Small Business Investment Companies

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Investing in Small Business Investment Companies (SBICs) is a CRA qualified activity that offers banks potential profits competitive with other lines of business. SBICs enjoy a special status within the CRA because they are recognized as specifically CRA-eligible. And, as will be mentioned in more detail a bit later in this article, SBICs may also enjoy a favored position in the emerging Gramm-Leach-Bliley regulatory framework relative to other permissible merchant banking activities. Nevertheless, SBICs pose certain challenges to those institutions seeking to participate in them. Participation in SBICs through a diversified special purpose investment vehicle may be an attractive alternative for many institutions and may help address these challenges.

The SBIC Program

The SBIC program was established with passage of the Small Business Investment Act of 1958, which aimed to foster economic development by facilitating the flow of equity capital and long-term loans into small businesses. Pursuant to the Act, the SBA, through the use of public markets and a government guarantee, provides capital to SBICs at rates which are pegged to the cost of funds to the United States Government. These low-cost funds expand the financing capacity of SBICs and can substantially increase the financial return to their private investors.

There are presently almost 500 licensed SBICs with over $15 billion in private capital. SBICs that are wholly owned by banks represent about half the industry and receive no capital from SBA. These SBICs were particularly prevalent in the Glass-Steagel era when they represented the primary vehicle through which banks could invest in the equity securities of private companies. Passage of Gramm-Leach-Bliley has removed this incentive for their formation.

The types of SBICs of most interest to investors are Debenture SBICs and Participating Security SBICs. Debenture SBICs, which date back to the establishment of the SBIC program, borrow money from SBA and in turn provide it to small businesses, typically in the form of fixed-income securities. The Participating Security program was established in 1994 to better accommodate the needs of the many small businesses that are not yet generating sufficient cash flow to service debt. Participating Security SBICs, which typically make equity investments in small businesses, receive funding from SBA on terms similar to those of Debenture SBICs, but instead of paying interest on a current basis to SBA, they remit to the SBA a portion of the profits they earn on their investment portfolio.

SBICs enjoy a mandate to invest in a broad range of companies. As long as SBIC managers comply with SBA regulatory guidelines, they need consider only the financial merits of prospective investments. With a few industry exceptions, SBICs may invest in companies that have as much as $6 million in average net income for the two preceding fiscal years and $18 million in net worth.

SBIC's have been quite profitable in recent years. In FY2000, for example, SBICs overall had a 39% return on invested capital (ROI) and Participating Security SBICs had an ROI of 99.4%. CRA Funding's analysis of data reported by SBA suggests that Participating Security SBICs have realized returns of three times their cost basis with nearly $4 billion of realized assets. As impressive as this performance has been, those returns were not evenly distributed among SBICs and occurred in a historically favorable investment climate.

CRA Qualification of SBICs

SBICs enjoy unusual clarity with respect to their qualification for consideration under the CRA. SBICs were specifically identified as an example of a qualified investment in the preamble to the CRA regulation published in 1995. In 1997, SBICs were granted a special status with the initial publication of the Federal Financial Institutions Examination Council's (FFIEC) Questions and Answer document on the CRA which serve as guidance by regulators to their field examiners and the CRA community. In this guidance, regulators established a "purpose test" to determine whether an investment by a bank constitutes "community development." Despite their broader investment mandate, SBICs were effectively exempted from the purpose test by the regulators who created a presumption "that any loan to or investment in a …Small Business Investment Company promotes economic development" and is potentially a qualified CRA investment.

The CRA regulation requires that community development activities benefit an institution's assessment area "or a broader statewide or regional area that includes the bank's assess ment area(s).” Pursuant to guidance issued earlier this year, banks that have already met the needs of their assessment area need not consider the inclusion of their assessment area in the broader geographic investment activity. Regulators may also evaluate the prospective impact an investment has on communities within an assessment area.

SBICs are particularly well suited to operate in a broad geography while, at the same time, benefiting a specific area within the region. This is because for every dollar invested by a CRA-oriented institution, the SBA matches that investment exponentially. As a result, even though the investing activity may be over a relatively broad geography, this multiplier increases the likelihood of a dollar-for-dollar, *bona fide* impact on a bank’s assessment area.

Investing in SBICs can be a challenge for many institutions. Since SBICs provide equity, they have a higher risk profile than most other banking industry lines of business. Moreover, SBICs offer limited current return and as ten-year private partnerships are generally not liquid. Banking regulations recognize these risks and typically limit financial institution SBIC investments to five percent of net capital.

Largely because of the CRA, SBICs seek out bank investors operating in their geographies. Some banks have chosen to operate collectively in forming regionally focused SBICs or by participating with banks from other regions in professionally managed partnerships that purchase diversified portfolios of SBICs.

While SBICs no longer enjoy a near-monopoly on bank private equity investment activity, they may retain an important advantage under the Gramm-Leach-Bliley Act. Regulators impose a special, higher reserve requirement on merchant banking activities authorized by Gramm-Leach-Bliley. It is likely these requirements will not be imposed on SBIC investments. So, while the amount of capital a bank may deploy in an SBIC remains limited, the associated “regulatory cost of capital” may ultimately be less than the cost of non-SBIC investments.

Financial Reporting and Accounting

Accounting and financial reporting of SBICs is similar to that for other assets held for investment. When an institution makes a commitment to an SBIC, it makes a small capital contribution that is recorded on the balance sheet as an asset. The balance of the commitment shows up as a contingent liability in the institution’s call report. Once recorded in the bank’s financial reporting system, the full amount of the commitment is eligible for CRA consideration. Fees and expenses of the SBIC that typically result in operating losses in the early years are generally capitalized on the balance sheet and not offset against operating earnings of the bank. They may, however, be deducted for tax purposes. The most common practice is to continue recording the investment on a cost basis until distributions are received or a demonstrable event occurs with respect to the SBIC’s portfolio to justify a change in valuation.

Summary and Conclusions

In summary, SBICs enjoy a unique position within the CRA framework that makes them ideally suited to that portion of a CRA portfolio where profit generation is the paramount goal. Institutions that understand and can tolerate the risks of private equity investing can enjoy enhanced financial and regulatory benefits by investing in SBICs. ***CI***

Lawrence Mondschein is the managing director of CRA Funding, LLC which is the Manager and General Partner of the CRA Fund of SBICs. The Fund, all of whose limited partners are banks, invests in a diversified portfolio of Small Business Investment Companies (SBICs) throughout the United States.

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REGULATORY OVERVIEW

Investment Type: Small Business Investment Companies (SBICs)

Definition: SBICs are privately-owned venture capital funds licensed by the Small Business Administration (SBA) to invest in the long-term debt and equity securities of small businesses. These businesses possess generally less than $18 million in net assets or $6 million in annual net income and are represented in a variety of industries such as manufacturing, services and wholesale trade. Almost 75 percent of the small businesses funded by SBICs are non-technology businesses. The SBA provides "financial assistance" to SBICs by purchasing securities from them on terms which are related to the cost of funds to the U.S. Government. These low-cost funds, or "leverage," augment the private capital invested in the SBIC and may represent up to 66 percent of the capitalization of an SBIC. The amount and attractive terms of this leverage have the potential to substantially increase the financial returns to private investors. As of March 1999, there were a total of 332 SBICs licensed to operate with a total of almost $10 billion in capital committed both from private sources and the SBA.

CRA Applicability: The CRA regulation defines the term "community development" to include activities that promote economic development by financing small businesses or farms that meet the size eligibility standards of the Small Business Administration's Development Company or Small Business Investment Company programs (13 CFR 121.301) or have gross annual revenues of $1 million or less. According to the Federal Financial Institutions Examination Council (FFIEC), examiners "will now presume that any loan to or investment in an SBIC promotes economic development."