# Understanding the Small Business Lending Fund

Robert L. Carothers, Jr.
Jones Walker
Mobile, Alabama
January 20, 2011

# I. Background

- The President initially proposed the Small Business Lending Fund ("SBLF) in February 2010.
- September 27, 2010: The President signs the Small Business Jobs Act of 2010 authorizing the establishment of the SBLF.
- The SBLF authorizes the U.S. Treasury Department to invest up to $30 billion in community banks with the objective of stimulating small business lending.
- December 20, 2010: Treasury issues an application form, term sheet and additional guidance for C Corporations.
  - The term sheet does not apply to mutuals, S Corporations or community development loan funds. Treasury is currently working on separate term sheets for these institutions.

# II. Who's Eligible to Participate?

- Financial institutions with total consolidated assets of less than $10 billion at December 31, 2009, are eligible to apply.
- If consolidated assets are $1 billion or less, an applicant is eligible to apply for an SBLF investment of up to 5% of its risk-weighted assets.
- If consolidated assets are more than $1 billion and less than $10 billion, an applicant is eligible to apply for an SBLF investment of up to 3% of its risk-weighted assets.

# Who's Eligible to Participate? (Cont'd)

- Banks on the FDIC's problem bank list (generally CAMELS 4 or 5-rated banks) or that have been removed from the list for less than 90 days are not eligible to apply.

# III. Application Process

- The applicant will be the top tier holding company.
- Applicant will file a one page application with Treasury. Application deadline is March 31, 2011.
- Applicant will also file a small business lending plan with its federal and state regulators at the time it submits the application.
- Applications will be reviewed as received and once approved it's anticipated that funding can occur soon thereafter.

# Application Process (Cont'd)

- Two-tier review process.
  - Treasury will review the applicant's proposed small business lending plan and will evaluate whether the applicant appears capable of generating qualified small business loans.
  - If Treasury believes a bank is capable of executing its small business lending plan, it will then consult with the bank's federal and state regulators to determine whether an investment should be made based on the risk associated with its financial condition.
  - Just because a bank has a CAMELS rating of 1, 2 or 3 doesn't mean it automatically gets approved.

# Application Process (Cont'd)

- Matching Capital
  - If a bank would not otherwise qualify due to its financial condition, Treasury (based on a recommendation from the regulators) may allow such a bank to participate if it raises a sufficient amount of private capital. (This does not provide a mechanism for 4 or 5-rated banks to participate).
  - Presently, it's unclear what criteria Treasury will use in determining which banks have to raise private capital.
  - Best Guess: If a bank has a significant concentration in ADC/CRE, negative trends with respect to asset quality, earnings, or capital, then it's more likely to be subject to a capital raise requirement. Probably no hard and fast rules, but rather a bank-specific analysis.
  - If subject to a capital raise requirement, the applicant is limited to an investment of up to 3% of its risk-weighted assets (even if its assets are $1 billion or less).
  - Generally, capital raised since September 27, 2010, will be allowed to count towards any capital raise requirement.

# IV. Key Terms of SBLF

- SBLF Investment will be in the form of noncumulative preferred stock.
- SBLF Investment will receive Tier 1 capital treatment.
  - Some commentators speculate that under Basel III, Tier 1 treatment at holding company level could be phased out beginning in 2013. However, other commentators believe it will continue to qualify as Tier 1 under Basel III and will not be subject to a phase-out.
- Dividend Rate
  - During the first two years, the dividend rate will adjust quarterly based on the increase in amount of small business lending as compared to the baseline.
    - Less than 2.5% Increase = 5% dividend rate
    - 2.5% - 4.99% Increase = 4% dividend rate
    - 5.0% - 7.49% Increase = 3% dividend rate
    - 7.5% - 9.99% Increase = 2% dividend rate
    - 10% or greater Increase = 1% dividend rate
  - The reduction in the dividend rate will not apply to a dollar amount of the SBLF investment that is greater than the dollar amount of the increase in small business lending compared to the baseline. The rate on any amount of the SBLF investment that is in excess of the increase in the amount of small business lending will be 5%.
    - Example: Assume the amount of SBLF funding is $5 million, small business lending has increased by $4 million, and this represents a 10% increase over the baseline, resulting in a 1% dividend rate. Based on these assumptions, the 1% rate applies to $4 million of the investment amount and 5% applies to the remaining $1 million.

# Key Terms (Cont'd)

- The baseline for purposes of determining changes in the amount of small business lending is the average amount of small business loans (as defined in the Act) reported in the call reports for the quarters ending 9-30-09, 12-31-09, 3-31-10, and 6-30-10, less certain adjustments.
- During the period beginning 2 years from the date of the investment and ending 4½ years from the date of investment, the dividend rate will be fixed. The fixed rate will be based on the schedule set forth above using call report data for the 8th quarter following the date of the investment.
  - If small business lending has remained the same or decreased, then the fixed rate during this period will be 7%.
- When the investment has been outstanding for 4 ½ years, the dividend rate increases to 9% irrespective of any increases in small business lending.

# Key Terms (Cont'd)

- Definition of small business lending.
  - The SBLF has a unique and broad definition of small business lending.
  - Small business loans include the following items in the call report: (i) commercial and industrial loans, (ii) owner-occupied nonfarm, nonresidential real estate loans, (iii) loans to finance agricultural production and other loans to farmers, and (iv) loans secured by farmland.
  - The SBLF excludes from this definition (i) any loan with an original principal amount greater than $10 million, (ii) a loan made to a business with annual revenue greater than $50 million, (iii) the portion of any loan guaranteed by the U.S. government, and (iv) the portion of any loan whose risk is assumed by a third party.
    - A group of loans to the same borrower or affiliate is treated as a single loan.
    - Borrower's revenue is based on the most recent fiscal year that had ended when the loan originated (using the borrower's parent company where applicable).

# Key Terms (Cont'd)

- SBLF is not a TARP program and TARP restrictions are not applicable.
- Consequences of Missing an SBLF Dividend Payment
  - For any missed payment, senior management must provide written notice to Treasury explaining why the dividend wasn't paid and the participant is prohibited from paying dividends on other equity securities for the quarter of the missed payment and the following three quarters.
  - If it misses four dividend payments (whether or not consecutive) and wasn't subject to a regulatory action prohibiting the payment of dividends, then the board must certify to Treasury that it used its best efforts to pay the dividend.
  - If it misses five dividend payments (whether or not consecutive), Treasury can appoint an observer to the board.
  - If it misses six dividend payments (whether or not consecutive), Treasury can elect two board members (if the SBLF investment is $25 million or greater).
  - The right to appoint an observer or elect board members expires when full dividends have been paid for four consecutive dividend periods.

# Key Terms (Cont'd)

- Restrictions on Payment of Dividends
  - Generally, participants may pay dividends on common stock and preferred stock and repurchase such securities, as long as after giving effect to the dividend payment or stock repurchase, the dollar amount of its Tier 1 capital would be at least 90% of the Tier 1 amount that existed at the time immediately after the closing date of the investment.
  - After two years, the 90% threshold may be lowered depending upon the amount of the increase in small business lending.
  - For privately-held institutions, dividends are prohibited after the 10$^{th}$ anniversary of the date of the investment (this should not be an issue since the investment should have been repaid by this time).

# Key Terms (Cont'd)

- SBLF preferred stock is non-voting, other than consent rights granted to Treasury with respect to (i) any authorization or issuance of shares senior to the SBLF preferred, (ii) any amendment to the rights of the SBLF preferred, and (iii) any merger, exchange, dissolution or similar transaction which would affect the rights of the SBLF preferred.
- Participants may redeem the SBLF preferred at any time without penalty, as long as it receives prior approval from its regulators. Approval will depend on the bank's financial condition at the time the request is made.
- Prudent Underwriting Standards
  - The Act requires the banking agencies to issue guidance on prudent underwriting standards to be used in originating small business loans.
  - The agencies issued these standards on December 23, 2010.
  - The standards are very general in nature. They should not pose an issue.

# V. Exchanging TARP For SBLF

- TARP participants can apply to exchange their TARP funding for SBLF funding.
- Applicants will be subject to the same approval criteria as non-TARP applicants.
- The exchange could result in a lower dividend rate.
- An applicant can apply for an SBLF investment in excess of its outstanding TARP, subject to the 3%/5% maximum limit.
- If a TARP participant has missed more than one dividend payment, it is not eligible for the exchange. Also, it must be in material compliance with the terms of its TARP investment.
- If small business lending has not increased relative to the baseline in the $8^{th}$ quarter after SBLF funding is received, the participant must pay an added quarterly "lending incentive fee" equal to 2% per annum on its outstanding SBLF investment. This fee is payable during the period beginning on the $5^{th}$ anniversary of the TARP investment date and ending 4 ½ years from the date the institution refinances into the SBLF.

# VI. Issues to Consider

- A bank should evaluate whether it has the ability to sufficiently (and prudently) increase its small business lending in order to take advantage of the lower dividend rate.
  - Be careful not to sacrifice asset quality by lowering underwriting standards in order to achieve a reduced dividend rate.
  - Look closely at the definition of qualified small business lending to determine if your bank generates the types of loans that qualify.
- A bank should have a plan in place to repay the SBLF investment within 4 ½ years.
  - Dividend rate increases to 9% at this time.
  - Regulator approval is required in order to redeem.

# Issues to Consider (Cont'd)

- Future Changes to the Program
  - Some banks have expressed concern over whether Congress or Treasury will change the terms after an investment has been made.
  - Congress can change the terms through the legislative process. However, this is a program that's important to the President and any legislative changes would need his approval (as well as support from both sides of the aisle).
  - This is a small program compared to TARP ($30 billion vs. $700 billion), is only available to community banks, and is designed to stimulate small business lending (as opposed to being viewed as a bailout fund for large banks). Thus, the SBLF should attract less legislative attention.
  - The Treasury Secretary has authority to issue additional guidance, which could include additional restrictions. However, it would seem unlikely that any change in terms occurring after an investment has been made would apply to existing participants.
  - If the terms do change, banks can redeem with regulator approval.

# Issues To Consider (Cont'd)

- Public Opinion
  - Some banks have expressed concern that the media and public may paint the SBLF as another taxpayer-funded bailout, which could harm their reputation.
  - The terms of the SBLF make it clear that (i) only healthy community banks are eligible, and (ii) the objective is to increase small business lending. It's clear that this is not a bailout program.
  - The Act specifically states that it's not a TARP program.
  - Due to the relatively small size of the SBLF, the fact that it's not open to large banks and its objective is increasing small business lending, it seems unlikely that it would receive much negative media attention.
  - The names of participants will become public and competitors could attempt to use this to their advantage by misleading customers about the objectives of the SBLF.

# Issues to Consider (Cont'd)

- Treasury has authority to look at the books and records of participants and discuss matters relevant to the investment with management. It's likely that Treasury will rarely use such authority.
- Additional Administrative Requirements
  - Participants will have to submit quarterly reports to Treasury providing data on small business lending (dividend rates are based on these reports).
  - Due to the SBLF's unique definition of qualified small business lending, participants will need to develop procedures for tracking loans meeting the definition so that quarterly reports are accurate.
  - Participants will have to submit a short annual lending survey to Treasury.
  - Participants have to provide "linguistically and culturally appropriate" outreach and advertising describing the availability and application process for small business loans and targeting minorities, women and veterans.
  - The Act requires participants to obtain from its business borrowers a certification that its principals have not been convicted of a sex offense against a minor.
  - A participant must submit an annual certification that it's in compliance with anti-money laundering rules. Its auditor must submit an annual certification that the bank's processes and controls used to generate quarterly reports on small business lending are satisfactory.

# Question & Answer Session

Please enter your questions in the box on the lower right hand side of your screen in the area provided.

# Contact Information


Rob Carothers, Partner

Banking & Financial Services Practice Group

Jones Walker

254 State Street

Mobile, AL 36603

251.439.7522

rcarothers@joneswalker.com

www.joneswalker.com