



## Alerts

### Small Business Lending Fund Terms and Application Process

January 5, 2011

*Corporate / Financial Institutions Alert*

On September 22, 2010, President Obama signed into law the Small Business Jobs Act of 2010, a new package of small business incentives. Part of these new incentives included the creation of a capital program, administered by the U.S. Department of the Treasury (the Treasury), to provide up to \$30 billion of capital funds to eligible community banks in order to promote lending to small businesses—the Small Business Lending Fund (SBLF).

On December 22, 2010, the [Treasury issued guidelines](#) setting forth the terms, conditions and process for the submission of applications by qualified banks and bank holding companies to obtain access to the SBLF funds.

All applications should be filed with the Treasury as soon as possible. While capital funding from the SBLF will be available through September 27, 2011, the Treasury has specifically indicated that all applications should be filed no later than March 31, 2011. The Treasury will make a determination, after consulting with the applicant's primary federal/state regulator, whether to accept the application.

As discussed in greater detail below, the Treasury may condition acceptance of an application on the additional requirement that an applicant raise matching capital from private sources. Even if an application is accepted by the Treasury for inclusion in the SBLF, there is no requirement that the applicant actually complete or accept the funds from the program. The SBLF application can be withdrawn at any time by a bank or bank holding company prior to actual funding by the Treasury.

*The current SBLF terms do not apply to mutual institutions, Subchapter S corporations or community development loan funds. Additional SBLF terms and conditions for these forms of financial institutions will be issued by the Treasury in the near future.*

The following memorandum discusses key terms and conditions that apply to eligible banks that wish to participate in the SBLF program.

#### Eligibility

For purposes of the SBLF, the Treasury has defined “community bank” and “bank” to include banks, thrifts and their parent holding *companies that had less*

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than \$10 billion in consolidated assets as of the end of the fourth quarter of calendar year 2009. For any bank that is controlled by a bank holding company, the combined assets of the holding company will determine eligibility, and the bank holding company will be required to submit the SBLF application and supporting information. In addition to the \$10 billion asset qualification ceiling, a bank or bank holding company will not be eligible if the bank or any bank holding company subsidiary bank currently or within the previous 90-day period has been identified as a “problem bank” by the Federal Deposit Insurance Corporation (FDIC). In general, an application by a bank (or a bank that owns a bank) that has a composite “4” or “5” CAMEL rating (or had such a rating within the preceding 90 days) will not be considered.

### **Eligibility Open to TARP CPP/CDCI Recipients**

The SBLF is also available to banks and bank holding companies that are participants in the Treasury’s Capital Purchase Program (CPP) or Community Development Capital Incentive (CDCI). In order to participate in the SBLF, the bank or bank holding company will be required to either repay or refinance all outstanding CPP or CDCI securities. As a prerequisite to any refinancing of CPP or CDCI securities under the SBLF program, applicants must be current with dividend payments to the Treasury and must not previously have defaulted on more than one dividend payment. If the CPP or CDCI securities have not been fully repaid, the refinanced amount of CPP/CDCI securities will be deducted from the amount of capital otherwise available to the bank or bank holding company from the SBLF program.

### **SBLF Funds—Available Amounts**

The maximum amount of SBLF capital funds that are available is determined on a sliding scale that takes into consideration both the applicant’s total consolidated assets and the amount of risk-weighted assets as of the end of the fourth quarter of 2009. Eligible banks or bank holding companies with consolidated assets of less than \$1 billion may apply for SBLF capital funds in an amount up to 5 percent of risk-weighted assets. Banks and bank holding companies with between \$1 billion and \$10 billion in consolidated assets are limited to SBLF capital funds of no more than 3 percent of risk-weighted assets.

### **SBLF Funds—Tier I Capital**

SBLF funds will be treated as Tier I capital and the Treasury will purchase senior perpetual noncumulative preferred stock (or an equivalent). The stock will pay a quarterly dividend on the first day of each quarter after closing of the SBLF capital program funding.

Banks and bank holding companies planning to apply for funding should review their charters to make certain that they have preferred stock available to sell to the Treasury. If not, they will be required to amend their charters to authorize the preferred stock. Normally, any such charter amendment will require the prior approval of shareholders.

### **Quarterly Dividend Calculation—Terms and Conditions**

*General.* The quarterly dividend rate paid to the Treasury on the preferred stock will depend on the amount of the applicant’s additional lending to qualified small businesses. As a part of application process, eligible banks or bank holding companies will be required to establish a baseline for measuring increases to small business lending. This baseline will be calculated by taking into consideration the average amount of qualified small business loans made during the four calendar quarters ending on June 30, 2010. This baseline amount may be adjusted to add any loans that are subsequently obtained through a merger or acquisition transaction or for those that are simply purchased by the bank. The adjustment to the baseline will discount these loans from the quarterly dividend rate calculation.

At the time the Treasury purchases the preferred stock, the bank or bank holding company will be required to prepare and submit a supplemental report that calculates any increase in small business lending over the baseline amount, as disclosed on the Call Report filed in the immediately preceding calendar quarter. Using this method, the dividend rate to be paid for the first quarter after SBLF capital funding will range on a graduated scale from a maximum rate of 5 percent of SBLF capital funds to a low dividend rate of 1 percent.



*Dividend Rate—First Nine Quarters.* During each of the first nine calendar quarters after funding, the bank or bank holding company will be required to recalculate the quarterly dividend rate by comparing the baseline small business loan amounts against the amount identified on the Call Report filed in the immediately preceding quarter. Therefore, the dividend rate during the first nine calendar quarters will fluctuate up or down for each quarter between the high 5 percent dividend rate and the 1 percent low dividend rate. For example, an increase in small business lending of 2.5 percent but less than 5 percent will result in a quarterly dividend rate of 4 percent. A lending increase of 5 percent but less than 7.5 percent will provide for a quarterly dividend rate of 3 percent. An increase in small business lending between 7.5 percent but less than 10 percent will result in a quarterly dividend rate of 2 percent. Any increase in small business lending of 10 percent or more will result in a quarterly dividend rate of just 1 percent.

During these initial nine quarters, any decrease in the dividend rate below 5 percent will only apply to the actual dollar amount of increased small business loans above the baseline amount. For example, if SBLF capital funding is made in the amount of \$5 million and small business loans increase \$4 million (representing a 10 percent increase over the baseline amount of \$40 million), the applicable quarterly dividend rate on the first \$4 million of SBLF capital would be at the lowest 1 percent rate. The remaining \$1 million of SBLF capital would have a dividend rate set at 5 percent.

*Dividend Rates—10th Quarter; 18th Quarter.* Beginning in the tenth calendar quarter, the dividend rate calculated will remain in effect as a fixed dividend rate for the next two years. If this 10th quarter dividend rate calculation indicates that there has been no increase in small business lending against the baseline amount or if there has been a decrease below the baseline, the quarterly dividend rate will be fixed at 7 percent for the next eight calendar quarters.

If the bank or bank holding company has not redeemed the preferred stock within four and one-half years, the quarterly dividend rate will automatically increase to 9 percent beginning in the 18th quarter after funding.

*Dividend Rate—CPP Refinancing.* If the eligible bank or bank holding company has used SBLF capital funds to refinance CPP securities and the quarterly calculation for the eighth SBLF quarter indicates that there has not been an increase in small business lending, the Treasury will impose an additional lending incentive fee of 2 percent per annum on the total outstanding SBLF funds. This additional lending incentive fee will be assessed in the first quarter after the fifth anniversary of the original CPP investment and will continue for either the next four and one-half years or until SBLF capital funds have been repaid.

## **Calculation of Qualified Small Business Lending**

The SBLF definition of “small business lending” differs from that commonly used in the Call Reports filed by community banks. However, subject to further conditions discussed below, the following loans that fall within the Call Report categories qualify as small business lending for purposes of the SBLF: (i) commercial and industrial loans; (ii) loans secured by owner-occupied nonfarm, nonresidential real estate; (iii) agricultural production financing or other loans to farmers; and (iv) loans secured by farm land.

SBLF-qualified loans in any one or more of the four general categories identified above are further conditioned by the requirement that they may not be greater than \$10 million in original principal commitment and must only be made to businesses that have no more than \$50 million in annual revenues. The business’s annual revenues are calculated at the end of the most recent fiscal year end that is immediately prior to the small business loan origination date.

To calculate the maximum \$10 million amount of lending that will qualify as small business lending for purposes of the SBLF, the bank will be required to aggregate loan commitments made to the same borrower or its affiliates and must treat these separate commitments as a single loan. The aggregated loans must not exceed the \$10 million maximum for inclusion as qualified “small business lending.” In addition, when calculating the maximum loan amount that will qualify for purposes of the SBLF, a bank may exclude the portion guaranteed by the United States from the loan amounts. If a third party has assumed an economic interest in any part of a loan, that portion is also excluded.

## **SBLF Application Process**



Although the SBLF has been established as a one-year program, the Treasury has indicated a preference that all applications *should be filed no later than March 31, 2011*. Submitting an application to the Treasury does not obligate the applicant to actually complete the process or require it to accept the SBLF funds, if it is approved.

The Treasury has created a [short application form for banks and bank holding companies](#). The fully completed form is required to be filed electronically via e-mail to the Treasury.

The single-page application requires the applicant's name; type of charter or formation; its primary federal/state regulatory agency; its assets as of the end of the fourth quarter 2009; whether the SBLF capital will be used to refinance CPP or CDCI securities previously issued; and the amount of the requested SBLF investment sought from the Treasury. The application must be executed by an official of the bank or bank holding company.

### **Small Business Lending Plan**

In addition to the application form, applicants *must submit to their primary federal/state regulatory agency* a small business lending plan (Plan). This Plan requires the applicant to specifically identify how its proposed participation in the SBLF will address the needs of small businesses that are located in the bank's market area. The applicant must also project the increase in small business lending that will be achieved or obtained during the first two years following the bank's receipt of SBLF funds. The Treasury has indicated that applicants should explain their small business lending goals and describe how the projected increase in lending is reasonable in context of the applicant's size and market area. Lastly, the applicant must identify the manner in which it will publicize the availability of the small business loans to its market area or how it will otherwise complete community outreach to organizations, trade associations and individuals that represent or work with women, minorities and veterans.

*The Plan is not submitted to the Treasury.* Instead, it is required to be filed at the same time as the SBLF application is filed with the Treasury with the applicant's primary federal regulatory agency and, if the bank is a state-chartered financial institution, with the appropriate state regulatory agency. The Treasury will consult with these primary regulatory agencies in making a final determination on approval of the SBLF application. Bank holding companies must submit the Plan to their regional Federal Reserve Bank. [Contacts for each of the Federal Reserve Banks](#) that can provide additional information on the filing process can be found on the Federal Reserve's website.

The Plan will be deemed to be confidential supervisory information. Individual bank Plans will not be disclosed. Information contained in the Plan will be used only in the context of the SBLF. The Plan will not substitute for any other supervisory request for information or required filing.

### **Application Process**

Following review of the application and the Plan, the Treasury will notify the applicant whether approval has been given. If the applicant elects to continue, the Treasury will assign an outside law firm as its representative to complete the closing of the Treasury's purchase of the preferred stock by means of a letter agreement and a securities purchase agreement.

As an alternative to full approval, the Treasury may condition participation in the SBLF capital funding program by requiring that an applicant raise matching capital from private nongovernmental sources. If a matching fund condition is imposed by the Treasury, the maximum amount of SBLF capital funds that will be available to the bank or bank holding company will be limited to 3 percent of risk-weighted assets.

Lastly, the Treasury may determine, after consultation with the applicant's primary federal/state regulatory agency, that the applicant is not eligible for participation in the SBLF program. In that event, the Treasury will notify the bank or bank holding company that the application is considered to have been withdrawn.

The mere filing of an application does not bind any bank or bank holding company to continue with the SBLF program. An application may be unilaterally withdrawn by the bank or bank holding company at any time prior to closing of the letter agreement and securities purchase agreement.



## Downstreaming of SBLF Funding

When a participating eligible community bank is controlled by a bank holding company, the application submitted for participation in the SBLF must be made by the bank holding company. Upon closing of the SBLF funding, the bank holding company is required to downstream no less than 90 percent of the SBLF capital funds to its subsidiary community banks. If the bank holding company controls more than one eligible bank, no single bank may receive SBLF capital in an amount that is more than the applicable 3 percent or 5 percent risk-weighted funding limits discussed above.

## Post-SBLF Funding Dividend Conditions

While the general terms and conditions of the SBLF do not prohibit participating community banks from making continued dividends to their shareholders or from redeeming shares, there are several conditions that may affect these dividends or repurchases. During participation in the SBLF funding program, any dividend or securities redemption must not result in more than a 10 percent decrease in the bank's Tier I capital from a level existing immediately after the closing of the SBLF securities purchase agreement. Any charge off of loans or any partial repayment of the SBLF capital funds will be excluded from the Tier I capital calculation.

Beginning in the third year and continuing through the tenth year, an additional 10 percent decrease in required Tier I capital will be allowed for each 1 percent increase in small business lending. Upon full repayment of the SBLF funds, there will no longer be any special requirements to maintain Tier I capital.

## Dividend Defaults

If the bank or bank holding company is unable to pay the required quarterly dividends, senior management must provide the Treasury with written notice and an explanation as to the cause of any dividend default. In addition, during any default quarter and for the following three quarters, the bank or bank holding company will be prohibited from repurchasing or paying dividends on any securities that are *pari passu* or junior to the Treasury's securities. If dividend defaults continue for four quarters, senior management must certify to the Treasury that they have used their best efforts to declare and pay such a dividend. Any default that continues for five quarters will provide the Treasury with a right to appoint an observer to the bank's or bank holding company's board of directors. If the dividend default continues for six quarters, and the total SBLF funds outstanding equal \$25 million, the Treasury has the right to elect two directors to the bank's or bank holding company's board of directors. The Treasury's right to appoint directors will expire once full dividends have been paid for four quarters.

In case of a Treasury dividend default, there is a prohibition on redeeming or paying dividends on other securities that either rank *pari passu* or are junior to stock held by the Treasury. The prohibition will be effective during the default quarter and for the next three quarters. However, for any quarter in which the Treasury dividend is paid, the bank or bank holding company will be allowed to pay dividends on other *pari passu* shares only to the extent that such dividend is required to prevent a material covenant breach.

Lastly, privately held banks and bank holding companies are prohibited from paying any dividends to *pari passu* or junior securities after the 10th anniversary of SBLF funding.

## Post-SBLF Funding Reporting Requirements

Banks or bank holding companies that participate in the SBLF will be required to submit both quarterly dividend rate calculations and an annual lending survey to the Treasury. Each of the supplemental reports must also be signed by the bank's chief executive officer, its chief financial officer and by each of the directors that would otherwise sign the Call Report.

For the first three years of SBLF participation, banks and bank holding companies must submit an annual certification from their auditors that the processes and controls used to generate the initial and quarterly supplemental reports are



accurate.

In addition, participating banks and bank holding companies must annually certify that the principals of the businesses that receive qualified small business loans have neither been convicted nor pled *nolo contendere* to a sex offense against a minor. Participating banks and bank holding companies are required to maintain these annual certifications in accordance with standard recordkeeping requirements.

Lastly, participating banks and bank holding companies must annually certify that they are in compliance with federal anti-money-laundering requirements, in particular the customer identification program requirements.

### **Redemption of Treasury Securities**

The SBLF capital funds may be repaid at any time, subject to prior approval by the bank's or bank holding company's primary federal regulator. Partial redemptions equal to at least 25 percent of the original SBLF funding are also allowed. Any redemption must include all accrued and unpaid dividends for the current dividend period.

### **Distinctions from TARP**

There appears to have been a concerted effort to distinguish the SBLF from the previous Troubled Asset Relief Program (TARP) initiatives and to eliminate negative conditions and connotations that were attributed to TARP-related funding. Banks and bank holding companies that elect to participate in the SBLF are not subject to executive compensation or absolute dividend restrictions. Warrants will not be issued in connection with the SBLF capital funding program. Lastly, unlike with the TARP, the SBLF's terms and conditions may only be changed by a subsequent change in the Small Business Jobs Act of 2010. The Treasury has no unilateral authority to impose any additional terms or conditions to the SBLF.

It should be remembered, however, that the Stimulus Act (enacted in February of 2009) made substantial revisions to TARP rules (especially with respect to executive compensation), which revisions were applicable to TARP participants which received funding prior to February 2009.

### **Term Sheet**

Click here to download or read the [Small Business Lending Fund Short-Form Term Sheet](#).

For more information, please contact [Michael D. Morehead](#), [Timothy Sullivan](#) or your regular [Hinshaw attorney](#).

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