SMALL BUSINESS INVESTOR ALLIANCE

October 22, 2012

VIA EMAIL

To: Office of the Comptroller of the Currency
(regs. comments@occ.treas.gov)/Docket ID OCC-2012-0009
Board of Governors of the Federal Reserve System
(regs.comments@federalreserve.gov)/Docket No. R-1442 RIN 7100 AD87
Federal Deposit Insurance Corporation
(comments@FDIC.gov)/FDIC RIN 3064-AD96

Re: **SBIA Letter 1 of 2 (Small Business Investment Companies)**
Regulatory Capital Rules: Standardized Approach
For Risk-Weighted Assets; Market Discipline and
Disclosure Requirements

We are the Small Business Investor Alliance ("SBIA"), which is the leading organization that represents middle market equity funds and investors. SBIA represents the vast majority of Small Business Investment Company ("SBIC") funds, both mezzanine or private equity funds, all of which focus on small business, making debt and equity investments generally in the $1 million to $15 million range. SBIA also represents non-SBIC lower middle market private investment equity funds, as well as limited partners which make investments in SBICs and non-SBIC small private equity funds.

We welcome the opportunity to comment on the joint notice of proposed rulemaking with respect to Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements ("Regulatory Capital Rules"). In particular, we welcome the opportunity to respond to Question 19 from the Regulatory Capital Rules which presents an approach whereby the treatment of SBIC investments under the risk-weighted methodology would be identical to community development investments. For the reasons stated below, we strongly support the alternative approach outlined in Question 19 to risk weight bank investments in SBICs at a 100 percent level, which is identical to the risk weight applied to bank investments in community development investments.

We are available to provide data and technical assistance to the agencies upon request, and we are available to meet with respect to these matters. In this letter, we will provide pertinent background information on the SBIC program and then provide comments in connection with the Regulatory Capital Rules.

Background of SBIC Program

SBICs are small, highly regulated private investment funds that invest exclusively in U.S. small businesses. They are licensed and overseen by the U.S. Small Business Administration (SBA). The purpose of the SBIC program is to increase the amount of capital available to small businesses. Since the passage of the Small Business Investment Act of 1958 ("SBIA"), SBICs have bridged the gap between entrepreneurs' need for capital and traditional financing sources and have provided more than $60 billion to over 109,000 job-creating small businesses that would otherwise be challenged to find available capital. SBICs commonly invest in companies "off the beaten path" and usually invest in companies that do not qualify for financing from large financial entities. SBICs have provided capital to many small businesses at critical moments in the early development stage, assisting in their growth to become major employers. Such businesses include: Intel, Apple Computer, Callaway Golf, Whole Foods Market, Staples, Federal Express, Costco, and Quiznos.

To become licensed as an SBIC, funds raise private capital from individuals, as well as from institutional and other equity investors, including increasingly commercial banks. Applicants are subject to a rigorous application process with the SBA. SBICs are highly regulated by the SBA, and go through several steps to become licensed. The SBA administers a rigorous risk management and oversight program to protect the American taxpayer's interests in SBICs and to ensure that the objectives of the law are being met. SBA regulations govern investments and operations of SBICs. SBICs make periodic reports to SBA and are subject to an annual audit and inspection by SBA. The objectives of the risk management program are:

1. to promote high standards of integrity and best fund management practices among SBICs;
2. to assess financial and regulatory issues affecting fund management;
3. to ensure that SBA personnel are providing continuity and consistency in their oversight responsibilities with active SBICs; and
4. to collect data and assist SBICs with evaluating their potential losses.[1]

Funds licensed as SBICs serve a statutorily mandated public policy purpose to improve and stimulate the national economy by investing in the small business segment of the national economy. The SBIC program supports and stimulates the flow of private equity capital and long-term loan funds to small business concerns by financing their business operations and their growth, expansion and modernization. SBICs are proud to support underserved communities. SBICs often invest in businesses located in low-to-moderate income ("LMI") areas, which

[1] SBIC TechNotes: Post Licensing SBIC Risk Management Procedures (December 2003 – Number 10). http://www.sba.gov/content/sbic-technotes-number-10-december-2003

businesses have at least 50% of its employees located in LMI Zones. Over the past five years, SBICs have financed more than 1,500 businesses in LMI Zones. In addition, SBICs have financed an average of 150 women, minority, and veteran-owned businesses per year during recent years.

As a testament to the SBIC program's continued ability consistently and effectively to provide capital to America's job creators, SBICs provided $1.85 billion of capital to small businesses in FY2009, which grew to $3.22 billion in FY2012. SBICs financed 1,094 domestic small businesses in FY2012 and, according to the SBA, created or retained over 68,000 jobs. The successful track record of the SBIC program, particularly during this unsettled economic time, motivated Congress to support the ongoing growth of SBICs.

Banks are a very important source of financing for SBICs and likely will play a greater role in the future for SBICs to raise the required capital to become licensed by the SBA. In the meantime, bank investments in SBICs have remained constant during the past five years. Some banks invest in multiple SBICs and it is common for some SBICs to attract investments from more than one bank. In Fiscal Year 2012, over 140 national, regional and community banks invested in SBICs and approximately 92 SBICs raised capital from banks to help them with their mission to provide needed capital to domestic small businesses. Without banks, SBICs would have less capital to finance America's most promising small businesses. We encourage the regulatory agencies to keep costs low for SBICs because SBICs serve an important public interest in helping small businesses get long-term financing to grow and create jobs.

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Comments on Regulatory Capital Rules Treatment of Bank Investments in SBICs

Under the Regulatory Capital Rules, bank investments in SBICs likely will be risk weighted at a 100 percent level in nearly all instances, but in order to obtain the 100 percent risk weight there is a somewhat complicated methodology in place related to a "safe harbor" cap (measured as a percentage of a bank's total capital) that pertains to investments in SBICs. As a policy matter, the effect of increasing the risk weighting of bank assets is that a bank has to hold additional capital to account for the higher risk level assigned to the assets by the regulators in order to maintain the bank's capital adequacy ratios required by U.S. regulations. From a policy perspective, a risk weighting of greater than 100 percent indicates a regulatory conclusion that the asset is riskier and requires more capital support. A risk weighting of 100 percent essentially is a judgment call by the regulatory officials that the asset is "neutral" as to risk and does not need additional capital support beyond the standard capital requirements applicable to banks.

Specifically, with respect to a bank's investments in SBICs under the Regulatory Capital Rules:

> "a banking organization would be permitted to apply a 100 percent risk weight to certain equity exposures deemed non-significant. Non-significant equity exposures would mean an equity exposure to the extent that the aggregate adjusted carrying value of the exposure does not exceed 10 percent of the banking organization's

> total capital. . . . To determine which of a banking organization's equity exposures qualify for a 100 percent risk weight based on non-significance, the **banking organization first would include equity exposures to unconsolidated small business investment companies, or those held through consolidated small business investment companies [i.e., any entity established to invest solely in small business investment companies[2]]** (emphasis added). Next, it would include publicly-traded equity exposures (including those held indirectly through investment funds), and then it would include non publicly-traded equity exposures (including those held indirectly through investment funds)."

So, under the proposed Regulatory Capital Rules, it is our view that as long as a bank's investments in SBICs do not exceed 10 percent of the bank's total capital, such investments will be given a 100 percent risk weighting. And, any remaining amount (after deducting the percent utilized by SBIC investments) of the 10 percent of a bank's total capital can be assigned to other equity exposures (as identified in the Rules) in order to also qualify for a 100 percent risk weighting.

While we are generally in support of a 100 percent risk weighting for bank investments in SBIC as set forth in the Regulatory Capital Rules, nonetheless, there are potential unintended consequences with the methodology used in the Regulatory Capital Rules. Most obviously, there is a danger of the SBIC investments "crowding out" the other equity exposures held by the bank because the SBIC investments are first counted against the 10 percent of the bank's total capital cap before applying the remaining amount available under the 10 percent cap to other equity exposures. Based on various internal financial return metrics, it is possible that the Regulatory Capital Rules might provide a disincentive for a bank to invest in SBICs because a bank may wish to utilize more of the 10 percent cap for non-SBIC investments. We do not believe that the regulatory agencies intended for such a possible outcome, but we note the danger due to the methodology proposed in the Rules.

Beyond this structural issue, there also is a serious potential regulatory safety and soundness problem because we would not expect the regulatory agencies to be trying to adopt a proposal that creates potential disincentives for bank investment in SBICs or an incentive for "overinvestment" in other equity exposures. One answer to this problem, which is detailed in more depth below and is one which we strongly support, is to pursue the alternative approach noted in Question 19 in the Regulatory Capital Rules and thereby designate bank investments in SBICs with a 100 percent risk weighting in all instances without any reference to the 10 percent total capital cap. In brief, this would--and we think properly so--unhinge the 10 percent total capital cap with respect to the bank investment level in SBICs.

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[2] The text of the notice of proposed rulemaking references section 302 of the Small Business Investment Act of 1958 to define consolidated small business investment companies. For ease of reference, we have included the relevant text of section 302 in brackets.

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Regulatory Capital Rules Alternative Treatment of Bank Investments in SBICs as set forth in Question #19 in the proposal:

Question #19: **The agencies solicit comment on an alternative proposal to simplify the risk-based capital treatment of banking organizations' non-significant equity exposures by assigning a 100-percent risk weight to equity exposures to small business investment companies** and to DPC equity exposures, consistent with the treatment of community development investments and the effective portion of hedged pairs. What other types of equity exposures (excluding exposures to small business investment companies and equities take for DPC) should be excluded from the non-significant equity exposure calculation under the alternative approach and what is the approximate amount of these exposures in relation to banking organizations' total capital? What would be an appropriate measure or level for determining whether equity exposures in the aggregate are "non-significant" for a banking organization? (emphasis added)

Reply: The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) continues a long standing practice of allowing banks to sponsor and invest in SBICs. The Dodd-Frank Act makes it clear that Congress supports small business growth, for example, by exempting SBICs from the Volcker rule and from the private fund investment advisor rule. The exemptions under the Volcker rule and the private fund investment advisor rule recognize that SBICs are not systemically risky and are important to the growth of our economy. Congress wrote these protections into law signaling that the partnership between banks and SBICs should be protected and not penalized.

It is critical to note that if the 10 percent total capital cap as provided in the Regulatory Capital Rules were ever exceeded by a bank's investment in SBICs, then the risk weighting for such SBIC investments would increase to 300 percent or 400 percent, depending on certain elements with respect to the SBIC investments. Simply put, at those levels of risk weighting, SBIC investments become uneconomical for banks and there would be a substitution away from investing in SBICs. We do not believe that the regulatory agencies intended such a possible outcome. This is an argument to abandon the 10 percent cap and instead to designate bank investments in SBICs with a 100 percent risk weighting in all instances.

We also draw attention to the fact that under the SBIA, banks are permitted to invest up to 5 percent of their capital and surplus in SBICs.[3] The Regulatory Capital Rules contain the 10 percent total capital cap as calculated using a bank's total capital (Tier One and Tier Two) which is a different base than the permissible investment calculation in the Small Business Investment Act. So, the amount of permissible investment as determined by Congress in the authorizing statute may not be the same as the 10 percent total capital cap "safe harbor" as reflected in the Regulatory Capital Rules. Again, it is not clear to us that the regulatory agencies intended to

[3] Small Business Investment Act of 1958 § 302(b)(1). 15 U.S.C. § 682(b)(1).

limit the level of permissible investment in SBICs by having calculations inconsistent with the Congressionally mandated level of "safe" investment in SBICs. This would be another argument to support classifying SBIC investments as being 100 percent risk weighted in all instances, and to move away from the 10 percent cap.

Moreover, SBICs should be treated similarly to other community development investments so that banks do not favor one community development investment over other ones. Several banks invest in community investment related investment products ranging from low-income housing projects to SBICs. Potentially favoring community development investments above SBICs raises the costs to invest in SBICs, and thus gives more reason for banks to invest elsewhere with their capital. The final rule should treat SBICs similarly to other community development investments, as intended by Congress and other regulatory rules, including the Community Reinvestment Act rules.

The SBA Debenture program administered by SBA has been remarkably successful and is operated at no cost to the U.S. Government. The number of debenture SBICs has grown from 129 in FY2008 to 158 in FY2012. At the end of FY 2012 there were 44 bank-owned SBICs that did not draw leverage from the SBA. Also at the end of FY 2012, total private capital (available to Debenture SBICs through commitments from its private investors and SBA debenture leverage outstanding) was in excess of $13.344 billion. The amount invested by debenture SBICs in private U.S. companies was $1.436 billion in FY 2008, which amount grew to $2.950 billion in FY2012. This latter amount was invested in 795 companies, of which 156 were less than two years old.

One Final Note: in response to Question 19, we limit our comments to the 100 percent risk weighting of SBIC investments at all times, and we do not comment on the other inquiries pertaining to other types of equity exposures.

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In conclusion, as the regulatory agencies develop the final regulatory capital rules, we urge you to pay particular attention to the impact that new regulations will have on the cost of investment in SBICs. SBIC investment is important to the long-term financing needs of small businesses, and any increase in the cost of investing in SBICs will inhibit SBICs from getting needed financing from banks. Regulators have an important responsibility to contain lending related risks that are systemic and therefore relevant to financial stability. However, please ensure that any future regulatory capital rules designed to address such systemic risk issues do not also penalize future investment in domestic small businesses.

We appreciate that the regulatory agencies have provided us the opportunity to comment on the regulatory capital rules and the treatment of SBIC investment as qualified community development investment.

Respectfully submitted,

SMALL BUSINESS INVESTOR ALLIANCE

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