

# Financial Services Report

## Treasury Announces Standard Terms of Small Business Lending Fund

This report discusses certain key terms of the U.S. Department of the Treasury's Small Business Lending Fund (SBLF), as well as the application process for participating in the SBLF program, as disclosed by the U.S. Department of the Treasury (Treasury) on December 21, 2010. Enacted into law as part of the Small Business Jobs Act of 2010 (the Act), the SBLF is a \$30 billion fund that encourages lending to small businesses by providing Tier 1 capital to qualified community banks with assets of less than \$10 billion.

The SBLF aims to stimulate small business lending by community banks by providing such institutions with the opportunity to receive a capital investment from the Treasury in the form of a preferred stock instrument that carries a dividend rate which decreases as the institution increases its small business lending. As discussed below in more detail, applications for eligible institutions for the SBLF should be submitted to Treasury by **March 31, 2011**. Institutions that previously received funding under the Treasury's Capital Purchase Program (the CPP) are eligible to seek to refinance their CPP investments with an investment under the SBLF and thereby avoid the limitations of the TARP rules that are applicable to CPP participants. Pursuant to the Act, SBLF participants are not deemed to be TARP recipients and the Act does not include any executive compensation restrictions or similar restrictions for SBLF participants. Participating institutions may repay their SBLF funding at any time with prior approval of their primary regulator.

Please note that Treasury is working on separate SBLF terms for S corporations, mutual institutions

and community development loan funds. Treasury will publish separate SBLF terms for these institutions at a later date. The summary of the terms and application process discussed below therefore are not applicable to S corporations, mutual institutions of community development loan funds.

### Overview of the Small Business Lending Fund

Treasury will provide an eligible institution with capital by purchasing Tier 1-qualifying, senior perpetual noncumulative preferred stock (or an equivalent instrument) of the institution. To encourage community bank participation, the initial cost of capital (i.e., dividend rate) will not exceed 5%. If an institution's small business lending increases by 10% or more, then the dividend rate will decrease to 1%. Institutions that increase their small business lending by less than 10% but more than 2.5% can benefit from dividend rates ranging between 2% and 4%. If an institution's small business lending does not increase during the first two years following the SBLF investment, however, the dividend rate will increase to 7%. **After four and one-half (4½) years, the dividend rate on the preferred stock will increase to 9% for each institution regardless of the amount of the institution's small business lending activities.** This feature is designed to encourage institutions to repay Treasury within a four and one-half (4½) year timeframe. Accordingly, an institution planning to participate in the SBLF program should also be simultaneously planning how it will exit the program in four and one-half (4½) years, lest the institution

be faced with limited alternatives other than to continue to pay 9% for the investment received under the program.

The Act defines small business lending as certain loans of up to \$10 million to businesses with up to \$50 million in annual revenues. These loans include loans that are classified in the following loan categories of an institution's Call Report:

- commercial and industrial loans;
- loans secured by owner-occupied nonfarm, nonresidential real estate;
- loans to finance agricultural production and other loans to farmers; and
- loans secured by farmland.

Loan portions guaranteed by the U.S. government or for which a third party assumes the risk are not included. In determining whether a loan's original principal and commitment amount is \$10 million or less, a group of loans to the same borrower or any of its affiliates will be treated as a single loan.

### *Eligibility*

As noted in Treasury's guidance, the SBLF is available to community banks. Specifically, an institution is eligible if it has total assets of less than \$10 billion as of the end of the fourth quarter of calendar year 2009. If an insured depository institution is controlled by a bank holding company or savings and loan holding company, the holding company must apply to participate in the program, and the combined assets of the holding company as of the end of the fourth quarter of calendar year 2009 determine eligibility for participation in the program.

An institution is not eligible if it is on the FDIC's problem bank list, or "similar list," or has been removed from such list in the previous 90 days. Generally, the FDIC's problem bank list will include any bank with a composite CAMELS rating of 4 or 5. Please note, however, that Treasury guidance does not define or discuss what constitutes a "similar list" and thus appears to give the regulators

some discretion in determining which other institutions may or may not qualify for the SBLF. Also, an institution may not simultaneously participate in the Treasury's CPP or Community Development Capital Initiative (CDCI) program and the SBLF. Consequently, if an institution is a CPP or CDCI participant and wishes to participate in the SBLF, it will need to either repay its CPP/CDCI investment or use the SBLF investment to refinance its CPP/CDCI investment.

### *Amount of Funding*

If an institution has total assets as of the end of the fourth quarter of 2009 of \$1 billion or less, it may apply for SBLF funding that equals up to 5% of its risk-weighted assets as reported in its most recent Call Report as of the date of its application. If an institution has total assets as of the end of the fourth quarter of 2009 of more than \$1 billion, but less than \$10 billion, it may apply for funding that equals up to 3% of its total risk-weighted assets as reported in its most recent Call Report as of the date of its application.

### *Determination of Dividend Rates and Qualified Small Business Lending*

If an institution's application to the SBLF is approved and it elects to participate, Treasury will invest funds in the institution, receiving shares of senior perpetual noncumulative preferred stock (or an equivalent instrument), with a liquidation preference of \$1,000 per share, in return. The institution will pay dividends on the SBLF preferred stock at rates that will decrease if the amount of the institution's qualified small business lending increases.

The dividend rate during the first two years will be, at most, 5% per year. With a 10% increase in small business lending, the rate will drop to only 1%. Lesser increases in small business lending can cause the rate to decrease to between 2% and 4% as noted in the chart below. The rate in the tenth quarter after the closing date will continue to apply until the end of the four and one half (4½) year period after the institution receives SBLF funding. In most cases, this rate will be 5% or less;

however, if the institution's small business lending does not increase at all by the tenth quarter, the applicable dividend rate will increase to 7%.

Four and one-half (4½) years following Treasury's initial funding, if the capital has not been repaid, the rate will increase to 9% for all institutions regardless of its small business lending activities. This feature of the preferred stock instrument is designed to encourage institutions to repay Treasury by the four and one-half (4½) year anniversary of the date on which such institutions receive their SBLF funding. According to Treasury guidelines, an institution may repay the SBLF capital at any time, in whole or in part, provided it receives the approval of its regulator; however, there is no guidance on the criteria to be used by regulators for approving such repurchase of SBLF preferred stock.

The amount of the institution's increase in small business lending is measured by the amount of small business loans outstanding each quarter versus the amount of small business loans that was outstanding in the four quarters ending June 30, 2010. The dividend rate the institution pays is determined by its aggregate increase in small business lending. The SBLF does not distinguish between refinanced loans and new loans, or require any "loan-by-loan" review.

To measure this increase, the institution will establish its "baseline" level of small business lending at the time it receives SBLF funding (equal to the average amount outstanding in the four quarters ending June 30, 2010). During the quarter in which it receives SBLF funding, the institution's initial dividend rate will be 5% or less. Whether it is less than 5% will depend on whether the institution has achieved a sufficient increase from its baseline in qualified small business lending as reflected in the institution's Initial Supplemental Report which, in turn, is derived from the Call Report that is published in the calendar quarter before the institution receives funding. For example, if the closing date occurs in the second quarter of 2011, the initial dividend rate will depend on the amount of qualified small business lending

reflected in the Initial Supplemental Report that was derived from the Call Report published in the first quarter of 2011, which will be the amount of qualified loans that were outstanding at the end of the fourth quarter of 2010. If such small business lending has increased sufficiently (i.e., 2.5% or more) compared to the June 30, 2010 baseline amount, then the initial dividend rate will be less than 5%.

In each of the following nine quarters, the institution's amount of small business loans outstanding (adjusted to include proper charge-offs taken since July 1, 2010) as of the previous quarter will be compared to the June 30, 2010 baseline number. That comparison is used to determine the applicable increase in small business lending and, in turn, determines the dividend rate the institution will pay on its SBLF funding for the current quarter. For example, the dividend rate for the third quarter of 2011 will depend on the amount of qualified small business lending reflected in the Supplemental Report derived from the Call Report published in the second quarter of 2011 (this amount will actually reflect qualified loans at the end of the first quarter of 2011). The applicable dividend for the third quarter of 2011 will then be determined based on the increase in the small business lending reported in the Call Report published in the second quarter of 2011 as compared to the June 30, 2010 baseline amount.

The table below sets forth the dividend rates for the nine calendar quarters, adjusted quarterly, based on applicable increases in small business lending:

<b>Lending Increase</b>	<b>Dividend Rate</b>
Less than 2.5%	5%
2.5% or more, but less than 5%	4%
5% or more, but less than 7.5%	3%
7.5% or more, but less than 10%	2%
10% or more	1%

Please note that for SBLF participants that participated in the CPP and did not redeem, or apply to redeem, the CPP investment on or prior to December 16, 2010, a potential repayment incentive fee may be added to the SBLF dividend. If, at the beginning of the tenth full calendar quarter after such institution's SBLF investment, such institution's most recent Supplemental Report shows no increase in small business lending compared to its June 30, 2010 baseline, then for the period beginning on the fifth anniversary of such institution's CPP investment and continuing until four and one-half (4½) years after the SBLF investment date, such institution shall also pay Treasury a lending incentive fee equal to 2% per year of the aggregate liquidation preference of the then outstanding SBLF preferred stock.

### *Reporting and Certification Requirements*

If the institution participates in the SBLF, it will need to submit an Initial Supplemental Report and Quarterly Supplemental Reports, which will determine the dividend rates for the SBLF funding as discussed above. The Initial Supplemental Report, due before closing, will establish the initial baseline of qualified small business lending, report initial increases in small business lending, and determine the initial dividend rate that will apply at the time of closing of the SBLF investment. The Quarterly Supplemental Reports will report any adjustments to the June 30, 2010 baseline amount (to incorporate subsequent mergers, acquisitions or loan purchases) and the applicable increase in small business lending, if any, and will be due within 30 days of quarter end. In addition, the institution will be required to complete a short annual lending survey and provide certain annual certifications to Treasury, as discussed below.

Similar to the Call Reports filed by institutions, Treasury will require different forms of Supplemental Reports from different institutions. There will be four different versions of each Supplemental Report, which track the form of Call Report an institution uses. If an institution is a state-chartered or nationally chartered bank, it will use the Supplemental Report for Banks. If an institution is

a savings association, it will use the Supplemental Report for Savings Associations, and if an institution is a holding company, it will use the Supplemental Report for Bank Holding Companies or the Supplemental Report for Savings and Loan Holding Companies, as applicable. These forms are not yet available, but Treasury intends to make each of these forms available shortly.

Each Supplemental Report must be certified as accurate by the Chief Executive Officer and Chief Financial Officer. The same members of the board of directors that sign the institution's Call Report (or, if the institution is a holding company, that sign the Call Reports of its insured depository subsidiaries) must also sign the Supplemental Report. All Supplemental Reports are filed with Treasury rather than the institution's primary regulator.

There are three additional certifications that participants in the SBLF must provide to the Treasury:

- Auditors must certify on an annual basis that the processes and controls used to generate the Initial and Quarterly Supplemental Reports are accurate. The audit certification is only required for the years in which the first ten Supplemental Reports are submitted;
- The institution must certify on an annual basis that the principals of the businesses that received loans have certified to the institution that they have not been convicted of, or pleaded nolo contendere to, a sex offense against a minor as defined by the Act; and
- The institution must certify on an annual basis that it is in compliance with federal anti-money laundering requirements, in particular the Customer Identification Program requirements.

### *CPP/CDCI Refinancing*

To be considered for refinancing of outstanding CPP or CDCI securities with SBLF funding, the

institution must meet all of the eligibility requirements that otherwise apply to SBLF participants, plus the following additional requirements:

- the institution must be in material compliance with all the terms, conditions and covenants of any CPP or CDCI agreement and financial instrument;
- the institution must not have missed more than one dividend payment under the CPP or CDCI (where a missed payment is defined as a payment submitted more than 60 days after the due date); and
- the institution must pay, in immediately available funds, the amount of any unpaid dividends for the payment period prior to the SBLF closing date, plus accrued and unpaid dividends as of the date of refinancing for the payment period that includes the closing date.

The maximum amount of available SBLF funding for CPP or CDCI refinancing is the same as it is for regular SBLF participants. If the institution has up to \$1 billion in assets, it may apply for SBLF funding that equals up to 5% of its risk-weighted assets as reported in its most recent Call Report as of the date of its application. If the institution has more than \$1 billion and less than \$10 billion in assets, the maximum will be 3% of risk-weighted assets as reported in its most recent Call Report as of the date of its application.

If the institution has CPP or CDCI stock with an aggregate liquidation preference greater than the maximum amount of permissible SBLF funding, the institution must redeem the additional CPP or CDCI stock in immediately available funds on or before the date it receives SBLF funding. All outstanding CPP and CDCI securities must be refinanced or repaid in full at the time of the refinancing. In addition, the SBLF funding must be at least 1% of the institution's risk-weighted assets.

Any warrants that the institution has issued to Treasury under CPP will remain outstanding after CPP refinancing through the SBLF, unless the institution repurchases them.

### *Provisions Upon Nonpayment of Dividend*

The following restrictions will apply whenever dividends payable on the SBLF preferred stock have not been declared and paid for any quarterly dividend period: (i) the CEO and CFO of the institution will be required to provide written notice, in a form reasonably satisfactory to Treasury, explaining the rationale of the institution's board of directors for not declaring dividends; and (ii) no repurchase may be effected and no dividends may be declared or paid on preferred shares ranking *pari passu* with the SBLF preferred stock, junior preferred shares or other junior securities (including common stock) during the current quarter and for the next three quarters following the failure to declare and pay dividends on the SBLF preferred stock (provided, however, that, in any such quarter in which Treasury's dividend is paid, dividend payments on shares ranking *pari passu* may be paid to the extent necessary to avoid any resulting material covenants breach).

Whenever dividends on the SBLF preferred stock have not been declared and paid for *four* quarterly dividends or more, whether or not consecutive, and during such time the institution was not subject to a regulatory determination that prohibits the declaration and payment of dividends, the board of directors of the institution must certify, in writing, that the institution used best efforts to declare and pay such quarterly dividends in a manner consistent with safe and sound banking practices and the directors' fiduciary obligation.

Whenever dividends on the SBLF preferred stock have not been declared and paid for *five* quarterly dividends or more, whether or not consecutive, Treasury will have the right, but not the obligation, to appoint a representative to serve as an observer on the institution's board of directors. The right will end when full dividends have been

paid for four consecutive subsequent dividend periods.

Whenever dividends on the SBLF preferred stock have not been declared and paid for six quarterly dividend periods or more, whether or not consecutive, if the liquidation preference of the SBLF preferred stock is \$25 million or more, the holder of the SBLF preferred stock will have the right to elect two directors to the institution's board of directors. The right to elect directors will end when full dividends have been paid for four consecutive dividend periods.

### *Downstreaming of Investment*

If the participating institution is a holding company, it shall contribute not less than 90% of the amount of Treasury's investment to the institution's insured depository institution subsidiaries; provided that no insured depository institution may receive more than 5% of its risk-weighted assets (if the institution has total assets of \$1 billion or less) or 3% of its risk-weighted assets (if the institution has total assets of more than \$1 billion and less than \$10 billion).

### *Voting Rights; Transferability*

The SBLF preferred stock will be nonvoting, other than for consent rights granted to Treasury with respect to (i) any authorization or issuance of shares ranking senior to the SBLF preferred stock, (ii) any amendment to the rights of the SBLF preferred stock and (iii) any merger, exchange, dissolution or similar transaction that would affect the rights of the SBLF preferred stock. The SBLF preferred stock will not be subject to any restrictions on transfer. The institution may merge or sell all, or substantially all, of its assets, provided that the rights of the SBLF preferred stock and the obligations of the institution relating thereto are assumed and an equivalent SBLF preferred stock is issued by the successor entity.

### *Access to Information*

A participating institution will be required to permit the holder of the SBLF preferred stock, the holder's designee(s), the Inspector General of the Treasury and the Comptroller General of the United States to examine the institution's corporate books and discuss matters relevant to the SBLF investment with the institution's principal officers, provided reasonable notice is first provided to the institution.

### *Changes in Applicable Law*

Unlike the TARP programs, if, after a SBLF investment has been made, there is a material change in law that modifies the terms of the SBLF investment in a materially adverse manner for an institution, the institution may, after consultation with its primary regulator, redeem the SBLF investment without impediment.

### **Application Process**

If an institution is eligible and wishes to apply to participate in the SBLF, it must submit a completed application to Treasury at [SBLFApps@do.treas.gov](mailto:SBLFApps@do.treas.gov). Treasury has stated that given application processing times, applications for eligible institutions should be submitted by March 31, 2011 (this deadline does not apply to S corporations, mutual institutions or community development lending funds). The application is a simple, one-page document requiring disclosure of basic information such as name, address and asset size of the applicant, as well as the requested investment amount and identification of the applicant's primary regulator. The application also asks if the applicant is seeking to refinance a CPP or CDCI investment.

In addition to submitting an application to Treasury, an applicant must submit a small business lending plan of approximately two pages in length to its primary federal regulator and to its state regulator, if applicable. If the institution is a holding company, it must also submit the lending plan to the primary federal regulator (and state regulator, if applicable) of each of its insured depository institution

subsidiaries. The lending plan should not be sent directly to Treasury.

### *The Small Business Lending Plan*

The lending plan to be submitted by an applicant to its regulator should: (i) address how the institution will meet the needs of small businesses; (ii) specify the projected increases in small business lending; and (iii) discuss the institution's planned community outreach efforts to female, minority and veteran small business organizations. The institution should submit its lending plan to its primary regulator(s) at the same time it submits its SBLF application to Treasury.

*Address the needs of small businesses.* The lending plan should describe how the institution intends to use funding from the SBLF to address the needs of small businesses in the communities it serves. The institution should provide a description of the basis for its lending goals and how it intends to achieve these goals. The lending plan also needs to explain why the projected increase in small business lending is reasonable in the context of the size of the institution and the market it serves. If feasible, the lending plan should also include a description of the types of loans that the institution anticipates making and the customers to be served.

*Specify the projected increase in small business lending.* The lending plan should describe the increase in qualified small business lending that the institution expects to achieve two years after the investment. Treasury has stated that it is acceptable to provide a projected range for the expected increase in small business lending activities. This projection should be based upon the institution's estimate of qualified small business lending, but the institution is not required to formally calculate such lending increase at the time of application. Each applicant, however, will be required to calculate such lending increase as part of the closing process, after receiving preliminary approval for participation in the SBLF. Prior to closing, the institution will be asked to revalidate the projection provided in this lending plan on the

basis of its formal calculation of qualified small business lending. As a result, even though an applicant is not required to produce a formal calculation of the expected increase in small business lending, it is advisable for the applicant to try to develop a formal calculation that is as realistic as possible at the time of submission of the application. Treasury has also noted that this lending plan is not intended to be an official business plan such as those submitted to the institution's primary federal regulator from time to time. As a result, Treasury does not require the submission of a pro forma income statement or balance sheet with the lending plan.

*Provide for community outreach.* The Act also requires institutions participating in the SBLF to provide outreach and advertising to certain groups describing the availability and application process for receiving small business loans. Pursuant to the Act, such outreach activities include the use of print, radio, television or electronic media outlets that target organizations, trade associations and individuals that represent, work with or are women, minorities or veterans. As a result, the applicant should describe the activities it will undertake to market small business loans to these targeted customers. In addition, the applicant should also describe how its outreach activities will be tailored to address linguistic or cultural factors that are relevant to such female, minority or veteran organizations or individuals.

### *Application Review and Approval Process*

Treasury will notify each institution whether its application has been approved, approved contingent on raising matching funds or not approved (and deemed to be withdrawn). Treasury has not provided any specific criteria that it will use in making this determination. If Treasury approves an application, the applicant will be notified and can then schedule a closing if the applicant wishes to proceed with the transaction. With respect to the matching funds program, Treasury may determine that an institution is eligible and should be considered for participation in the SBLF, provided it

raises separate matching funds from private, nongovernmental sources. If Treasury requires that the institution raise a matching amount of capital from private sources, the maximum investment amount from Treasury will be equal to 3% of the institution's risk-weighted assets. Treasury may, however, require the institution to raise matching funds from private sources in an amount in excess of Treasury's proposed investment amount. Such matching funds will need to be received either prior to or concurrent with

Treasury's SBLF funding. In general, an institution may count capital raised from private sources after September 27, 2010 for purposes of determining whether it has met any applicable matching funds requirement. Please note, institutions applying to refinance CPP or CDCI securities will not be considered for approval on a matching funds basis.

*If you have specific questions regarding the SBLF or would like to discuss this bulletin further, please contact any of the attorneys listed below.*

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