

E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss
DATE: May 31, 2011
SUBJECT: We're Here to Help You

Late in 2010, the Treasury introduced the \$30 billion Small Business Lending Fund (SBLF). The SBLF is designed to provide capital to community banks (up to \$10 billion in total assets) to promote lending to small businesses. Originally, its terms applied only to C-corp banks. So far interest in the fund has been muted. As of May 11 (the initial deadline was extended from March 31 to May 16), banks had applied for only \$9.2 billion—or less than one-third of the available capital.

Earlier this month, the Treasury Department publicized terms for S-corp and mutual banks seeking capital from the SBLF. The deadline for S-corps and mutuals to apply is June 6, 2011. Now that Treasury has outlined terms for S-corps and mutuals, we examine some of the terms and assess the wisdom of participation.

Regular readers of our monthly scribbling know well our aversion to government meddling in the banking business. Much of the mischief that caused the great financial crisis we just experienced can be traced to government involvement. But as businessmen, we are also pragmatists and we would be remiss not to consider SBLF to determine if it makes sense for community banks. The unfortunate question for community bankers is not whether to allow the government to be involved in their business, but how much involvement they can stomach and whether in this heavily regulated industry they will invite even more regulation. The answer can be ascertained only on a case-by-case basis, but all bank investors should know the issues at play.

It is seldom wise counsel to advise any company to jump into bed with the government. Bankers, we are confident, are far better allocators of capital than their regulators. But as we've already noted, banks don't have a choice of whether to be involved with the government—but rather how much. Just as with TARP's Capital Purchase Program (in which many more banks participated), SBLF permits Treasury to modify its agreement with banks. As every community banker knows, regulators have been modifying their requirements for several years now. (For example, in response to the financial crisis, regulators are requiring many banks to carry higher levels of capital than required by written regulations.) While this is nothing new for bankers, it raises the question whether the SBLF contract is truly a contract. Banker beware.

On the other hand, SBLF can provide cheap capital to banks willing and able to utilize it to increase small business lending. Banks meeting SBLF requirements can pay as little as 1.5% on Treasury's investment. Try to find funding like that elsewhere. Moreover, SBLF incentivizes banks to do precisely what they should be doing anyway: boosting concentrations of commercial and industrial loans. The last decade has taught many bankers (and regulators too) that excessive concentrations in real estate can lead down a dangerous road.

So, what's the answer? First, it's necessary to examine some of the terms for S-corps and mutuals:

- Amount available:
 - Banks with \$1 billion or less in total assets can issue to Treasury so called "senior securities" between 1% and 5% of risk-weighted assets.

- Banks between \$1 billion and \$10 billion can issue senior securities between 1% and 3% of risk-weighted assets.
- Type of security: unsecured subordinated debenture.
- Maturity: 10 years.
- Interest rates:
 - For first 9 quarters, between 1.5% and 7.7%, depending on utilization of capital to increase lending to small businesses. (Small businesses are defined as those with up to \$50 million in annual revenue.)
 - For quarters 10 through 18, between 1.5% and 10.8%, depending again on utilization of capital to increase lending to small businesses.
 - After 18 quarters, 13.8%, regardless of utilization of capital to increase lending to small businesses.
- Capital treatment: Tier 2.

It's these last two terms—interest rate and capital treatment—that suggest interest in SBLF will be downright anemic among S-corps and mutuals. As many current TARP participants struggle to find a way to repay Treasury and at the same time struggle to find borrowers, they will certainly be wary of the possibility of paying the government up to 7.7%, 10.8%, or even 13.8%. More fundamentally, regulators have repeatedly emphasized (and often ordered) the need for increased Tier 1 capital. Among S-corp banks wishing to replace TARP (Tier 1, for S-corps with a holding company) with SBLF (Tier 2), this creates a huge problem. Even for those without TARP, there is likely to be little interest as growing Tier 2 capital is not a priority.

As we review the terms of SBLF for S-corps and mutuals, it appears designed to discourage application. It's not a hard call. S-corps and mutuals desperate for capital will consider applying; no one else will.

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