NASBIC
America's Small Business Partners

Testimony of Charles McCusker
On Behalf of the National Association of Small Business Investment Companies
Before for a Joint Hearing of the Committees on
Small Business and Financial Services
February 26, 2010

Chairwoman Velazquez, Chairman Frank, Ranking Member Graves, Ranking Member Bachus, and Members of the Small Business and Financial Services Committees, thank you for the opportunity to testify today on behalf of the National Association of Small Business Investment Companies (NASBIC) regarding the state of small business lending. Clearly banks are critical to small business lending, but non-bank lenders, such as Small Business Investment Companies (SBIC) are an important and often overlooked part of the equation. When the Treasury and the Small Business Administration held a summit on small business financing last November, the only small business participant at the small business forum who said he had adequate access to capital was backed by an SBIC. Small businesses need more SBICs.

My name is Charles McCusker. I am a founder and a managing partner of the Patriot Capital family of investment funds. Patriot Capital holds three Small Business Investment Company ("SBIC") licenses and in conjunction with its predecessor funds, has been investing in small businesses for two decades. Under its three licenses, Patriot Capital has provided investment capital to 64 small businesses and the Patriot Capital portfolio of companies employs over 10,000 people. 6,000 of these jobs were created as a direct result of our in investments.

SBICs are very small, highly regulated private investment funds that invest capital exclusively in domestic small businesses, primarily through long-term debt investments. The SBIC program has been operating with bipartisan support since 1958. Under this program, funds raise private capital from institutional and individual investors and, upon licensure by SBA, can access low cost leverage to multiply the amount of capital available for small business investment. Through fees and interest payments, the SBIC Debenture program operates at a zero subsidy rate and does not require or receive annual appropriations from Congress to provide leverage. One of the keys to the success of this program is the fact that all taxpayer dollars are repaid to SBA before investors begin to receive any return of their investment capital. Unlike some other types of private equity, SBICs generally provide growth capital and expertise to support small business owners and managers. SBICs have provided some of the early capital for such well-known companies as Federal Express, Intel, Outback Steakhouse, Staples, Quiznos, and hundreds of companies that are listed on the NASDAQ.

In the autumn of 2008 small business lending dramatically tightened following the financial meltdown. Credit lines for many companies were reduced or pulled entirely and many small businesses were immediately limited in how their businesses could operate. Across most industries, the result was decreased production, increased unemployment, and a substantially reduced taxpayer base. Access to senior debt, usually provided by banks, largely disappeared and many small business transactions froze. Almost eighteen painful months later, the capital access problem for small businesses remains. It has thawed to a degree – senior debt may be available but it is very restrictive. For example, we have a recycling company in the Midwest that has struggled but survived the economic downturn, met every expectation that they laid out to the bank and yet the bank continues to reduce the amount of credit available to this company. And while debt capital would be available if the company were on a larger scale, small businesses like this paper recycler are having serious problems accessing capital. While there have been some recent signs of bank credit availability for small businesses increasing, there are still reasons for concern as small businesses still have limited access to long-term capital.

This is where SBICs fill the capital void in the marketplace. SBICs function in a symbiotic relationship with banks. Banks are not competitors, but are major investors in our funds and are sources of daily credit for the businesses in which we invest. SBICs fill an important and unique role in providing capital to small businesses. SBICs generally provide long-term capital in the $500,000 to $5,000,000 range, a range in which banks are often not comfortable lending, particularly smaller community banks. SBICs also invest in small businesses which, despite being solid companies, are considered too risky for banks to consider worthy of credit. For example, in FY 2009 SBICs made over 20% of their investments in Low and Moderate Income areas and well over 90% of investments held by SBICs were in smaller enterprises. In addition, banks are often more comfortable lending to small businesses with SBICs as long-term capital investors. The country needs more SBICs in total and more SBICs in underserved markets. For example, some very large states only have two active SBICs and some smaller states have none.

Over the last decade, our three Patriot Capital funds collectively have invested over $200 million in 64 domestic small businesses in 23 states (AZ, CO, CT, FL, GA, IL, KY, LA, MD, NC, NJ, NV, NY, OH, OK, OR, PA, SC, TN, TX, UT, VA) and these businesses employ over 10,000 people. Over 6,000 of these jobs were created as a direct result of our investment. We have businesses in multiple industries and very few are immune to the current lack of liquidity in the market place. Several very solid, well-managed companies in our portfolio, from the Midwest paper recycler to a Southeastern trucking company to an East Coast telecommunications manufacturer to a rural provider of natural gas equipment, would have been put <u>out of business and liquidated</u> by their banks if not for the SBIC program and the capital we can bring to support these small businesses. In approximate numbers, these four companies represent over $100 million in revenue and over 600 American jobs. These may not seem like large numbers, but they are huge numbers to their employees and their hometowns. Also, consider that these four companies represent only 4% of our portfolio and Patriot Capital, while collectively one of the largest SBIC licensees, still represents less than 2% of the SBIC program. Stories like this can be told by every one of the SBICs in the marketplace. It is a fact that it is faster and easier to save and create jobs in a solid small business than it is to create them from scratch.

Thanks to the leadership of Chairwoman Velazquez and the Small Business Committee, last year Congress passed a number of SBIC improvements that were signed into law via the Recovery Act. Last fall, the Small Business Committee passed a bipartisan reform of the SBIC program that is still pending in the Senate. With these Congressional actions and the Administration's appointment of quality officials at SBA, the SBIC program is experiencing a renewal that should release billions of dollars to small businesses without any additional cost to the taxpayer. In 2008 only six SBIC licenses were issued. Only a few months into FY 2010, SBA has already issued eight new licenses. Further, there are approximately 50 more funds currently in the application pipeline. If most of these funds are licensed it is reasonable to expect that billions of dollars will soon be flowing to small businesses, again at no cost to the taxpayer. If the House passed SBIC improvement legislation is enacted, that number could increase by another couple of billion dollars.

However, without private sector investment these SBICs in formation cannot get their licenses and cannot get capital flowing.

Despite the laudatory efforts of the Administration and Congress to fully utilize the SBIC program to facilitate capital flowing to small businesses, there are a number of issues which are currently chilling institutional investment in SBICs and therefore denying small business access to credit. The key to the 52-year success of the SBIC Debenture program is the fact that private capital leads and SBA leverage follows. No taxpayer money is at risk until the private money is lost (a very rare occurrence). Policymakers should remove barriers and create incentives for private investment in SBICs.

Bank Investment in SBICs

The day after the President announced his proposal to ban all bank investment in private equity, a number of banks immediately suspended their investment commitments to SBICs in formation. Banks do not want to invest in SBICs and a few months later find out that they may have to divest their positions. Some SBIC funds have 100% of their capital coming from banks. While 100% is no the norm, 40-50% is common. If bank capital is banned from SBICs, then the wave of SBICs currently in formation will have a much harder time raising the required private capital – many will not get licensed. The result will be fewer SBICs and the loss of over $2 billion of capital to small businesses. As an important matter of legislative history, prior to Gramm-Leach-Bliley, when banks were severely limited in their ability to take equity stakes in companies, bank investments in SBICs were explicitly allowed and encouraged. Bank involvement in highly regulated SBICs is completely unrelated to hedge funds or other unregulated financial investment funds and offer no systemic risk.

CRA Credit for Investment

The Community Reinvestment Act has been an effective incentive for banks to invest in SBICs and needs to be strengthened significantly. To oversimplify a bit, about 25% of a banking institution's CRA score is derived by the bank examiners' review of bank investments. Given the nature of the SBIC and their limitations to exclusively invest in small business, banks have received dollar for dollar credit for investing in SBICs. In the past nine months that has changed – although there has been no change in regulations or statute. Suddenly a few banks are being told by their regulators that the amount of CRA investment credit they will receive is far from certain. The net effect of this unexplained change in direction by a handful of regulators is that some banks have stopped investing in SBICs. One major bank has stopped investing entirely and another major bank is actively considering ceasing investing in SBICs. This change is cutting off capital to small businesses. This policy change is particularly damaging to underserved areas because many states do not have any SBICs or have too few for their size. Causing confusion on CRA credit limits the creation of new funds and therefore limits increases in the diversity of new SBIC licenses. As mentioned before, if SBICs do not have access to this institutional investor group, this important small business program will be in jeopardy. Regulators should reaffirm that bank investments in SBICs will receive full credit for the investment portion of their CRA score.

Community Bank Capital – TARP

In addition to the above mentioned reasons for reductions in bank investment in SBICs and despite the excellent returns on invested capital, there is another reason for reductions in bank investment and lending – they simply don't have or don't want to put more money to work while their regulators are aggressively scouring their books. Banks are being asked to lend more while be required to reserve more. It is this very reason, that the Obama Administration recently proposed providing $30 billion in unused TARP funds to community banks expressly for small business investment. This promising proposal should help community banks lend more and is a welcomed development. However, this proposal also presents an opportunity to use the billions in dormant SBIC leverage that could help thousands of small businesses and result in job creation. If community banks were provided legislative incentive to invest only three (3%) percent of this money in CRA-eligible SBICS then the SBIC mechanism would quickly release nearly an additional two billion dollars in capital for growing small businesses without any additional cost to the taxpayer. At a minimum, the Administration or Congress should issue public guidance to banks that they are allowed to use these new funds to invest in SBICS. Setting aside a fraction of this capital for community banks to invest in SBICs would be even more beneficial to small businesses.

Capital Gains

Although your two committees do not have direct jurisdiction over tax policy, it is important to discuss the President's proposal for zero capital gains for qualified small business investments. This proposal is a healthy incentive to provide private capital to small businesses. However, this proposal could have a much bigger impact if it were to specifically include SBICs. Because of the money multiplying nature of the SBIC program, applying this tax incentive to SBICs would triple the benefit to small businesses. We would encourage that SBICs be explicitly included in this tax provision.

Thank you for the opportunity to testify at this joint hearing. I would welcome the chance to share my first hand small business knowledge and answer any questions you may have.