law office

Philip G. Feigen and **David M. Allred** are attorneys with Polsinelli P.C. based in Washington, D.C. and Denver, respectively. Feigen can be contacted at 202-626-8330, or pfeigen@polsinelli.com and Allred at 720-931-1193, or dallred@polsinelli.com.

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BankNews

Can You Satisfy CRA Requirements and Still Make Money? Try SBICs

Have you considered an investment in or creating a Small Business Investment Company? Doing so may provide financial institutions with a number of benefits, including credit toward annual investment requirements under the Community Reinvestment Act.

"The more banks learn about SBICs the more attractive they find them, both for high profit and regulatory relief under the CRA and the Volker Rule" says Brett Palmer, CEO for the Small Business Investor Alliance, a trade association of private equity funds and investors that promotes investment and growth in small and medium-sized businesses in the United States. "There are very few investments that are exclusive in domestic small business, create jobs and are highly profitable."

In 1958, Congress created the SBIC program as one of the many financial assistance programs available through the Small Business Administration. Its mission, among other things, is to facilitate the flow of private venture funds (with the support and financial backing of the U.S. government) to small businesses by way of loans and investments. Under the SBIC program, the SBA does not invest directly into small businesses, but rather guarantees low-cost capital (leverage) for SBICs that in turn loan or invest in qualifying small

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businesses. In order for an SBIC to invest in a qualifying small business, the business generally must have a net worth of less than $18 million and less than $6 million in after-tax income during the previous two years. Some well-known businesses that received SBIC financing at an early stage include Staples, Costco, FedEx, Hewlett Packard, AOL and Apple.

Federal statutes specifically permit financial institutions to invest in SBICs because the mission of an SBIC is very similar to that of traditional bank lending. A number of well-known financial institutions participate in the SBIC program as either investors or sponsors. "TD Bank supports well-managed SBIC funds, which provide capital to promote growth and job creation to small and middle market companies in a diverse set of industries" says Carl Kopfinger, senior vice president of Wilmington, Del.-based TD Bank. Some banks are not aware that they can satisfy CRA requirements through either investments in existing SBICs or creating their own "captive" SBICs. Under CRA regulations, an SBIC investment is presumed to be a "qualified investment" for purposes of the CRA. As long as the SBIC is either located in or doing business in a bank's assessment area, a bank's investment in an SBIC will generally be accorded CRA credit.

Not only do SBIC investments receive CRA benefits but, as Palmer notes, "SBIC investments are the only exclusion specifically written into the Volker Rule." Unlike investments in private equity funds or hedge funds, SBIC investments are not limited to 3 percent of a bank's Tier 1 capital, nor do they count against the cap. Subject to certain limitations, SBIC investments are also treated as Tier 1 capital.

Banks also invest in SBICs for financial incentives and business opportunities. SBICs provide competitive investment returns due, in part, to the low-cost leverage provided through the SBIC program with SBA guarantees. According to industry statistics, SBICs have historically produced annual returns between 10 percent and 20 percent. SBIC investments also provide co-investment opportunities for banks. Very often a bank will provide a senior secured loan to a small business at the same time an SBIC will provide mezzanine debt financing and/or an equity investment to that same small business.

So, what exactly are SBICs? They are privately owned and managed investment firms, usually organized as limited partnerships, that are licensed and regulated by the SBA. An SBIC fund is managed by a management team/general partner that is subject to SBA scrutiny at the time of licensing and thereafter.

A leveraged SBIC may borrow up to twice the amount of private capital it raises from private investors.

The management team makes all of the investment decisions with the investments typically funded by institutional investors (such as financial institutions) that in turn become limited partners of the SBIC. Although percentages may vary between SBICs, limited partner investors of an SBIC generally are returned all of their capital investment first and then will split any profits with 80 percent going to the limited partner investors and 20 percent going to the management team/general partner.

While there is no requirement for SBICs to borrow money under the SBIC program, its low-cost leverage is financially attractive. A leveraged SBIC may borrow up to twice the amount of private capital it raises from private investors. While the SBA imposes a $150 million limit on such capital, SBICs may qualify for additional leverage by investing in low-income geographic areas. This leveraged capital is provided at an attractive interest rate, currently around 50 basis points (excluding fees) above the U.S. Treasury bond rate, and is required to be paid back over a 10-year period.

A financial institution making a minority investment (less than 33 percent) in a newly organized or existing SBIC need not file a license application with the SBA. Such an investment is eligible for CRA consideration based on the geographic footprint of the SBIC even though the SBIC is not controlled by the bank. A financial institution that creates its own SBIC will maintain greater control over the type of investments made by the SBIC and the geographic area where such investments are made. Given this level of control, the SBA requires the financial institution creating the captive SBIC to file a license application. It should be noted that in most cases, in order to draw leverage through the SBIC program, at least 30 percent of the captive SBIC's ownership must be unaffiliated with the financial institution.

There are generally 25 to 50 SBICs in the fundraising process at any one time.