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Big Incentives for Small Business Lending

To stimulate small business lending and strengthen bank balance sheets, the U.S. Treasury will invest as much as \$30 billion in community banks and bank holding companies through the Small Business Lending Fund. The investment will be made by the Treasury's purchase from institutions of preferred stock or similar instruments with a dividend rate that may decrease for a period of time if the institution increases its qualified small business lending.

Although there are advantages to participating in the SBLF, including potentially low dividend rates on the capital and no restrictions on executive compensation, there are other factors to consider.

As this article goes to print, the Treasury has only released SBLF guidance for institutions taxed as C-corporations, but not guidance for organizations that are taxed as S-corporations or mutual institutions.

Eligibility and Application Process

To be eligible to participate in the SBLF, an institution

must (1) have assets under \$10 billion as of Dec. 31, 2009, and (2) not have appeared on the FDIC's problem bank list or a similar list in the past 90 days, which generally means an institution has a CAMELS rating of 1, 2 or 3. An institution with \$1 billion or less in assets may apply to issue capital to the Treasury in an amount up to 5 percent of its risk-weighted assets as of Dec. 31, 2009. An institution with more than \$1 billion in assets, but less than \$10 billion, may apply to issue capital to the Treasury in an amount up to 3 percent of its RWA as of Dec. 31, 2009. The minimum investment by Treasury in any institution is 1 percent of RWA.

An institution is not permitted to simultaneously participate in the SBLF and the TARP Capital Purchase Program or the Community Development Capital Initiative. The capital may be used to refinance CPP and CDCI investments. If CPP capital is refinanced, any then outstanding CPP warrants may remain outstanding.

To apply for the SBLF, an institution must submit by March 31, a completed version of the one-page SBLF

application form to the Treasury and a Small Business Lending Plan to its federal and state regulators. That plan must describe how the institution will address the needs of small businesses in the community it serves, its expected increase in small business lending, and its approach to community outreach for small business lending.

The three possible responses to an institution's SBLF application are (1) preliminary approval, (2) preliminary approval contingent on the institution's receipt of "matching funds" concurrently with or before SBLF funding, or (3) the institution is asked to withdraw its application. The Treasury has indicated that it will not publicly disclose the existence of withdrawn application.



If an institution is required to obtain matching funds, those funds must be received from one or more private, non-governmental investors, on terms satisfactory to the Treasury in an amount at least equal to the capital being invested. However, in the event matching funds are required, the capital will not exceed 3 percent of the institution's RWA as of Dec. 31, 2009, notwithstanding the institution's asset size.

Use of Proceeds

If the Treasury invests in a bank holding company, 90 percent of such investment must be contributed to its bank subsidiaries.

On Dec. 22, 2010, the Federal Reserve, FDIC, OCC and OTS issued a joint statement regarding underwriting standards for small business loans made with the capital. In part, the statement indicated that the institutions participating in the SBLF will have "considerable latitude" in developing underwriting standards for SBLF lending and that lenders must adhere to the Interagency Guidelines Establishing Standard for Safety and Soundness.

Cost of the Capital

The change in an institution's QSBL will determine the initial cost of the capital. The loans that qualify as QSBLs are (1) commercial and industrial loans; (2) loans secured by owner-occupied nonfarm, nonresidential real estate; (3) loans to finance agricultural production and other loans to farmers; and (4) loans secured by farmland.

The initial dividend rate on the capital will be 5 percent per annum of the \$1,000 liquidation value per share. For each of the first nine quarters of participation in the SBLF, if the institution's QSBL increases, as compared to the four quarters that ended on June 30, 2010, the capital's dividend rate will decrease. Increases in QSBL lending may allow the dividend rate to drop from the initial 5 percent rate per annum to as low as 1 percent per annum, assuming an increase of the QSBL of at least 10 percent. The dividend rate will remain at the level established in the 10th quarter until four and one-half years after the capital investment date.

If there is no increase in an institution's QSBL, the dividend rate on the capital will remain at 5 percent per annum during the initial 10 calendar quarters, and thereafter will rise to 7 percent per annum, until the period that ends four and one-half years after the institution's initial participation in the QSBL.

After four and a half years, regardless if there has been an increase in the institution's QSBL, the dividend rate will increase to 9 percent per annum until the capital is repaid.

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If an institution participated in CPP and did not redeem or apply to redeem such investment by Dec. 16, 2010, and if at the beginning of the 10th full calendar quarter after the Treasury's investment date the institution's QSBL has not increased, a lending incentive fee of 2 percent per year of the liquidation preference of the outstanding capital will be levied, in addition to the dividend payments. That fee will be assessed beginning with the fifth anniversary of the CPP investment.

Other Considerations

The following are other considerations in deciding if an institution should participate in the SBLF.

- Unlike the CPP, the SBLF does not have limitations on executive compensation and an institution will not be required to issue warrants.
- In addition, an institution may pay a dividend on or redeem capital stock other than the capital if the institution's Tier 1 capital after that transaction would be at least 90 percent of the amount at the time immediately after the closing date of the capital investment and the current quarter's dividends on the capital is paid. After two years, the 90 percent limitation is decreased by a dollar amount equal to 10 percent of SBLF capital for every 1 percent increase in QSBL.
- Although the capital may be repaid at anytime with no penalty or fee, federal banking regulatory approval is required to make such repayment.

Conclusion

With capital markets still thawing, the SBLF will be a financing win-win for many institutions and their customers. Institutions will benefit from the potentially low cost of capital from the SBLF in an era of difficult private capital raising, while providing an initiative to banks to increase lending to borrowers. Institutions are encouraged to discuss with their advisers if the SBLF is right for their organizations well in advance of the March 31, SBLF application deadline. **BN**