

# FINANCIAL INSTITUTIONS ALERT

NEWS FOR THE CLIENTS AND FRIENDS OF BASS, BERRY & SIMS PLC

## **Small Business Lending Fund: Should My Community Bank Participate?**

**December 23, 2010**

On September 27, 2010, President Obama signed into law the Small Business Jobs and Credit Act of 2010 (the "Act") for the purpose of making capital investments in eligible institutions in order to increase the availability of credit for small businesses.<sup>1</sup> On December 20, 2010, the U.S. Department of the Treasury ("Treasury") promulgated, via a special Web site, the terms sheet for the Small Business Lending Fund ("Fund") investments authorized by the Act for financial institutions other than Subchapter S and mutual institutions and Community Development Loan Funds.

### **Small Business Lending Fund**

#### *Overview*

The Act establishes the Fund in the Treasury, administered by the Secretary of the Treasury (the "Secretary"), to cover purchases of preferred stock and other financial instruments<sup>2</sup> from eligible institutions. The Act allows eligible institutions having total assets of more than \$1 billion but less than \$10 billion, as of the end of the fourth quarter of 2009, to receive a capital investment from the Fund of up to 3 percent of risk-weighted assets, as reported in the institution's call report immediately preceding the date of application. Eligible institutions with total assets of less than \$1 billion may receive an amount up to 5 percent of risk-weighted assets.

#### *Tier Status of Investments*

The terms sheet published on December 20, 2010 provides that Treasury will purchase senior, non-cumulative preferred stock which will be eligible for Tier 1 capital treatment. Because the investment is non-cumulative preferred stock, it will satisfy the Collins Amendment requirement of the Dodd Frank Act for Tier 1 treatment and will likely not be subject to the phase-out provisions of Basel III that start in January 2013.

#### *Eligibility*

In addition to the two size limitations described above that define the maximum permissible investment, the Act declares ineligible for a capital investment from the Fund any institution that is either on the FDIC problem bank list or has been removed from such list for less than 90 days.

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<sup>1</sup> "Small business" has the meaning given the term "small business concern" under section 3 of the Act, and generally means a business with \$50 million or less in annual revenues.

<sup>2</sup> Other financial instruments include only debt instruments for which an eligible institution is fully liable or equity equivalent capital of such eligible institution.

“FDIC problem bank list” means the list of institutions with a current rating of 4 or 5 under the Uniform Financial Institutions Rating System, or such other list designated by the Federal Deposit Insurance Corporation. Furthermore, institutions with TARP Capital Purchase Program (“CPP”) preferred stock outstanding, cannot have missed more than one CPP dividend (i.e., submitted payments more than 60 days after the due date) and must be in material compliance with all terms of the institution’s CPP agreement with Treasury.

### *Small Business Lending Plan*

In order to receive a capital investment from the Fund, an applicant institution (including a state-chartered bank) is required to submit to its primary federal regulator and state regulator, if applicable, (but not Treasury): a small business lending<sup>3</sup> plan (which shall be treated as confidential supervisory information) describing (1) how its business strategy and operating goals address the needs of small businesses in the areas it serves; and (2) its approach to community outreach, including its plans to provide linguistically and culturally appropriate outreach.

### *Incentives to Lend*

The guidelines published by Treasury prescribe the following terms and conditions governing the preferred stock to be issued to Treasury by an eligible institution receiving a capital investment under the Fund:

- dividends or interest are payable quarterly at 5 percent per year initially;
- within the first two years after the date of the capital investment, the rate on dividends or interest may be adjusted downward based on an increase in the amount of an eligible institution’s small business lending; changes in the amount of small business lending shall be measured against the baseline of the average amount of small business lending reported by the eligible institution in its call reports for the four full quarters ending June 30, 2010 minus certain adjustments (principally related to mergers and acquisitions);
- during each calendar quarter during the initial two-year period discussed above, an institution’s rate shall be adjusted to reflect the following schedule, based on that institution’s change in the amount of small business lending relative to the baseline:
  - if the amount of small business lending has increased by less than 2.5 percent, the dividend or interest rate shall be 5 percent;
  - if the amount of small business lending has increased by 2.5 percent or greater, but less than 5 percent, the dividend or interest rate shall be 4 percent;
  - if the amount of small business lending has increased by 5 percent or greater, but less than 7.5 percent, the dividend or interest rate shall be 3 percent;
  - if the amount of small business lending has increased by 7.5 percent or greater, but less than 10 percent, the dividend or interest rate shall be 2 percent; and

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<sup>3</sup> The term “small business lending” means lending as defined by and reported in an eligible institutions’ quarterly call report, where each loan comprising such lending is one of the following types: (i) commercial and industrial loans; (ii) owner-occupied nonfarm, nonresidential real estate loans; (iii) loans to finance agricultural production and other loans to farmers; and (iv) loans secured by farmland. Loans greater than \$10 million or to businesses with more than \$50 million in revenue are excluded. If any part of the loan is guaranteed by a U.S. government agency or enterprise, the guaranteed portion is subtracted from the loan amounts.

- if the amount of small business lending has increased by 10 percent or greater, the dividend or interest rate shall be 1 percent.

If the amount of qualified small business lending by a participating institution has increased from the baseline by a sufficient percentage to result in a lower dividend rate, the lower rate will apply to the dollar amount of the capital injected by the Fund only up to the amount by which qualified small business lending has increased. For example, assume that the amount of funding from the Fund is \$5 million, qualified lending has increased by \$4 million in the two years after receiving the capital, and this amount represents a 10 percent increase over the baseline, resulting in a 1% dividend rate. On these assumptions, the 1 percent rate applies to \$4 million of the funding and a 5 percent rate applies to the remaining \$1 million. If qualified small business lending had increased by at least \$5 million, which is the amount of the funding received, the 1% rate would have applied to the entire amount.

#### *Timing of Rate Adjustments*

The timing of any rate adjustment shall occur in the calendar quarter following the publication of call report data, such that the rate based on call report data from any one calendar quarter, which is published in the first following calendar quarter, shall be adjusted in that first following calendar quarter and payable in the second following calendar quarter. For example, if the closing date of an investment occurs in the second quarter of 2011, the initial dividend rate will depend on the amount of qualified small business lending reflected in a supplemental report to be filed by the institution that will be 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.

The rate based on the call report period following the initial two-year period shall be payable until the expiration of the four-and-a-half-year period that begins on the date of the investment. In the case where the amount of small business lending has remained the same or decreased relative to the institution's baseline in the eighth quarter after the date of the capital investment, the rate shall be 7 percent until the expiration of the four-and-a-half-year period. If an institution uses funding from the Fund to refinance a CPP investment, an added fee will apply if the institution's small business lending has not increased relative to its baseline amount in the eighth quarter after funding is received (as reflected in a supplemental report submitted in the ninth quarter after the funding is received). In such a case, the bank will be required to pay a quarterly lending incentive fee equal to 2 percent per annum on the total amount of outstanding funding from the Fund, starting at the beginning of the first quarter after the fifth anniversary of the initial CPP investment (not the initial Fund investment date) and ending four-and-a-half years following the date the institution refinances into the small business lending fund.

The dividend or interest rate paid on any preferred stock issued by an eligible institution that receives a capital investment shall increase to 9 percent at the end of the four-and-a-half-year period.

#### *Consequences of Failure to Pay Dividends*

Although dividends on the preferred stock are non-cumulative, failure to pay dividends on the preferred stock carries consequences. On such an occasion, the senior management of a participating institution must provide Treasury with written notice as to why the institution's board of directors did not declare dividends. And, the institution may not repurchase shares or pay dividends on shares that are pari passu or junior to the preferred shares issued to Treasury during the quarter of nonpayment and for the following three quarters.

If a participating institution does not pay dividends on the preferred stock for four quarters, and during such time it was not subject to a regulatory determination that prohibits the declaration and payment of dividends, then the institution's board of directors must certify to Treasury, in writing, that the institution used its best efforts to declare and pay such quarterly dividends in a manner consistent with safe and sound banking practices and the directors' fiduciary obligations.

If a participating institution fails to pay its preferred stock dividends for five quarters, Treasury will have the right, but not the obligation, to appoint an observer to the institution's board of directors. This right expires when full dividends have been paid for four consecutive dividend periods. After six missed payments, if the amount of a participating institution's funding totals \$25 million or more, Treasury will have the right, but not the obligation, to elect two directors to its board. The right to elect directors expires once full dividends have been paid for four consecutive quarters.

For privately held banks, paying dividends on shares ranking *pari passu* or junior to the shares of preferred stock issued to Treasury through the Fund also is prohibited from the tenth anniversary of the investment date onward. Treasury expects any outstanding funds invested through the Fund to be repaid before that time.

#### *Downstreaming of Funds*

Because the intent of any investment by the Fund is to generate small business lending, if funding is provided to a holding company, the holding company must contribute at least 90 percent of the amount it receives to its insured depository institution(s).

#### *Capital Purchase Program Refinance*

Treasury's guidelines related to the Fund permit participants in the CPP to refinance securities issued to the Treasury under the CPP and Community Development Capital Initiative ("CDFI"). However, CPP and CDFI investments would be required to be paid in full since simultaneous participation in the CPP or CDFI and the small business lending fund is not permissible.

### **Maximum Purchase Limit and Termination of Authority**

The Act provides that the Fund shall make capital investments in the aggregate of \$30 billion. The Act terminates the authority to make capital investments in eligible institutions on September 26, 2011.

### **Separate from TARP and Changes in Law**

The Act establishes the Fund as separate and distinct from the Troubled Asset Relief Program ("TARP") and states that an institution shall not be considered a TARP participant by virtue of capital investment under the Act.

If, after a capital investment has been made in an eligible institution, there is a change in law that modifies the terms of investment or program in a materially adverse respect for the eligible institution, the eligible institution may, after consultation with the appropriate Federal banking agency for the eligible institution, repay the investment without impediment.

Bass, Berry & Sims PLC's Financial Institutions Subgroup specializes in advising and assisting financial institutions in their dealings within a complex banking environment. We have represented numerous financial institutions, and their holding companies, in public and private equity and debt

offerings, including in participation in the United States Department of the Treasury's Capital Purchase Program; counseled financial institutions in mergers and acquisitions; and advised boards of directors of financial institutions concerning director liability and regulatory issues. From small community banks and thrifts in Tennessee and Kentucky to large publicly held banks and insurance companies and their holding companies, we counsel our financial institution clients on a broad range of federal and state regulatory matters.

If you have any questions regarding the issues addressed in this Financial Institutions Alert please feel free to contact communicate with any of your regular contacts in the Corporate and Securities Group or any of the attorneys in our Financial Institutions Subgroup listed below.

Bob Thompson	(615) 742-6262	<a href="mailto:bthompson@bassberry.com">bthompson@bassberry.com</a>
Rob Ledyard	(615) 742-6259	<a href="mailto:rledyard@bassberry.com">rledyard@bassberry.com</a>
Steve Taylor	(615) 742-7758	<a href="mailto:staylor@bassberry.com">staylor@bassberry.com</a>
Scott Holley	(615) 742-7721	<a href="mailto:sholley@bassberry.com">sholley@bassberry.com</a>
Price Wilson	(615) 742-7820	<a href="mailto:pwilson@bassberry.com">pwilson@bassberry.com</a>
Frank Pellegrino	(615) 742-7947	<a href="mailto:fpellegrino@bassberry.com">fpellegrino@bassberry.com</a>

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