

Financial Services and Products ADVISORY

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Small Business Jobs Act of 2010: New Capital for Small and Mid-Size Banks

A new source of government-provided capital, the Small Business Lending Fund (SBLF, or the “Fund”), is now available to banks and bank holding companies with less than \$10 billion in assets and that plan to increase lending to small businesses. The Fund was established by the Small Business Jobs Act of 2010 (the “Act”) that was signed into law on September 27, 2010. The Act includes several other provisions designed, ultimately, to increase credit to, and hiring by, small businesses.

Briefly, the Treasury Department will use the \$30 billion transferred to the Fund to purchase preferred stock or other instruments in qualifying institutions.¹ An issuing institution may, depending upon its size, sell securities to Treasury in an amount up to three or five percent of its risk-weighted assets. There are two mechanisms by which the Fund will support community lending: a banking institution must submit an acceptable small business lending plan, and the dividend rate on the preferred stock will adjust downward as small business lending increases. A term sheet attached to this advisory identifies several important and specific provisions that will enter into a decision to seek an SBLF investment. Highlights of the program are these:

Structure and Purpose. The Fund is located within, and administered by, Treasury. It is funded with \$30 billion transferred to it from the Troubled Asset Relief Program (TARP). The relationship between the SBLF and TARP is a complicated one. On the one hand, the Act is clear that SBLF is separate from TARP and that an SBLF recipient is not subject to the TARP conditions. On the other hand, the terms of an SBLF investment are likely to track the terms of investments under the core TARP initiative, the Capital Purchase Plan (CPP), in part to ensure Tier 1 capital treatment. Additionally, a participating bank or bank holding company may replace preferred stock issued under the CPP (or the Community Development Capital Initiative (CDCI)) with SBLF stock.

The broad and anodyne purposes of the Fund are to increase the availability of credit to small businesses generally and to promote American jobs. However, the Act also identifies a few specific target borrowers that should guide the development of a small business lending plan: (i) minority-, veteran- or women-owned businesses; (ii) borrowers within low- and moderate-income, minority and other underserved or rural communities; (iii) borrowers in areas with unemployment rates that exceed the national average; and (iv) small businesses affected by or located in communities affected by the Deepwater Horizon oil spill in the Gulf of Mexico.

¹ In addition to banks and bank holding companies, certain “community development loan funds” (CDLFs) are eligible to participate, but total SBLF investments in all CDLFs are capped at \$300 million out of the \$30 billion in the Fund. This advisory is focused on banking institutions and does not address CDLFs in detail. A CDLF should bear in mind that the Act contains provisions focused specifically on its participation.

Eligibility. Any bank or bank holding company with total consolidated assets of \$10 billion or less is eligible for investments by the Fund.² The percentage amount of an SBLF investment depends on whether an institution has more or less than \$1 billion in assets. For those below \$1 billion, the maximum investment is five percent of risk-weighted assets; for those above \$1 billion, it is three percent. The maximum amount of an investment will be reduced by the amount of any equity or debt issued under the CPP or the CDCI.

Depository institutions on the “FDIC problem bank list” (or that were on the list within the preceding 90 days) are ineligible. How the list is compiled is left largely up to the FDIC, but it will include all banks with composite CAMELS ratings of 4 and 5. Presumably the list will resemble the problem bank list that the FDIC now maintains in determining the need for and timing of receiverships.

Approval Process. A bank or bank holding company seeking to sell stock or debt to the SBLF must file with its primary federal or state regulator a small business lending plan that describes how the institution will address the needs of small businesses in its area. An outreach plan also is required. Treasury then will consult with the regulator before deciding whether to make an investment. Treasury has broad discretion in making this decision. Moreover, as with the CPP, Treasury may make conditional approvals, requiring at least matching (and subordinate) investments from the private sector.

Four categories of loans comprise the loans that a small business plan should target and that are used in calculating an increase or decrease in small business lending. The four categories are: (i) commercial and industrial loans; (ii) owner-occupied nonfarm, nonresidential real estate loans; (iii) farm loans and other loans to finance agricultural production; and (iv) loans secured by farmland. Loans of more than \$10 million or loans that go to a business with more than \$50 million in revenue are specifically excluded from eligibility—regardless of their purpose. This exclusion may rule out a number of commercial real estate loans.

Terms of the investment. The Act does not specify many of the terms that will be material to an investment. For example, the deadline for repayment is 10 years, after which Treasury may impose more stringent repayment incentives, but there is no formal maturity date. To encourage early repayment, the dividend or interest rate on any instrument will (as described below) increase significantly after four-and-a-half years.

The terms of preferred stock issued under the CPP are likely to be guideposts on many terms. Using the CPP as a model, preferred stock issued under the SBLF should be senior to the issuer’s common stock and *pari passu* with the issuer’s most senior class of existing preferred shares as to liquidation preference and dividends. Approval of the institution’s primary federal regulator, Treasury and, for holding companies, the Federal Reserve, presumably will be required for any redemption of the stock. Other restrictions on dividends and repurchases or redemptions with respect to other classes of stock likely will be imposed. Indeed, Treasury has authority to impose requirements on new, non-SBLF capital in order to encourage repayment after the 10-year deadline or to manage the risks associated with administration of the fund.

The essential incentive in the Act for participating banks and bank holding companies to increase small business lending is a reduction in the dividend or interest rate for the first four-and-a-half years, as small business lending increases. There is an initial or presumptive rate of five percent, but adjustments come into play quickly. There are three phases of rate adjustments: the first two years following the investment,

² Note that a bank with less than \$10 billion in assets is eligible even if its holding company has more than \$10 billion in assets and is ineligible. In such a case, Treasury may choose to make the investment in the holding company rather than in the bank.

the next two-and-a-half years, and the remaining five-and-a-half years (assuming a participant does not redeem the instrument before the deadline).

In the first period, the first two years after the investment, the basic rule is that, for every calendar quarter in which small business lending has increased over a baseline by 2.5 percent, the annual dividend or interest rate falls by one percent, to a floor of one percent. Thus, if a participant increases small business lending in a quarter by three percent (more than 2.5 percent, but less than five percent) against the baseline, its rate falls from five percent to four percent. A participant that increases small business lending by 10 percent or more will pay a rate of one percent. A participant that increases small business lending by less than 2.5 percent, or that experiences a decrease in small business lending, continues to pay the default rate of five percent during the initial two-year period.

The calculation of an increase or decrease in small business lending against the baseline and the timing of changes to the dividend or interest rate are somewhat complicated. The baseline from which increases or decreases in a quarter are measured is the average of small business loans reported for the four full calendar quarters immediately preceding the investment.³ The amount of total qualifying small business loans reported at the end of each calendar quarter after the investment is compared to the baseline to measure the percentage increase or decrease. There is *not* any kind of rolling measurement in which lending in a quarter is compared to lending in another quarter following the investment. The change in the interest rate dictated by the measurement against the baseline takes effect for the payment due in the second calendar quarter following the calendar quarter in which the change occurred. For example, if, in the first calendar quarter of a year, a participant has increased its small business lending by three percent, the new annual rate of four percent is the rate applied to the payment due in the third quarter of the year.

The rate for the second phase, the two-and-a-half years after the first two years, is fixed at the rate dictated by lending versus the baseline in the eighth calendar quarter following the investment. Thus small business lending in this particular quarter is critical. Additionally and importantly, if small business lending in the eighth quarter remains flat or decreases against the baseline, then the annual rate for such a participant does *not* remain flat at five percent, but rises to something of a penalty rate of seven percent.

For the third phase, the five-and-a-half years to the deadline, the Act encourages early redemptions by increasing the annual dividend or interest rate to nine percent for all institutions, including those that may previously have been paying a one percent rate. The Act also permits the Treasury Secretary to establish additional repayment incentives. If an investment is not repaid within ten years, a participant may face additional penalties and requirements, including higher rates and dividends to be determined by Treasury.

Any proceeds the Treasury Department receives through redemptions or repayments of SBLF instruments will be paid into the general revenue fund in order to reduce the national debt.

Capital treatment. Although the purposes of the SBLF differ from that of the CPP—the SBLF attempts to spur a particular kind of lending, while the CPP did not—SBLF stock is intended to receive the same Tier 1 capital treatment as the CPP stock. Accordingly, the terms relating to an SBLF investment should be close to those for a CPP investment, as described above, especially since the Federal Reserve Board relied on the CPP

³ The reported amounts will be adjusted for net charge-offs and the effects of mergers, acquisitions and purchases in the secondary market.

terms in granting Tier 1 capital treatment. Of course, Treasury has yet to release a model term sheet, and the Federal Reserve has yet to make a determination on capital treatment. One justification for the Federal Reserve's decision on the CPP stock was that CPP was part of an emergency program designed to promote financial stability in the financial markets and the banking industry as a whole. The SBLF, by contrast, has a much more specific focus and is not specifically intended to promote financial stability generally. The SBLF has at least one feature that is the same as a feature of the CPP stock and that otherwise would disqualify it from Tier 1 treatment—a dividend step-up.

Other regulatory issues. The Act also creates regulatory responsibilities for Fund participants and for Treasury. Most importantly, a participant will become subject to new underwriting standards for qualifying small business loans that will be issued by its primary federal regulator. Presumably such standards would not vary widely from a participant's current standards, but it is not possible to foresee what a regulator may decide. A participant must provide advertising and outreach targeted to potential borrowers who are minorities, women or veterans. The outreach must include information about the availability of loans and application procedures.

In Treasury, an Office of Small Business Lending Fund Program Oversight is established within the Office of the Inspector General. This particular office must make various monthly, quarterly and semi-annual reports to Congress. The General Accounting Office will conduct an annual audit of the program.

SBLF Terms for Banks and Bank Holding Companies

Nature of Fund	
Structure	<ul style="list-style-type: none"> • Located within and administered by Treasury.
Source of Funds	<ul style="list-style-type: none"> • Reallocation of \$30 billion in TARP.
Duration	<ul style="list-style-type: none"> • All investments must be made within one year.
Use of Receipts	<ul style="list-style-type: none"> • Paid into general fund of Treasury to reduce public debt.
Implementation and Rulemaking	<ul style="list-style-type: none"> • Broad discretion granted to Treasury. • No specific deadlines, but all SBLF investments must be made by September 27, 2011. • Appropriate federal banking agency to issue guidance on prudent underwriting standards loans made with SBLF funds.
Oversight	<ul style="list-style-type: none"> • Three types of Treasury reports to Congress: <ul style="list-style-type: none"> – Monthly transaction report – Semi-annual report on projected costs, liabilities and expenses of program, and on specific investments. – Quarterly report on the use of proceeds by participating institutions. • Dedicated oversight office within the IG office at Treasury. Oversight office must make its own semi-annual reports to Congress. • Annual GAO audit. • Report to Congress from Treasury within one year on impact of program on women-, veteran- and minority-owned businesses.
Participation	
Eligibility	<ul style="list-style-type: none"> • Banks not controlled by a holding company with total assets \$10 billion or less. • Bank holding companies with consolidated assets of \$10 billion or less.
Ineligible Institutions	<ul style="list-style-type: none"> • Banks on FDIC problem bank list within the last 90 days are ineligible. All 4- and 5-CAMELS-rated banks are ineligible. • Not clear on how this rule will apply to bank holding companies.
Approval Process	<ul style="list-style-type: none"> • Submission of acceptable small business lending plan and outreach plan to primary federal or state regulator. • Consultation by Treasury with primary federal or state regulator. • Approval by Treasury. • Approvals may be conditional, requiring private investment match.
Regulatory Obligations for Participant	<ul style="list-style-type: none"> • Treasury to require outreach to minorities, women and veterans. • BSA/AML compliance certification. • Disclosure of investment on website and outreach notice.
Capital Treatment	<ul style="list-style-type: none"> • Unspecified, but presumably Tier 1, which is likely to dictate certain terms.

Terms

Nature of Instrument	<ul style="list-style-type: none"> Preferred stock, debt with full recourse, equity equivalent amounts.
Principal Amount	<ul style="list-style-type: none"> Institutions with less than \$1 billion in consolidated assets: up to 5% of risk-weighted assets. For institutions with more than \$1 billion but less than \$10 billion in consolidated assets, up to 3% of risk-weighted assets. CPP- or CDCI-preferred stock deducted from eligible amount.
Dividends	<ul style="list-style-type: none"> Variable, in three time periods: <ul style="list-style-type: none"> First two years: Rate adjusted quarterly. Annual rate reduced from initial 5% rate by 1%, with every 2.5% increase in small business lending from the baseline lending amount—the average small business loan amount over the four calendar quarters immediately preceding SBLF investment. If participant’s small business lending is flat or declines, rate remains 5%. Next 2 ½ years: Annual rate is fixed at rate determined by lending changes in the eighth quarter of the first two-year period. Rate rises to 7% for issuer whose small business lending is flat or declines. After 4 ½ years, 9% annual rate regardless of increase or decrease in qualified lending. For S Corporations, Treasury may adjust rate to take into account any relevant differences in tax treatment. Not clear what the dividends will be, cumulative or non-cumulative.
Small Business Loans Included in Determination of Rate	<ul style="list-style-type: none"> Commercial and industrial loans. Owner-occupied nonfarm, nonresidential real estate loans. Farm loans and other loans that finance agricultural production. Loans secured by farmland.
Ineligible Loans	<ul style="list-style-type: none"> Loans of more than \$10 million. Loans to businesses with more than \$50 million in assets.
Deadline	<ul style="list-style-type: none"> 10 years, but no formal maturity date. Treasury may issue rules to encourage earlier redemption or repayment. Treasury may impose additional terms and conditions if redemption or repayment does not occur within 10 years, including requirements with respect to new capital.
Priority (CPP model)	<ul style="list-style-type: none"> Senior to common stock. Pari passu with existing most senior class of preferred shares.
Repurchase (CPP model)	<ul style="list-style-type: none"> Prior approval of primary federal regulator, Federal Reserve and Treasury required.
Restrictions on Dividends (CPP model)	<ul style="list-style-type: none"> Until SBLF stock fully repurchased, most dividends prohibited. Repurchases or redemptions of other stock barred until all accrued and unpaid dividends on the SBLF stock are fully repaid.

Terms	
Common Dividends (CPP model)	<ul style="list-style-type: none"> Treasury consent required for any increase in common dividends per share during first three years after SBLF stock issued, unless SBLF stock repurchased before then or Treasury has sold the stock.
Repurchases (CPP model)	<ul style="list-style-type: none"> Treasury consent required for most repurchases of other shares during first three years after SBLF stock issued, unless SBLF stock repurchased or Treasury has sold the stock before then.
Voting rights (CPP model)	<ul style="list-style-type: none"> Non-voting, other than customary class voting rights on matters affecting rights of class. If dividends not paid in full for six dividend periods (whether or not consecutive), right of Treasury to elect two directors. Right ends when full dividends paid for four consecutive dividend periods.
Transferability	<ul style="list-style-type: none"> Statutory authority for Treasury to sell or transfer SBLF shares. Under CPP model, publicly traded participant required to file shelf registration as promptly as practicable. Also under CPP model, other requirements to ensure marketability.
Executive compensation	<ul style="list-style-type: none"> Provision in Act distinguishing SBLF from TARP suggests intent that TARP-related executive compensation restrictions will not apply. However, Treasury not explicitly barred from imposing restrictions.
Refinancing of CPP and CDCI Securities	<ul style="list-style-type: none"> Treasury authorized to permit refinancing of securities issued to Treasury under CCP or CDCI with securities issued under SBLF. CCP participant that has missed more than one dividend repayment by more than 60 days is ineligible to refinance.

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