# A Guide to Bank Investment in Small Business Investment Companies (SBICs)

## Banks are a Very Important and Common Source of Capital for SBICs

Licensed by the Small Business Administration (SBA) since 1958, SBICs serve a statutorily-mandated public policy purpose to increase capital to American small businesses. To become licensed as an SBIC, funds raise private capital from individuals and institutional investors (including commercial banks), which is matched at up to two dollars of public funding for every one dollar of private capital. Banks have consistently been a very important source of private capital for SBICs. According to SBA data, during the 2012 fiscal year there were 227 investments by 160 banks in 85 different SBIC funds.

## Why Should My Bank Invest in SBICs?

Banks investing in existing SBICs often do so as "Limited Partners" (LPs). With hundreds of national, regional and community banks already investing in SBICs, the financial and regulatory attraction of SBICs for banks is increasingly desirable. Depending on the size, type and needs of your institution, there are regulatory incentives provided by bank regulators and the Securities & Exchange Commission to invest.

## Top Business Reasons To Invest In SBICs

**Strong Investment Rate of Return (IRR):** Banks and fund of funds managers invest in SBICs because they often provide a strong IRR. The median SBIC licensed between 1998 and 2008 had an annual return of 15%, with top quartile SBICs providing an annual return of 28%.

**Opportunities for Deal Flow:** Many banks find SBICs to be useful investments to drive deal flow and referral opportunities. For instance, banks often provide senior loans in the same business where SBICs are providing mezzanine or equity investments.

**Vetted Management Teams:** LPs that invest in SBICs benefit from additional SBA scrutiny on the SBIC's management team. Initial due diligence during the SBIC licensing process and periodic examinations of the SBIC provide a de facto "seal of approval" from the SBA that an LP might not otherwise have when assessing other investment opportunities, including private equity and hedge funds. Additionally, following the investment the LPs can benefit from SBIC annual and quarterly reporting requirements to the SBA.

**Opportunity to expand Banking Services:** Banks that invest in SBIC funds may have the opportunity to provide banking services, including cash management and other services to the portfolio companies of SBIC funds. Another business development opportunity for banks is to provide private wealth services for GP principals or portfolio company principals.

**Suitable for All Types of Banks: Local/Community Banks, Regional Banks and Large Banks and Fund of Funds:** With a typical minimum SBIC investment requirement of $250,000, banks of all sizes and focus may find investments through the SBIC program suitable.

## Top Regulatory Reasons to Invest in SBICs: Favorable Bank Treatment Under Volcker and CRA

Banks benefit from investments in SBICs from a regulatory standpoint because (1) SBICs are exempt from the definition of "covered fund" under the recently enacted Volcker Rule and (2) banks may receive Community Reinvestment Act (CRA) consideration for making investments in SBICs.

*(over please)*

SBIA
SMALL BUSINESS INVESTOR ALLIANCE



1100 H Street, NW | Suite 610 | Washington, DC 20005 | (202) 628-5055 | sbia.org

## Volcker Rule Exemption for Bank Investments in SBICs

Under the Volcker Rule, there are restrictions on bank investments in "covered funds" (including private equity or hedge funds). Congress made it clear in the law that SBICs are not considered "covered funds," therefore banks are not restricted from investing in SBICs under the Volcker Rule.

## Community Reinvestment Act (CRA) Consideration for Bank Investments in SBICs

Not only are banks permitted to invest in SBICs under the federal banking laws (see 12 USC 1431(h); 12 CFR 956.2(e); 12 CFR. 225.107(c)), due in large part to the shared mission of SBICs and banks, but banks are incentivized to make such investments through Community Reinvestment Act (CRA) consideration. SBIC investments meet the definition of "qualified investments" under the CRA as set forth in the following:

- **Small Business Investment Act of 1958** – Banks may invest in one or more SBICs or any entity established to invest solely in SBICs provided such investments do not exceed 5 percent of the institution's capital and surplus.
- **Public Welfare Investments** – National Banks may make investments designed to promote the public welfare under 12 USC 24 (Eleventh), which is an investment that would receive consideration as a "qualified investment" under the CRA. Investments in SBICs are "qualified investments."
- **Investments by Federal Savings Associations** – While federal savings associations generally have limited authority to make investments of the type permitted for national banks under 12 CFR 24, federal savings associations are specifically permitted to make investments in service corporations engaged in a broad range of preapproved activities, including activities related to SBIC investments.

## Bank Size Implications of CRA

- Large banks and Intermediate small banks receive CRA consideration under the "investment test" (12 CFR 25.23) or "community development test" (12 CFR 228.25.25) for investments in SBICs when they benefit the bank's assessment area or a broader statewide or regional area that includes the bank's assessment areas. Small banks can request examiners look at their SBIC investments to enhance a "satisfactory rating."

## CRA Assessment Area

- The bank's assessment areas need not receive an immediate or direct benefit from the SBIC's investment, provided the SBIC is focused on serving geographies or individuals located within the institution's assessment area.
- Examiners will look at the investment objectives identified in the SBICs business plan to determine whether the SBIC's investments benefit the bank's assessment area or broader state or regional area.
- A bank should discuss the benefits of an SBIC investment as well as documentation of SBIC investments with its CRA examiner.

## Other Considerations for Banks: Capital Treatment and SBIC Investment Risk Weight

Under general risk-based capital rules for national banks, SBIC investments that do not exceed 15 percent of Tier 1 capital are assigned a Tier 1 capital requirement of eight percent. SBIC investments that are greater than 15 percent of Tier 1 capital are subject to partial deduction from capital. SBIC investments are risk weighted at 100% for national banks and federal savings associations whose exposures to SBIC investments do not exceed 10% of the aggregate of Tier 1 and Tier 2 capital. SBIC investments in excess of 10% of Tier 1 and Tier 2 capital of national banks and federal savings associations are risk weighted at 400%.