



JONES DAY  
**COMMENTARY**

## SBLF CAPITAL—NOW OR NEVER

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. SBLF investments can be funded only through September 27, 2011. The SBLF and its terms are discussed in detail in “Capital for Banks from the Treasury’s Small Business Lending Fund—Apply by May 16 and Consider Terms Before Closing,” *Jones Day Commentary* (May 16, 2011) (the “*SBLF Capital Commentary*”) available at [www.jonesday.com/capital\\_for\\_banks](http://www.jonesday.com/capital_for_banks). This *Commentary* updates the *SBLF Capital Commentary*, highlights certain terms in the definitive SBLF documents that should be considered, and offers suggestions for applicants.

### THE SBLF TODAY

The Treasury has received applications from 926 depository institutions and their holding companies aggregating about \$11.8 billion, or about 39.3 percent of the \$30 billion offered by the Act for SBLF. Through August 17, 2011, the Treasury had funded 80 approved

applicants with an aggregate of just over \$1.0 billion. The applicants that have received SBLF funds through August 17 had average Tier 1 capital ratios of 9.8 percent, Tier 1 capital to risk weighted assets of 14.3 percent, and total risk-based capital ratios of 13.2 percent. Following the funding of 50 additional banks announced on August 31, 2011, approximately 796 applications, 86.0 percent of the total, are still pending, have been denied, or the applicants have determined not to participate.

The Treasury Office of Inspector General (“OIG”) estimated in May that 43.0 percent of applications through April 18, 2011 sought to repay TARP Capital Purchase Program (“CPP”) or Community Development Capital Initiative (“CDCI”) capital. Fifty percent of the 80 banks receiving SBLF funds through August 17 had received TARP CPP or CDCI funds. The final SBLF terms for institutions that have elected to be taxed under Subchapter S (“Sub S”) of the Internal Revenue Code of 1986 (the “Code”) and mutual SBLF terms provide that any subordinated debt issued under the SBLF by these institutions will be Tier 2 capital for regulatory purposes. SBLF subordinated

debt will have annual interest rates ranging from not less than 1.5 percent to as high as 7.7 percent in the first nine quarters, and from 1.5 percent to 10.8 percent during quarter 10 through quarter 18, depending upon the increase in Qualified Loans over the Baseline. After quarter 18, the rates on all SBLF subordinated debt will be 13.8 percent. As a result, the Treasury believes that few Sub S and mutual institutions will take SBLF funds.

## APPROVAL PROCESS

Applying for SBLF funds was easy and is closed. Obtaining SBLF approval has been a relatively opaque, long process, with continuing changes in how the Treasury considers applications. The Treasury Office of Inspector General Report, *SBLF: Investment Decision Process for the Small Business Lending Fund, 016-SBLF-11-001* (May 13, 2011) (the "OIG Report") chronicles the changes and demystifies many of the delays that SBLF applicants have experienced.

The Treasury has reviewed projections from independent contractors of future cash flows, earnings, asset quality, business model, and capital structure and adequacy for SBLF applicants. According to the OIG Report, "institutions must have at least an 80 percent probability of repayment to participate in the SBLF Program, which is the ratio used by the Federal Reserve in its 2009 Supervision Capital Assessment Program ("SCAP" or "Stress Test")." The Treasury believes that Tier 1 common equity to risk weighted assets is the "most statistically significant factor in predicting bank defaults." Surprisingly, the Treasury initially did not focus on applicants' small business lending plan or compliance as a Small Business Administration ("SBA") lender.

As a result of the OIG Report, the Treasury agreed to:

- Consider applicants' SBA lending history and compliance and other information from the SBA;
- Comprehensively review small business lending plans;
- Collaborate more with the SBA and SBLF recipients;
- Increase consultation with the applicable federal bank regulatory agencies (each, an "FBA") on material supervisory issues following multiple levels of FBA reviews; and
- Conduct bring-down diligence on SBLF applicants' safety, soundness, and viability.

Similar to the TARP CPP, it is unclear when matching capital from private sources ("Matching Capital") will be required as a condition to SBLF participation, and even whether Matching Capital will influence a Treasury decision. The Treasury has indicated only limited circumstances, generally institution-specific, where Matching Capital would alter a viability determination by the Treasury. The OIG Report provides examples of where Matching Capital may be required following discussions with the applicable FBA, including institutions with:

- Significant securities losses that are unrelated to investment or asset-liability management practices;
- Temporary impairments related to natural disasters; or
- Historical losses that have reduced capital, including as a result of asset sales that have improved asset quality and returned the institution to profitability.

While the Treasury agreed to document these situations, we are unaware of any public guidance on Matching Capital.

The OIG Report indicates that the SBLF approval process focuses on meeting the Act's requirement that SBLF recipients be "financially viable." "Financially viable" includes banks that are at least adequately capitalized, and not expected to become undercapitalized or placed into conservatorship or receivership.

The process between the FBAs and the Treasury took months to establish. Unlike TARP, the FBAs were required only to advise the Treasury on the financial viability of SBLF applications and not make any investment recommendations. The FBAs also advised the Treasury on:

- Material supervisory issues, including risk management and compliance issues;
- Financial condition concerns;
- Enforcement actions;
- Whether Matching Capital should be required by the Treasury as a condition to receiving SBLF funds;
- Other issues believed inconsistent with issuing securities pursuant to SBLF; and
- Safety and soundness issues regarding applicants' small business lending plans.

State regulators have the opportunity to comment on SBLF applications, but state regulatory comments are not required by the Treasury.

## SIGNIFICANT TERMS OF DEFINITIVE DOCUMENTS

The SBLF documents for C corporations largely reflect the terms discussed in depth in our earlier *SBLF Capital Commentary*, and most terms are customary. Applicants seeking to make a decision on SBLF or awaiting Treasury approval should consider, in addition to the matters in our earlier *Commentary*, the following:

**Dividends.** The Treasury will not approve applicants who cannot pay dividends or where dividends require approval by a governmental entity or a third party. This includes restrictions as a result of federal or state supervisory determinations or formal or informal enforcement actions, or statutory or policy restrictions.

The dividend rate on SBLF preferred stock can be reduced depending upon a bank's increase in Qualified Loans (as defined in our *SBLF Capital Commentary*) over the SBLF Baseline (the "Baseline"). Rates can be as low as 1 percent in the initial quarters, if the increase in qualified loans is 10 percent or more. The decreased rate, however, is only applied to the dollar amount of SBLF preferred stock equal to the dollar increase in Qualified Loans over the Baseline, with the balance carrying a 5 percent annual dividend rate for the first nine quarters after issuance. If Qualified Loans have not increased over the Baseline by the end of the eighth quarter after issuance, the dividend rate will be 7 percent through the 18th quarter. 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 actual amount of dividends payable on SBLF preferred stock will be an amount that varies based on (i) any reduced rate applicable to the dollar amount of SBLF preferred stock equal to the dollar amount of the increase in Qualified Loans over the Baseline, and (ii) the rate applicable to the balance of the SBLF preferred stock.

**M&A and Loan Sales Activity Affects SBLF Preferred Stock Dividend Rates.** The Baseline is increased for any mergers, acquisitions, and purchases of Qualified Loans, making it important to consider potential increases in dividend rates on SBLF preferred stock from the lowest rates provided. Any increase in Qualified Loans is adversely affected by loan sales. Companies still considering the SBLF should factor these strategic events into their SBLF model.

**Issuer Representations and Warranties.** Most representations and warranties in the SBLF securities purchase agreement are typical and qualified by "material adverse effect." Unqualified representations are required regarding (i) compliance with anti-money laundering rules, (ii) the absence of any insider loans that are not Regulation O compliant, and (iii) the absence of any restrictions on dividends.

**Annual Auditor Certifications.** Prospective issuers should discuss with their outside auditors the time and cost of the following required annual SBLF certification to the Treasury:

In connection with our audit, nothing came to our attention that caused us to believe that the Bank failed to comply with the Small Business Lending Fund Securities Purchase Agreement (the "Agreement") between the Bank and the United States Department of the Treasury ("Treasury") dated [Date], insofar as the Agreement relates to accounting matters provided on the Bank's Supplemental Reports filed with Treasury during the year ended [Date] under sections 1.3(j) and 3.1(d) of the Agreement, including that the Bank's Supplemental Reports set forth a complete and accurate statement of loans held by the Bank in each of the categories described therein for the time period(s) specified therein. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance.

**Outreach and Advertising Efforts.** The exact nature of the linguistically and culturally appropriate outreach and advertising efforts to be required by the Treasury Secretary under Section 4103(d) of the Act is uncertain and subject to interpretation and change, perhaps as a result of the collaboration contemplated with the SBA. Section 4103(d) requires:

...appropriate outreach and advertising in the applicant pool describing the availability and application process of receiving loans from the eligible institution [under the SBLF] through the use of print, radio, television or electronic media outlets which target organizations, trade associations, and individuals that- (A) represent or work within or are members of minority communities; (B) represent or work with or are women; and (C) represent or work with or are veterans.

The Treasury will also require SBLF recipients to furnish information that the Treasury requests to complete a mandated study on the effects of the SBLF on women-owned businesses, veteran-owned businesses, and minority-owned businesses. The scope of such information and its uses have not been specified yet.

**Borrower Certifications.** Each SBLF lender must obtain and maintain certifications from borrowers funded at least partially from SBLF funds that:

no principal of such business has been convicted of a sex offense against a minor (as such terms are defined in section 111 of the Sex Offender Registration and Notification Act, 42 U.S.C. §16911).

This is required by the Act, but banks have expressed concerns over embarrassment to bankers and potential borrowers, the privacy effects of this mandate, and whether banks are the appropriate persons to enforce 49 U.S.C. §16911.

## CONCLUSION

The SBLF approval process has been lengthy, with multiple levels of Treasury and FBA reviews. Only 12.4 percent of all FDIC-insured institutions with under \$10 billion of assets ("Small Banks") as of March 31, 2011 applied. Through August 17, 2011, only 80 applicants have been approved and funded. On August 31, the Treasury announced that an additional 50 applicants had been funded with a total of \$767 million from the SBLF. Only 1.7 percent of all Small Banks had received SBLF funds by August 31, 2011, and these funds were only 6.0 percent of the total SBLF funds appropriated by Congress.

All applicants should consider carefully the terms of the SBLF Program and determine whether its costs, reporting, and other requirements are consistent with their business strategies, including their lending and profit targets. The costs of SBLF preferred stock are affected by mergers and acquisitions, and loan purchase and sales transactions, and the SBLF Program should be considered in light of existing and contemplated transactions and the issuer's strategic plans.

Although the Treasury indicates it will process SBLF applications and fund approved issuers by the September 27 statutory deadline, applicants who determine that they want SBLF funds and are waiting for approval should be proactive with the Treasury and their regulators to determine their status and push to obtain funding. As the funding deadline nears, applicants should be prepared to close very quickly, if and when their SBLF applications are approved.

The small number of SBLF fundings to date, the Treasury's emphasis on Tier 1 to risk weighted assets, and the high capital levels of those who have been funded through August 17 do not bode well for more normally capitalized applicants and those that need capital to survive. All applicants who have not been approved and need capital should have or quickly develop contingency plans. Alternatives may include:

- Private sales of common or noncumulative preferred stock in offerings to directors and executive officers and principal shareholders, and/or other accredited investors, including institutional investors.
- Rights or rights-like offerings.
- Registered direct and underwritten offerings, including equity lines that may include a private equity offering, as well as at the market or "ATM" offerings.

- Shelf registration statements may be useful, and are potentially available for issuers that have been reporting to the SEC on a timely basis for at least one year, whether or not they have stock held by non-insiders (public float) valued at \$75 million or more in the aggregate. Small registrants can issue securities off the shelf with a value of not more than 33-1/3 percent of the dollar amount of the issuer's public float during any 12-month period.
- Noncumulative preferred stock may be attractive to investors if the issuer has the capacity to pay dividends, especially where dividends on common stock are low or not being paid. This also will avoid dilution. Bank holding companies should continue to have at least a majority of their capital in the form of voting common equity.
- Negotiating a reduction in the amount of securities held by the government as an inducement to obtaining new capital. This is an option for an issuer to the extent TARP CPP or other government funds are still held by the issuer.

While the SBLF Program has some interesting opportunities, it appears that it will fall short of being fully deployed and that it will not have as much effect upon small businesses or small banks as may have been contemplated when it was established. Weak market demand and corresponding weak small business loan demand since Spring 2011 may make it difficult for recipients to realize the lowest dividend rates and therefore earn meaningful returns from Treasury SBLF investments. SBLF recipients should plan now for retiring the SBLF preferred stock in four and a half years, including using omnibus shelf registration statements and the capital raising techniques suggested above.

## LAWYER CONTACT

For further information, please contact your principal Firm representative or the lawyer listed below. General email messages may be sent using our "Contact Us" form, which can be found at [www.jonesday.com](http://www.jonesday.com).

### **Chip MacDonald**

Atlanta  
+1.404.581.8622  
[cmacdonald@jonesday.com](mailto:cmacdonald@jonesday.com)

### **Heith D. Rodman**

Atlanta  
+1.404.581.8356  
[hdrodman@jonesday.com](mailto:hdrodman@jonesday.com)

### **Brett P. Barragate**

New York  
+1.212.326.3446  
[bpbarragate@jonesday.com](mailto:bpbarragate@jonesday.com)

### **Bradley C. Brassier**

Chicago  
+1.312.269.4252  
[bcbrazier@jonesday.com](mailto:bcbrazier@jonesday.com)

### **Christopher M. Kelly**

New York  
+1.212.326.3438  
[ckelly@jonesday.com](mailto:ckelly@jonesday.com)

### **James C. Olson**

San Francisco  
+1.415.875.5749  
[jcolson@jonesday.com](mailto:jcolson@jonesday.com)

### **John T. Owen**

New York  
+1.212.326.7874  
[jtowen@jonesday.com](mailto:jtowen@jonesday.com)