Small Business Lending Fund Rates Poised to Jump

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In 2011, the U.S. Department of the Treasury (Treasury) created the Small Business Lending Fund (SBLF), a $30 billion fund aimed at encouraging lending to small businesses by providing capital to qualified community institutions (holding companies and banks). Under the SBLF, Treasury provided capital to eligible community institutions with consolidated assets of less than $10 billion through the purchase of preferred stock, or equivalents, that qualify as Tier-1 capital.

SBLF funding takes two forms. While most participating institutions issued preferred stock to Treasury that receives Tier 1 capital treatment, those participating institutions that are S corporations or mutual institutions issued to Treasury senior unsecured subordinated debentures that receive Tier 2 capital treatment. The initial dividend rate for the preferred stock was 5%, and the initial interest rate for the senior debentures was at most 7.7%. These amounts are subject to reduction (or increase) if a participating institution increased (or did not increase) its lending to small businesses. After a period of four and a half years, however, the dividend rate on the preferred stock increases to 9%, and the interest rate on the senior debentures increases to 13.8%, if the SBLF funding has not been repaid. Participating institutions are beginning to reach the end of this four and a half year period.

Institutions facing this increase in rates should be evaluating alternative sources of replacement capital in lieu of the increased SBLF funding costs.

Equity as Replacement Capital

Although raising additional capital through equity can be an attractive alternative, it is not always possible to sell new equity with acceptable terms. While common stock and non-cumulative perpetual preferred stock receive Tier 1 capital treatment, common stock may need to be sold at a dilutive discount, and preferred stock may carry a high dividend and will be dilutive if it is convertible into common. As a result, many participating institutions are considering issuing senior or subordinated debt as an alternative to SBLF.

Debt as Replacement Capital

Sources of senior and subordinate debt are actively marketing their products as alternatives to SBLF funding, particularly given the tax deductibility of senior and subordinated interest as compared to a non-deductible SBLF preferred stock dividend. This is great news for participating institutions looking for options, but it is important to analyze the key differences between senior and subordinated debt.

Senior debt lenders are typically correspondent bank lenders that are well versed in making loans to holding companies and banks. The senior debt they offer will normally have a lower interest rate than subordinated debt, and senior debt incurred by a participating holding company will be treated as Tier 1 capital at a bank once the funds are down-streamed to the bank.
These positives can, however, be offset because senior debt typically is secured by the stock of the bank subsidiaries and imposes various operational and financial covenants. Senior debt requiring the periodic payment of principal and interest is also generally required to be amortized, which can result in the continuing loss of capital during the term of the debt. As a result, senior debt may not be a viable option for a participating institution if there is existing secured debt at the holding company, or if acceptable operating and financial covenants cannot be successfully negotiated.

Although subordinated debt will typically have a higher interest rate than senior debt, it typically is unsecured and imposes few, if any, operational and financial covenants. Also, unlike senior debt, subordinated debt typically does not need to be amortized over its term. Subordinated debt can also be structured to receive Tier 2 capital treatment for a certain period at the holding company, and Tier 1 capital treatment at a bank once the funds are down-streamed.

Subordinated debt lenders also come in many different forms, from inside directors and officers, to friends and family, to subordinated debt investment funds. Placing subordinated debt with insiders or friends and family can typically be done on more favorable terms to the institution than with a fund. An investment fund or institutional investors will typically request certain covenants and perhaps a higher interest rate.

**Next Steps**

In addition to the varying terms and attractiveness of common equity, preferred equity, senior debt, and subordinated debt, other considerations should also be reviewed. If an institution has deferred tax assets, then their preservation should be a key consideration in assessing capital raising alternatives. If an institution is subject to regulatory restrictions on incurring indebtedness or paying dividends, then the institution should include in its assessment early discussions with its regulators.

Paying off SBLF funding is also subject to a participating institution receiving prior approval from the Federal Reserve and/or its primary banking regulator. If an institution is a small bank holding company with less than $1 billion in assets subject to the Federal Reserve’s May 2015 revised policy statement applicable to such institutions, then consideration should be given to the revised terms of such policy that could impact deciding between alternatives or an institution’s capital requirements.

Overall, the market is ripe with less costly alternatives to SBLF funding, but deliberate planning and evaluation of alternatives are essential to the success of a participating institution.

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