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PPP 2.0 – A Renewed Opportunity (and New Set of Headaches) for Lenders

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As the old saying goes, the best deals are made when neither side gets exactly what it wants. By that standard, the most recent federal pandemic relief bill that finally passed into law in late December certainly qualifies as a great deal.

Democrats who for months had been seeking a bill in excess of $3 trillion were undoubtedly disappointed by the final price tag of slightly more than $900 billion and the large number of key priorities that were left out as a result, particularly including more significant aid to state and local governments. Many Republicans, in turn, would have preferred a bill half the size of the one that was passed. They've criticized a number of budgeted line items they view as "pork" and unrelated to the crisis at hand.

In all of this, one of the very few priorities both parties broadly agreed on from the onset of negotiations was the need for extended support for small businesses, and it has been clear for a while that the final relief package would ultimately include a "2.0" version of the Paycheck Protection Program (PPP) that was initially offered from April until August of 2020. However, much like the overall relief package, neither the small businesses that the PPP is intended to help nor the banks and other lenders who will facilitate the process got close to everything they wanted.

In this Flash Report, we review the key provisions of PPP 2.0, highlight the significant changes from PPP 1.0, and address some of the key challenges lenders are likely to face as the process unfolds.

A More Targeted Plan

Despite its objective success in quickly delivering more than $500 billion to approximately 5.2 million small businesses, PPP 1.0 has faced a number of criticisms since its inception. The program launched only a week after the Coronavirus Aid, Relief, and Economic Security (CARES) Act passed with limited time for lenders to build the necessary processes and technology infrastructure, and the Small Business Administration (SBA) issued detailed procedural guidance (which subsequently changed numerous times) only the day before the application portal opened. As a result, many banks were not equipped to take applications at the onset, and many of those that were only accepted applications from existing customers.

This issue was exacerbated by attention-grabbing headlines involving an NBA team and several large national restaurant chains, among other high-profile businesses, that received some of the earliest PPP loans. Eventually, it also became clear that outright fraud was endemic within the PPP, resulting in press reports spotlighting criminal gangs and fortune seekers using PPP funds to buy exotic cars, yachts and other high-profile purchases. With extraordinarily high levels of demand and a limited initial group of lenders, the PPP funding pool ran dry in just two weeks and left on the sidelines many borrowers without established commercial banking relationships.

Subsequently, when a second round of funding was quickly passed, more banks and fintech lenders joined the program and by the time it expired in August, approximately $138 billion in funding remained available. Although one could argue this serves as evidence that any business owner who wanted and qualified for a PPP loan could eventually have gotten one, the program has nevertheless been unable to shake its reputation for allowing wealthy and well-connected borrowers to cut the line while the “true” small businesses it was really designed for were left without funding.

It’s clear that Congress took this criticism to heart in the design of PPP 2.0. There are a number of new program features designed to prioritize smaller businesses and those in harder-hit industry segments, channel funding through lenders most closely connected to those business communities, while also including new eligibility restrictions and fraud control measures to reduce the likelihood of funds going to borrowers who can’t demonstrate a need or shouldn’t be eligible for a loan in the first place. Some of these provisions are specific to a new “second draw” PPP loan offering to allow borrowers who already received a PPP 1.0 loan to access additional funding, subject to tighter eligibility restrictions (borrowers were only allowed one loan in PPP 1.0).

The following table summarizes the significant changes between PPP 1.0 and 2.0. Please note that this summary is a significant simplification of complex legislation and is not intended to be exhaustive. Although it reflects subsequent implementing guidance initially issued by the SBA in a series of Interim Final Rules (IFRs) beginning on January 6, we expect these standards to be clarified further as the program rolls out.

Attribute	PPP 1.0	PPP 2.0
Eligible Borrowers	Generally, U.S. businesses with <500 employees.	• Makes 501(c)(6) organizations and certain other business types eligible for first-time PPP loans. • Publicly traded companies expressly ineligible. • Businesses with certain ties to China and Hong Kong are excluded. • Shrinks employee count cap to 300 employees for second PPP loans. • Provides funding set-asides for businesses with <10 employees, and businesses operating in low- and moderate-income areas.
Authorized Lenders	Existing and new SBA lenders, including banks and non-banks.	Generally the same, but funding set-asides are established for Community Development Financial Institutions (CDFIs), Minority Depository Institutions (MDIs), and banks with <$10 billion in assets.
Maximum Loan Amount	$10 million.	$2 million for second draw loans. Also, although an individual entity within a single corporate group may apply for its own loan, the amount of all second draw loans to the corporate group of entities may not exceed $4 million.
Loan Amount Calculation	The business's average monthly payroll cost, multiplied by 2.5.	Generally the same as PPP 1.0, except hotels and restaurants are eligible for up to 3.5x payroll cost. Also, businesses may now base the loan amount calculation on payroll costs for the 12 months preceding the loan date or calendar year 2019.
Hardship Test	Borrower certification that "economic uncertainty" caused by COVID makes the loan necessary.	Businesses applying for a second PPP loan must demonstrate a quarterly revenue loss of >25% compared to the same quarter in 2019.
Expenses Eligible for Forgiveness	Payroll, mortgage interest or rent, utilities.	Same as PPP 1.0, but adds workplace safety costs, certain supplier expenses, and software and accounting services.
Tax Treatment of Expenses Paid Using PPP Funds	Silent in the CARES Act, later IRS opinion ruled expenses to be non-deductible, effectively making PPP funds taxable.	Explicitly allows deduction of costs covered by PPP loan.
Loan Forgiveness	Detailed application demonstrating use of funds required for all loans regardless of size.	Streamlined one-page application presenting more limited borrower data and attestations allowed for loans <$150,000.

Attribute	PPP 1.0	PPP 2.0
Fees Paid to Lenders	• Loans <$350,000 = 5% of loan amount. • $350,000 - $2 million = 3% of loan amount. • >$2 million = 1% of loan amount.	• Loans <$50,000 = Lesser of 50% of the loan amount or $2,500. • All other tiers unchanged.

Key Considerations for Lenders

There are several key wins for PPP lenders in the 2.0 legislation, notably the eased forgiveness process as well as stronger hold-harmless protections when lenders rely in good faith on information provided by borrowers. Nevertheless, the legislation leaves several industry requests unmet or only partially met. Additionally, the new 2.0 standards will create new challenges lenders didn't initially face in 1.0. Some of these key points include:

- *Forgiveness:* Although the streamlined forgiveness process should be significantly less burdensome for lenders than the status quo would have been, industry advocates had argued for full automatic forgiveness by which the SBA would convert the loans to grants and reimburse lenders with no action needed on either the lender or the borrower's part. The streamlined process will still require steps for borrower outreach, application intake and review, and submission to the SBA, along with all of the attendant process design, technology infrastructure and quality control work those activities necessitate. Lenders are rightfully frustrated by the additional work still required of them now that the forgiveness process is largely a "check the box" exercise that is unlikely to deter a meaningfully larger number of improper or fraudulent forgiveness requests than true auto-forgiveness would have allowed.

- *Revenue reduction test:* As noted above, borrowers seeking a second draw PPP loan will be required to demonstrate a 25%+ reduction in revenue in 2020 compared to 2019. From a public policy perspective, this makes good sense in encouraging PPP funds to flow where they are most needed. However, we think this will create significant operational challenges that could lead to inconsistent practices across the industry, encourage questionable accounting gimmicks on borrowers' parts and potentially delay access to funding in many cases. A few of the numerous questions and concerns related to this include:
  - As noted above, the revenue reduction test is based on quarterly revenue in 2020 vs. 2019. Borrowers have flexibility to pick the "comparison quarter,"

but even within the legislation itself, the rules are fairly complex regarding how this will be done.

- All of the concerns lenders raised around forgiveness and the right to rely on borrower representations are even more acute as they relate to the standard of review that will be required for revenue reduction. Lenders should closely review the IFRs recently issued on this topic by the SBA. Interestingly, the SBA indicated that, for second draw loans of less than $150,000, borrowers can submit documentation to demonstrate having met the 25% revenue reduction test at the time of forgiveness rather than at application. However, we think for the peace of mind of both the borrowers and lenders, most will elect to confirm eligibility upfront rather than risk having a forgiveness request rejected if the lender or the SBA eventually determines that the revenue reduction test was not met at the time of origination.

- Relatedly and particularly in a pandemic year, many small businesses are not going to have detailed audited quarterly financial statements readily available. As we suggested in a recent Banking Dive interview, SBA guidance needs to strike the right balance between audited statements and financials handwritten on the back of a napkin. The IFRs did not set a definitive documentation standard but did provide examples of the types of evidence that lenders might request, including tax returns, quarterly financial statements and bank statements.

- These complications related to revenue and expense documentation are highlighted further by various other provisions in the IFRs. For example, borrowers may use 2020 tax returns to substantiate a 25%+ revenue reduction; however, since the deadline for second draw loans is March 31, 2021, businesses will face a compressed deadline to file their 2020 taxes. Also, the IFRs indicate that *forgiven* amounts from PPP 1.0 loans are not counted in gross receipts for purposes of determining revenue reduction, but fail to recognize that many if not most 1.0 borrowers will still be in forgiveness limbo at the time they are considering applying for a 2.0 loan. This is likely to put further pressure on lenders that have not yet opened their forgiveness processes because their existing borrowers will urgently seek clarity on the status of their 1.0 loans. An unforgiven 1.0 loan would not only require repayment but would also potentially make it harder for the borrower to meet the 25% revenue reduction test necessary to qualify for a 2.0 loan.

- *Lender liability and fraud review standards:* As noted above, lenders received a partial break with hold-harmless protection from enforcement activity being added to the PPP 2.0 bill that is retroactive to the CARES Act. However, this is conditioned on the lender having adhered to all federal and state regulatory requirements applicable to the loan. When one considers this includes very broad safety and soundness standards as well as customer identification and due diligence rules, a lot of space is left for interested examiners to question a lender's practices. Further, the legislation provides additional fraud mitigation resources to the SBA itself and lenders are going to need to support those inquiries, likely for years to come. These risks are all heightened in – though certainly not limited to – the context of new provisions like the revenue loss test mentioned above, as well as the larger loan amounts now allowed for NAICS code 72 businesses in the hotel and restaurant industries. Are lenders going to have to validate whether a business truly operates as a restaurant, or for clients with multiple operations, how much of the revenue flows from the eligible restaurant business? Consider a conference center, for example, which under the new legislation is eligible for different relief applicable to its live events operations (some of which offset its eligibility for PPP loans), apart from its hotel and food and beverage revenue. This scenario is going to be challenging to parse in regulatory guidance to start with and next to impossible for lenders to sort out with confidence with respect to a particular borrower. For its part, the IFRs make clear that the SBA is continuing to ramp up fraud control measures. For example, lenders were notified that, in contrast to 1.0, there will be a slight delay between when a loan application is submitted by lenders and the SBA issues a loan authorization number in order to allow the SBA to perform additional compliance checks (presumably looking for things like duplicate loan applications by the same borrower, or applications submitted by borrowers being investigated for 1.0 fraud).

- *Resourcing:* Many lenders we work with recall PPP 1.0 as a seven days a week, 18 hours a day exercise that was achievable only by temporarily re-tasking employees in other lines of business. This was aided by the fact that 1.0 happened largely at the height of the first lockdown when, for example, many branches were shut down or on limited capacity, enabling many of their tellers and personal bankers to be redeployed. By now, most of these operations have settled into at least a "new normal" state and excess capacity is no longer available. This is further challenged by the fact that new 2.0 originations will hit just as clarity finally arrives on forgiveness standards for 1.0 and lenders must begin to process those requests. As a result of all of this, we're seeing a surge in temporary staffing and consulting support requests for

2.0, while other lenders who participated in 1.0 as an originator are exploring partnerships where they can white-label a PPP 2.0 offering but outsource the origination and servicing/forgiveness processes to a third party.

- *Pending flood of applications:* We're hearing varying views about how long the $284 billion funding pool for 2.0 will last, with some lenders making plans for potentially two to three months of operation. We think those expectations are optimistic. In the first round of 1.0, there were relatively few lenders participating initially and limited automation on both the lender and SBA side, resulting in significant system failures. Also, there was much borrower confusion and/or hesitancy to apply because of questions about what the forgivability and tax treatment of the loans would look like, as well as how the pandemic's impact on their business would unfold. In spite of all of that, $349 billion in funding was exhausted in two weeks. For 2.0, lenders' and the SBA's technology infrastructure to process large volumes of applications has dramatically improved. More than 5,000 lenders are now prepared to participate from day one and many of these lenders have been registering "pre-applications" for weeks. Some businesses that did not receive a loan in 1.0 may now be inclined to participate with a better understanding of forgiveness, more favorable tax treatment, and (relatively, compared to April 2020) more certainty about how long they'll need to operate under restrictions until vaccines are broadly rolled out. The SBA has recognized and taken steps to address this issue by limiting access to CDFIs and MDIs during the initial round of originations in the week of January 11. However, and based on all of the other considerations above, we wouldn't be surprised if the funding pool lasts only days, or at most, a few weeks once the market at large is able to participate. Because of this, lenders should make sure not only that they have the necessary processes and infrastructure in place to service the loan request volumes they saw in 1.0, but also consider capacity planning and the availability of surge resources under different volume scenarios. For example:
    - Should there be a prioritization hierarchy that would start with second draws for PPP 1.0 borrowers, followed by existing customers applying for a first time PPP loan, then opening up to new clients?
    - Should there be a dedicated queue to perform revenue reduction test reviews for second draw borrowers? And for existing clients who are expected to apply for a second loan, can the bank start some of this work now by reviewing financial information it already has on file?

- Should the lender consider outsourcing the forgiveness process, at least for loans below the $150,000 threshold, to preserve internal resources for 2.0 originations?
- Should applications with significant documentation gaps be moved to a different queue or the back of the line in general to increase the number of “clean” applications that can be processed?
- Beyond first-line or customer-facing resources, has the lender thought through all of the other functions that are necessary to support the process, and do those functions have sufficient surge staffing, as well? For example, fraud review teams became a significant bottleneck that held up originations for many lenders in 1.0.
- We suspect there are going to be some unexpected inefficiencies in all of the funding set-asides, where the bulk of the $284 billion runs out quickly but some of the protected pools are relatively unused. Lenders should plan for this with respect to the pools that operate on borrower characteristics and make sure they are identifying any special pools each borrower may be eligible for at the application stage. Also, lenders may want to consider establishing referral arrangements with a CDFI and/or MDI in the event that the primary funding the lender itself can access runs out more quickly.

One point worth making in the context of concerns about the adequacy of the funding pool: We believe the outcome of the recent Georgia run-off elections that resulted in Democrats gaining control of the Senate make additional federal fiscal relief in general much more likely. By extension, if the initial $284 billion is quickly exhausted, we think it’s more likely to be replenished than it would have been in a split Congress. However, the PPP is but one item on a very long list of hot topics in Washington and pending priorities for the incoming Biden administration, and we wouldn’t be surprised if the need to refill the PPP pool is slowed by negotiations over other priorities and a timing gap is created after it initially runs out. For example, the restaurant industry has lobbied for its preference for dedicated and direct funding grants instead of additional PPP loans. Although it lost that battle for purposes of the December relief bill, that proposal will likely resurface after the inauguration and could result in restaurants being carved out of future PPP eligibility in exchange for those grants.

Conclusion

It may not be enough money (at least right away) and it's certainly taken longer than it should have, but PPP 2.0 will nonetheless provide significant relief to borrowers and also reduce credit exposure for lenders that have existing relationships with those clients. Because of this, virtually all lenders – and especially those that participated in 1.0 and are going to have borrowers counting on them for 2.0 second draws – are going to be under significant pressure not only to participate in 2.0, but also execute the process effectively to make sure they deliver for their borrowers. We hope the thoughts we've shared here are helpful to prepare for what is going to be another unprecedented challenge to end a year that has had too many of those already.

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