Statement for the Record
for the
U.S. House Small Business Committee
hearing entitled

"Unleashing Main Street's Potential: Examining Avenues to Capital Access"

2360 Rayburn Building at 10:00AM
January 18, 2024

Brett Palmer
President
Small Business Investor Alliance (SBIA)

On behalf of its members, the Small Business Investor Alliance (SBIA) submits the following statement for the record of the Small Business Committee hearing entitled "*Unleashing Main Street's Potential: Examining Avenues to Capital Access.*"

The Small Business Investor Alliance

SBIA was formed in 1958 to represent Small Business Investment Companies, the original American venture capital and private equity funds. As the small business investing market grew more complex, so did SBIA. SBIA now includes Small Business Investment Companies (SBICs), Rural Business Investment Companies (RBICs), Business Development Companies (BDCs), conventional private equity funds, private debt funds and other funds investing in American private small businesses. We also represent the institutional investors (e.g., community banks, university endowments, pension funds) who invest in these small private funds. Our association's purpose is to represent the entire lower middle market investing ecosystem, both General Partner and Limited Partner. As such, our public policy goals are balanced and focused on maintaining a robust, healthy, and competitive market for investing in American businesses.

Current Capital Access Market

The Bank Challenge

The paths to accessing capital for many small businesses are currently very strained and are at risk of being further reduced. Without access to capital America's small businesses, located in small towns as well as big cities across the country, will be unable to grow, hire, and innovate. In short, without better access to capital we are stifling our own economy and our economic future.

With the collapse of Silicon Valley Bank in 2023, there were massive outflows of capital (deposits) that flowed from smaller banks to the larger banks because the larger banks were identified as systemically important by regulators and therefore likely to receive aid if the banks came under stress. The smaller banks were given no such assurances by regulators. The resulting rush of capital from smaller institutions to larger institutions cuts off the ability of smaller banks to provide many small business loans. The result is smaller businesses simply cannot borrow from the banks that they have had long-term relationships with. It is not a matter of intent, but a simple matter of cash on hand and regulations.

Further, a significant part of Silicon Valley Bank's collapse was due to it holding long term paper that was purchased when interest rates were very low. Many banks are holding vast sums in this low interest rate paper. If a bank must sell these low interest rate notes when interest rates are higher (as they are today) then the value of those notes plummets and the bank is put under major duress. Rates were too low for too long and went high too quickly. Again, this risk of interest rate dislocation reduces a bank's ability to loan to small businesses.

The flight of capital to large banks was not the fault of the large banks. However, it is important to note that it is just as much work, and often more work, for a large bank to lend to a small business as it is to make bigger loans to bigger businesses. Large banks are trying to fill the lending gap, but they simply cannot replace the role of smaller banks. Large financial institutions are inherently biased towards deploying larger businesses, simply because of the scale of capital involved. This scale problem is exacerbated by the regulations put on large banks by things like Basel III.

In summary, when banking is stressed by market forces or by excessive regulation the first thing that gets cut back on is small business lending.

The Interest Rate Challenge

The steep increase in interest rates is particularly damaging to smaller businesses. As if fewer lenders servicing the small business market were not bad enough, the cost of the few loans available has become prohibitively expensive. To put this in perspective, small businesses that were previously growing at an annualized growth rate of 40% (a very robust clip), are now growing at 5% or less because the cost of growth capital (loans) has risen so high and so quickly. Growth is better than shrinkage, but the cost of borrowing has become a massive drag on economic growth and opportunity in towns across America.

Small Business Investment Companies (SBIC) and Rural Business Investment Companies (RBIC) provide debt and equity capital exclusively to American small businesses. They are a pipeline of growth capital during good times and lifeline of capital during tough times. Demand for SBIC capital has never been stronger, with a record amount of capital deployed in FY2023 (in excess $8 Billion), a record amount of private capital committed to SBICs, and a record amount of SBIC leverage reserved for future investments. However, higher interest rates have impacted SBICs' cost of capital and in the same way that banks are constrained from lending due to capital outflows to larger banks, many smaller banks are facing regulatory limits that are constraining their ability to invest in SBICs (and in turn service small businesses).

SBICs and RBICs regularly empower banks to lend. Often growing small businesses are only able to access bank loans in conjunction with SBIC or RBIC capital. Currently, SBICs are often the only capital providers available because even with the equity and debt provided by SBICs, banks cannot provide loans (at any rate) to small businesses. Without SBICs and RBICs, smaller businesses would be in deeper trouble accessing capital than they already are. Congress should empower SBICs and RBICs to help more small businesses, with common sense, bipartisan regulatory relief.

What Can Congress Do to Improve Capital Access to America's Small Businesses?

1) Congress can provide regulatory relief to allow more SBIC investment into America's small businesses.
    a. Pass **<u>H.R. 5333 – Investing in All of America Act</u>**

    America's small businesses should be able to access growth capital when they are ready for it. This should be true not only for businesses near financial centers, but also for rural and low-income areas. This bipartisan legislation, introduced by Reps. Meuser and Scholten, will incentivize private capital investments in the parts of America that are too often overlooked. Further, current outdated regulatory caps are cutting off billions of dollars in investment by SBICs into small businesses across America.

    The Investing in All of America Act reforms the Small Business Investment Company program at SBA to encourage private capital in underserved areas and industries with the following benefits:

- ➢ No new spending.
- ➢ No new mandates.
- ➢ No subsidies.
- ➢ 100% of investment is in American small businesses.
- ➢ Encourages investment in Low-income and Rural Areas.
- ➢ Encourages investment in industries that are vital to national defense.
- ➢ Inflation adjustment allows the program to keep up with inflation over time.
- ➢ Market-led and market-driven.

b. Pass **HR 400 Investing in Main Street Act** (passed by the House several Congresses in a row, but no action in the Senate)

This bipartisan legislation (Reps. Chu and Garbarino) fixes a statutory drafting error where banks are currently allowed to invest more capital into SBICs (and therefore into American small businesses), but where SBICs are not allowed to accept more money from banks. There is no cost to this legislation, and it is non-controversial.

c. Raise the Annual SBIC Authorities

The current programmatic caps of $5 Billion dollars are rapidly approaching their limits. These caps need to be raised to at least $6 Billion dollars. This does not increase federal spending or appropriations. It just allows SBICs to grow to fill the demand for small business capital. SBIC Debenture leverage has consistently run at a zero subsidy (or better) since Congress mandated zero subsidy in 1998.

d. Reassess the Impact of Basel III on America's Small Businesses

The proposed higher risk weight averages in the Basel III End Game create a disincentive for banks to make certain investments because it would require them to reserve capital to compensate against the perceived risk of potential loss. Banks are long-standing investors in SBICs and RBICs. The Basel III End Game proposal threatens bank interest in making further investments into these public-purpose vehicles and therefore bank capital would not be deployed to domestic small businesses.

The Small Business Investor Alliance would be welcome the chance to work with the Small Business Committee in its efforts to increase access to capital to America's small businesses.

SUMMARY OF THE SMALL BUSINES INVESTMENT COMPANY PROGRAM

Small Business Investment Companies are an American success story and an example of a successful federal public policy that aligns the power of private markets with the public interest of job creation and economic growth. Congress declared in its original authorizing legislation that the SBIC program should "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" while also stimulating the national economy and job growth.[1]

SBICs invest exclusively in domestic small businesses, creating jobs and empowering U.S. small businesses to compete in a global economy. Companies that in their early stages received SBIC investments and have subsequently grown into icons of American industry include Federal Express, Apple, Intel, and Callaway Golf. While these are recognized companies globally, many more small businesses backed by SBICs have grown from smaller businesses into robust, sustainable mid-sized businesses. Generational ownership changes deserve a special mention because private equity plays a critical role in successfully managing these changes, particularly for SBIA's funds. Most small businesses are "lifestyle businesses" that provide a fulfilling career and support a family, but the business will end when the owner ceases working. But there are also a large number of businesses that are meant to continue on past their founder's time and many of these founders are aging. There are hundreds of thousands of successful businesses, commonly small businesses, which were founded by baby boomers or post-baby boomers, whose owners need to retire and whose business still has its brightest days ahead. In many of these businesses the founder/owner does not have a child who is willing or able to take over this business. Without a buyer, often a private equity fund or a management team backed by a private equity fund, many of these otherwise successful small businesses will simply shut down – harming their employees, the economy, and their communities.

SBICs are essential not only to the success but, in certain cases, survival of these smaller businesses that bring prosperity, employment, and hope to communities across the country, many in Low and Moderate Income (LMI) areas, and underserved markets, because there were no other sources of patient capital available to them.

At the end of FY2023, the SBIC program has grown to nearly 320 licensed funds with combined SBA commitments and private capital exceeding $42.5 billion, an increase of 40 percent since 2019 and the highest level ever in program history.[2]

Over the last five fiscal years, on average, SBICs have invested over $7.6 billion annually in over 1,160 small businesses, creating or sustaining nearly 130,000 jobs annually.[3] Twenty-five (25%) percent of SBIC

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[1] Small Business Investment Act of 1958, Pub. L. 85-699 (Aug. 21, 1958). 15 U.S.C. 661.

[2] *Small Business Investment Company (SBIC) Program Composition for the fiscal year ending September 30, 2023* (last visited Jan. 11, 2024).

[3] Id. SBA estimates jobs created or sustained using "The 1999 Arizona Venture Capital Impact Study" (confirmed by the DRI-WEFA study of 2001) whereby one (1) job is created for every $36,000 of SBIC investment (adjusted for inflation).

investments were made in small businesses that were either women-, minority- or veteran-owned, or located in LMIs areas.[4]

These investments are in real companies with real staying power and real growth potential.

SBIC Program Structure

The SBIC program is a market-driven platform that serves an important public purpose of facilitating private investment into and filling capital access gaps for domestic small businesses. SBICs are federally regulated, privately-owned and managed investment funds that invest exclusively in domestic small business. SBICs, primarily formed as limited partnerships, provide long-term loans, equity investments, or both along with management assistance to small businesses across a range of sectors, geographic locations, and stages of growth. Some SBICs specialize in an industry sector while others invest more broadly.

Most SBICs are levered (debenture) funds. These levered SBICs invest private capital that is amplified by access to an SBA-backed credit facility using the Federal Home Loan Bank system. This permits individual SBICs to multiply paid-in private capital up to three-times capital or $175 million, whichever is less. In exchange for accessing federal leverage, SBICs limit themselves in a number of ways including investing only in domestic small businesses.

The maximum leverage for an SBIC family of funds (a group that holds multiple SBIC licenses) is currently $350 million. Three times leverage is the statutory limit, which is rarely used and which the SBA will only permit under unusual circumstances. Most levered SBIC funds lever private capital one to two times their private capital. For example, an SBIC may raise $87.5 million in private capital and then, after licensure, may access up to an additional $175 million line of credit (SBA leverage), which combines for a total of $262.5 million – a very large boost in the small business economy. **The leverage is provided at a zero-subsidy rate, with no annual appropriations necessary to fund up to $5 billion a year in SBIC leverage, which is eventually paid back in full to the SBA with interest and fees.**

Successful SBIC small business investing continues to support the community with jobs and local taxes for many years.

[4] Id.