

## SBA's Small Business Investment Company Program

---

Created in 1958, the Small Business Investment Company (SBIC) program is designed to stimulate growth in America's small businesses by supplementing the long-term debt and private equity capital available to them. The American Recovery and Reinvestment Act of 2009 enhanced the program by increasing the maximum funding available to SBICs and, in turn, to small businesses.

### What Is a Small Business Investment Company?

SBICs are privately owned and managed investment funds licensed and regulated by the U.S. Small Business Administration (SBA). SBICs raise private capital and can, if they choose to, supplement it with additional capital borrowed at lower cost using SBA-guaranteed securities to make investments in qualifying small businesses and smaller enterprises as defined by SBA regulations.

SBICs generally are formed as limited partnerships, with the fund managers acting as the general partner. The limited partners, who supply the majority of the private funding, are typically institutional investors, including banks, and high-net-worth individual investors. By regulation, SBICs may invest only in small businesses and must allocate a minimum of 25 percent of their capital to smaller enterprises.<sup>1</sup> A

small business is a business, including its affiliates, that has a tangible net worth not in excess of \$19.5 million, and average net income not in excess of \$6.5 million after federal income taxes (excluding any carry-over losses) for the preceding two completed fiscal years. A business may also be deemed "small" using the (NAICS) codes. On average, SBICs invest between \$1 million and \$10 million for each investment, although some SBICs go outside this range.

There are two types of SBICs: leveraged, which use SBA leverage in the form of SBA-backed borrowings; and unleveraged, which do not. The majority of active SBICs are leveraged. Unleveraged SBICs, including bank-owned SBICs, make up about 15 percent of active SBICs.

### What Are the Benefits of Investing in SBICs for Banks?

National banks and federal savings associations (collectively, banks) may be interested in investing in SBICs for the following reasons:

- **Investment performance:** The main advantage of leveraged SBIC funds is their potential for producing competitive returns, compared with similar classes of investment funds. This is a direct result of employing

---

<sup>1</sup> A smaller enterprise is a small business that (1) together with its affiliates, and by itself, meets the SBA's North American Industry Classification System (NAICS) size standard at the time of financing; or (2) together with its

---

affiliates has a net worth of not more than \$6 million and average net income after federal income taxes (excluding any carry-over losses) for the preceding two years no greater than \$2 million.

- low-cost, SBA-guaranteed debentures to supplement the funds' private capital.
- **Community Reinvestment Act (CRA) consideration:** Investments in SBICs meet the definition of qualified investments under the CRA.<sup>2</sup>
- **Volcker rule exemption:** SBICs are exempt from the Volcker rule, which generally prohibits "banking entities" from engaging in proprietary trading and investing in hedge funds or private equity funds.
- **Small-business development opportunities:** When investing in an SBIC, many banks build mutually beneficial financial relationships with companies included in the SBIC's investment portfolio.
- **Investments by federal savings associations:** Under 12 CFR 160.36, federal savings associations have limited authority to make investments of the type permitted for national banks under 12 CFR 24. Federal savings associations also are authorized under 12 CFR 5.59(f)(8), through one or more service corporation, to make community development investments that are permissible under 12 CFR 24. Pursuant to 12 CFR 5.59(g), an FSA may invest up to 3 percent of its assets in service corporations, but any amount exceeding 2 percent must serve "primarily community, inner-city, or community development purposes."

## What Are the Regulatory Considerations for Investing in SBICs?

Banks may make investments in SBICs using one or more of the authorities discussed below:

- **Small Business Investment Act:** Banks have authority under the Small Business Investment Act of 1958 (as amended) to invest in one or more SBICs, or any entity established to invest solely in SBICs. Under this authority, total investments in SBICs by any one bank may not exceed 5 percent of the institution's capital and surplus.
- **Public welfare investments:** Banks may make investments designed primarily to promote the public welfare under 12 USC 24(Eleventh) defined as an investment that would receive consideration as a "qualified investment" under the CRA (12 CFR 25.23). Qualified investments under the CRA include SBICs.<sup>3</sup>

<sup>2</sup> Interagency Questions and Answers Regarding Community Investments, \_\_.12(g)(3)-1.

## What Are the Key Risks of Investing in SBICs?

Investments in SBICs have risks similar to those in other types of private investment firms. These risks can be mitigated by performing proper due diligence on the SBIC funds being considered for investment. The following are key issues to consider in any risk management strategy associated with investing in SBICs:

- **Loss of principal:** Loss of principal is a risk of investing in small businesses. This may be particularly so for investments in SBICs, which are long-term in nature with no guarantee of repayment. The fact that SBICs are licensed by the SBA does not in itself protect bank investments in SBICs.
- **Liquidity:** SBIC investments are illiquid. Banks should recognize that making investments in SBICs is similar to purchasing unratable and nonmarketable securities. There is no formal secondary market to provide an SBIC investor with the option of selling its investments should the bank have an immediate need for cash.

<sup>3</sup> Ibid., \_\_.12(t)-4.

- **Operational risk:** SBICs are governed by a set of rules established by the SBA and are audited by the SBA annually (leveraged funds) or every other year (unleveraged funds). Banks should familiarize themselves with SBA regulatory considerations on SBIC investment size and eligibility standards; affiliates and conflict of interest; qualifying and structure investments; management ownership diversity; and reporting requirements.
- **General partner:** During the SBIC underwriting process, banks must carefully evaluate the management team serving as the general partner. The individuals composing that team and their related experience have a significant impact on how the proposed SBIC performs. They are responsible for identifying portfolio companies in which the SBIC invests as well as maintaining an ongoing advisory role with these companies, with the goal of securing repayment of the SBIC’s original investment plus a healthy return.

## A Note on CRA Considerations

Bank equity investments in SBICs meet the definition of qualified investments under the CRA. Large banks and intermediate small banks receive CRA consideration under the “investment test” or “community development test,” respectively, 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 area(s). To enhance a satisfactory rating, banks evaluated under the small-bank CRA test can request that examiners review their performance in making qualified investments, such as SBICs.

Federal banking regulators revised CRA guidance related to (1) activities in the broader statewide or regional area that include, but do not benefit, the institution’s

assessment area or areas; (2) the meaning of a “regional area”; and (3) qualified investments in nationwide funds.<sup>4</sup>

## Resources

- Code of Federal Regulations 13 CFR 107, “[Small Business Investment Companies](#)”
- OCC’s September 2015 Community Developments *Insights*, “[Small Business Investment Companies: An Investment Option for Banks](#)”
- OCC’s [Small Business Resource Directory](#)
- OCC’s [Public Welfare Investments Resource Directory](#)
- SBA Small Business Investment Company program [Web site](#)
- Small Business Investor Alliance [Web site](#)

### Disclaimer

*Community Developments Fact Sheets* are designed to share information about programs and initiatives of interest to bankers and community development practitioners. These fact sheets differ from OCC bulletins and regulations in that they do not reflect agency policy and should not be considered definitive regulatory or supervisory guidance. Some of the information used in the preparation of this fact sheet was obtained from publicly available sources. These sources are considered reliable, but the use of this information does not constitute an endorsement of its accuracy by the OCC.

<sup>4</sup> Questions and Answers Regarding Community Reinvestment, November 2013. See [\\_.12\(h\)-6](#), [\\_.12\(h\)-7](#), and [\\_.23\(a\)-2](#).