

UPDATE

News of Developments in the Financial Sector and Related Areas

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Capital for Subchapter S Banks Small Business Lending Fund

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The Treasury has released its *Terms* for Subchapter S corporations and mutual depository organizations to participate in the Small Business Lending Fund. An application for participation is required to be filed by June 6, 2011. The Small Business Jobs Act of 2010 included the creation of a \$30 billion Small Business Lending Fund (the "Fund") which authorizes the Treasury to make capital investments in depository institutions with an incentive structure to support new small business lending. The Fund encourages broader participation by depository institutions in that participants do not face existing TARP restrictions such as limitations relating to executive compensation. Current participants in TARP will be able to convert from the existing TARP program to the new program thereby substantially reducing their costs.

The Treasury utilizes unsecured subordinated debentures ("Senior Securities") for purposes of the capital injection which will not constitute a class of stock or represent equity ownership in a participating depository institution. The Senior Securities will qualify as Tier 2 capital. The capital treatment as Tier 2 should not be a problem for small bank

holding companies with consolidated assets under \$500 million. The Federal Reserve Board's Small Bank Holding Company Policy generally provides that a small bank holding company is only tested for capital at the subsidiary bank level. As a result, there is no capital requirement at the holding company level of a small bank holding company and the proceeds from the sale of Senior Securities can be contributed by a holding company to its subsidiary bank as additional Tier 1 capital. Approximately 80% of all institutions in the United States are less than \$500 million in asset size.

Depository institutions with less than \$1 billion in assets would be able to receive capital infusions from the Treasury up to 5% of their risk-weighted assets. Depository institutions between \$1 billion and \$10 billion in assets would be eligible to receive up to 3% of their risk-weighted assets. To participate, depository institutions will have to be recommended by their primary bank regulator. Depository institutions on the FDIC problem bank list or that have been removed from the problem list for less than 90 days are not eligible to participate. The Fund defines a problem bank as a depository institution having a CAMELS composite rating of 4 or 5, or such other list designated by the FDIC. The Fund also provides that simply because a bank has a CAMELS rating of 3 or better that the Treasury Department still has the discretion to deny an application of an eligible institution.

The Treasury has the authority to permit participation by an institution that would not otherwise be eligible conditioned on private

matching investments. In this instance, the institution would be eligible to receive a capital infusion not to exceed 3% of risk-weighted assets based on private matching investments and subordinate to the capital infusion to be received from the Treasury.

An applicant must deliver with its application for participation a small business lending plan describing how its business strategy and operating goals will allow it to address the needs of small businesses in the area it serves, as well as a plan to provide linguistically and culturally appropriate outreach, where appropriate. The plan will be confidential supervisory information and not available to the public. The term "small business lending" means (i) commercial and industrial loans, (ii) owner-occupied non-farm, non-residential real estate loans, (iii) loans to finance agricultural production and other loans to farmers, and (iv) loans secured by farm land. No loans that have an original amount greater than \$10 million or to a business with more than \$50 million in revenues are eligible.

The initial dividend rate for the capital investment provided by the Treasury under the proposed program will begin at 7.7%, with reductions to as low as 1.5% if a bank demonstrated specific levels of increased small business lending. During the initial two-year period of participation in the program, participants would receive decreases quarterly in the dividend rate based on incremental business lending they achieve over the two-year period, down to a minimum dividend rate of 1.5%. Banks would realize the reduction in the dividend rate sooner if they made earlier, but consistent progress towards increased lending. Changes in the rate will be measured against a baseline of the average amount of small business lending reported by the bank during the period of July 1, 2009 through June 30, 2010, less adjustments for loan charge-offs and loans

acquired through purchase and merger transactions.

During the first two years, if small business lending has increased less than 2.5%, the dividend rate will be 7.7%; if small business lending has increased by 2.5% or greater but less than 5%, the dividend rate will be 6.2%; if small business lending has increased by 5% or greater, but by less than 7.5%, the dividend rate will be 4.6%; if small business lending has increased by 7.5% or greater, but less than 10%, the dividend rate will be 3.1%; and if small business lending has increased by more than 10%, the dividend rate will be 1.5%. If a bank increases its small business lending above the prior year baseline average, the rate adjustment will take effect the calendar quarter following the change in small business lending and will be payable in the second following quarter. At the end of the two years of adjustments, the rate in place at the end of the two year period will be the rate for the next 2 ½ years. In those situations where a bank has not increased its level of small business lending as of the end of the two year period, the rate will be changed to 10.8% for the next 2 ½ years. The rate would increase to 13.8% at the end of the 4 1/2 –year period following a bank's participation in the program. The capital investment must be repaid at the end of 10 years.

Any business receiving a loan from a participating institution using funds received under the program is required to certify to the institution that the principals of such business have not been convicted of a sex offense against a minor. Participating institutions will probably need to obtain this certification from all borrowers since it may be difficult to determine which loans are made or not made under the program.

Our firm is experienced in transactions with the Treasury and available to assist institutions in participating in the program.