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LEGAL UPDATES AND NEWS

Treasury Issues Term Sheets for Small Business Lending Fund

On December 21, 2010, the Treasury Department began implementing the Small Business Lending Fund ("SBLF") by releasing term sheets and application information. The SBLF, which was established by the Small Business Jobs Act of 2010, will provide up to $30 billion of capital to community banks to support their small business lending.

Certain key items from the newly released materials, which are available on Treasury's website at http://www.treasury.gov/resource-center/sb-programs/Pages/Small-Business-Lending-Fund.aspx, are presented below. Please note that Treasury has advised institutions to submit their applications for SBLF funding by March 31, 2011. Terms and guidance for mutual institutions, Subchapter S corporations, and community development loan funds will be released by Treasury in the future.

Eligibility

Eligibility for SBLF investments (which will generally take the form of preferred stock) is limited to insured depository institutions and their holding companies with less than $10 billion in total consolidated assets. Institutions with less than $1 billion in assets may receive investments of up to 5% of risk-weighted assets. Institutions with between $1 billion and $10 billion in assets may receive investments of up to 3% of risk-weighted assets. Institutions that are on the FDIC's "problem bank list" (i.e., with a CAMELS rating of 4 or 5), or that have been off of the problem bank list for less than 90 days, are not eligible to participate. SBLF investments qualify as Tier 1 capital and carry a dividend rate that begins at 5% and adjusts downward (to as low as 1%) based on a participating institution's increase in small business lending.

Qualified Small Business Lending

The SBLF uses a definition of small business lending that is broader than the Call Report categories of "loans to small businesses" and "loans to small farms." For SBLF purposes, small business lending includes: (i) commercial and industrial loans; (ii) loans secured by owner-occupied nonfarm, nonresidential real estate; (iii) loans to finance agricultural production and other loans to farmers; and (iv) loans secured by farmland. A loan in any of these four categories will qualify as small business lending provided that (a) the loan's original principal and commitment amount is $10 million or less and (b) the loan does not go to a business with more than $50 million in revenues.

Calculation of Dividend Rate

A "baseline" of each participant's small business lending will be established using Call Report data from the four quarters ended June 30, 2010. The institution must then pay dividends on its SBLF investment at a rate that *decreases* as its small business lending increases from the baseline. During the first nine quarters after receipt of SBLF funding, an institution may decrease the 5% base dividend rate by 1% for each 2.5% increase in its small business lending over the baseline, down to a minimum dividend rate of 1%. For example, an institution that increases its small business lending by 5% over its baseline will reduce the dividend rate to 3%. However, the lower dividend rate will apply to a dollar amount of SBLF funding *only up to the amount by which qualified small business lending has increased.* For instance, using the above example, if the institution received $5 million in SBLF funding, and increased its small business lending by $4 million (representing a 5% increase over its baseline), the 3% reduced dividend rate would apply only to $4 million of the SBLF funding, and the 5% rate would apply to the remaining $1 million. If the institution increased its qualified small business lending by at least $5 million, which is the amount of SBLF funding received, the reduced dividend rate would apply to the entire amount.

The reduced dividend rate is locked in from the tenth quarter after funding through the end of the 4½-year period after the closing date. However, if an institution's small business lending at the end of the two-year period after funding has remained the same or decreased relative to its baseline, its dividend rate will be 7% until the end of the 4½-year period after the closing date. Regardless of lending activity, at the end of the 4½-year period after funding, the dividend rate for each participating institution will increase to 9%. An SBLF investment may be repaid at any time (with regulatory approval) and *must be repaid* in full after 10 years. Participating institutions will be required to supplement their Call Reports with Quarterly Supplemental Reports that detail their small business lending.

Small Business Lending Plan

Each applicant must submit a "small business lending plan," of approximately two pages in length, to its federal banking regulator, and, if state chartered, to its state banking regulator. The small business lending plan must: (1) describe how the institution will use SBLF funding to address the needs of small businesses in the communities it serves and explain why the projected increase in small business lending is reasonable; (2) specify the increase in small business lending that the institution expects to achieve; and (3) provide for community outreach, such as through advertising describing the availability and application process for receiving small business loans. Treasury has released a template small business lending plan that institutions may use to satisfy these requirements.

Underwriting Standards

The legislation that established the SBLF also required the federal banking agencies to issue guidance on prudent underwriting standards for small business loans made with SBLF funds. On December 21, 2010, the federal banking agencies jointly issued the required guidance, which, among other things, directs each participating institution to ensure that its small business lending policy is consistent with safe and sound credit practices and supportive of the institution's participation in the SBLF program. An institution's small business lending policy should address prudent loan portfolio diversification by establishing growth rates and concentration standards as a percentage of capital for different loan types, industries, borrower groups, and collateral support. The guidance also provides that institutions should consider all relevant credit factors when underwriting small business loans, including the borrower's ability to service the debt from current income; the value and quality of the collateral; the overall creditworthiness of the borrower; the level of equity invested in the business; any secondary sources of repayment; and any additional collateral or credit enhancements (such as guarantees or key-person insurance).

TARP Refinancing

SBLF investments may be used by an institution to refinance securities issued in connection with the TARP Capital Purchase Program ("CPP"), provided that the institution's outstanding TARP securities are refinanced or repaid in full at the time of the refinancing. To be eligible for TARP refinancing, an institution must not have missed more than one dividend payment under the CPP and 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. Unlike TARP, there are no employee compensation restrictions associated with SBLF investments.

Reporting and Certification Requirements

An institution that participates in the SBLF will be required to submit to Treasury an Initial Supplemental Report (which is used to establish its small business lending baseline) as well as Quarterly Supplemental Reports (which are used to monitor its small business lending and determine the dividend rates for SBLF funding). In addition, SBLF participants will be required to complete a short annual lending survey and submit the following annual certifications to Treasury: (1) a certification from the institution's auditors stating that the processes and controls used to generate the Initial and Quarterly Supplemental Reports are accurate; (2) a certification that businesses that received loans from the institution have certified to the institution that their principals have not been convicted of, or pleaded no contest to, a sex offense against a minor; and (3) a certification that the institution is in compliance with federal anti-money-laundering requirements, particularly Customer Identification Program requirements.

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Luse Gorman is one of the leading firms nationally in advising financial institutions on capital-raising transactions, including U.S. Treasury programs such as the TARP Capital Purchase Program. For further details regarding this newsletter, please contact any of the attorneys listed below.

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