We assessed the SPV's monitoring of credit quality processes administered by FRB Boston because the Board authorized the lending facilities and reports to Congress and the public in accordance with sections 11(s) and 13(3) of the Federal Reserve Act as well as the CARES Act. Moreover, the Board authorized FRB Boston to establish and operate the MSLP, and as such, the lending facilities, including the MSLP, are subject to the limitations, restrictions, and regulations of the Board.

We conducted our work for this evaluation from November 2021 to September 2023. Shortly after the end of our scoping phase, in July 2022, we split the original evaluation into two phases. Phase I focused on the loan participation purchase process and was issued separately.[7] Phase II focuses on the credit monitoring process for the loan portfolio and is the subject of this report. Phase II was suspended between December 2022 and March 2023. We conducted this evaluation in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluation*.

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[7] Office of Inspector General, *The Board and FRB Boston Generally Followed Their Process for Purchasing MSLP Loan Participations but Can Formally Document Some Key Processes*, OIG Report 2023-FMIC-B-011, July 17, 2023.

Abbreviations

CARES Act	Coronavirus Aid, Relief, and Economic Security Act
EOC	Executive Oversight Committee
FRB Boston	Federal Reserve Bank of Boston
MSLP	Main Street Lending Program
SPV	special purpose vehicle

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