

BANKING & FINANCIAL SERVICES ECONOMIC RECOVERY

U.S. TREASURY LAUNCHES SMALL BUSINESS LENDING FUND

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In this week before Christmas, the U.S. Treasury quietly launched a program that may provide relatively low-cost, Tier 1 capital to some holding companies and depository institutions. This program, the Small Business Lending Fund ("SBLF"), was authorized in September by the Small Business Jobs Act.

Background

The SBLF was created to make up to \$30 billion of capital available to smaller holding companies and institutions for the purpose of increasing lending to small business. For the first two years, the price of the capital is variable, at a rate no higher than 5%, with lower pricing afforded to participating institutions that increase their qualified small business lending over prior levels. SBLF capital may be repaid at any time, with approval of the primary Federal bank regulator.

Certain features of the SBLF may make it attractive to some institutions. In addition to the possibility of reduced pricing based on increased small business lending, institutions that have sold preferred shares to Treasury under the TARP Capital Purchase Program ("CPP") may refinance those securities under the SBLF. This may be viewed as desirable because the SBLF does not impose the executive compensation limits and dividend restrictions applicable under the CPP.

Eligibility Criteria and Pricing

The SBLF is not for all holding companies or depository institutions (collectively, "institutions"). Only institutions with assets of \$10 billion or less at the end of 2009 qualify for the program. Moreover, no institution which is, or within the preceding 90 days has been, on the FDIC "watch list" (generally an institution with a CAMELS rating of 4 or 5) is eligible. Applications under the SBLF should be submitted by March 31, 2011.

The amount of capital available depends on an institution's size. For those institutions with assets of \$1 billion or less, application may be made for an amount from 1% up to 5% of risk-weighted assets, less the amount of any securities outstanding under the CPP. For those eligible institutions with assets of more than \$1 billion, the comparable amount is from 1% up to 3% of risk-weighted assets, again less any securities issued under CPP. No institution will be permitted to participate in both the CPP and the SBLF at the same time.

Preferred shares issued to Treasury under the SBLF will have a variable dividend rate, not exceeding 5%, during the first nine calendar quarters. Each quarter, the institution's qualified small business lending at the end of the second preceding quarter will be compared to its baseline for such lending (described below). In general, the applicable dividend

rate for the quarter will be determined by the level of increase in lending over the baseline, as shown in the following table:

Lending Increase	Dividend Rate
Less than 2.5%	5%
2.5% or more, but less than 5%	4%
5% or more, but less than 7.5%	3%
7.5% or more, but less than 10%	2%
10% or more	1% ¹

Thereafter, if qualified small business lending has increased over the baseline at the end of the eighth quarter following SBLF funding, the dividend rate will be fixed at the rate determined in accordance with the table and remain in effect until 4.5 years after funding.² If such lending has not increased at the end of the eighth quarter, however, the dividend rate will increase to 7%, and remain at that level until 4.5 years after funding. After 4.5 years following funding, if not already repaid, the dividend rate will increase to 9%. Repayment may be made at any time (with approval of the primary Federal bank regulator) either in full or in amounts equal to 25% or more of the original investment.

An institution's baseline is its quarterly average qualified small business lending for the four full quarters ending June 30, 2010, adjusted for increases in such small business lending during those quarters resulting from mergers, acquisitions, or loans purchased after their origination and syndication. The baseline will also be prospectively adjusted on a cumulative basis for increases resulting from mergers, acquisitions, or loan purchases that occur after the quarter ending September 30, 2010.

Qualified small business lending consists of loans in the following categories that meet certain criteria. The loan categories are (i) commercial and industrial, (ii) loans secured by owner-occupied nonfarm, nonresidential realty, (iii) loans to finance agricultural production and other loans to farmers, and (iv) loans secured by farmland. To be qualified under the SBLF, a loan must have an original principal and commitment amount of \$10 million or less, and must not be made to a business with more than \$50 million in revenues for the most recently completed fiscal year. For purposes of the SBLF, the loan amount is reduced by the amount of any guarantee from any U.S. government agency or enterprise, and also by any participation or other interest in the loan held by a third party. The Federal bank regulatory authorities are required by the statute to issue guidance on prudent underwriting standards to be observed in making qualified small business loans under the SBLF.

An otherwise eligible institution with securities issued under the CPP wishing to refinance them under SBLF must satisfy additional



requirements. It must (i) be in material compliance with all terms of its CPP security, (ii) not have missed, or been more than 60 days late in making, one or more dividend payments on its securities issued under the CPP, and (iii) pay any unpaid CPP dividend for the period preceding the SBLF closing and accrued and unpaid CPP dividends through the date of SBLF closing. If the amount of its outstanding CPP preferred shares exceeds the maximum amount of SBLF funding available to it, the institution must redeem the excess on or before closing on the SBLF funding. Any warrants issued to Treasury under the CPP will remain outstanding unless the institution repurchases them.

Applications Process

SBLF applications by eligible institutions should be made to Treasury on prescribed forms by March 31, 2011. Submission of an application does not obligate an institution to proceed if approved by Treasury.

An applicant must simultaneously and separately submit to its primary Federal bank regulator (and, if State-chartered, to its State bank regulator) a small business lending plan of approximately two pages. The plan should describe how the institution would use SBLF funding to address the needs of small businesses in its service area, include a projection (or projected range) of the increase in small business lending anticipated two years after the Treasury investment, and explain why the projected increase in small business lending is reasonable. Treasury does not require a formal calculation or *pro forma* income statement or balance sheet at the application stage. The plan should also describe how the institution will provide linguistically and culturally appropriate outreach and advertising materials targeted to minority, women, and veterans' communities regarding availability and application processes for small business loans.

Treasury has stated that the lending plan will be deemed confidential supervisory information and individual institution plans will not be disclosed. They are to be used only in connection with the SBLF and will not substitute for any other required filing or supervisory request.

Treasury will coordinate the review of SBLF applications with the Federal (and, if applicable, State) bank regulators. Specifically, Treasury will consult the relevant Federal bank regulator in determining institution qualification to receive SBLF funding, and will consider the views of the applicable State bank regulator regarding institution financial condition.

Treasury will notify an institution of its decision under one of the following options: (i) preliminary approval; (ii) preliminary approval contingent upon the institution raising a specified amount of separate matching capital funds from private, nongovernmental sources (an option not applicable to institutions seeking to refinance CPP securities); or (iii) application considered withdrawn. Following receipt of Treasury's decision, in either of cases (i) or (ii) the institution is free to determine whether it wishes to proceed. In the case of option (ii), net private capital raised after September 27, 2010 will generally be considered as matching. Further application processing will involve interaction with private counsel representing Treasury and execution of definitive documentation by the institution.

In view of industry criticism of the CPP, statutory safeguards were included in the SBLF legislation. These include provisions intended (i) to prevent Treasury from applying newly-adopted regulations or guidance under SBLF to capital investments already made under the program, (ii) clearly to specify that institutions participating in SBLF are not thereby participating in TARP, and (iii) to permit any SBLF recipient, after consultation with its Federal bank regulator, to repay the investment without impediment if, after receiving the investment, any change in law modifies the terms of the program or the investment in any materially adverse respect for the institution.

Conclusion

The Small Business Lending Fund presents the opportunity for qualifying institutions to obtain reduced cost Tier 1 capital, while at the same time making a positive contribution to the economic recovery of small businesses in their service area. For those qualifying institutions with preferred shares outstanding under the Capital Purchase Program of TARP, the SBLF may provide an attractive exit strategy from the executive compensation, dividend, and other restrictions of that program, in addition to the possibility of reducing the cost of such capital through increased qualified small business lending. The design of the SBLF program is significantly less intrusive than TARP.

Given its features and the relatively short time before the application deadline, those institutions that qualify for it may wish to give the SBLF careful consideration.



FOR MORE INFORMATION, CONTACT:

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¹ If qualified small business lending has increased over baseline by a percentage sufficient to result in a lower dividend rate, the lower rate will apply to a dollar amount of SBLF preferred shares only up to the amount by which qualified small business lending has increased. For example, if SBLF funding were \$5 million, qualified lending increased by \$4 million, and that represented a 10% increase in the institution's qualified lending, the resulting 1% dividend rate would apply to \$4 million of the SBLF funding and a 5% rate would apply to the remaining \$1 million.

² An institution which refinanced CPP securities under the SBLF and which has not increased its qualified small business lending at the end of the eighth quarter after its SBLF funding will be required to pay an additional lending incentive fee to Treasury. This fee, equal to 2% p.a. of the amount of the preferred shares issued under SBLF, will be payable on the fifth anniversary of issuance of the CPP securities, and at the beginning of each full calendar quarter thereafter, until 4.5 years after the SBLF closing.