

Community Investments Vol. 9, Issue 4 SBICs: More Than An Equity Investment

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There's good news for financial institutions seeking ways to earn investment test credit under the new, performance-based CRA. In addition to earning a healthy return on capital, investing in a Small Business Investment Company (SBIC) offers a unique opportunity to serve the equity needs of emerging small businesses while receiving favorable consideration under the CRA investment test. Under the new CRA, a qualified investment must have community development as its primary purpose. The regulation defines community development to include the following provision related to SBICs: "activities that promote economic development by financing businesses or farms that meet the size eligibility standards of the Small Business Administration's Small Business Investment Company programs." According to the Federal Financial Institutions Examination Council (FFIEC), examiners "will now presume that any loan to or investment in a Small Business Investment Company promotes economic development."¹ Small business and banking experts expect that these recent regulatory changes will generate new interest in SBIC investments among financial institutions.

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.²

Banks can establish their own SBICs, work in partnership with other banks to develop a joint SBIC, or invest in an existing SBIC. Currently, 73 commercial banks own and manage their own SBICs while 12 banks invest in but do not manage SBICs (i.e. bank associated SBICs). These bank-owned or bank-associated SBICs provide \$3.3 billion or over half of the \$6 billion in capital under management by all SBICs. The remaining \$2.7 billion in capital is generated by more than 200 non-bank SBICs nationwide.

The Benefits of SBIC Investment

Through SBIC investments, financial institutions can realize a number of potential benefits and regulatory easements not otherwise permitted. For example, banks will find a safe harbor from Glass-Steagall Act restrictions that have traditionally separated commercial and investment banking. In addition, banks are allowed to own more than five percent of a company, thus making equity investments that would otherwise be prohibited by banking statutes. Keep in mind, however, that banks are not permitted to invest more than five percent of their capital and surplus in any one SBIC or multiple SBICs.

The SBIC program also offers leverage options, such as raising capital through the sales of SBA-guaranteed certificates, yet few banks utilize these options. If a bank chooses to use SBA leveraged capital, it would have to repay it with interest and in some cases, pay a percentage of its profits before the bank could receive a return on its original investments. Not surprisingly, most banks find it more profitable to use their own capital rather than leveraging SBA-guaranteed securities. Of the \$3.2 billion in bank capital, only \$19 million is leveraged.

Of course, money motivates. One of the primary reasons financial institutions are attracted to the SBIC program is the opportunity to make equity investments with healthy returns. An example is Wells Fargo Equity Capital, Inc., an SBIC established by the bank-holding company of Wells Fargo Bank in 1995. In its early years of operation, the SBIC has invested \$26 million in 12 companies. All of its investments are either in common/preferred shares or are subordinated debt with equity warrants. According to Richard Green, manager of Wells Fargo Equity Capital, Inc., these SBIC investments make solid returns on invested capital and help augment the bank's commercial banking business. Through its SBIC, Wells Fargo is able to meet the equity needs of the large "middle banking" market, such as family-owned businesses; a segment that can be difficult to serve through conventional commercial lending products.

Given the recent implementation of the revised CRA regulation, banks have another reason to invest in SBICs. Large banks contemplating qualified investments under CRA might consider SBIC investment as a viable financial instrument *and* an effective way to meet CRA requirements. Prior to July 1997, a bank's investment in an SBIC was considered under CRA only if the SBIC's portfolio investments were qualified investments. Now that SBICs are specifically referenced in the new regulation, investing in an SBIC itself is considered a qualified investment as long as the SBIC serves some or all of the bank's business region.

Federal Home Loan Banks Get Into the Act

Another change that could render SBICs more attractive to small banks is the Federal Home Loan Banks' new authority to invest in SBICs. Federal Housing Finance Board (FHFB) Chairman Bruce Morrison stated, "The Finance Board is exploring ways to bring the Federal Home Loan Bank System together with the SBIC program in areas where private investment is inadequate."³ According to legislation passed in October 1996, the Federal

Home Loan Banks may now establish their own SBICs, set up SBIC investment vehicles for small banks, or invest in existing SBICs.

Because not all banks are able to meet the \$5-10 million investment requirement without exceeding the 5 percent cap on total assets in an SBIC, a Federal Home Loan Bank SBIC could be a wise alternative for its members who want to make pooled, smaller investments with less risk. It is not clear how many Federal Home Loan Banks will establish SBICs since parameters for Federal Home Loan Bank SBIC activities have not yet been set by the Federal Housing Finance Board. Look for more information on FHLB-SBIC activities in the coming months.

Although investing in an SBIC is not a new idea, recent regulatory refinements may encourage financial institutions to take a fresh look at these innovative investment opportunities. For financial institutions interested in learning more about the SBIC program, contact Mr. Len Fagan, Financial Analyst, SBA Investment Division at (202) 205-7583 or visit the SBIC homepage at <http://www.sba.gov/INV>.

Bank-Owned SBICs

Midwest

1st Source Capital Corporation
ABN AMRO Capital (USA), Inc.
Banc One Capital Partners, L.P.
Banc One Venture Corp.
Continental Illinois Venture Corp.
First Chicago Equity Corporation
Heller Equity Capital Corporation
Key Equity Capital Corp.
M&I Ventures Corp.
Norwest Equity Partners IV

Norwest Equity Partners V, L.P.
National City Capital Corporation
Peterson Finance and Investment Corp.
Shorebank Capital Corporation
United Missouri Capital Corp.

South

Banc One Equity Investors, Inc.
Banc First Investment Corporation
Charter Venture Group, Incorp.
CFB Venture Fund I, Inc.
CFI Venture Fund II, Inc.
First Commerce Capital, Inc.
First Union Capital Partners, Inc.
Hibernia Capital Corp.
Hickory Venture Capital Corp.
MESBIC Financial Corp. of Houston
MESBIC Ventures, Inc.
Mapleleaf Capital, Ltd.
UNCO Ventures, Ltd.
Victoria Capital Corp.

West

Bancorp Hawaii SBIC
Far East Capital Corp.
First Interstate Equity Corporation
First Security Business Investment Corp.
Hall, Morris & Drufva II, L.P.
Imperial Ventures
Opportunity Capital Corporation
Shaw Venture Partners IV, L.P.
UnionBanCal Venture Corporation

Wasatch Venture Corp.
Wells Fargo SBIC, Inc.

East

399 Venture Partners
BT Capital Partners, Inc.
BancBoston Ventures
Barclays Capital Investors Corp.
CB Investors, Inc.
CIBC Wood Gundy Ventures
Chase Manhattan Capital Corp.
Chemical Venture Capital Associates
Citicorp Venture Capital, Ltd.
Commonwealth Enterprise Fund, Inc.
CoreStates Enterprise Capital, Inc.
Creditanstalt SBIC
Domestic Capital, Inc.
First Fidelity Private Capital, Inc.
First New England Capital, L.P.
Fleet Venture Resources, Inc.
Greater Phil. Venture Capital Corp.
IBJS Capital Corp.
J.P. Morgan Investment Corporation
M&T Capital Corp.
Mellon Ventures, L.P.
NatWest USA Capital Corp.
PNC Capital Corp.
Paribas Principal Incorporated
Pyramid Ventures
RFE Capital Partners, L.P.
Sixty Wall Street SBIC Fund, L.P.
Societe Generale Capital Corp.

Toronto Dominion Corp (USA), Inc.
Triad Capital Corp. of New York
UBS Partners, Inc.
UST Capital Corp.

¹ Bylsma, Michael, Interpretative letter regarding Lake County Integrated Financing Program, FFIEC, May 22, 1997.

² Today's SBICs: Investing in America's Future, National Association of Small Business Investment Companies, Page 2.

³ Financial Institutions, New CRA Rules Open Doors for Banks, Small Businesses, Daily Report for Executives, Lotus Notes/Newsstand, Page 2.

About the Author



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