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CAPITAL FOR BANKS FROM THE TREASURY'S SMALL BUSINESS LENDING FUND—APPLY BY MAY 16 AND CONSIDER TERMS BEFORE CLOSING

The Small Business Lending Fund ("SBLF") was approved as part of the Small Business Jobs and Credit Act of 2010 (the "Act"), which was signed into law on September 27, 2010. The Act, including the SBLF, is intended to promote small businesses and job growth.

The SBLF offers banks and thrifts ("banks") with consolidated assets of less than $10 billion the opportunity to issue capital instruments to the Treasury, bearing rates that decrease as the issuers' originations of qualifying small business loans ("Qualified Loans") increase compared to a baseline (the "Baseline") of the average Qualified Loans outstanding during the four quarters ended June 30, 2010 (the "Baseline Period").

The SBLF guidelines were first published in late 2010, and an initial application deadline of March 31, 2011 was set for banks other than mutual institutions and those electing to be taxed under Subchapter S ("Sub S") of the Internal Revenue Code of 1986 (the "Code"). Only about 600 banks have applied for approximately $9 billion of SBLF funds. The Treasury has extended the application deadline to May 16, 2011.

Banks that may be eligible for SBLF capital should carefully consider the SBLF following submission of an application and before closing. Many of the SBLF program terms and processes have been developed and changed since the initial terms were published. Requested SBLF amounts can be reduced, and banks have the option not to close after SBLF funding has been approved by the Treasury.

WHAT IS THE SBLF?

The SBLF is a $30 billion fund authorized by the Act and administered by the Treasury, and it is separate from the Troubled Asset Relief Program ("TARP"). Eligible banks with less than $10 billion of assets may acquire capital from the SBLF upon application to the Treasury and their primary regulators. The

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instruments are intended to be Tier 1 capital with variable annual rates ranging from 1 percent to 9 percent, with the maximum rate applying to all issuers beginning 4.5 years after the issuance to the Treasury. SBLF funds can be used by banks to retire TARP Capital Purchase Program ("CPP") funds in their entirety with appropriate approvals. Banks cannot have both TARP and SBLF funds.

The Treasury has published application and reporting forms and term sheets, but not the actual preferred stock and stock purchase documents. Term sheets for mutual and Sub S banks have not yet been proposed.

APPLICATIONS AND ELIGIBILITY

The Treasury's application forms are extremely simple and include a two-page small business lending plan (the "Lending Plan"). The Lending Plan requires estimates of Qualified Loans but is "not intended" to be a formal business plan for bank regulatory purposes. The Lending Plan also requires a community outreach and advertising plan for small business lending. This should be consistent with and supportive of the applicant's Community Reinvestment Act ("CRA") plan and efforts. The Lending Plan also needs to be consistent with any existing business plan approved by the bank's regulators and comply with any regulatory enforcement actions applicable to the bank.

The application process includes Treasury consultation with the applicable bank regulators. The process and the Treasury's criteria for approval are unclear, and they do not appear to reflect the recommendations made by the General Accountability Office ("GAO") in *Troubled Asset Relief Program—Opportunities Exist to Apply Lessons Learned from the Capital Asset Purchase Program to Similarly Designed Programs and to Improve the Repayment Process*, GAO-11-47 (October 2010).

The following are important:

- Only one application for, and disbursement of, SBLF funds is permitted;
- The application is confidential, although reports of Qualified Loans and changes in qualified lending generally are not;
- Problem banks (generally any bank with a CAMELS rating of 4 or 5) or banks that have been on the FDIC's problem bank list within the last 90 days are *ineligible* for the SBLF;
- Only the top tier holding company may apply for the SBLF, and all banks within the consolidated group are considered in determining the applicant's asset size;
- Similar to the TARP CPP, the Treasury may require matching private capital subordinate to SBLF capital. Capital raised after September 27, 2010 on terms satisfactory to the Treasury from persons not recipients of SBLF funds may qualify for purposes of the match;
- Where the Treasury requires private matching capital, the bank's total SBLF funding cannot exceed 3 percent of its risk-weighted assets regardless of the bank's size;
- All outstanding TARP CPP must be retired, whether from private sources, the SBLF funds, or a combination.

Issuers will file an Initial Supplemental Report with the Treasury five days before closing the sale of SBLF Preferred Stock to determine the Baseline amount of Qualified Loans and related adjustments, including net charge-offs, the initial quarter-end amount of Qualified Loans, and the initial dividend rate on SBLF Preferred Stock. The initial dividend rate is a weighted average of (i) the base rate of 5 percent and (ii) any reduced rate that reflects percentage increases in Qualified Loans over the Baseline, which will apply only to the dollar amount of SBLF Preferred Stock equal to the dollar increase in Qualified Loans over the Baseline. This Initial Supplemental Report has to be certified by the issuer's CEO, CFO, and three bank directors. Bank holding company Initial Supplemental Reports require no director certifications.

PRINCIPAL TERMS OF SBLF PREFERRED STOCK

The SBLF Preferred Stock is perpetual, noncumulative, and nonvoting. The SBLF Preferred Stock will be *pari passu* with the issuer's most senior outstanding preferred stock and senior to all the issuer's other preferred and common stock. Banks and their holding companies with consolidated assets of $1 billion or less generally may issue SBLF preferred stock in an amount up to 5 percent of risk-weighted assets. Those banks and their holding companies with consolidated assets of $1 billion to $10 billion, and those institutions that are required to have matching

private capital, can issue SBLF preferred stock only up to 3 percent of their risk-weighted assets. Unlike the TARP CPP, no warrants to purchase issuer common stock are required by the SBLF, and there are no SBLF constraints on executive or other compensation.

Qualified Loans. The dividend rate on SBLF Preferred Stock depends on each issuer's Qualified Loan originations and outstanding amounts of, and increases in, Qualified Loans. Qualified Loans are defined by reference to the following Call Report categories and related FFIEC instructions:

- Commercial and industrial loans ("C&I Loans");
- Loans secured by owner-occupied nonfarm, nonresidential real estate ("Owner-Occupied CRE Loans");
- Agricultural production loans and other loans to farmers ("Agricultural Loans"); and
- Loans secured by farm land ("Farm Loans").

Each loan in these categories also must be related to an aggregate commitment of $10 million or less to the same "small" borrower and its affiliates. It is unclear whether the Treasury will use regulatory loan-to-one borrower concepts to determine this aggregation. Additionally, a borrower under Qualified Loans must be "small" and cannot:

- have aggregate consolidated revenues, including its ultimate parent company, for the most recent fiscal year of more than $50 million; and
- have any principals who have been convicted of or pleaded *nolo contendere* to a sex offense against a minor.

Loans or interests in Qualified Loans that result from mergers, acquisitions, or loan purchases ("Acquired Loans") after the Baseline Period will not count as increases in Qualified Loans. Instead, Acquired Loans will increase the issuer's Baseline of Qualified Loans cumulatively from the quarter ended September 30, 2010. Cumulative net charge-offs of Qualified Loans beginning July 1, 2010 are added back to the total Qualified Loans for each Call Report. Absent Treasury guidance to the contrary, sales of Qualified Loans would reduce the amount of Qualified Loans and reduce the rate of growth of such loans, even if undertaken to improve a bank's credit quality and risks. Accordingly, Qualified Loans not only need to be originated by the issuer, but also need to be held by the issuer to achieve reduced dividend rates on SBLF Preferred Stock.

Dividend Rates. Dividends are payable quarterly on January 1, April 1, July 1, and October 1, at a floating rate for the first nine quarters after issuance based on the percentage changes in Qualified Loans originated over the Baseline amount. The variable rate in effect at the beginning of the 10th calendar quarter is fixed for the next eight quarters. Presumably, this would be the weighted average rate of 5 percent and the variable rate then in effect. If Qualified Loans have not increased from the Baseline at the end of the eighth quarter, the SBLF Preferred Stock will have a 7 percent annual rate. Beginning in the 19th quarter after issuance, all SBLF Preferred Stock will pay dividends of 9 percent annually, regardless of the volume of Qualified Loans.

The initial annual rate of 5 percent on SBLF Preferred Stock will decline 1 percent for each 2.5 percent increase in Qualified Loans over the Baseline to a minimum rate of 1 percent for increases of Qualified Loans of 10 percent or more over the Baseline. The reduced rate will apply only to the dollar amount of SBLF Preferred Stock equal to the dollar amount that Qualified Loans have increased over the dollar amount of such loans in the Baseline calculation, with the balance carrying a 5 percent rate. Therefore, the dividend rate on SBLF Preferred Stock is expected to be a weighted average rate during the first 10 quarters. Shares of the same series of preferred stock cannot carry different dividend rates generally under applicable corporate laws.

Use of Proceeds. SBLF funding is available only to the top tier bank holding company. Ninety percent of the proceeds from the issue of SBLF Preferred Stock must be downstreamed by the issuer to its bank subsidiary. If there is more than one bank subsidiary, each bank is limited to proceeds equal to the same percentage of risk-weighted assets as the eligible assets of the group permit (*i.e.*, 3 percent or 5 percent of risk-weighted assets). If SBLF Preferred Stock is used to repay TARP CPP, 90 percent of any amounts exceeding that needed to repay the TARP CPP must be downstreamed to the issuer's subsidiary bank(s). Also, if SBLF Preferred Stock is used to repay TARP CPP, the issuer will have to pay, beginning on the fifth anniversary of the TARP CPP funding, a 2 percent annual "lending incentive fee" to the Treasury through the 18th quarter following issuance of the SBLF Preferred Stock, if the issuer has not increased its Qualified Loans from the Baseline by the ninth quarter after the issue of SBLF Preferred Stock.

Priority, Share Dividends, and Repurchases. SBLF can restrict dividends upon, and share repurchases of, other shares of *pari passu* and junior securities generally, and without regard to whether any SBLF Preferred Stock dividends have not been paid. Such restrictions apply if, after giving effect to such dividends or repurchases, the issuer's dollar amount of Tier 1 capital would be less than 90 percent of the Tier 1 capital amount immediately preceding the issuance of the SBLF Preferred Stock (the "Tier 1 Dividend Threshold"), subject to adjustments. Net charge-offs and redemptions of SBLF Preferred Stock since the issue date of the SBLF Preferred Stock are excluded from this calculation. Between the second and 10th anniversaries of issue, for every 1 percent increase in Qualified Loans over the Baseline amount, the dollar amount of the Tier 1 Dividend Threshold is decreased by 10 percent of the amount of the SBLF Preferred Stock.

"Nonpublicly traded issuers" whose securities are not traded on a national securities exchange and who are not required to file periodic reports under the Securities Exchange Act of 1934 (the "1934 Act") cannot pay dividends or repurchase *pari passu* or junior securities, if SBLF Preferred Stock is outstanding 10 years or more from the date of issue.

Missed Dividends. Although SBLF Preferred Stock is not cumulative, missed dividends have significant consequences. If dividends are not declared and paid in any quarter, the issuer's CEO and CFO have to give the Treasury reasonably acceptable reasons for nonpayment, and no dividends on or repurchases of *pari passu* or junior securities may be made for that quarter *plus* three additional quarters. Dividends on *pari passu* shares may be paid to the extent necessary to avoid any "material covenant breach."

After four quarters of nonpayment of SBLF Preferred Stock dividends, absent a bank regulatory prohibition on dividend payments, the issuer's board must provide a written certification that the issuer used its best efforts to pay the dividends on SBLF Preferred Stock consistent with safe and sound banking practices and their fiduciary obligations. Although not in the Treasury's current guides, a lack of holding company cash and an inability of subsidiary banks to pay dividends, whether due to statute or regulatory order, should suffice.

After five missed dividends, the Treasury may appoint a board observer who can attend board meetings until four consecutive dividends have been paid on the SBLF Preferred Stock. After six missed dividends, if the issuer's outstanding SBLF Preferred Stock has an aggregate liquidation value of at least $25 million, the Treasury or any subsequent holder can appoint two directors until four consecutive dividends have been paid.

Redemption. SBLF Preferred Stock may be redeemed at any time, in whole or in part, in amounts not less than 25 percent of the aggregate original liquidation amount of an insurer's SBLF Preferred Stock, subject to prior regulatory approval. Board of Governors of the Federal Reserve System ("Federal Reserve") Supervision and Regulation Letter SR No. 09-4, *Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies* (February 24, 2009) (as amended and with addenda, "SR 09-4"), will apply, and capital planning and stress tests analogous to the Federal Reserve's Comprehensive Capital Analysis and Review ("CCAR") may be used by the regulators in approving or denying any redemption request. *See* Federal Reserve, *Comprehensive Capital Analysis and Review: Objectives and Overview* (March 18, 2011). Since 90 percent of SBLF proceeds, other than proceeds used to redeem outstanding TARP CPP, must be downstreamed to the subsidiary banks, issuing holding companies will need to raise new capital to redeem SBLF Preferred Stock, unless their bank subsidiaries have regulatory approval to pay sufficient dividends to their parent holding companies, or the bank regulators also approve redemption of preferred stock or other instruments issued by the subsidiary banks that mirror the SBLF Preferred Stock. In all cases, the issuers and their bank subsidiaries should be well capitalized following any redemption of SBLF Preferred Stock.

Reporting and Treasury Access. Within 30 days of the end of each calendar quarter, each SBLF recipient has to file with the Treasury a Quarterly Supplemental Report, certified by its CEO and CFO, and, in the case of banks without holding companies, by three directors. The Quarterly Supplemental Report updates the Baseline calculation, the Qualified Loans, and dividend rate. The Quarterly

Supplemental Reports use the bank call report information or Thrift Financial Reports ("TFRs"). The federal bank regulators have proposed requiring thrifts to use call reports in lieu of TFRs beginning March 31, 2012, 76 F.R. 7082-87 (Feb. 8, 2011), and it is expected that all banks will use call reports in 2012.

The issuer's auditors must certify annually by March 31 that the issuers' processes and controls used to generate the Initial and Quarterly Supplemental Reports are accurate for each year during the first three years after SBLF Preferred Stock is issued. Issuers are required to certify annually that no borrower principals have been convicted or pled *nolo contendere* to sex offenses against minors, and that the issuer is in compliance with federal anti-money laundering requirements, including the customer identification requirements.

Issuers will agree to permit the Treasury or other holders of SBLF Preferred Stock and their designees, the Treasury Inspector General, and the United States Comptroller General to examine the issuer's books and records and discuss matters with the issuer's principal officers.

LEGISLATIVE PROPOSALS

Senator Olympia Snowe introduced S. 681, the Greater Accountability in the Small Business Lending Fund Act of 2011 (the "SBLF Reform Bill") on March 30, 2011. Even though Senator Snowe preferred to terminate the SBLF completely, if passed, the following provisions of the Reform Bill will make the SBLF less accessible and less attractive:

- Instruments issued under the SBLF will not count as Tier 1 capital for regulatory purposes;
- Only "healthy banks" would be permitted to participate in the SBLF;
- No TARP CPP recipient would be eligible for SBLF funding;
- Affirmative bank regulatory approval, not just no objection or consultation, would be required for any issuer to receive SBLF funds;
- All SBLF funds must be repaid within 10 years, without any extension by the Treasury Secretary;
- The SBLF would terminate in 2025, or sooner if the FDIC is appointed receiver or conservator of 5 percent or more of the eligible institutions that receive SBLF funds.

The Treasury, in a series of webinars held after the SBLF Reform Bill was introduced, has encouraged applications notwithstanding the proposed Reform Bill.

SBLF PREFERRED STOCK—IS IT TIER 1 CAPITAL?

The Treasury states that SBLF Preferred Stock is Tier 1 capital for bank regulatory purposes. It is labeled as "perpetual" and noncumulative and requires prior regulatory approval for redemption—all prerequisites for capital treatment under current capital guidelines. However, some of the terms may raise issues under existing capital rules, and also as U.S. bank regulators revise their capital rules to reflect the capital rules set by the Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems* (December 2010) ("Basel III"). The following are concerns:

- Is the required CEO/CFO notice justifying the issuer's rationale for not paying dividends an impermissible "restriction" on the issuer's "ability or legal right to defer or waive dividends"?
- Are multiple dividend adjustments, based upon the issuer's Qualified Loan volumes, permissible?
- The step-up in rates to 9 percent after 4.5 years is expressly designed to encourage repayment. Does the final step-up to a 9 percent dividend impermissibly "require or create significant incentives for the issuer to redeem the instrument in cash" that makes SBLF Preferred Stock ineligible for treatment as Tier 1 capital?
- The prohibition on dividends or repurchases or any other stock applicable to nonpublic companies 10 years after issuance of SBLF Preferred Stock also could create significant incentives to redeem the SBLF Preferred Stock, inconsistent with current capital rules.
- Under Basel III, is SBLF Preferred Stock a "public sector capital injection" not grandfathered as regulatory capital, and do the dividend step-up features create other issues under Basel III?

It is uncertain how future U.S. capital rules under Basel III may affect SBLF Preferred Stock or other SBLF instruments. In the case of TARP CPP preferred stock that was cumulative and therefore limited in the amount that could be included in Tier 1 capital, the U.S. bank regulators quickly amended

their capital rules to permit TARP CPP preferred stock as Tier 1 capital, which was generally unlimited as to amount. Similarly, in the case of trust preferred securities, the Federal Reserve allowed banking organizations that were not "internationally active" to issue more trust preferred as Tier 1 capital than permitted by the Basel capital rules then in effect. It will be especially difficult for the Treasury to design debt instruments that are Tier 1 capital for mutual and Sub S banks in light of Basel III and the Collins Amendment to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

CONCLUSIONS

SBLF Preferred Stock should be attractive for banks and their holding companies that anticipate having the qualified personnel and processes to soundly generate new Qualified Loans while maintaining their existing portfolios of such loans. Applying for SBLF funds is simple, but the Treasury recently estimated that approvals have taken four to five months, so the SBLF is unlikely to be useful for those needing capital quickly. Issuers of SBLF Preferred Stock have no obligation to close, if approved, and the amount of SBLF funds sought can be reduced by the issuer. Closing is expected by the Treasury within 30 days of approval, assuming the Treasury finalizes and makes the transaction and closing documents available. The application process is confidential, and unless previously disclosed by the issuer, public disclosure of SBLF approval or disapproval is required only if the SBLF transaction closes.

All dividends on SBLF Preferred Stock will be payable from after-tax earnings. Applicants should consider their capital structure and their statutory and regulatory capacity to timely pay dividends on SBLF Preferred Stock, as well as dividends and payments on existing instruments. Issuers with outstanding TARP CPP securities should carefully consider navigating the process of seeking Treasury approvals of a TARP CPP redemption and SBLF funding, as well as the bank regulatory approvals needed to retire all their remaining TARP CPP obligations. Using the SBLF and/or private capital to retire TARP is desirable to end TARP restrictions and stigma, and the SBLF offers a potentially lower cost of capital than TARP CPP.

"Problem banks," and institutions that are not in compliance with their existing TARP CPP preferred stock, including having missed dividends more than once after a 60-day period of grace, likely will not qualify for SBLF funding and should not count on the SBLF to meet their capital needs.

Banks interested in the SBLF and that are not clearly disqualified from participating should discuss the SBLF with their regulators and apply now, assuming there are no regulatory objections. While their applications for SBLF funds are pending, banks should consider:

- Their markets, customers, processes. and personnel to evaluate whether they can safely and soundly increase their Qualified Loans.
- The risks and concentrations of their existing loan portfolios and consider how to add Qualified Loans to improve their loan diversification and risk profile. Banks with existing enforcement actions or examinations criticizing concentrations of CRE lending should focus on other kinds of Qualified Loans in order to diversify their portfolios and meet existing requirements as to diversification and reduced concentrations of risk.
- FDIC and other warnings regarding potential speculation in farm land, as well as potentially temporary increases in crop and other agricultural products' prices and demand that may not last. *See* FDIC Press Release, *FDIC to Host Symposium on Rising Farmland Values* (February 22, 2011). Banks have to manage these risks if they seek to increase their Qualified Loans through Farm Loans and Agricultural Loans.
- The Interagency Statements *Meeting the Credit Needs of Creditworthy Small Business Borrowers* (February 5, 2010) and *Underwriting Standards for Small Business Loans Originated Under the Small Business Lending Fund Program* (December 22, 2010).
- How to structure their internal controls and processes with respect to originating and reporting Qualified Loans, and calculating the rates on SBLF Preferred Stock so that their auditors may provide the annual certifications required by the Treasury in the first three years of the SBLF. Issuers and their auditors should discuss the costs of the internal control letters required by the Treasury.

- Other than the auditor certifications, SBLF reporting to the Treasury on the Quarterly Supplemental Reports is relatively easy and based upon simple calculations from the issuer's call reports.
- Appropriate documentation of Qualified Loans and appropriate inclusion of Qualified Loans in the appropriate Call Report categories, which is essential to minimizing the rate payable on the SBLF Preferred Stock and to SBLF compliance and reporting.
- That small businesses often finance their businesses through personal loans and through their personal resources. Recent data show that almost half of these businesses do not use any external funding. Only about 5 percent of small business owners used business loans and have not even applied for business loans in the past five years. Small loans to businesses constitute only 23 percent of total business loans outstanding at commercial banks but a much higher percentage at banks with less than $1 billion in assets. It is possible that even with increased availability of credit, small businesses' borrowing will continue to depend more upon customer demand, taxes, and government regulations than credit availability.[1]
- SBLF Preferred Stock as a limited term funding source due to the step-up in the dividend rate to 9 percent after 4.5 years, and the need to have capital plans to refund the SBLF Preferred Stock before such rate increases.
- Their capital planning, dividend requirements, and the discussions in Federal Reserve SR 9-04 and the CCAR when considering the amount and desirability of SBLF Preferred Stock. In all cases, proposed SBLF issuers need to maintain voting common equity as their predominant form of capital.
- That only originated loans, not purchased loans or loans resulting from mergers or acquisitions or SBA guaranteed loans, are includible within Qualified Loans in calculating the dividend rate on SBLF Preferred Stock.
- Loan sales programs involving Qualified Loans will adversely affect the rate and amount of increases in Qualified Loans. While loan sales may reduce bank risks and improve performance, these may result in higher dividend rates on SBLF Preferred Stock.
- Legislative developments and changes in the Treasury's SBLF terms and documents.

Also, the bank regulators should clarify that SBLF funding is clearly Tier 1 capital and should grandfather such instruments as Tier 1 capital under the new Basel III capital guidelines.

It is critical that issuers develop a long-term plan as part of the SBLF process to address their capital requirements, dividend payments, risks, concentrations of credit, and the sources of capital to redeem SBLF Preferred Stock at the end of 4.5 years, while maintaining the issuer and its bank subsidiaries as "well-capitalized." Holding companies may need funds to retire SBLF Preferred Stock in addition to funds from bank dividends, and alternative sources of capital to retire SBLF Preferred Stock should be developed.

The SBLF can provide intermediate term capital on attractive terms for eligible issuers. Applying is simple, but the terms are complex, and thoughtful planning is needed before closing a SBLF transaction.

1 Speech of Federal Reserve Governor Elizabeth A. Duke, *Small Business Credit Availability*, the 2011 International Factoring Association Conference (April 14, 2011).

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