Statement for the Record

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Hearing Entitled “Investing in Small Businesses: The SBIC Program”

The House Committee on Small Business
Subcommittee on Agriculture, Energy, and Trade

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Chairman Blum, Ranking Member Schneider, and Members of the Subcommittee, thank you for the opportunity to testify today and for holding this hearing, "Investing in Small Businesses: The SBIC Program." SBIA's members are proud of their role in creating small business jobs and are thankful to Congress and the Small Business Administration (SBA) for supporting American small businesses.

The Small Business Investment Company (SBIC) Program, administered by the Small Business Administration (SBA), has broad support because the core features of the program address fundamental problems in the small business economy:

- We need more small business investment;
- We need to create more jobs here in the United States;
- We need to support jobs domestically and not outsource and offshore our economic dynamism;
- We need more investment in domestic manufacturing;
- We need to be very frugal and wise with the taxpayers' money and trust; and
- We need the government to serve Americans and their interests and not work against them.

SBIA thanks the members of the Committee for supporting small business investment and job creation by unanimously voting through the Committee—and then unanimously through the full House—the Small Business Investment Opportunity Act and the Investing in Main Street Act. If we are able to get these bills through the Senate, then more small businesses will be able to access growth capital.

My testimony is broken into three parts. The first section explains how the program works and why it has been so successful growing small businesses and creating American jobs. The second section covers common questions about the SBIC program. The concluding section covers some of the issues that would benefit small businesses if improved. I have also attached a recent non-partisan Library of Congress study on the extraordinary record of SBIC job creation; a small sample set of small businesses that have received investment in districts represented by members of this committee; and a state-by-state table of SBIC investment from 2012-2016.

The Small Business Investment Company Program Overview

It seems that only bad news gets attention, which does not make it easy for SBICs to get attention because SBICs are an American success story. For example, in 2016 SBIC invested a record amount, nearly $6 billion, in American small businesses. The program is having the best (lowest) loss rates in its 59-year history. There is currently unprecedented private sector interest in getting capital to small businesses via investment in SBIC funds. A recent Library of Congress study found that SBIC-backed businesses created 3 million new jobs and supported an additional 6.5 million jobs from 1995-2014 (a period that included the Great Recession and the tech bubble recession). These quiet successes were achieved while being the only major SBA program that was able to maintain its zero-subsidy rate - even through the Great Recession and Financial Crisis. With the help of Congress and SBA, SBICs have seen significant operational reforms to the program that have been producing positive results for the American small business economy.

SBICs are highly regulated private funds that invest exclusively in domestic small businesses. At least 25% of an SBIC's investments must be made in "Smaller Enterprises." (Smaller Enterprise are smaller than the SBA's normal small business standards.) SBA currently licenses two types of SBICs: non-levered SBICs and Debenture (levered) SBICs. Both forms of SBICs invest in growing domestic small businesses, with non-levered SBICs tending to provide more equity capital and Debenture SBICs tending to provide more debt capital.

SBIC leverage significantly increases the amount of money invested into the small business economy. The private capital forms the foundation of an SBIC fund. SBICs raise capital from accredited investors and institutional investors (pension funds, university endowments, banks, etc.). After the SBIC applicant raises private capital, the SBA applies a rigorous licensing regime. If the SBIC applicant meets the legal and performance criteria, then an SBIC license is issued. Once licensed, an SBIC is permitted to access a line of credit (SBIC debenture leverage) to increase the amount of capital available for investment. For example, an SBIC may raise $50m in private capital and then, after licensure, may access up to an additional $100 million line of credit, which combines for a total of $150 million. The leverage is provided at a zero-subsidy rate and is eventually paid back in full (plus interest and fees). All of this capital is to be invested in domestic small businesses and may not be used for "offshoring," relending, project, finance, or for purposes that are not in the public interest. Unlike many government programs, the private capital is in first-loss position, which means the private investors lose their money before the taxpayer is exposed to risk of loss. This is an important taxpayer safeguard and a key reason why the SBIC program has been able to maintain its zero-subsidy rate. The program is effective and distinct because the private sector leads with its capital and investment expertise and then SBIC leverage follows to augment the impact of the private investment. It is a mark of SBIC industry pride that the program continued to maintain its zero-subsidy throughout the Great Recession.

- Since 1958, SBICs have invested over $80 billion in hundreds of thousands of small businesses.
- In FY 2016, SBICs invested $5.99 billion in businesses that employ approximately 122,000 workers across the U.S.
- For FY 2016, 313 SBICs were operating across the United States, which is a similar number as were operating 10 years ago. These SBICs managed $27.8 billion in committed capital resources.
- Of the 1,210 U.S. small businesses that received SBIC financing in FY2016, 28% were located in Low-to-Moderate Income (LMI) areas of the country.
- The SBIC program has operated at a zero-subsidy rate since Congress mandated a zero subsidy in the late 1990s.
- A 2017 study by the Library of Congress found that the average small business backed by a Debenture (leveraged) SBIC Fund created approximately 125 new jobs and non-levered funds created an additional 530 new jobs.
- Levered funds tend to provide more debt capital and non-levered funds tend to provide more equity capital.
- From 1995-2014 SBIC-backed small businesses created over 3 million new jobs and supported an additional 6.5 million jobs – all of which were in the United States.
- Many icons of American industry were once small business that received critical growth capital from SBICs including: Apple Computer, Intel, Buffalo Wild Wings, Build-A-Bear Workshop, Callaway Golf, Costco, Federal Express, Gymboree, Jenny Craig, Restoration Hardware, and Staples.

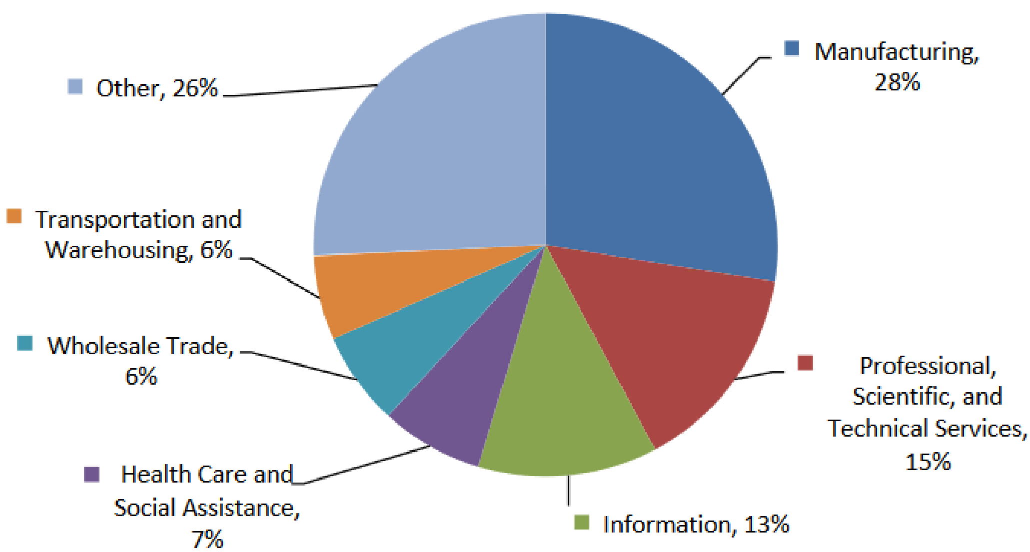
SBIC Frequently Asked Questions

How does the SBIC Program Help the Taxpayer and the American Public?
The SBIC Program helps the taxpayer by providing capital to growing small businesses that in turn hire more employees, invest in capital improvements, and generally grow the economy. A 2017 study by the Library of Congress found that one new job was created for every 35 dollars of taxpayers' money spent administering the program. (The leverage operates at zero subsidy, but there are still some administrative costs.) Correlation is not causation, but there is no doubt that the ability of successful small businesses to access growth capital empowers them to grow and hire more employees.

SBIC investments are made in areas of the country and in industry sectors that are commonly overlooked by conventional venture capital and private equity. The overwhelming percentage of venture capital is invested in Northern California and the New York to Boston corridor. While SBICs do invest in those areas, SBICs invest most of their capital in places other than this investment footprint. For example, 28% of SBIC investments are in areas certified as Low-Moderate Income. Even SBICs that are primarily located in population centers regularly invest well outside of their local area so the SBIC program helps move capital to underserved areas – both urban and rural.

SBIC investments are commonly made in industry sectors largely passed over by many conventional venture capital and private equity funds, including manufacturing and asset-light services businesses.

**Distribution of SBIC Financing Dollars by Industry
FY 2010-2014**



** Numbers will not add to 100% due to rounding.*

Is the SBIC Program Effective?

- Yes. Multiple studies, including a 2017 Library of Congress study (attached) have found the SBIC program is very effective at supporting growing small businesses and creating jobs.
- It could be even more effective with broader benefits to more communities with modest reforms.

Is the SBIC Program an Efficient Use of Capital?

- Yes. It is one of the most efficient, job-creating programs within the government. According to a 2017 Library of Congress study, only $35 in administrative government costs were associated with creating each new job. There were only $11 in administrative costs for each additional job supported. Further, the fact that the SBIC Program's leverage has successfully sustained its zero subsidy for so long is a testament to its operational effectiveness and efficient use of capital.

Is SBIC Investing the Same as Bank Lending?

- No, SBIC investing and bank lending are very different.
- SBICs provide education, training, and professional guidance that banks generally do not provide.
- Banks are often only able to provide conventional lending to a small business *after* an SBIC has invested in a small business.
- SBICs provide long-term capital that empowers small businesses to survive and recover from the inevitable surprises that can happen in business.
- SBIC capital can be in the form of debt, equity, or both.
- Banks and SBICs collaborate, but offer different types of capital so they do not compete.

Does SBIC Investment Displace Conventional Bank Lending?

- No. Banks are partners, not competitors.
- Banks are often only able to provide capital after a business has received SBIC capital because the SBIC capital changes the capital structure of the business and thereby makes it more "bankable."
- Over 500 banks, ranging from small community banks to large banks, are investors in SBIC funds.
- Some banks own non-levered SBIC funds and other banks are forming their own internal SBIC units to provide equity capital that the banks cannot otherwise provide.
- If small businesses could access this capital from banks, then they would get bank loans because there are thousands of banks and conventional bank lending is less expensive.

	Bank	**SBIC**
Provide Debt	Yes	**Yes**
Provide Equity	No	**Yes**
Provide Convertible Debt	No	**Yes**
Provide Unitranche Capital	No	**Yes**
Can revoke capital on 30 to 60 day notice in the event small business hits a snag or if there is a macroeconomic disruption?	Generally, Yes	**No**
Are loans required to be fully collateralized?	Generally, Yes	**No**
Cash Flow Lending	Limited	**Yes**
Able to provide Capital to businesses that are not otherwise bankable	No	**Yes**
Commonly has a Formal Role on the Board of the Small Business	No	**Yes**
Provides Management Assistance to Help the Small Business Grow and Have Good Governance	No	**Yes**

Does the Government Own Any Part of these Small Businesses?

- No. The government does not invest in or own any portion of any small businesses.
- There was a time (1994-2004) when the government effectively participated in the ownership of some types of SBIC funds, and therefore the small businesses, but that program ceased licensing funds in 2004.

Is the Government a "Limited Partner" in SBIC Funds or Does It Own a Part of the SBIC Fund?

- No. The government manages access to and guarantees a private sector credit facility, but is not a "Limited Partner." The government is in a more advantaged position than the private sector limited partners.
- The SBA does not own an interest in SBICs or their portfolio companies.

- The SBA stopped being a “fund of funds” and stopped being a “Limited Partner” with the end of licensing funds where the government participated in the profits (and losses) in 2004.
- The SBA is a regulator and a guarantor of credit facility.

Can the 7a and 504 programs do what the SBIC program is doing?

	SBA 7a	**SBA 504**	**SBA SBIC**
Government (Taxpayer) Guarantee on Each Investment	Yes	Yes	**No**
Must the small business have collateral or a personal guarantee to loan against?	Yes	Yes	**No**

Does the Government Choose Which Small Businesses Receive Capital?
All SBIC investments are made entirely by the private sector via investing professionals without the government’s involvement. Investments are made for real economic reasons. SBICs invest in growing small businesses and then notify the SBA which small businesses received capital after the investment has been made. There are size standards and other basic requirements and taxpayer protections that must be adhered to, but government involvement stops there. The program is successful at creating jobs and growing small businesses because it allows the private sector to find the businesses with the greatest growth potential and direct capital to them.

What Happens if an Investment Underperforms?
A single SBIC will invest in many different small businesses. Unlike the 7a and 504 programs, when a single investment underperforms or loses money, only private capital is lost, not taxpayer guaranteed capital (leverage). The profits from the other investments cover the losses from the isolated underperforming investment(s). If the profits from the other investments are inadequate to cover all the losses, then the private investors’ capital is lost before taxpayer money is at risk. There is generally a large private capital cushion that would need to be burned through before the taxpayer guarantees would be realized. Even if the guarantees would be used, SBIC funds pay an annual fee on their leverage that is designed to offset losses and maintain the statutorily-required zero subsidy rate. SBA can cut off SBICs from accessing additional leverage or trigger an orderly liquidation process run. Even if a fund is ordered into orderly liquidation, it does not necessarily lose private capital or realize losses for the taxpayer.

What Built in Accountability Exists in the SBIC Program?
There is extensive accountability built into the program. Private capital being in first-loss position is a very effective accountability tool because there is no “gambling with other people’s money.” Private capital being in first-loss position is an important, built-in taxpayer safeguard. The SBA has reporting

obligations that ensure the SBA is fully apprised of the health of the fund, and the funds receive independent audits plus SBA examinations. The SBA can cut off underperforming SBICs from further leverage and can even require disgorgement if an investment does not meet the SBA's statutory and regulatory requirements. SBA can require an orderly wind down of the SBIC and limit compensation. In extreme cases, SBA can remove the fund managers.

Are Repeat Licensees a Good Thing?
Repeat licensees are exceptionally good for the small businesses and the taxpayer. Repeat SBICs specialize in small business investing, which is good for small business, the SBA, and ultimately the taxpayer. SBICs are only able to receive an additional license if their previous fund was a success and the private sector was willing to commit its own money first. The private sector leads, and only then can a license be issued. The market speaks before the SBA licenses. Keeping successful fund managers in the program and culling poor performers is one of the reasons the program has been so good at growing businesses and has been able to sustain its zero-subsidy rate. Congress recognized the importance of repeat licensees by raising the "family of funds limit" to allow more successful managers to continue to invest more money into more growing small businesses. The GAO studied this issue in 2016 and found repeat licensees were far less likely to be put into an orderly wind down than first time funds.

Is the SBIC Program Stress Tested and Sound?
The Great Recession and Financial Crisis were a real-life stress test. Unlike other SBA programs, the SBIC Debenture program was able to maintain its zero-subsidy rate. Further, many small businesses were able to survive the Great Recession because they were backed by SBICs. Banks were forced by their regulators to pull lines of credit from thousands of small businesses, which then failed. SBIC-backed small businesses benefitted from the longer-term capital provided by SBICs and had a much better chance of surviving.

Opportunities for Improvement

Licensing
Licensing is down over 40% (year over year) and has slowed considerably since January. This drop off was not caused by lack of private market interest in investing in SBICs. To the contrary, there is record institutional interest in investing in domestic small businesses via SBICs. As many polls have pointed out, small business optimism has been inspired by this Administration. In the face of this licensing slowdown, licensing staff have been loaned to disaster loan processing, which will further slow licensing. Fund managers, even repeat SBICs, are uncertain as to what is required for licensure or how long it will take. This is particularly foreboding to smaller funds and funds that are not in financial centers for whom taking the risk to form an SBIC is a very big personal, professional, and financial risk. This lower licensing rate is likely a leading indicator of reduced future investments in small businesses. To quantify what this slow down and confusion means, there is currently nearly $1 billion of private investment for small businesses that is in licensing limbo, and some private institutions have pulled out of investing in new Small Business Investment Companies.

The licensing process for repeat licenses, which the GAO recently studied and found to be much less risky, should be clear and relatively fast because these fund managers are well known to SBA and have a history of performance and compliance. However, the licensing process for all funds, even repeat SBICs has slowed. For example, to pass the "Green light" phase of the licensing process used to take two weeks but now requires a 4-6-month advance notice before filing the application, and then it will take several more months to get a decision. These new built-in delays do not apply to new fund investors with whom the SBA has no direct experience and has never regulated before. To be clear, new funds are experiencing all sorts of new delays too, but they are different delays. SBICs would like a return to a clearer, faster process so they can increase small business investment, which would seem very much in line with President Trump's pro-jobs, pro-small business, pro-manufacturing, America-first economic agenda.

Similarly, the Investment Division's committee process has become protracted for performing licensing interviews, licensing reviews, and approving leverage. The committee reviewing license applications used to meet regularly (often weekly), but now meets irregularly with meetings and interviews being rescheduled more often than occurring as scheduled. The committee chair has ceased the decades-long practice of actively participating and attending nearly all the interviews for licensure. Lack of consistent scheduling, attendance, and constructive engagement have added unnecessary delays. When the committees do meet, the agenda is commonly not followed and key decisions are regularly not made or repeatedly postponed. Additional delays have been caused by new internal policies that the committee performing interviews must now give a minimum of 28-day notice before internally scheduling a licensing interview, and the committee no longer is allowed to deliberate and decide immediately after the interview while the information is fresh in their minds. There is now a mandatory delay period before the matter can be discussed and decided, which runs counter to private sector best practices and creates more unnecessary delays. Even when licensed, actual documentation of being licensed is taking an additional several months. Scheduling delays are compounded by more and more scheduling delays. The industry has not seen delays of this magnitude since 2007-2008.

Licensing Recommendations

SBA should return to a more timely licensing process, particularly for repeat licensees whose tracks records are already very well-known and documented with the SBA. SBA should also return to having regularly scheduled meetings. Both the industry and the SBA would benefit from clearly articulated timelines and applicant feedback.

Finally, SBA should provide a more complete picture of what is happening in the licensing process by regularly reporting data that recognizes the numbers and timeframes for applications and similar regulatory requests that have been "set aside" or otherwise sit in procedural limbo and may not be showing up in the system now.

Examinations

SBICs are regularly examined by private, independent auditors. In addition to these conventional audits, SBA performs additional regulatory examinations. Delays in these examinations have significantly increased this year, particularly recently. For example, the year-over-year number of exams performed is down 35% as of SBA's most recent data release (June 30, 2017), and cycle times are up 33%. These numbers are worse for leveraged funds. From January 1, 2017 to June 30, 2017, examination cycle time for leveraged funds has increased from 10.8 months to 16.6 months. The delays in examinations do not mean the SBIC has never been examined before (they likely have many times), or that the SBA does not have insights about what is going on in the SBIC, because SBICs still file reports after every investment and provide detailed quarterly and annual reports to the SBA. SBICs have no control over when examinations take place, and yet SBICs are being frozen in licensing or in securing leverage commitments because the SBA has not performed a recent enough examination.

Examination Recommendations

SBA deserves credit for having recently contracted out some of their examinations. SBA recently made another positive reform by allowing SBA examiners to perform multiyear exams instead of doing multiple single-year exams. SBIA would also suggest that for SBICs with multiple licensees that examiners should try to examine all licenses at the same time to reduce disruption to the SBIC's operations and to reduce wasting SBA's travel budget and human resources. We encourage Congress to support SBA's efforts to get caught up with the examinations, and we ask that this Committee maintain its oversight role to make sure the examinations backlog is improving. Finally, SBA should recognize that SBICs have no control over the timing of their examinations and should not penalize SBICs for matters that are solely under SBA's control.

SBIC Program Transparency

SBIC data has become less transparent and more outdated. The 504 and 7a programs release their data weekly, but the SBIC program releases its data quarterly, and then holds the data back for nearly two months before releasing it. This data used to be released monthly in the first few days of the new month. Further, SBIC program data and reports have been removed from the SBA website.

SBIC Program Transparency Recommendations

The SBICs do not need weekly data like the 7a and 504 programs, but the program data should be made available in a timely fashion. SBIA believes this data should be released no later than two weeks after the reporting period ends with the reporting period being no less than quarterly. SBA should return to posting the information on the SBA website. SBA also should release the 2016 SBIC Program Annual Report that was completed at the beginning of FY 2017 but is still unpublished.

Informational Technology (IT)

SBA staff cannot serve the public as effectively as the public deserves without the tools to do the job efficiently. SBA deserves credit for undertaking an effort to make IT improvements, and SBIA asks Congress to support their modernization efforts.

Operations

The Investment Division's Operations section is run by experienced managers and frontline staff who regularly engage directly with SBIC fund managers as their primary regulatory contact. Many of these SBIC-Regulator contacts have become less constructive because the SBA staff are no longer clear about what they are allowed to do and what are the current policies or interpretations. This is not because they are not competent but because policies and practices are changing without advance notice to the SBICs or the staff. Without formal communication to them or the industry it is very difficult to provide informed regulatory guidance. This is currently happening with the proposed TechNote 7b, which has been proposed but not finalized. Despite not being finalized, it is being enforced much to the surprise of SBICs and some SBA staff.

Operations Recommendations
The Investment Division should provide clear polices and guidance to both SBA staff and SBICs with realistic timelines for completing tasks. Communication of changes before they go into effect would also be very helpful to both the SBA and the private sector. Finally, applying the rules with a greater degree of consistency and clarity would benefit both SBA and SBICs.

Conclusion
Thank you for considering the views of the SBIC industry. We thank you for your consideration of these matters. We also thank the SBA for their time and effort in working with SBICs to grow the small business economy. Without the support of the Congress, the SBA, and the private sector, this program would not be able to provide such a positive impact for the taxpayers.

I would welcome any question you may have for me.