The U.S. Treasury Small Business Lending Fund: An Opportunity for Community Banks

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Introduction

In an effort to spur economic growth and, in particular, expand small business employment, the U.S. Congress passed the Small Business Jobs Act of 2010.[1] One section of that legislation established the Small Business Lending Fund (Fund) the stated purpose of which is "to address the ongoing effects of the financial crisis on small businesses by providing temporary authority to the Secretary of the Treasury to make capital investments in eligible institutions in order to increase the availability of credit for small businesses."[2] The legislation authorizes the U.S. Department of the Treasury (Treasury) to invest up to $30 billion in the form of preferred stock investments in community banks. In December 2010, Treasury released its guidelines (Guide) for participation in the Fund.[3]

Overview

The Fund is available only to banks with assets less than $10 billion (*i.e.*, designated community banks).[4] These community banks may obtain investments from the Treasury with the expectation that the banks will use the funds to increase their lending to small businesses. The greater the increase in a bank's small business lending, the lower the dividend rate that the bank will pay, with a rate as low as one percent for those banks that increase their small business lending by ten percent or more. As noted in the Guide, the Fund "will help create jobs and promote economic growth in local communities across the nation while enabling "Main Street" banks to better extend credit to their customers by utilizing the incentives that the Fund provides."[5] Unlike the Capital Purchase Program which provided capital to banks under the Troubled Asset Relief Program (TARP),[6] the Fund carries no executive compensation restrictions and does not require the issuance of any warrants.

Details of the Small Business Lending Fund

Eligible Institutions and Amount of Funding. Banks with assets of $1 billion or less may obtain funding in an amount up to five percent of the bank's assets.[7] Banks with assets between $1 billion and $10 billion may obtain funding up to three percent of the bank's assets.[8] To be eligible, a bank must not be on the FDIC's problem bank list or have been on that list within the past 90 days.[9]

Dividend Rate and Term. The dividend rate to be paid to Treasury on the preferred stock will vary from one percent to five percent during the first two years.[10] The rate will depend on the amount of the bank's small business lending: the greater the increase in small business lending, the smaller the dividend rate. After two years, the rate can stay as low as one percent or can increase to as high as seven percent if the bank's small business lending does not increase at all.[11] After four and a half years, the dividend rate will increase to nine percent, so banks should consider their plans for replacing the capital at that time. The capital may be repaid at any time with the approval of the bank's regulators.

Calculation Process for the Dividend Rate. The Guide specifies that a bank's dividend rate will be based upon the amount of the bank's small business lending as compared to the amount of small business lending that was outstanding in a base period comprised of the four quarters ending June 30, 2010. The baseline will be the quarterly average of "Qualified Small Business Lending" for the four quarters ending June 30, 2010 and will be established at the time a bank receives funding.[12] The bank's dividend rate for the first nine quarters will depend upon any increases in Qualified Small Business Lending going forward.[13] For example, if the funding closing date occurs in the second quarter of 2011, the initial dividend rate will depend on the amount of Qualified Small Business Lending as reported in the bank's year-end 2010 Call Report as compared to the baseline amount.[14] "For the first nine calendar quarters after the closing date, the dividend rate for each quarter will be similarly determined."[15] The dividend rate that applies in the 10th calendar quarter after the closing date will stay in effect through the remainder of the four and one-half year period following the closing date.[16] For each calculation date, if Qualified Small Business Lending has increased less than two and one-half percent over the baseline, the dividend rate will be five percent. If Qualified Small Business Lending has increased two and one-half percent or more but less than five percent, the dividend rate will be four percent; for lending increases of five percent or more but less than seven and one-half percent, the dividend rate will be three percent; for lending increases of seven and one-half percent or more but less than ten percent, the dividend rate will be two percent; and for lending increases of ten percent or more, the dividend rate will be one percent.[17]

Refinancing of TARP Investments. Banks that participated in TARP and still have TARP funds outstanding may apply to refinance their TARP capital with new capital issued under the Fund. To be eligible for refinancing, a bank must be in compliance with the terms of its TARP Agreement and must not previously have missed more than one dividend payment. Warrants issued in connection with TARP investments will remain outstanding. Banks that choose to refinance TARP investments through the Fund must increase their small business lending to receive an economic benefit from refinancing. If a bank refinancing TARP investments does not increase its small business lending relative to its baseline amount by the beginning of the 10th calendar quarter after closing, it will be required to pay an annual repayment incentive fee equal to two percent on outstanding Fund capital.[18]

Application Process and Small Business Lending Plan. The application process is quite simple. A bank wishing to participate in the Fund must submit a completed one-page application to Treasury.[19] These applications should be submitted by March 31, 2011. Submitting an application does not obligate a bank to participate in the Fund and a bank may withdraw its application at any time prior to entering into a definitive agreement with Treasury. In addition to the application to Treasury, a bank must submit a two-page small business lending plan to its primary federal regulator and to its state regulator, if applicable. A Small Business Lending Plan Form and Small Business Lending Plan Guide are available from Treasury.[20] Generally, the Small Business Lending Plan must describe how participation in the Fund will enable the bank to better address the needs of small businesses in the market it serves, estimate the projected increase in small business lending that the bank hopes to achieve, and describe the bank's approach to community outreach for small business lending.

Eligible Small Business Loans. For purposes of the Fund, eligible small business loans include loans reported under the categories of Loans to Small Businesses and Loans to Small Farms in the Call Reports.[21] Additionally, any loan in the Call Report categories of 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 will be considered as Qualified Small Business Lending provided that the loan's original principal and commitment amount is $10 million or less and the loan is not made to a business with more than $50 million in revenues.[22] A borrower's revenues will be measured at the most recent fiscal year that ended when the loan originated. Any portion of a loan that is guaranteed by the U.S. Government or for which the risk is assumed by a third party is excluded from the definition of Qualified Small Business Lending.[23]

Underwriting Standards for Small Business Lending. The federal banking agencies have issued guidance on loan underwriting standards for banks that elect to participate in the Fund.[24] As provided in the guidance, the board of directors of each bank participating in the Fund should ensure that its small business lending policy is consistent with safe and sound credit practices and is supportive of the bank's participation in the Fund. A bank's small business lending policy should address prudent loan portfolio diversification by establishing appropriate growth rates and concentration standards as a percentage of capital for different loan types, industries, borrower groups, and collateral support. While banks participating in the Fund are encouraged and expected to increase their small business lending, the federal banking agencies will be certain to scrutinize those institutions to make sure that such lending is conducted in a prudent and sound manner.

Conclusion

For those community banks that will be able to make even modest increases in their small business lending, the Fund provides an excellent vehicle for raising very inexpensive capital at a time when other sources of capital are scarce for community banks.

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1 Public Law No. 111-240 (Sept. 27, 2010).

2 Small Business Jobs Act of 2010, Section 4101.

3 The U.S. Treasury Small Business Lending Fund Getting Started Guide (Guide) is available at http://www.treasury.gov/resource-center/sb-programs/Documents/SBLF_Getting_Started_Guide_Final.pdf.

4 Guide at page 2.

5 Guide at page i.

6 Public Law No. 110-343 (Oct. 3, 2008).

7 Guide at page 3.

8 Guide at page 3.

9 Guide at page 3. *See also*, Press Release, Federal Deposit Insurance Corporation, *FDIC-Insured Institutions Earned $21.7 Billion in the Fourth Quarter of 2010*, PR-44-2011 (Feb. 23, 2011) and Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, available at http://www2.fdic.gov/qbp/2010dec/qbp.pdf (last visited February 23, 2011). As of the latest report released by the FDIC on December 31, 2010, there were 884 banks on the problem bank list.

10 Guide at page 12.

11 Guide at page 13.

12 Guide at page 12.

13 Guide at page 12.

[14] Guide at page 12. Call Reports are the Reports of Condition and Income that banks file with the banking agencies on a quarterly basis. The bank's year-end 2010 Call Report is used in this example because it is the Call Report published during the first quarter of 2011—the calendar quarter immediately preceding the bank's receipt of the funding—and consequently the most recent report of the bank's Qualified Small Business Lending. This year-end 2010 Call Report will reflect any increases in Qualified Small Business Lending over the baseline amount. The increase in lending will determine if the initial dividend rate is five percent, which is the dividend rate assigned to lending increases up to two and one-half percent, or less than five percent for lending increases that exceed two and one-half percent.

[15] Guide at page 12.

[16] Guide at page 13.

[17] Guide at page 13.

[18] Guide at page 9.

[19] The application is available at http://www.treasury.gov/resource-center/sb-programs/Documents/SBLF_%20Application_%20Final.pdf.

[20] The Small Business Lending Plan Form is available at http://www.treasury.gov/resource-center/sb-programs/Documents/SBLF_Lending_Plan_Final.pdf.

[21] Guide at page 10.

[22] Guide at page 10.

[23] Guide at page 10.

[24] This guidance is available at http://www.federalreserve.gov/boarddocs/srletters/2010/sr1017a1.pdf.