The Daily Dish

Policy Design and CARES

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Eakinomics: Policy Design and CARES

The U.S. economy is suffering from massive, cascading cash-flow crunches. With the arrival of the virus, large swaths of the economy – airlines, hotels, entertainment, restaurants, and so forth – overnight lost their customers and revenue. They reacted to this cash crunch in two ways. First, there was a massive sell-off as firms dumped financial assets to get cash to pay their bills. The Fed has quite effectively addressed this by committing to open-ended liquidity for as long as necessary.

But not everyone could raise enough cash this way. Instead they laid off workers and cut off suppliers. This effectively shifted the cash-flow crunch onto other firms or U.S. households.

The Coronavirus Aid, Relief, and Economic Security (CARES) Act includes several provisions designed to provide a reprieve to homeowners. Most notably, the bill provides significant relief to holders of mortgages backed by federal loans in the form of six months to a year of forbearance and immunity from eviction or fees relating to late rent payments.

That is great for the household, but who picks up the tab? As AAF's Thomas Wade explains in The CARES Act and Mortgage Servicers, the payments are withheld from mortgage servicers, "a third party that a mortgage lender will contract with to handle the processing of the loan, which includes, for example, tracking loan payments, calculating variable interest, and filing foreclosure notices in the event of default." In performing these roles, mortgage servicers will frequently assume the loan itself, and the magnitudes of lost revenue from CARES for the servicers are staggering, estimated between $75 billion to $100 billion.

Notice that the policy design simply shifts the cash-flow cascade from households to servicers. It does not inject funds that would allow the households to defer and then hold the servicers harmless. At least nothing direct for the servicers: It is true that they will be

eligible for the large, low-cost lending programs that CARES erects. Regardless, the aid will need to come from somewhere, as nothing about the CARES Act pauses payments servicers must make to their investors or the IRS.

Separately, the Fed announced, "To facilitate lending to small businesses via the Small Business Administration's Paycheck Protection Program (PPP), the Federal Reserve will establish a facility to provide term financing backed by PPP loans. Additional details will be announced this week." Recall that the PPP are loans to small businesses (under 500 employees) that can be forgiven as long as the employers maintain their pre-pandemic levels of employment. Under the CARES Act as written, the banks must hold these loans on their balance sheet. Since the whole idea is to have the loans be forgiven, this policy is tantamount to asking banks to hold onto large amounts of non-performing loans – normally a recipe for trouble. Once again, the policy design was just shifting an earnings crunch.

Eventually, the Small Business Administration would reimburse the banks (without actually buying the loans), but the minimum wait appeared to be nearly two months. The Fed facility would permit banks to sell their loans to the Fed right away; this means both the small business and the bank can be whole and hopefully the cash-flow crunch nipped in the bud. Further, it frees up the banks to continue lending to small businesses to the extent possible.

It is important to help households and firms in these circumstances, but how one does so really matters.