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December 15, 2023

Accrual and Reinvestor Small Business Investment Companies (SBICs)

The Small Business Administration (SBA) administers several programs to increase access to capital for small businesses. Among those is the Small Business Investment Company (SBIC) program. Under the SBIC program, the SBA provides capital at favorable terms to SBA-certified venture capital funds who agree to invest in small businesses.

Congress and the SBA have expressed interest in the composition of SBICs and of the portfolio of SBIC investments. In July 2023, the SBA finalized a rule, effective August 17, 2023, that created two new types of SBICs. Accrual and reinvestor SBICs have access to a special SBA funding instrument intended to increase program investment diversification and patient capital financing.

SBIC Program Background

The SBIC program is a long-standing SBA initiative intended to increase the amount of medium-term and equity-based financing (such as stock or partnership interests) available to small businesses. In the SBIC program, a private venture capital fund submits a detailed application to the SBA, demonstrating that the fund's managers have extensive successful investment experience and a viable strategy of investing in small businesses. If initially approved by the SBA, the SBIC then must raise sufficient private capital to be viable (generally $5 million) before submitting a final application for an SBIC license. If given final approval by the SBA, the SBIC license-holder may draw leverage from SBA funding sources.

Currently, most SBICs receive SBA funding through a standard debenture, or debt securities. The SBA guarantees 100% of the debenture principal and interest payments with the full faith and credit of the U.S. government, allowing SBICs to borrow at favorable interest rates. For most standard debentures, SBICs can access $2 in SBA leverage for every $1 in private capital, up to $175 million in leverage. The SBA has the discretion to approve up to $3 in leverage for every $1 in private capital. The SBIC must make interest payments on the debenture every six months. The principal is repaid in its entirety when the debenture matures in 10 years.

SBICs have other regulatory advantages. They are exempt from certain Securities and Exchange Commission registration requirements for investment advisors. SBICs are also exempt from the "Volcker Rule" in Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203), which prohibits banks from conducting certain investment activities. SBIC investments are also presumed to be qualified for the Community Reinvestment Act (Title VIII of P.L. 95-128, as amended). These regulatory advantages have led some venture capital funds to seek an SBIC license but not draw on SBA leverage. These nonleveraged SBICs are often affiliated with banks, who are mainly attracted to the program for the regulatory incentives and use their own funds to make investments.

In FY2023, SBICs reported financing 1,208 small businesses for a total of $8.1 billion: $5.2 billion (65%) was debt only, $2.0 billion (24%) was equity only, and $0.9 billion was debt with equity features.

The SBA's September 2023 SBIC program report identified 318 SBICs, of which 256 (81%) were debenture SBICs and 53 (17%) were bank-owned or nonleveraged SBICs. Of the financed companies, 228 (19%) were located in low- to moderate-income (LMI) areas, and 82 (7%) were woman-, minority-, and/or veteran-owned businesses.

For more information about the SBIC program, please see CRS Report R41456, *SBA Small Business Investment Company Program*.

Accrual SBICs

The SBA's July 2023 final rule (88 *Federal Register* 45982) created accrual SBICs. Accrual SBICs are SBICs that receive SBA financing from an accrual debenture. In the final rule, the SBA stated accrual SBICs are intended to "increase program investment diversification and patient capital financing."

Accrual debentures are debt securities for which the SBA guarantees 100% of the debenture principal and interest payments. Unlike the standard debenture, semiannual interest payments are not required, and thus the entire principal and all accrued interest payments are due at maturity.

In the SBA's October 2022 proposed rule (87 *Federal Register* 63436), the SBA stated the belief that most SBIC financings include a debt component due to a need for an SBIC to quickly generate positive cash flow to make the required semiannual interest payments. The SBA therefore asserted that the flexibilities offered by an accrual debenture align more closely with the cash flows of an investment strategy focused on longer-term equity investments.

Accrual SBICs are not required to make any payments before the debenture's maturity date. However, if an accrual SBIC makes any distributions to private investors, it must pay a portion to the SBA. The regulations specify a distribution waterfall. First, the SBIC must pay all annual charges and accrued interest. Second, the SBIC must repay the SBA leverage principal in an amount at least proportional to the SBA's share of the SBIC's total capital. Only then may the SBIC distribute any remaining amount to private investors, and it must report the distribution to the SBA.

Accrual SBICs have a lower leverage commitment multiple than standard SBICs. Whereas standard SBICs can generally access up to $2 in SBA leverage for every $1 of private capital, accrual SBICs may only access $1.25 in SBA leverage for every $1 of private capital. Since leveraged investing is a relatively risky investment strategy, limiting the leverage multiple may reduce the SBA's risk of loss.

In the proposed rule, the SBA sought to limit accrual SBICs to only SBICs that committed to investing at least 75% of their total financings (based on dollar amount) in equity-based investments. The SBA stated that it recognized that this would restrict participants' investment strategies, but it believed that the equity investment requirement was a reasonable trade-off for the SBA's increased risk with accrual debentures. The SBA did not move forward with the equity investment requirement in the final rule, with the stated goal of giving program participants greater flexibility.

Reinvestor SBICs

The SBA's July 2023 final rule created reinvestor SBICs, which are SBICs that "provide a meaningful percentage of equity capital investments to underserved small business reinvestors" (13 C.F.R. §107.720(a)(2)(i)). In turn, the business that makes the reinvestment may only invest in small businesses that generally would have been eligible to receive an investment directly from an SBIC.

Reinvestor SBICs issue the same accrual debentures as accrual SBICs. Unlike accrual SBICs, reinvestor SBICs are eligible for an SBA match of up to $2 in SBA leverage for every $1 in private capital (equal to the match for standard SBICs). Therefore, reinvestor SBICs similarly are not required to make any payment on the debenture before maturity. However, they must follow the same repayment waterfall as accrual SBICs if they want to distribute earnings to private investors before the debenture's maturity date.

Standard SBICs must invest in small businesses directly—they are not permitted to invest in entities that will reinvest or relend the funds. Under previous regulations, there was a limited exception for investments in disadvantaged businesses that are reinvestors or relenders. The general prohibition prevented SBICs from pursuing "fund of fund" investment strategies, which may offer advantages due to greater diversification.

The "underserved small business" concept is broader than the "disadvantaged business" concept. Underserved small businesses include disadvantaged businesses, as well as businesses in rural and low- to moderate-income areas, and businesses owned by women or veterans. A disadvantaged business is one at least 50% owned, controlled, and managed by individuals who are socially or economically disadvantaged. Identification with certain racial and ethnic groups establishes eligibility as a disadvantaged business. Other individuals can establish eligibility by demonstrating social or economic disadvantage by submitting a narrative justification (for social disadvantage) or personal financial statements (for economic disadvantage).

In the proposed rule, the SBA said it was "expanding this provision [to] significantly help improve [the SBIC program's] footprint in underserved communities." Additionally, the SBA said the change would "[help] SBA grow its emerging fund manager pipeline."

Cost Estimates for Accrual SBICs

Equity-based investments are generally riskier than debt-based investments. Therefore, a greater focus on equity investments may increase the risk of program losses that could require higher participant fees or appropriations from Congress to cover.

The SBA provided information on its cost estimates for accrual SBICs in the final rule. The SBA acknowledged that accrual debentures have "a higher default risk profile and net loss rate" compared with standard debentures. For the FY2024 cohort, the SBA estimates a lifetime default rate of 36% of disbursements for accrual debentures (compared with 17% for standard debentures) and a lifetime recovery rate of 68% of defaults (compared with 80% of standard debentures).

The SBA is statutorily required to charge an annual fee on debentures at a level that ensures the program has no federal credit subsidy (15 U.S.C. §683(b); for the SBIC program, the primary cost is defaults). The fee varies each fiscal year based on program performance expectations. Given the expected higher cost of accrual debentures, the SBA could maintain a zero subsidy cost in several ways. It could charge a separate and higher annual fee for accrual debentures, as it did for the Participating Securities program. Alternatively, the SBA could consider accrual and standard debentures together for budgetary accounting, and charge a higher annual fee on all debentures. If the risk of standard debentures did not change, then this would allow cross-subsidization between the standard and accrual debenture programs. Standard SBICs would pay a higher fee than their expected risk would require, while accrual SBICs would pay a lower fee than their expected risk would require.

The SBA is charging the same annual fee for both standard and accrual debentures. For all debentures issued in FY2024, the annual charge is 0.129% for the life of the debenture. This is more than the FY2023 charge of 0.047%, possibly as a result of adding accrual SBICs. However, the FY2024 charge is less than the FY2022 charge (0.173%) and the FY2002-FY2019 average (0.625%).

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