Testimony of Brett T. Palmer
President, National Association of Small Business Investment Companies
Before a CRA Interagency Public Hearing
Los Angeles Branch of the San Francisco Federal Reserve
August 17, 2010

My name is Brett Palmer and I am the President of the National Association of Small Business Investment Companies (NASBIC). I would like to thank the Federal Reserve, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision for holding this hearing on small business lending and the Community Reinvestment Act. I look forward to sharing with you how Community Reinvestment Act (CRA) ratings have coupled with the Small Business Investment Company (SBIC) program to support small businesses and the economy as a whole. Although much job-creating investment has occurred due to CRA, there are improvements that could be made to ensure our nation's entrepreneurs will continue to have the access to capital they need as the Nation again turns to them to help us move toward an economic recovery. If applied in a constructive manner to Small Business Investment Companies (SBIC), the CRA currently has the potential to unlock at least five billion dollars of new small business investment via SBICs. NASBIC encourages you to support small business investment by reaffirming and clarifying that bank commitments of private capital to SBICs will receive full CRA investment credit. Specifically, we suggest the following:

- **Regulators should provide uniform clarity that commitments of private capital to SBICs and in funds that invest exclusively in SBICs should receive full investment credit under CRA at the time of the commitment.**
- **Regulators should make efforts to inform and educate examiners and banks that commitments of private capital to SBICs are fully acceptable and have been mandated in federal law with a specific public policy purpose.**
- **SBIC investments that trigger the release of more capital than the size of the direct investment (i.e. SBA leverage) should be given credit for the increased capital available to small businesses.**

Since its establishment by Congress in 1958, the Small Business Administration's Small Business Investment Company program has been specifically designed and statutorily mandated under the Small Business Investment Act to " improve and stimulate the national economy in general and the small business segment thereof in particular" and "to stimulate and supplement the flow of private equity capital and long term loan funds which small business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization, and which are not available in adequate supply: Provided, however, that this policy shall be carried out in such manner as to insure the maximum participation of private financing sources." And that is what SBICs do. They provide critical patient capital to small businesses in sectors and geographies passed over by the rest of the financial world. Our economy and our communities need SBICs now more than ever.

SBICs are very small, highly regulated private investment funds that invest capital exclusively in domestic small businesses, primarily through long-term debt investments. Under this Small Business Administration program, funds raise private capital from institutional and individual investors, increasingly commercial banks. Upon licensure by SBA, SBICs can access low cost leverage to multiply the amount of capital available for small business investment. A number of SBICs do not access leverage at all, but still invest under the same regulatory regime.

While much of the venture and private equity world invests heavily in Silicon Valley and the Manhattan to Boston corridor, particularly in technology and "green" technology, SBICs commonly invest in great businesses located off the beaten path or in overlooked industry sectors. Because the program's mission is to stimulate the economy by focusing exclusively on domestic small businesses, we don't pass over good opportunities because they are not in the flashiest industries or locations. SBICs invest in everything from mom and pop dry cleaners in Louisiana to janitorial services in Arizona to light fixture manufacturers in Philadelphia and everywhere in between. It is never missed by us that a good business is a good business and a good job is a good job. It is for this reason that SBICs have been instrumental in the growth of job-creating small businesses, providing $56 billion, funding hundreds of thousands of small businesses. Since 1958, many small businesses that received SBIC funding have since grown into icons of the American economy including: Federal Express, Intel, Apple Computer, Callaway Golf, Staples, and Outback Steakhouse. We do not have hard numbers on the amount of investment that was enabled by banks investing in SBICs since the creation of the CRA investment credit, but I can assure you that it has been a meaningful amount that has aided thousands of small businesses. In this tough credit environment, there are more small businesses that will grow their businesses and employment rolls if they are able to access SBIC funding with the help of capital commitments from CRA-conscious institutions.

Small companies often require financing in the critical $250,000 to $5 million range in the form of either subordinated loans not made by banks or equity investments not generally available from non-SBIC private equity firms. Subordinated loans or equity investments are either too risky for banks or too small for traditional private equity funds to fit their business model. SBICs fill that gap—supporting thousands of U.S. small businesses each year. For example, in FY 2009 the average SBIC investment was approximately $688,000 – an impossibly miniscule investment size for most private equity funds, but a huge capital lifeline for small business owners. The financial crisis caused the entire financial sector to temporarily freeze, particularly in regards to small business lending. SBIC fund managers were forced to slow new investments because lines of credit for their existing portfolio small businesses were often slashed or revoked entirely. However, because SBICs take a longer term view of investing and support their portfolio companies by investing in riskier portions of the capital structure than banks, the SBIC-funded businesses weathered the storm. When the Treasury Department and SBA held a summit on small business lending in November of 2009, all of the participants complained that they were being cut off from capital – all except the one small business backed by an SBIC.

The performance of SBICs in the financial crisis combined with the ongoing conditions in the financial markets has caused a resurgence in SBIC formation. Currently, there are scores of SBICs in formation representing the potential of several billion dollars in private capital and approximately five billion in additional leverage – 100% of which will be put to work in small businesses. There are even funds of funds being started that will invest exclusively in SBICs to provide CRA credit to banks that commit private capital to such funds. However, funds can only become licensed SBICs if they are able to raise private capital, and while the typical SBIC fund has received 35-50% of its private capital commitment from banks (some receive 100% of their private capital commitment from banks), recent actions by regulators have dramatically chilled bank investment in SBICs and therefore risk cutting off billions of dollars in capital to small businesses.

Recently, SBICs have been informed by several banks that currently or have previously committed private capital to SBICs that a few CRA examiners were looking unfavorably at SBICs investments and offering reduced CRA credit. To make matters worse, banks were being informed of the fractional credit years after the fact. Because of this shift a number of banks have stopped making private capital commitments to SBICs, not because the SBICs had performed poorly (to the contrary they had performed quite well), but because they were being given only fractional CRA investment credit and were being given guidance by their examiners that future SBIC capital commitments would also be at risk for only fractional credit. The problem seems to be limited to a few examiners, but it only takes one to muddy the waters and scare off investment. At a time when there are fewer banks and fewer institutional investors able to make private capital commitments in SBICs, this regulatory uncertainty is particularly destructive. To understand the scope of the range of damage being created just review the numbers. A typical non-leveraged SBIC is extremely sensitive to CRA credit and every dollar not committed to a non-leveraged SBIC cuts off one dollar of small business investment. For every dollar not committed to a leveraged SBIC, up to three dollars are cut off from small business investment. Banks committing capital to non-leveraged funds should immediately be getting dollar for dollar credit and banks committing capital to leveraged SBICs ought to be given credit for the amount of capital their actions are releasing into communities – which is commonly up to three to one. The ambiguity surrounding banks receiving fractional credit is counterproductive and is adding to the capital access crisis facing small businesses.

As a matter of history, beginning in July of 1997 the investment activities of banks began being examined as part of the CRA rating system with the implementation of CRA's investment test. This test grades an institution's investments based on their impact on community development and makes up a meaningful portion of the total CRA rating. According to the "CRA Interagency Questions and Answers Regarding Community Reinvestment" released on March 11, 2010, the method of determining a "qualified investment" whose primary purpose is community development involves a "size" and "purpose test." In past and present "Questions and Answers" notices regarding CRA, commitments of capital by institutions to SBICs have been explicitly cited as meeting the "purpose test" since SBICs are "presumed" by regulators to promote economic development. In regards to the "size test" placed on investments from institutions seeking CRA credit, the SBIC program's eligible small business size standards are described as the same numerical standards applied under the CRA investment test. SBICs investments should be given full credit.

It is worth noting that in the recent sweeping financial regulatory reform, SBICs were specifically exempted from the "Volcker Rule" because of the public benefit realized by SBICs. It makes no sense to chill commitments of capital to SBICs when past bank regulator practice and recent statutes have affirmed and reaffirmed the important role of SBICs in community and economic development.

The CRA/SBIC dynamic has successfully provided capital and created small business jobs in investment starved communities and sectors, and this relationship should be maintained. A commitment of private capital by a financial institution to a SBIC should continue to be explicitly considered as a qualified investment for CRA credit. There are many reasons why investment in SBICs have in the past been considered qualified investments that promote economic development, and for the sake of thousands of job-creating small business owners and entrepreneurs, we encourage the overseeing agencies to ensure this rating system stays intact in the future.

Thank you for the chance to testify and I would welcome any questions that you may have.