



U.S. Small Business Administration
Washington, D.C. 20416

OFFICE OF
INSPECTOR GENERAL

May 24, 2004

TO: Ronald E. Bew
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FROM: Harold Damelin /s/ Original signed
Inspector General

SUBJECT: New Management Challenge on **The SBIC Program**, Report #4-21

We are submitting a new management challenge on the Small Business Investment Company (SBIC) program under the report title ***The SBIC Program: At Risk for Significant Losses***. This challenge provides a concise statement of the problems that have been identified in past General Accounting Office and Office of Inspector General (OIG) reports, and in the Program Assessment Rating Tool (PART) assessment recently released by the Office of Management and Budget. One of the most important challenges facing the Small Business Administration today is that the current structure and oversight practices of the SBIC program place too much risk on taxpayer money.

In accordance with the Reports Consolidation Act of 2000, this challenge will be incorporated with other Agency challenges in our Report on the Most Serious Management Challenges Facing the Small Business Administration in Fiscal Year (FY) 2005. The complete FY 2005 report will be included in SBA's annual Performance and Accountability Report this fall. Meanwhile, following OIG practice, the SBIC challenge report will be available shortly on our Website <http://www.sba.gov/IG/>.

We appreciate the assistance you provided on this important issue.

Attachment

U.S. Small Business Administration

Office of Inspector General

Inspection and Evaluation Division

THE SBIC PROGRAM: AT SIGNIFICANT RISK FOR LOSSES

May 24, 2004

Report No. 4-21



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Challenge: The current structure and oversight practices of the Small Business Investment Company (SBIC) program place too much risk on taxpayer money.

It has been estimated by SBIC program officials that, given the rapidly mounting losses in the portfolio, the cumulative cost of the program to the Federal Government is projected to be almost \$2 billion on an outstanding portfolio of \$5 billion. Although the venture capital industry is designed to assume substantial risk in support of new and growing businesses, the structure of the SBIC program and funding process has contributed significantly to losses in recent years. SBA’s “profits” are not proportional to the investment that the agency makes in SBICs, and insufficient incentives exist to encourage SBICs to pay back principal debt to SBA as quickly as possible. Moreover, the subsidy model underestimates the cost of the program, with the technical assumptions more optimistic than actual performance.

Over the last 10 to 15 years, the General Accounting Office (GAO) and the OIG have found that SBA’s policy of allowing extensive time for financially troubled SBICs to attempt rehabilitation has allowed SBIC assets to decrease and reduced SBA’s potential for recovery. SBA’s policy of allowing capially-impaired SBICs to charge significant management fees and the way SBA applies distributable gains from SBICs also contribute to program losses. The standard operating procedure (SOP) for the SBIC program has not been revised since March 1989 and existing guidance does not provide a systematic approach for estimating the level of financial risk, ensuring the implementation of restrictive operations, transferring capially impaired SBICs to liquidation status, or liquidating SBICs receiving participating securities.

According to program officials, actions are being taken which will strengthen the assessment and management of financial and regulatory risks inherent in the program. A new SOP is in the clearance process. SBA has also submitted a legislative proposal to Congress to increase its fees and share of profit earnings. Although such legislation would be helpful, the Agency should act to limit program losses without waiting for legislative revisions. For example, capially impaired participating securities SBICs that have been transferred to liquidation are not being liquidated. To improve the program’s ability to limit risk and prevent major avoidable program losses, officials should pursue legislative reforms and act in a timely manner in dealing with and liquidating capially impaired SBICs.

Actions Needed	Progress
<i>Revise the subsidy model estimation methodology to develop more realistic technical assumptions and try to capture more accurately fluctuations in the economy.</i>	Red
<i>Submit and pursue legislative proposals that will more effectively protect the Federal Government’s financial interest, by appropriately increasing fees and SBA’s share of profit earnings, and by placing SBA in a more favorable position for maximizing recoveries.</i>	Yellow
<i>Develop and implement management fee policies that will slow the erosion of assets of capially impaired SBICs.</i>	Yellow
<i>Provide documented analysis justifying the need for the: (i) concept of forbearance, (ii) forbearance periods, and (iii) capital impairment percentages.</i>	Red
<i>Implement more systematic criteria and a more timely approach for transfers to liquidation.</i>	Yellow
<i>Develop and implement a control process for liquidating participating securities.</i>	Red
<i>Include in a revised SOP the items recommended in the OIG’s FY 2003 SBIC audit to</i>	Yellow
<ul style="list-style-type: none"> • perform and document quarterly risk assessments, including an analysis of repayment potential, and recommended actions. 	Yellow
<ul style="list-style-type: none"> • ensure the timely and consistent implementation of restrictive operations. 	Yellow

Green-Implemented Yellow-Progress being made Red-Not implemented/no substantial progress

Additional Information

Because this is a newly issued challenge, the following information is being included to further illustrate the issues involved.

- The venture capital industry runs in cycles and is structured to assume substantial risk in support of new and growing businesses. In recent years there has been a significant downturn in the venture capital industry. The structure of the SBIC funding process for participating securities and the quality of SBA oversight have contributed significantly to the losses in the SBIC program in recent years.
- Program Structure and Design: SBICs using participating securities comprise the largest portion of private capital and program leverage. For these SBICs, SBA guarantees the funds and the SBICs can spend the funding over a period of 10 years. If the SBIC has losses and ceases operations, SBA may receive nothing. The Office of Management and Budget (OMB) Program Assessment Rating Tool (PART) assessment points out significant design flaws in the participating securities program. SBA's "profits" are not proportional to the investment that the Federal Government makes in SBICs. The Agency invests up to two-thirds of total funds and receives only about 10 percent of an SBIC's profits which is generally insufficient to fully repay the original principal investment. There are insufficient incentives to encourage SBICs to pay back principal debt to SBA expeditiously. In addition, SBA currently applies the distributable gains from an SBIC first to profit participation as opposed to redemption of leverage. This allows SBA to show profit participation from an SBIC that may eventually not repay all the outstanding leverage and therefore distort program results. The program will show positive short-term results when the long-term prognosis is negative. Moreover, a distribution ratio that is favorable to SBA would help mitigate the Agency's risk of loss.
- The SBIC debenture program also has had large losses. In addition, the subsidy model underestimates the cost of the program, with the technical assumptions more optimistic than actual performance.
- General partners or managing members charge management fees to the SBICs. According to Investment Division officials, until recently this generally amounted to roughly 7.5% of private capital in one year. Because capital impairment is based upon private capital, even assuming that a fund has no other expenses and incurs no portfolio losses, after five years in business, the capital impairment percentage based solely upon payment of the management fee could exceed 37 percent. In 2003 changes were made in the management fee policy for new licensees. The changes occurred after the last audit and should be examined.
- Oversight and Follow-up: As a result of OIG and GAO recommendations, over the last 10 to 15 years SBIC oversight and follow up have been improved but serious problems remain. In a series of reports on SBIC management and oversight in the mid-1990s, the GAO found that SBA's oversight was "clearly inadequate." Although SBA responded to GAO's critiques by increasing the frequency of its SBIC examinations, GAO later reported that SBA did not have "a risk-based oversight strategy for targeting its limited oversight resources to periods that pose the greatest risk of losses to the government." Program officials report they have now developed a risk-based oversight strategy. Because it was developed after the last OIG audit, it has not yet been evaluated.
- Although quarterly analyses are conducted by SBA to assess the Agency's level of risk in the SBIC program, analysts are not required by existing operating procedures to identify either the SBIC's potential for repayment of the outstanding leverage or actions that SBA should take such as

transferring the SBIC to liquidation status. Proposed changes to the SBIC Operations SOP will include these requirements.

- In 1993, the OIG found that delays in placing financially troubled SBICs in liquidation reduced the potential recovery of government funds. In 1995, the GAO reported that there was no evidence that SBA's policy of allowing extensive time to rehabilitate financially troubled firms resulted in financial improvements to the firms, but instead gave firms additional time to sell off assets. Eight years later in 2003, an OIG audit found that the asset value of the sample of 23 capitally impaired SBICs reviewed continued to decline during the time program management hesitated in transferring them to liquidation status. This erosion resulted from sales, charge-offs, re-evaluations of the licensees' portfolio holdings and the operating costs of the SBICs. Moreover, SBA paid about \$13 million in unnecessary prioritized payments as a result of these untimely liquidation actions.
- A major obstacle to SBA's ability to limit risk has been the "forbearance concept" which, per Agency regulations, precludes SBA from considering SBICs as being capitally impaired for up to eight years after receiving their participating securities. Even though requested, program officials have not provided the OIG with analyses supporting the capital impairment decision points of 85 and 100 percent. Prior to the OIG's audit of SBIC Oversight, because of SBA's interpretation of the forbearance rule, no participating securities SBIC was transferred to liquidation status as a result of its capital impairment. Proposed SOP changes provide a systematic approach to transferring troubled SBICs to liquidation status. Twenty-four participating securities have now been transferred to liquidation. Nevertheless, liquidation methods are not being chosen and 22 participating securities SBICs have been in liquidation status for at least 12 months without liquidation procedures having begun.
- The SOP for the SBIC Operations has not been revised since March 1989 and the SOP for SBIC Liquidations has not been revised since Dec 1998. Periodically issued technical notes have served as interim but inadequate guidance. The SOP for Operations is currently under revision and, when issued, should address some of the OIG's concerns. The SOP for Liquidations is not under revision even though it does not address participating security SBICs.
- Because the SBIC program is a zero subsidy program, accumulated program losses could result in significant increases in the fees to current and future SBICs. If SBICs pass on the increases to small business concerns, the latter may be discouraged from using the program. Fee increases may also cause the number of applications by potential SBICs to decline and force SBICs to leave the program early. These developments would reduce the amount of venture capital available to small business concerns.
- Program Improvements: In response to the OIG's 2003 audit recommendations, program management pointed to previous program improvements, such as developing stringent new licensing regulations and standards. Officials also cited new initiatives which include: an annual report that "will begin to clarify and quantify the potential risks and rewards of taxpayers' 'participation' in the SBIC program;" a "more robust portfolio risk rating model to replace the current system of monitoring funds under financial strain;" a reorganization of the Office of SBIC Operations; and a more aggressive resolution of cases and the creation of better incentives for management of SBICs in receiverships. SBA has also submitted a legislative proposal to increase its fees and share of profit earnings.

NOTE: The SBIC examination function has not been reviewed since the 1995 GAO report and is scheduled to be competitively sourced. Currently, the OIG is conducting an audit of the liquidation function.

Appendix 1: Relevant Reports

Most SBA OIG reports listed can be found at: www.sba.gov/ig/igreadingroom.html. GAO reports are located on the GAO Website at: <http://www.gao.gov/>.

- OMB, *Small Business Administration: PART Assessment on the SBIC Program*, February 2, 2004.
- SBA OIG *FY 2003 Financial Statement Audit in the SBA FY 2003 Performance and Accountability Report*, January 30, 2004, pp. 230-60.
- SBA OIG, *Audit of SBIC Oversight*, Report # 3-33, July 1, 2003.
- GAO, *Small Business: Update on SBA's Small Business Investment Company Program*, Report # GAORCED-97-55, February 1997.
- GAO, *Small Business Administration: SBA Monitoring Problems Identified in Case Studies of 12 SBICs and SSBICs*, Report # GAO/OSI-96-3, April 1996.
- GAO, *Small Business Administration: Better Oversight of SBIC Programs Could Reduce Federal Losses*, Report # GAO/T-RCED-95-285, September 28, 1995.
- GAO, *Small Business Administration: Inadequate Oversight of Capital Management Services, Inc.-An SSBIC*, Report # GAO/T-OSI-95-19, August 7, 1995.
- GAO, *Small Business Administration: Prohibited Practices and Inadequate Oversight in SBIC and SSBIC Programs*, GAO/OSI-95-16, May 28, 1995.
- GAO, *Small Business Administration: Inadequate Oversight of Capital Management Services, Inc.-An SSBIC*, Report # GAO/OSI-94-23, March 1994.
- OIG, *Audit Report on the Small Business Investment Company (SBIC) Liquidation Function*, Report # 3-2-E-004-031, March 31, 1993.