U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
Washington, DC 20416

AUDIT REPORT
ISSUE DATE: JULY 1, 2003
REPORT NUMBER: 3-33

To: Jeffrey Pierson, Associate Administrator for the Investment Division

From: Robert G. Seabrooks, Assistant Inspector General for Auditing Original Signed – FOIA Ex. 6

Subject: Audit of SBIC Oversight

Attached is a copy of the subject audit report. The report contains one finding and four recommendations to the Associate Administrator for the Investment Division. You agreed with one recommendation and partially agreed with a second, and nonconcurred with two recommendations. The partial agreement and nonconcurrences will be resolved during the audit resolution process. As a result of your comments, we modified certain passages in the report. Your comments have been synopsized in the report and included as an attachment.

The finding in this report is the conclusion of the Office of Inspector General's Auditing Division. The finding and recommendations are subject to your review and corrective action by your office in accordance with existing Agency procedures for audit follow-up and resolution

Please provide your management response to the recommendations within 30 days from the date of this report on the attached SBA Forms 1824, Recommendation Action Sheet. The SBA Forms 1824 should be sent to:

Audit Manager
SBA OIG/Auditing Field Office, Suite 1803
233 Peachtree Street, NE
Atlanta, Georgia 30303

Any questions you may have regarding this report may be directed to Garry Duncan, Director, Credit Programs Group, at 202.205-7732.

Attachments

cc: ADA/Capital Access

AUDIT REPORT
AUDIT OF SBIC OVERSIGHT
Washington, DC

AUDIT REPORT NUMBER 3-33

July 1, 2003

The finding in this report is the conclusion of the OIG's Auditing Division based on testing of SBA operations. The finding and recommendations are subject to review, management decision, and corrective action in accordance with existing Agency procedures for follow-up and resolution. The report may contain proprietary information subject to the provisions of 18 USC 1905 and must be released to the public or another agency without permission of the Office of Inspector General.

SUMMARY

The Small Business Administration (SBA) is authorized by the Small Business Investment Act to establish a program to stimulate and supplement the flow of equity capital and long-term loans to small business concerns using Small Business Investment Companies (SBICs). The SBICs are private investment firms, licensed by SBA, that independently make their own investment decisions utilizing private capital plus borrowed funds guarantied by SBA. The borrowed funds are either in the form of debentures for which interest is to be paid semi-annually and the principal repaid at maturity, or participating securities which are redeemable preferred equity-type securities with quarterly interest payments (prioritized payments) made only to the extent of the SBIC's profits. The redemption period for both types of securities is generally 10 years. The SBICs typically provide financing to small business concerns in the form of loans, debt-securities, and equity investments. The program is managed within SBA by the Investment Division (Division) which is responsible for regulatory and financial oversight and providing leverage guaranties to over 400 SBICs.

Our audit objective was to determine whether SBA's oversight process limited financial risk as it pertains to the evaluation of each SBIC's reported financial condition and the management of financially troubled SBICs. We examined the controls, policies, and procedures used to assess the financial condition of SBICs and those methods used to limit financial risk to SBA. The audit showed that the evaluation of each SBIC's reported financial condition and the management actions taken to limit risk from financially troubled SBICs needed improvement to ensure the risk of financial loss is effectively limited for SBA.

- SBA's ability to limit risk was restricted by the "Forbearance Concept". This concept precludes SBA from considering SBICs as capitally impaired (a financial condition occurring when an SBIC's net realized and unrealized losses exceed its earnings and unrealized gains) for up to 8 years after receiving their first participating securities. As a result, the liquidation of capitally impaired SBICs was delayed, resulting in an erosion of the value of the SBICs portfolio assets and the unnecessary disbursement of prioritize payments. We determined that the forbearance concept:

  - used decision points to implement forbearance which were not supported by analyses and, therefore, may be inappropriate,
  - decreased SBA's potential for recovery of leveraged Federal funds due to the reduced value of SBIC assets, and
  - resulted in the unnecessary payment of about $13 million in prioritized payments for capitally impaired SBICs that were not transferred to liquidation status timely.

- SBA's ability to limit risk was also impeded by the fact that existing guidance for the operation of the SBIC program, Standard Operating Procedure (SOP) 10 06, had not been revised since March 1989. This SOP was no longer adequate because it did not:

  - address current practices and procedures,
  - require an analysis of SBIC financial data to determine the potential for recovery of SBIC leverage guarantied by SBA,

- include procedures to ensure the consistent implementation of restrictive operations,
- ensure the consistent application of forbearance, and
- provide a systematic approach for transferring capitally impaired SBICs with participating securities to liquidation status and include the use of receiverships to effect recovery, when warranted.

We recommend that the Associate Administrator for the Investment Division improve the Division's ability to limit risk by reassessing the appropriateness of forbearance regulations and obtaining a written opinion from the Office of General Counsel concerning whether SBICs with participating securities and a condition of capital impairment can be liquidated using receiverships. Additionally, we recommend that the Associate Administrator revise SOP 10 06 to ensure that: (i) financial analyses include the potential for recovery, (ii) the implementation of restrictive operations includes consideration of the level of impairment, time periods and types of remedies to be used, and the applicability of forbearance regulations, (iii) a systematic approach is used in determining whether to transfer SBICs with participating securities to liquidation to ensure prioritized interest payments are kept to a minimum, (iv) and that receiverships be considered, where appropriate and if deemed an acceptable approach by the Office of General Counsel.

The Investment Division's response provided justification for the concept of forbearance, and agreed: (a) to obtain a written opinion from the Office of General Counsel as to whether capitally impaired SBICs with participating securities can be liquidated using receiverships; (b) to provide support for the forbearance periods; and, (c) to revise SOP 10 06. The Division did not agree to provide support for the forbearance capital impairment decision points nor did the Division agree with our recommendations concerning restrictive operations.

AUDIT REPORT

AUDIT OF SBIC OVERSIGHT
Washington, DC

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INTRODUCTION

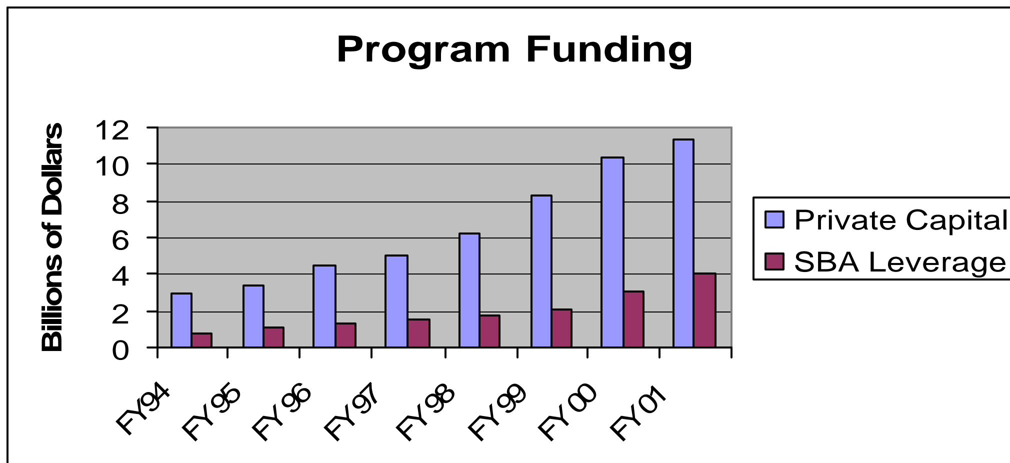
A. Background

In an effort to fill the gap between the availability of venture capital and the needs of small businesses in start-up and growth situations, Congress created the Small Business Investment Company Program in 1958. The Program uses SBA licensed Small Business Investment Companies (SBICs) which are private investment firms that independently make investment decisions using their own private capital plus SBA guarantied borrowed funds.

The borrowed funds are in the form of: (i) 10-year debentures requiring semi-annual interest payments; or (ii) redeemable preferred, equity type participating securities requiring quarterly prioritized interest payments if the SBIC is profitable. SBA is obligated to make prioritized payments on the behalf of the SBIC to the company's private investors until such time the SBIC becomes profitable. SBA expects to be reimbursed by the SBIC for any prioritized payments made under its guaranty over the life of the participating security.

The SBIC program is administered by SBA's Investment Division (Division), an activity reporting to the Associate Deputy Administrator for Capital Access. One of the primary responsibilities of the Division is to assess the financial health of SBICs. An element of the financial assessment is the SBIC's impairment ratio. This ratio represents the financial losses incurred by the SBIC as expressed as a percentage of its regulatory capital. Capitally impaired SBICs generally represent a greater risk for loss within the SBIC portfolio. Title 13 Code of Federal Regulations (CFR), Part 107.1830, establishes maximum impairment ceilings for SBICs based on their percentages of equity investments and outstanding leverage expressed as a ratio. This ratio is referred to as the maximum capital permissible impairment (MPCI) ratio. At the point the SBIC exceeds its MPCI, it is considered capitally impaired and could be subject to actions by SBA to protect the government's interest.

The Small Business Equity Enhancement Act of 1992 drastically changed the SBIC program by creating participating security leverage. This increased the amount of available leverage to individual SBICs and the minimum private capital required. Since the implementation of the Act, the program has expanded significantly. The number of licensees has risen from 280 in fiscal year (FY) 1994 to 428 at the end of FY 2001. Private capital increased from $2.9 to $11.5 billion and outstanding leverage held by SBICs increased from $805 million to $4 billion by the end of FY 2001, as shown in the following graph.



In FY 1993, ID program officials, with input from the private venture capital sector, established "forbearance periods" for the SBIC program in 13 CFR, Part 107.1820 and 1850. According to Division personnel, the forbearance concept was based on the idea of "patient money" – SBA needed to wait until the portfolios of the SBICs matured in order to receive repayment of guarantied debt and not take punitive action against financially troubled SBICs. The forbearance periods preclude SBA from considering an SBIC as being capitally impaired for:

- the SBIC's first fiscal year,
- impairment percentages below 50 percent,
- the first 48 months after the issuance of the first participating security as long as the impairment percentage was below 85 percent,
- the first 60 months after issuance of the first participating security as long as the impairment percentage was below 85 percent and two thirds (cost basis) of the SBIC's portfolio was composed of startups, and
- the first 8 years after issuance of the first participating security as long as the impairment percentage exceeded 100 percent of regulatory capital.

The Small Business Investment Act (Revision 10), Section 308(g)(2)C requires the Administrator to report on efforts taken to maximize the recoupment of funds incident to the administration of the SBIC program. The OMB Circular A-129 (Revised), Policies for Federal Credit Programs and Non-Tax Receivables, requires agencies to implement management practices to ensure the goals of credit programs are met while properly identifying and controlling cost. Such policies and procedures must be designed to include the minimizing of unintended costs to the Government. Additionally, OMB Circular A-123 (Revised), Management Controls, states that management accountability requires managers to be responsible for controlling cost and mitigating adverse aspects of agency operations.

B. Objectives & Scope

Our audit objective was to determine whether SBA's oversight process limited financial risk as it pertains to the evaluation of each SBIC's reported financial condition and the management of financially troubled SBICs.

We identified 23 SBICs that exceeded their MPCI ratios for two or more consecutive quarters during the period April 30, 1994, through March 31, 2002, to assess the controls and procedures used by the ID to monitor the program and its methods for limiting financial risk to SBA. Of the 23 SBICs, 18 had participating securities and 5 had debentures. As of March 31, 2002, outstanding leverage for these SBICs totaled approximately $449 million with accrued prioritized payments of about $60.5 million.

We examined the processes used to collect and evaluate financial data, conducted tests to determine the accuracy, completeness, and timeliness of the data, and reviewed the financial analysis process for thoroughness. We evaluated and tested procedures taken by the Division to mitigate the risk of loss after an SBIC was identified as having above average risk. We also interviewed appropriate management officials and staff within the Division, the Office of General Counsel, and the President of the National Association of Small Business Investment Companies.

Audit fieldwork was performed from October 2001 through August 2002. The audit was conducted in accordance with generally accepted Government Audit Standards.

C. Statement on Management Controls

Our assessment of management controls was limited to those applicable to the Division's ability to assess reported financial information and to limit financial risk resulting from financially troubled SBICs. A study and evaluation made for the limited purpose described above would not disclose all material weaknesses in the Division's management controls. For the areas audited, we identified material weaknesses in management controls that impacted the Division's ability to identify and limit the amount of financial risk for SBICs that had exceeded their MPCI. The more significant weaknesses identified were the lack of: (a) approved current operating procedures addressing SBIC oversight practices and procedures; (b) financial analysis addressing each SBIC's potential for repayment of SBA guarantied leverage;
(c) consistent implementation of restricted operations, (d) criteria for determining when to transfer financially troubled SBICs with participating securities to liquidation status; and (e) forbearance requirements and documentation of decision points used to implement it. During the audit, management took action to improve some of the aforementioned weaknesses, but additional corrective actions are necessary. The weaknesses and their impact are discussed in the finding.

RESULTS OF AUDIT

Finding SBA's Oversight of the SBIC Program did not Limit Financial Loss to the SBIC Program

SBA's oversight process did not ensure that the Agency limited financial risk in the SBIC program. The Small Business Investment Act and Office of Management and Budget (OMB) Circulars require SBA to maximize the recoupment of funds related to the SBIC program and to control and minimize unintended program costs. These goals were not accomplished because SBA had established a forbearance regulation which limited actions that could be taken to liquidate capitally impaired SBICs with participating securities. Additionally, SBA did not meet the OMB goals because existing procedures were over 13 years old, predated the initiation of the participating security program, and did not address: (i) analysis of potential for recovery; (ii) use of restricted operations; and (iii) liquidation of SBICs with participating securities. These weaknesses resulted in up to $13 million in additional prioritized interest payments and reduced SBA's potential for recovery of leveraged Federal funds.

Concept of Forbearance

The Division's ability to oversee the program and to limit risk was hampered by forbearance regulations. The forbearance regulations included decision points for which management could not provide supporting analysis, allowed SBIC assets to decline in value thereby reducing SBA's potential for recovery, and resulted in the unnecessary payment of additional prioritized payments.

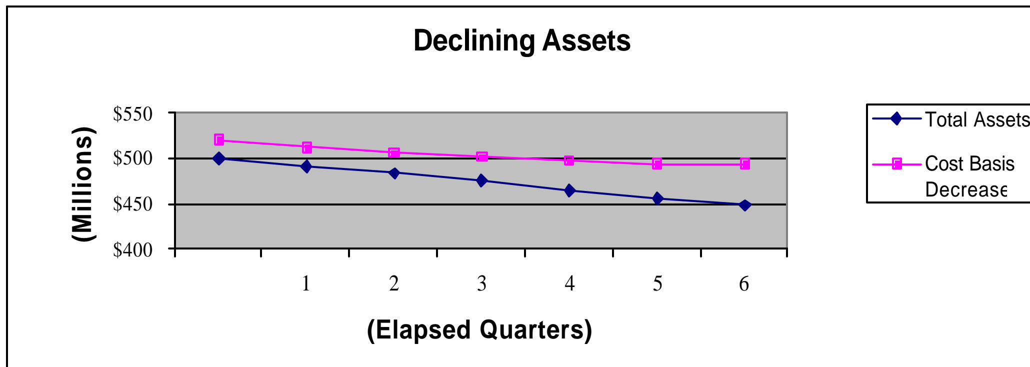
Support for decision points

Program officials could not provide any justification to support the establishment of forbearance decision points. No analyses were provided to support the forbearance periods (i.e., 1, 4, 5, and 8 years) or the impairment percentage ceilings of 85 and 100 percent. Also, management could not explain why SBA was not required to forbear between the 85 percent impairment percentage and the 100 percent impairment percentage. Without supporting analyses, there is no assurance that the decision points were appropriate. Both the time frames and the capital impairment percentages may be inappropriately restricting the Division's ability to protect the government's interest.

Declining Assets

Asset value continued to decline during the time our sample of SBICs remained impaired. To measure the amount of the erosion to the SBIC's assets, we identified all SBICs that had exceeded their impairment ratio for 6 months or more during our review period. From this 6-month point, we analyzed the changes in both the fair market value and cost basis of assets through March 31, 2002. We determined that the fair market value of total assets held by the 23 sampled SBICs eroded by approximately $51 million and the cost basis of portfolio investments decreased by $26 million. These decreases

were attributable to sales, charge-offs, re-valuations of the licensees' portfolio holdings, and operating costs of the SBICs. The reductions are shown in the following table:



Four of the 23 SBICs reviewed had net increases to total assets totaling $21.4 million while impaired. The increases were due to additional contributed capital or SBA leverage. If these four SBICs were excluded from the sample, the decrease in the fair market value of total assets for the other 19 SBICs would be $72.5 million.

Prioritized Payments

SBA paid about $13 million in unnecessary prioritized payments due to untimely liquidation actions. To measure the increase to prioritized payments for the 18 SBICs with participating securities in our sample, we identified all SBICs that exceeded their MPCI for at least 6 consecutive months. We then calculated the amount of additional prioritized payments made by SBA from the end of the initial 6-month impairment period through March 31, 2002. The Small Business Investment Act establishes the obligation of SBA to make quarterly interest payments on behalf of the SBIC until such time that a profit is realized. If a profit is not realized, the obligation for an SBIC to repay prioritized payments to SBA is extinguished and may cause taxpayers to suffer a loss due to the inability of the SBIC to repay SBA.

Changes Pertaining to Forbearance

In [FOIA Ex. 5] 2002, the ID [FOIA Ex. 5] transfer to liquidation status seven capitally impaired SBICs with participating securities. All seven SBICs were at 100 percent impairment and, as such, were still within their 8-year forbearance period. According to management officials in both the Division and OGC, a decision was made to place these capitally impaired SBICs with participating securities into liquidation status in July 2002 and to allow them to self-liquidate (existing management remains in place and performs an orderly disposition of the SBIC's assets). They further stated that self-liquidation does not entail the appointment of a receivership or transfer of the SBIC's assets to SBA and, as such, would not be considered to be in conflict with the forbearance requirement. By transferring these SBICs to liquidation status, the Division purchased the outstanding participating securities from the public market and, thereby, ended future prioritized payments.

This new practice may eliminate unnecessary prioritized payments and initiate recovery actions sooner, but it is not codified in the CFR or a SOP and, therefore, may not be continued on a routine basis. Also, because self-liquidating SBICs are not routinely examined by SBA, inappropriate actions by the SBIC's management may not be identified.

Inadequate Procedures

Existing procedures were outdated and did not effectively minimize program risk. The Division had not revised its Standard Operating Procedures (SOP) 10 06, Oversight and Regulation of SBICs, since March 1989, over 13 years ago. The SOP was issued prior to the establishment of the participating securities program and, as such, did not cover current management practices and program issues. In 1998, a revised SOP was drafted but was not finalized as of January 2003. During the 13-year period, management officials issued Technical Notes to serve as interim guidance. Neither of these documents adequately addressed: (i) analysis of potential recovery; (ii) restrictive operations; (iii) specific criteria for transferring capitally impaired SBICs with participating securities to liquidation status; and (iv) applicability of the forbearance rules.

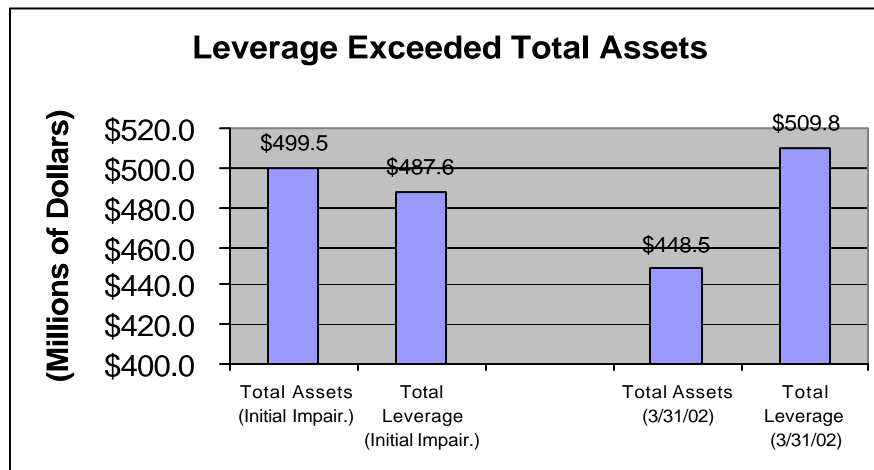
Analyses of the potential for repayment

Existing financial analyses did not require analysts to identify the SBIC's potential for repayment of outstanding leverage on a continuing basis. Currently, the Division conducts financial analyses quarterly and annually based on data submitted by the SBICs. The purpose of the annual analyses is to assess SBA's level of risk. The results are documented in the annual review process and are also contained in the Division's monthly Risk Assessment Profile Report (RAP), formerly known as the Watch List. The RAP is used by the Division to measure the level of risk and to monitor progress of SBICs that were either approaching capital impairment or were actually capitally impaired.

While the analyses may have cited increasing impairment ratios and erosion of portfolio values, they fell short of linking SBIC's financial condition to the SBIC's ability to repay indebtedness guarantied by SBA. Further, the analysis did not provide a recommended course of action for SBA to take, such as transferring the SBIC to liquidation status. Financial analyses for capitally impaired licensees should focus on the probability or likelihood that the SBIC can repay both its outstanding leverage and accrued prioritized payments.

For 10 of the 23 SBICs in our sample (43 percent), total SBA guarantied debt exceeded the fair market value of the assets by nearly $12 million at the date they initially became capitally impaired. As of March 31, 2002, SBA guarantied debt exceeded the fair market value of the assets by about $61 million for 15 of 23 (65 percent) sampled SBICs. Such an analysis demonstrates the widening gap between the SBICs' outstanding debt and its ability to repay debt through the disposition or sale of existing portfolios.

The following chart shows the widening of this gap during the time our sample SBICs were impaired.



Implementation of Restrictive Operations

The Division was not consistent in its implementation of restrictive operations due to the absence of specific operating procedures. The concept of restrictive operations is not addressed in SOP 10 06, but 13 CFR, Part 107.1820(e), describes 11 events that may result in the implementation of restricted operations. Capital impairment is one of the events that may result in the implementation of restrictive operations. CFR, Part 107.1820(f), describes those remedies that SBA can avail itself of when a restrictive operation condition occurs. The regulation allows SBA to:

- restrict future investments and distributions,
- require all commitments to be funded,
- re-determine approved management expenses, and
- reserve the right to deny additional leverage to the SBIC.

While the CFR describes the conditions upon which restrictive operations may be used, it does not indicate: (i) what level of impairment is appropriate for placing SBICs into restrictive operations; (ii) the length of time SBICs should remain in restrictive operations status; and, (iii) whether some remedies are more appropriate than others for certain financial or regulatory violations. The CFR is unclear as to whether forbearance precludes the use of restrictive operations for capitally impaired SBICs.

Our review disclosed that only 6 of 18 capitally impaired SBICs with participating securities were placed in restrictive operations status as of March 2002. (The remaining 5 SBICs had debenture funding and, as such, were not subject to restricted operations.) Management discretion was cited as the reason for not placing the other 12 SBICs with participating securities into restricted operations. And, at least one area manager cited forbearance as the reason for not placing impaired SBICs into restricted operations. Documentation could not be provided for the rationale used in

determining when SBICs were to be placed in restrictive operations. In the absence of restrictive operations, the risk of financial loss is even greater for impaired SBICs.

Transfer to Liquidation Status

The existing guidance provided regulatory and financial reasons for transferring capitally impaired SBICs to liquidation status but did not provide a systematic approach for making the determination. The reasons provided in the guidance for transfer to liquidation included significant violations of the regulations, fraud, uncured conflicts of interest, capital impairment, and bankruptcy. The existing guidance stated that once a "determination" was made concerning the SBIC's incapability or unwillingness to resolve the problem, a memorandum for a pre-liquidation conference was to be prepared. The memorandum and pertinent facts about the case were to be reviewed by the conference attendees who could recommend transfer to liquidation status.

The existing guidance provided no specific instructions as to how the determination was to be made nor did it identify how to weigh certain elements such as: (i) level of impairment (i.e., extreme); (ii) length of time impaired; (iii) amount of prioritized payments accrued as compared to regulatory capital; and (iv) severity of regulatory violations. The lack of guidance addressing these areas had not been a problem because prior to our audit the only SBICs to be transferred to liquidation status were those funded with debentures or suspected of fraudulent acts. No SBICs with participating securities had been transferred to liquidation status as a result of its capital impairment because the 8-year forbearance period precluded considering the SBIC as being capitally impaired. As a result, the Division had not taken actions, prior to the start of our audit, to remove poorly performing SBICs with participating securities from the program.

Applicability of Forbearance

Existing operating procedures did not address the use of forbearance periods in monitoring SBICs with participating securities. The term forbearance is not defined in any guidance, but is applied as a set period of time after the first issuance of participating securities during which SBA may not consider an SBIC as capitally impaired. The concept of forbearance is not addressed in SOP 10 06. Forbearance is of paramount importance because it allows high risk SBICs to continue to operate without any restrictions. Consequently, SBA may not be able to enforce any of the remedies outlined in the CFR if it cannot consider an SBIC as impaired.

Our review disclosed that management's application of the forbearance period was not consistent with CFR guidance. Management officials cited the forbearance period of 8 years following the SBIC's first issuance of participating securities, as discussed in Part 107.1830 of the CFR, as the primary reason for not transferring capitally impaired SBICs to liquidation status. To be eligible for the 8-year forbearance period, the CFR states that the SBIC must be at least 100 percent capitally impaired. We identified five capitally impaired SBICs that did not meet the 8-year forbearance requirements. SBA could have transferred the following companies to liquidation status

during the period of time indicated in the following chart--thereby limiting SBA's financial risk from loss.

License	*MPCI*[1]	*Date licensed*	*Actual Impairment %*	*Period when Action could have been taken*
[				
FOIA Ex.				
				]

Three of these SBICs were subsequently transferred to liquidation status and allowed to self-liquidate.

Summary of Finding

SBA's ability to oversee the SBIC program and limit risk was hampered by forbearance rules and outdated procedures. The forbearance rules used unsupported decision points, reduced SBA's potential for recovery, and resulted in unnecessary prioritized payments. Additionally, existing guidance did not: (i) address the potential for recovery in the Division's financial analysis, (ii) ensure the consistent implementation of restrictive operations, (iii) ensure the consistent application of the forbearance rules, and (iv) provide a systematic approach for transferring SBICs to liquidations. As a result, unnecessary costs have been and will continue to be incurred unless corrective action is implemented. Our following recommendations address each of these weaknesses.

RECOMMENDATIONS

We recommend that the Associate Administrator for the Investment Division take the following actions to improve the Division's ability to limit risk:

1.A. Provide documented analysis justifying the need for the: (i) concept of forbearance, (ii) forbearance periods, and (iii) capital impairment percentages.

1.B. Obtain a written opinion from the Office of General Counsel concerning whether SBICs with participating securities can be liquidated using receiverships due to a condition of capital impairment.

1.C. Revise SOP 10 06, Oversight and Regulation of SBICs, to ensure it includes requirements to:

- perform and document quarterly risk assessments for capitally impaired SBICs,
- include an analysis of potential for repayment of outstanding leverage in its risk assessments,

[1] Maximum permissible impairment percentage – the point at which an SBIC is considered as capitally impaired.

- provide a recommended course of action in its risk assessments,
- implement restrictive operations consistently,
- implement the forbearance regulations consistently, and
- determine what criteria should be used to recommend an SBIC transferred to liquidation.

1.D. Revise SOP 10 06 to ensure that the implementation of restrictive operations addresses:

- appropriate levels of impairment requiring restrictive operations,
- time periods SBICs should remain in restrictive operations,
- appropriateness of remedies or combination of remedies that should be used and under what circumstances, and
- whether forbearance regulations preclude the application of restrictive operations.

Management Comments in Response to Recommendation 1.A

The Associate Administrator's response stated that the concept of forbearance is inherent to the structure of a private equity investing program and provided a detailed discussion of the venture fund investment cycles, average number of years before capital is returned to investors, the linkage between rate of return of capital to the growth and decline of the stock market, and other significant venture capital concepts. The response added that the regulations were adopted only after publication of proposed regulations and review of the subsequent comments.

The Associate Administrator also agreed to provide documentation supporting the forbearance periods. His response elaborates on this issue by stating that the average exit timeframe for portfolio concern is 4-6 years according to the venture capital industry and the response discusses in detail the historical rates of return on paid-in capital, citing the average rate of return as 8 years (1985 - 1989), 6 years (1990 to 1994), and 3 years (1995-1999), respectively, during the 12-year period prior to 2000. He further stated that given the current market conditions, it is likely to take 1998-2001 funds anywhere from 5-10 years to return contributed capital to investors.

Concerning justification for the capital impairment decision points, the Deputy Associate Administrator referred the OIG to the legislative history and reiterated the point that the forbearance period and percentages were adopted after an extensive public comment period. He added that although the Investment Division is open to suggestions for improving the program, it is not prepared to recommend specific changes to the forbearance concept at this time.

Evaluation of Management's Comments to Recommendation 1.A

The Associate Administrator partially agreed with our recommendation. His response adequately provided the logic for the concept of forbearance and stated that he would provide documentation supporting the forbearance periods. We reviewed the legislative and regulatory history and asked management during the audit for support for the forbearance percentages. We did not see and were not provided support for the forbearance percentages.

Additionally, the response does not explain the need to codify the forbearance concept in the CFR with specific forbearance periods and capital impairment levels. The information provided by the Associate Administrator shows that the period needed to exit from an investment and to obtain a return on the investment varies by vintage year. Given this fact, any time period included in the CFR will ultimately result in SBA forbearing either for too long a period or for too short a period. Also, the concept of "patient money" assumes that a positive return sufficient in size to repay SBA in full will eventually be realized. This concept must be matched with a reasonable analysis of the SBIC's potential for repayment of the SBA guarantied funds. The audit found that this type of analysis either was not done or, if done, was not documented and, consequently, SBA was being "patient" past the point where full recovery was likely.

Management Comments in Response to Recommendation 1.B

The Associate Administrator agreed to request an opinion from the Office of General Counsel. He stated that the Division has operated under the assumption that it is precluded from imposing the remedies available for Extreme Capital Impairment for a period of 8 years in accordance with the CFR and, unless advised otherwise by OGC, will continue to believe that SBA has no right to seek a receivership or to otherwise replace SBIC management for capital impairment as long as the SBIC is within its first 8 years.

The Associate Administrator stated that additional factors to be considered in liquidation transfers included level of impairment, the age of the fund, its distribution history, and the type of investing. This notwithstanding, he stated that the OIG had not given full consideration to (i) the unique equity type structure of the SBIC program (patient capital), (ii) the effect of a transfer to liquidation on portfolio company value, and (iii) other funds' favorable conditions to be considered (e.g., distributions to SBA, reserves of co-investors) in deciding whether to transfer SBICs to liquidation.

Additionally, the Associate Administrator stated that a transfer to liquidation by itself imposes no additional restrictions beyond restrictive operation status and that the transfers add no value to SBIC portfolio companies. He also stated that the funding of prioritized payments will continue—unless there is significant and permanent diminution of portfolio value that makes recovery of the SBA's financial exposure unlikely, based on thorough analysis.

Evaluation of Management's Comments for Recommendation 1.B

The Associate Administrator generally agreed with the recommendation although he expressed concerns regarding the transfer of participating securities to liquidation status. His comments seem to agree that a thorough financial analysis addressing the recovery of SBA's financial exposure is warranted. The question seems to be when this analysis should be done. As stated in the audit, we did not find evidence that this type of financial analysis was routinely done. His comments concerning the effectiveness of a transfer to liquidation status imply that the SBIC would be allowed to self liquidate or that existing SBIC management would otherwise be allowed to remain in place. Our position is that if the SBIC does not show a potential for recovery of SBA's current and future financial exposure, then it should be transferred to liquidation status and a receivership should be sought. This would have a threefold effect: (a) it would allow SBA to maximize recovery through an orderly liquidation of the portfolio concerns; (b) it would allow SBA access to the SBIC's books and records for identification of improper activity; and, (c) it would stop the payment of prioritized payments and, therefore, reduce SBA's losses.

Management Comments in Response to Recommendation 1.C

The Associate Administrator stated that the Investment Division generally concurs with this recommendation, although it takes exception to the comment regarding consistency. He further stated that an SOP that had been drafted will need to be revised to reflect recent developments and initiatives within the Investment Division. The Division will begin the process of revising the SOP before the end of FY 03. The Deputy Associate Administrator stated that the SOP is expected to provide a more detailed explanation of these requirements.

Evaluation of Management's Comments to Recommendation 1.C

The Associate Administrator agreed to revise the SOP. However, we will wait to see the revised SOP before we can determine if he fully concurred with our recommendation. While we applaud the decision to update the SOP to reflect current Division goals, initiatives, and practices, we believe the requirements listed in the recommendation are necessary to limit financial risk to SBA.

Management's Comments in Response to Recommendation 1.D

The Associate Administrator stated that the Division should begin the process of revising the SOP before the end of FY 03. The new risk assessment model will incorporate the factors believed relevant in determining the financial condition of an SBIC and thus assisting in an appropriate course of action. The Deputy Associate Administrator stated that the regulations address the levels of impairment that allow for restrictive operations and that this will be referenced in the SOP. Further, he stated that the SOP will provide detailed guidance concerning how long an SBIC should remain in restrictive operations, but the SOP will not be a substitute for the detailed, comprehensive analysis that an analyst would provide. Concerning the appropriateness of remedies, he

stated that the SOP cannot confer new or additional remedies other than the ones permitted by statute or regulation. Finally, he stated that the Division does not believe that the forbearance regulations preclude the imposition of restricted operations.

Evaluation of Management's Comments to Recommendation 1.D

We consider the Associate Administrator's response to be a partial concurrence. Although he agreed to revise the SOP, his response indicates that he does not agree with some of the bulleted points included in the recommendation. As stated in the report, the Division was not consistent in its implementation of restrictive operations due to the absence of specific operating procedures. We believe the recommended requirements will promote consistency which, in turn, will help SBA better manage the program risk.

APPENDIX A

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

DATE: April 22, 2003

TO: Robert G. Seabrooks
Assistant Inspector General for Auditing

THRU: Ronald E. Bew Original Signed FOIA Ex. 6
Associate Deputy Administrator
for Capital Access

FROM: Jeffrey D. Pierson Original Signed FOIA Ex. 6
Associate Administrator
for Investment

SUBJECT: Draft Report – Audit of SBIC Oversight

INTRODUCTION

The Investment Division (ID) of the U.S. Small Business Administration (SBA) appreciates the continuing efforts of the Office of the Inspector General (OIG) to help identify areas of improvement in SBA's regulatory and financial oversight of the Small Business Investment Company (SBIC) program.

As the OIG is aware, SBICs are privately-owned and managed venture capital funds, where both the SBA and private investors may serve as limited partners (as opposed to lenders). SBICs are on the front line of our battle to restore our economy to its maximum strength. With over 10,800 companies in 442 funds supported by $11.7 billion in private venture capital and another $4.7 billion in SBA matching investments at the end of FY 02, the SBIC program has a unique formula for the federal government to help small businesses survive and grow.

In the program's history, SBICs have invested over $35 billion in small businesses in more than 130,000 separate transactions. These SBIC-financed businesses have paid billions in taxes and generated millions of jobs, while promoting innovation and efficiency in the U.S. economy.

Under the program, the government does not make direct investments – professional private venture funds do. The government does not select industries to invest in. SBIC fund managers decide to invest in entrepreneurial companies based on disciplined, acceptable return expectations and a steady focus on profit maximization.

SBICs are part of a legacy of early investing in some of the world's most successful companies – Callaway Golf, Outback Steakhouse, Staples, Federal Express, Apple Computer, America Online, and Intel, to name a few.

SBICs are the building blocks of future economic prosperity. Of course, the SBIC program, just like the rest of the venture capital industry, runs in cycles and is structured to assume substantial risk in the interest of

supporting U.S. small businesses. SBA's challenge is to manage the SBIC program in a way that balances the risks of long-term venture investing with the huge potential rewards to businesses, customers and communities throughout the United States.

VENTURE CAPITAL INDUSTRY AND THE SBIC PROGRAM

In 1958, Congress passed legislation creating the SBIC program. The SBIC program literally created the venture capital industry – a new asset class – to bridge the gap between entrepreneurs, looking to start or grow their businesses, and traditional financing. Forty-five years later, the program's mission remains the same:

> ***Our mission is to encourage economic growth, innovation, and entrepreneurship by licensing and investing in privately-owned and managed venture capital funds, for the benefit of America's small businesses and the customers and communities they serve.***

We accomplish our mission by:

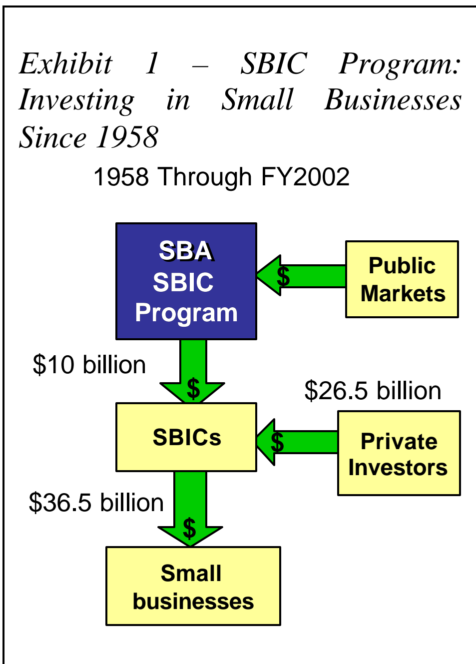
- Licensing qualified fund managers with exceptional deal flow
- Encouraging the participation of major private investors
- Building multiple lines of defense to manage risk to taxpayers
- Communicating understandable program ground rules
- Offering funds time to develop results, given venture investing cycles ("forbearance")
- Focusing on profit maximization as the key to success

A common misperception about the SBIC program is that it is a *credit* program. While not a true venture capital program in the sense that all limited partners' commitments are at risk (the federal government has the ability to limit its financial exposure in certain adverse circumstances), it is nonetheless structured as a unique public-private *investment* program. Typical tools and methods for limiting "credit risk" to taxpayers – essentially by monitoring interest payments – are thus not entirely suitable for the SBIC portfolio.

From a venture investment standpoint, both the federal government and private equity investors put money into SBICs with the understanding that, under a worst case, there could be a total loss of their investment. Sophisticated private investors are willing to assume that risk based on their confidence in SBIC management teams to produce acceptable returns. The government assumes the risk of total loss of investment based on (a) the expectation that SBIC investments will contribute significantly to U.S. economic productivity, job growth, and innovation; and (b) its sharing in the same prospective returns as private investors.

Although the government does not invest money directly in small businesses, the SBIC program – similar to the housing industry's FannieMae – ensures that funds are available to small businesses by providing comparatively inexpensive capital to professional privately managed venture funds that provide equity capital, long-term loans, and debt-security investments, as illustrated in Exhibit 1.

In addition, as shown in Exhibit 1, the SBIC program harnesses private capital alongside its SBA-guarantied funds, providing a much larger base of capital for its investments. While over $36.5 billion in small financings have taken place through this program, less than $10 billion came from SBA-guarantied funds.[2]

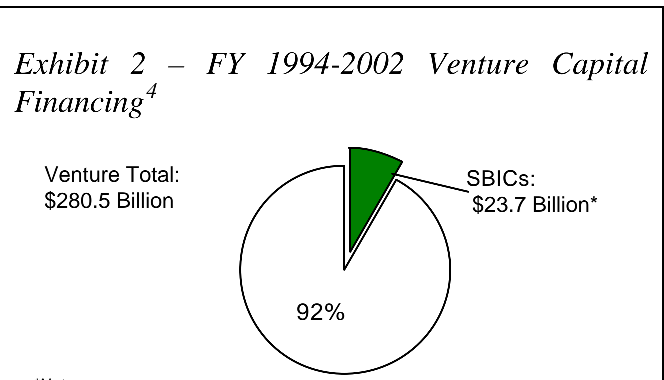


Not only does private investor capital provide a larger financing base, but it also ensures that all SBIC fund managers are profit-motivated. As with traditional venture funds, the managers of the funds earn incentive fees that are tied to fund profitability (known as the "carry"). The fund makes its money on the success of its investments. Thus, their success is closely aligned with the small businesses they invest in.

For that reason, SBICs, in addition to investing capital, provide hands-on involvement in their portfolio companies, including: board participation, corporate governance, strategic planning and marketing, recruitment, financial support, capital-raising, and company exit support via Initial Public Offerings ("IPOs") or sales/mergers.

A 2002 study conducted by Stanford University stated: "Evidence strongly points in one direction: venture capitalists provide value-added services, help to professionalize the companies they finance, and help their companies establish themselves in the marketplace."[3] Therefore, small businesses not only receive capital, but critical expertise to grow their company.

Industry Description. As shown in Exhibit 2, SBICs form a subset of the overall Venture Capital ("VC") industry that provided over $280 billion in financing between fiscal years 1994-2002. As such, VCs address the funding needs of entrepreneurial companies that for reasons of size, assets, and stage of development cannot seek capital from more traditional sources, such as public markets and banks.



Venture capital differs from traditional financing (including lending) in that venture capital typically focuses on young, high-growth companies; invests equity capital, rather than debt; takes higher risks in exchange for

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[2] 2002 SBIC Statistical Package, Table 1 – Regular & Specialized SBICs Financing to Small Businesses Reported for Years Ending March 31, 1960 and Table 36 – Disbursements from 1959 through September 30, 2002.

[3] Hellmann, Thomas and Puri, Manju, On the Fundamental Role of Venture Capital, *Federal Reserve Bank of Atlanta Economic Review*, Fourth Quarter 2002, page 22.

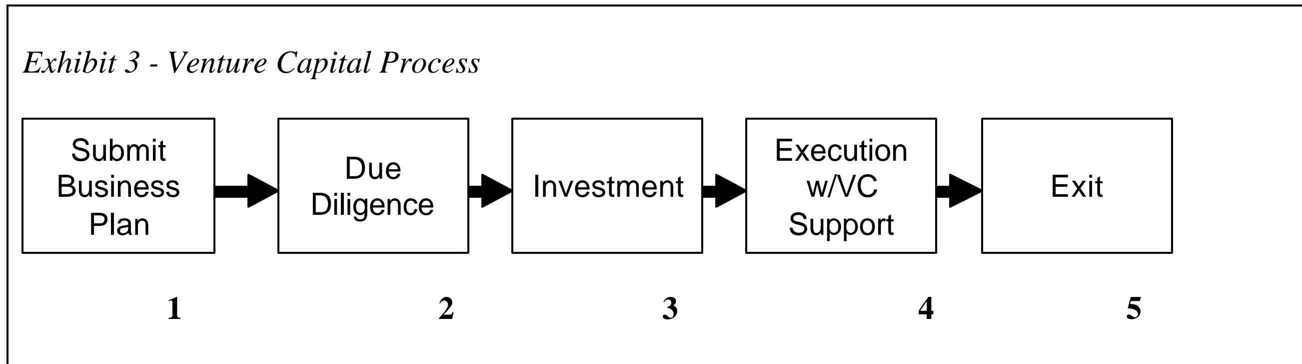
[4] Note 1: Total 2002 Venture Capital Financing figure as reported by PriceWaterhouseCoopers (PWC) (www.pwcmoneytree.com), Full Year and Q4 2002 Results MoneyTree Survey and Historical Trend Data file: National_Aggregate_Data 95Q_02Q4.xls. All SBIC financings may not have been covered within the PWC survey.

Note 2: SBIC figures include only SBIC financings with equity features, based on financing/disbursement date. This figure may be incomplete, as the Investment Division receives reports of financings for a particular fiscal year only after the end of that year.

Note 3: All SBIC financings may not have been covered within the PWC survey from which the total Venture Capital financings figure was derived. The Investment Division expects to work to improve SBIC coverage in these statistics for future reports.

potential higher returns; has a longer investment horizon than other financings; and actively monitors portfolio companies via board participation, strategic marketing, governance, and capital structure.

How Venture Capital Returns are Generated. A business looking for venture capital typically can expect the following process:



1. **Submit Business Plan:** The venture fund reviews an entrepreneur's business plan, and talks to the business if it meets the fund's investment criteria. Most funds concentrate on an industry, geographic area, and/or stage of a company (e.g., Start-up/Seed, Early, Expansion, and Later).

2. **Due Diligence:** If the venture fund is interested in the prospective investment, it performs due diligence on the small business, including looking in great detail at the company's management team, market, products and services, operating history, corporate governance documents, and financial statements. This can include a term sheet describing the terms and conditions under which the fund would make an investment.

3. **Investment:** If at the completion of due diligence the venture fund remains interested, an investment is made in the company in exchange for some of its equity and/or debt. The terms of an investment are usually based on company performance, which help provide benefits to the small business while minimizing risks for the venture fund.

4. **Execution with VC Support:** Once a venture fund has invested, it becomes actively involved in the company. Venture funds normally do not make their entire investment in a company at once, but in "rounds." As the company meets previously-agreed milestones, further rounds of financing are made available, with adjustments in price as the company executes on its plan.

5. **Exit**: While venture funds have longer investment horizons than traditional financing sources, they clearly expect to "exit" the company (on average, 4-6 years after an initial investment) – since that is generally how they make money! Exits are normally performed via mergers, acquisitions, and IPOs. In many cases, venture funds will help the company exit through their business networks and experience.

Venture Fund Investment Cycles. Since it can take 4-6 years for a venture fund to exit a business, investors in the fund must be willing to wait for their returns. This is why venture funds typically experience what is known as the "J" curve (Exhibit 4) in terms of returns to the investor. Returns tend to be negative for a few years at the beginning of a fund's investment cycle because cash is used for investment and management fees, and investments are carried at cost or occasionally written down.[5]

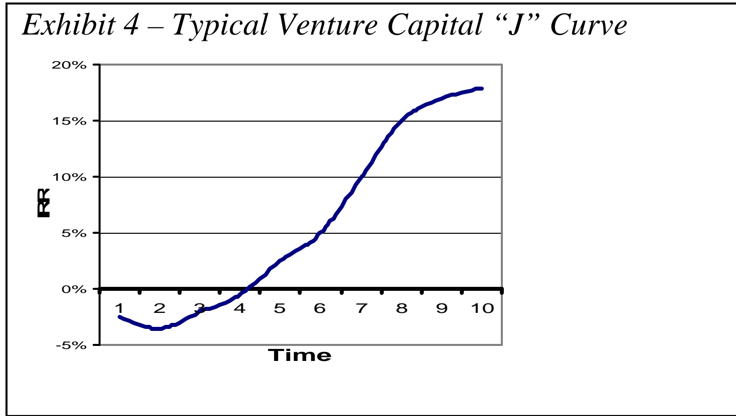


Exhibit 4 – Typical Venture Capital "J" Curve

Exhibit 5 shows the average number of years before investors' capital is returned from a venture fund by "vintage year" – the year the fund was formed and started to invest. As shown, it took as long as ten years during the early 1980s, but only three years for vintage year 1997 funds, before investors saw positive returns. It is difficult to predict how long it will take the more recent venture funds to return capital to investors. For example, as of 12/2001, the 1998 funds as a group had distributed 58% of paid-in capital. Therefore, the payback time could possibly stretch anywhere from 5-10 years for funds in the 1998-2001 vintage years.

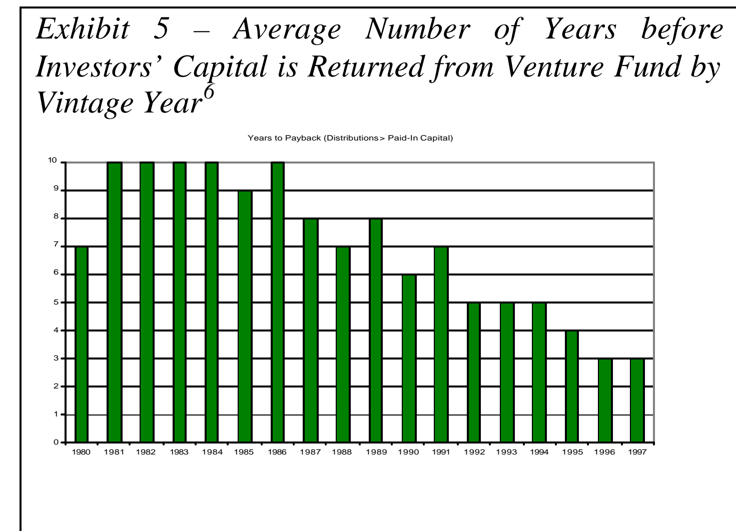


Exhibit 5 – Average Number of Years before Investors' Capital is Returned from Venture Fund by Vintage Year[6]

[5] "Structuring a Venture Capital Portfolio: An Investor's Perspective," Henry G. Robin, CFA, p. 14 (AIMR Readings in Venture Capital, 1997).

[6] Data derived from Thomson Financial Venture Economics 2002 Investment Benchmarks Report, Page 46, Figure 3.012, Vintage Year Results by Fund Age (in Years) After Formation, Cumulative Average Distribution to Paid-In. Payback years were identified as the year when Cumulative Average Distribution to Paid-In ratio exceeded 1.

"Time to exit" can depend on the nature of the company in terms of both its operating history and its position in the industry. But the overall economy and stock market usually drive the outcome. The chart to the right (Exhibit 6) shows the average fund cumulative internal rate of return ("IRR") as of December 2001. Vintage year appears as columns on the left axis, alongside the S&P Index as a line on the right axis across the years 1980-2000. In general, the IRRs of venture funds follow the growth and decline of the stock market.

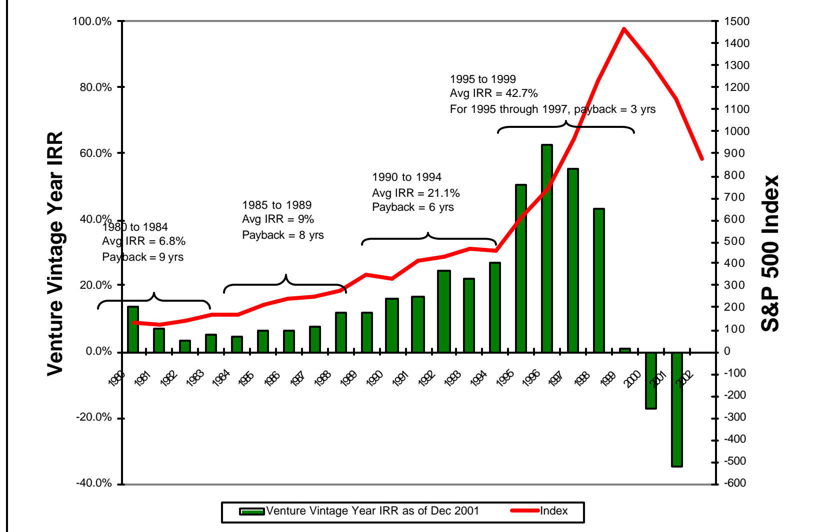


Exhibit 6 - Venture Fund Vintage Year Average Cumulative IRRs vs. S&P Index (as of December 2001)[7]

An example is vintage year 1996, when the highest average return preceded the high S&P index by three years. In other words, it would appear that the time to invest in venture capital is roughly two to three years prior to a peak in the market – when company valuations are lower – following the classic "buy low – sell high" theory.

Vintage years 2001 and 2002 cumulative IRR measures are negative, but this might be expected following the "J" curve. The question is whether the decline in the stock market over the last three years will lengthen the time before the average cumulative IRR turns positive for vintage year 2001 and 2002 funds.

Exhibit 7 shows that the ideal time for a venture capital fund to invest is an estimated two to three years before a market upswing. Exhibit 7 shows when venture capital exits actually occurred, in terms of IPO activity. Just as there is an optimal time to get in, there is an optimal time to get out of an investment. Following the "buy low - sell high" principle, venture funds attempt to time the exit of their portfolio companies at market peaks.

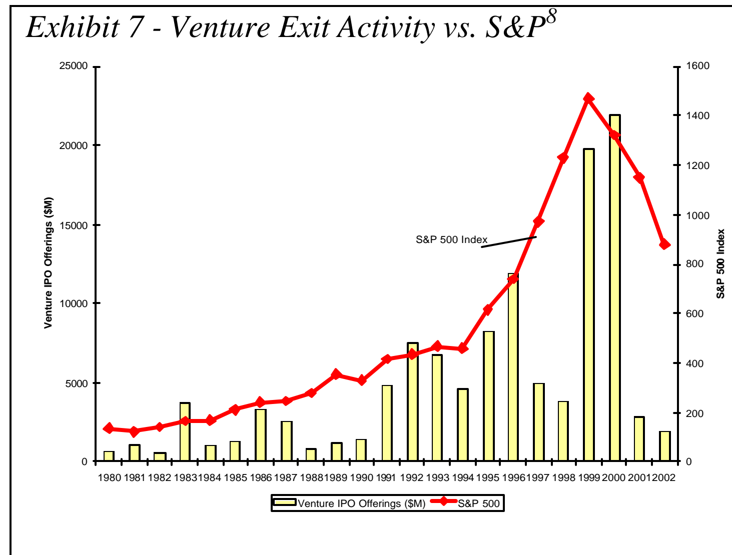


Exhibit 7 - Venture Exit Activity vs. S&P[8]

However, as shown by the chart, venture IPOs tend to lag the market by about one or two years. When the S&P peaked in 1999, for example, venture IPOs peaked one year later. It is therefore possible that, following historic trends, once the current stock market rebounds, venture IPOs may follow one to two years later.

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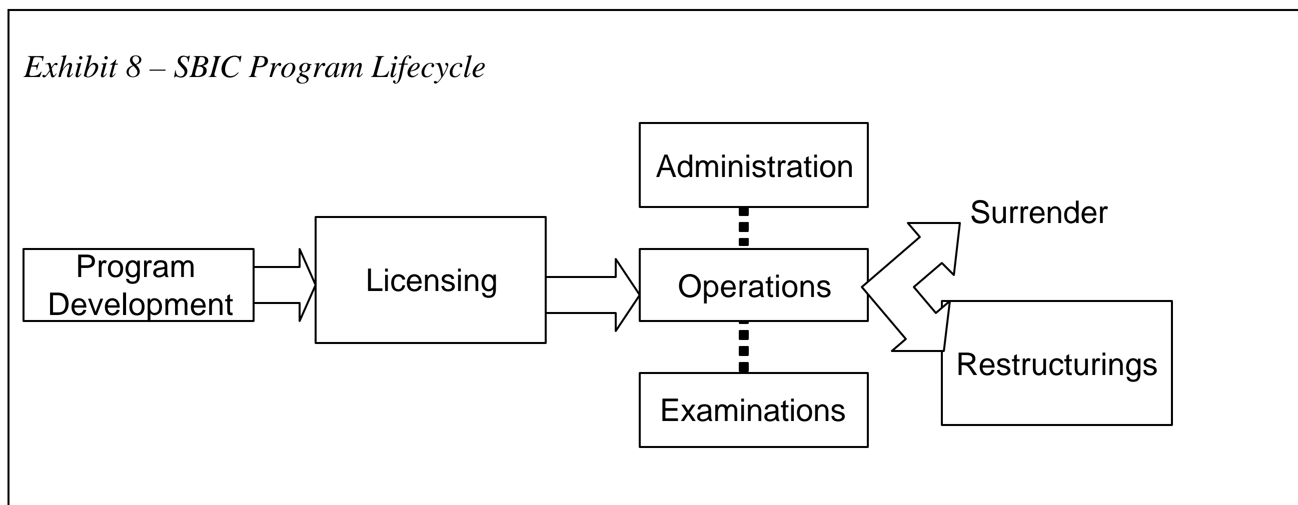
[7] S&P Data derived from Commodity Systems Incorporated via Yahoo.com, using year end historical prices. Venture Vintage Year IRRs taken from Thomson Financial Venture Economics 2002 Investment Benchmarks Report, Page 39, Figure 3.002, Cumulative Benchmark Results as of December 31 2001 Overall Sample By Vintage Year.

[8] S&P Data derived from Commodity Systems Incorporated via Yahoo.com, using year end historical prices. Venture IPO data taken from Thomson Financial Venture Economics 2002 Investment Benchmarks Report, Page 353, Appendix C, U.S. Venture Capital Statistics.

Management and Oversight of the SBIC Program

In February 1992, an SBIC Investment Advisory Council, composed of members from the venture capital industry, the National Association of Small Business Investment Companies (NASBIC), and other stakeholders in the SBIC program, submitted a report to the SBA Administrator regarding the SBIC Program. Because the government guarantys the funds used in the SBIC program, the SBA holds a fiduciary responsibility to ensure that SBICs utilize these funds in the best interest of the taxpayer.

Exhibit 8 depicts the typical process for obtaining an SBIC license and the lifecycle of an SBIC as it moves through the various oversight offices of the Investment Division. As indicated, SBIC Program Development screens applicants and conducts preliminary evaluations of prospective SBIC venture fund management teams and their proposals. If they pass initial hurdles, SBIC applicants then face a rigorous licensing process. If they receive their license, they are transferred to the Office of SBIC Operations. The Offices of SBIC Administration and SBIC Examinations play key roles during this timeframe. At the end of a fund's life (usually ten years), the SBIC either surrenders its license or in some cases is transferred to the Office of Liquidations. Further detail regarding each step and the related office are described below.



SBIC Program Development. One of the recommendations from the 1992 SBIC Program Study was to "Establish a Marketing/Business Development function reporting to the Associate Administrator for Investment (AA/I) to promote the SBIC program nationally to potential new sources of private capital and prospective management teams." Program Development, under the Office of Chief Administrator Office, performs this function. This team proactively markets the program to prospective venture fund management teams. In general, Program Development looks for the following attributes in SBIC candidates:

- Private equity investing experience and strong "deal flow" of the same type that the proposed fund would perform
- At least two general partners who have five or more years of "decision-making" experience as a principal in a venture capital fund (rather than as an agent such as consultant, investment banker, broker, etc.)
- Realized track record of superior returns, placing a fund in the upper half of performance for venture funds of the same vintage year and style
- Managerial, operational or technical experience that can add value at the portfolio company level
- Cohesive management team, with complementary skills and history of working together

Candidates going through Program Development typically follow these steps:

- ***Management Assessment Questionnaire ("MAQ"):*** This comprehensive evaluation form is a series of structured questions concerning management's plans for the prospective SBIC and the detailed experience and qualifications of the management team.

- ***Analyst Review and Preliminary Due Diligence***: Once the MAQ is submitted, the Investment Division assigns a program development specialist to the case. The specialist works with the applicant to clarify and analyze the MAQ in detail, especially with regard to the applicant's strengths and weaknesses, and performs initial due diligence.

- ***Preliminary Investment Committee Review***: Generally, within one to two months, the assigned staff person makes a recommendation to the Investment Committee (composed of senior members of the Division) whether to invite the principals to the SBA for a formal interview.

- ***Investment Committee Presentation***: If the initial impression and supporting documentation and due diligence show that the management team may be qualified for a license, the entire team is invited to an interview with approximately 7-15 SBA personnel in attendance. This allows the applicant to expand on their strengths and discuss any weaknesses identified through the MAQ.

- ***Assessment***: After the interview, the Investment Committee decides whether or not to issue a "go-forth letter," which moves the applicant into an even more rigorous licensing phase. A go-forth letter does not mean that the SBA has determined that the applicant qualifies to receive an SBIC license, only that they qualify for further consideration and due diligence.

Licensing. Another recommendation of the 1992 SBIC Program Study was, "Establish stringent new licensing regulations and standards, and allow the SBA to reject applications for licenses when those standards are not met." The study noted that as of 1992, "…the SBA hasn't declined many license applications over the SBIC program's 30-year history" and "Had the SBA felt secure in its authority to decline license applications, some of the SBA's exposure to loss might have been avoided." Since licensed SBICs hold the investment decision, management, and oversight of the SBA-guarantied funds, ensuring that only qualified applicants are licensed is critical to minimize potential financial losses of the program.

The Office of Licensing and Program Standards holds this crucial responsibility:

- ***License Application and Private Capital Commitments:*** The applicant must raise so-called "regulatory capital" in the form of commitments from private sources. Prior to filing its license application, the applicant is required to raise a minimum private capital commitment of $5 million for a debenture fund, and $10 million for an equity, or so-called "participating securities" fund. A minimum of 30% of this capital must come from sources unaffiliated with the fund management.

- ***Analyst Review:*** The Office of Licensing assigns a lead analyst to review each application. The analyst performs an in-depth review of the application, business plan, financial projections, legal documentation and final due diligence on the management team. When the review is complete, the applicant then undergoes three levels of approval before actually receiving its license.

- ***Divisional Approval:*** The lead analyst presents the application to the Investment Division Licensing Committee, which generally meets on a monthly basis. This committee is composed of senior managers of the Investment Division.

- ***Agency Licensing Approval:*** If Divisional Licensing approves the application, it is then presented to the Agency Licensing Committee, which is composed of certain senior managers of the SBA.

- ***SBA Administrator Final Approval:*** Finally, if the Agency Licensing Committee approves, the application is submitted to the SBA Administrator for final approval. If signed, the applicant receives an SBIC license and is transferred to the Office of SBIC Operations.

Operations. The 1992 SBIC Program study noted the importance of continuous monitoring of the SBICs' portfolios, in terms of "clear and timely analysis of financial statements," "…balance sheet, cash flow and income statement analysis with particular emphasis on key indicators of potential problems in SBICs, and " .. spotting potential problems early." The study's emphasis was to maintain a relationship such that potential problems could be identified early to give time for SBIC management and the Investment Division to work towards possible solutions. The Office of SBIC Operations addresses these concerns through its oversight.

The Director of SBIC Operations is responsible for regulatory, financial oversight, and leverage (funding) to the SBICs. Each licensee is assigned an operations analyst who serves as their primary contact. The operation analyst is responsible for the analysis of all financial statements, examinations, and investigation reports covering the operations and practices of individual SBICs. In addition, the analyst evaluates the financial stability and reliability of the SBICs, and their compliance with the Small Business Investment Act of 1958, as amended, and other related rules and regulations.

Administration. The 1992 SBIC Program study stressed the importance of data collection and analysis, suggesting "simple off-the-shelf financial reporting models and analytical software" and "quarterly financial reporting… in a format that most closely resembles a venture capital fund's normal quarterly reporting, with additional data provided annually to the Agency on companies backed, and jobs, wealth, and taxes created." Data Management provides this responsibility as part of the Office of Chief Administrative Officer. In addition, Funding Administration as part of this office directs, administers, and coordinates the periodic pooling and funding of both SBIC debentures and participating securities for the program.

Examinations. The 1992 SBIC Program Study also recommended, "The examination function provided in Section 310 of the Small Business Investment Act should be returned to the Investment Division to assure control over the frequency, scope, and performance of compliance exams." The intent of this recommendation was to put the responsibility back in the program office directly responsible for administering the program.

The Office of SBIC Examinations plans, directs and coordinates the Agency's program for examining SBICs that operate under the provisions of the Small Business Investment Act of 1958, as amended. Primary goals of examinations include:

- Determining whether licensees are complying with the Small Business Investment Act and implemented regulations;
- Assessing the financial condition of licensees and SBA's financial vulnerability; and
- Ensuring the accuracy of information that licensees submit to SBA.

The Office of SBIC Examinations is headed by a Director in the Washington headquarters, and supported by 29 examiners in six field offices. Examiners independently gather and report factual information to the Office of SBIC Operations, so that the Office of SBIC Operations can monitor and regulate the activities of the licensees.

Liquidations. The Office of SBIC Operations proactively monitors the SBICs to determine as soon as possible any possible problems in the portfolio. If severity of problems warrants action, the operations analyst recommends transfer of the SBIC into "Restricted Operations" mode (for participating securities SBICs). If the

severity of the fund's condition worsens, the Office of SBIC Operations may recommend transfer of the SBIC to the Office of SBIC Liquidations. For debenture SBICs, the process is less complex: when an SBIC defaults on its interest payments, it is transferred directly to the Office of Liquidations. The difference in procedures between Participating Securities SBICs and Debenture SBICs is based on the program's structure to allow a Participating Securities fund sufficient time to realize exits on its investments. The procedures also reflect differences in the type of investing by Participating Securities SBICs and Debenture SBICs.

The Office of SBIC Liquidations develops, recommends, and implements policies and procedures for the administration and liquidation of the SBICs transferred to "restructuring" status. The office's primary goal is to maximize the net recoveries in an appropriate amount of time on these SBICs, while recognizing the interests of other parties affected (i.e., small business concerns funded by SBICs) and furthering program integrity. The Office of SBIC Liquidation manages, oversees, and takes necessary action on behalf of SBA, both as creditor and as Receiver.

Surrender. The Office of SBIC Liquidations is neither the typical nor preferred way for an SBIC to exit the program. Typically, the SBIC requests approval to surrender its license, accompanied by an offer of immediate repayment of all outstanding leverage (including any prepayment penalties thereon), or by a plan satisfactory to the SBA for the orderly liquidation of the Licensee. An SBIC may not surrender its license without SBA's prior written approval.

BUSINESS ACTIVITIES OF THE INVESTMENT DIVISION SINCE THE END OF THE OIG REPORT PERIOD (SEPTEMBER 2002)

In a memorandum dated December 10, 2002, the Investment Division set forth its FY 03 business plan, including (a) Division-wide performance goals and (b) key policy and program initiatives. Recently, in a memorandum dated March 24, 2003, the business plan went through a six-month review (since September 30, 2002) with respect to:

1) Execution of Administration Policy. The Investment Division's business plan puts into action several elements of the President's Management Agenda, the Administration's Agenda for Small Business, and the SBA's Strategic Plan.

2) Achievement of Performance Objectives. The business plan shows overall that the Investment Division is on track to meet or exceed its performance objectives with respect to SBIC licensing, financings, examinations, and restructurings.

3) Progress in Completing Priority Projects. The Investment Division's policy and program initiatives have reached significant milestones, and the business plan itself has been refined, adding more specificity to ensure successful completion of goals.

The Investment Division's business plan is the product of extensive management and staff discussions within the SBA. It is the result of ongoing feedback from Congress, the White House, OMB, the venture capital industry, private investors, analysts, and other stakeholders in the SBIC program. With guiding principles, performance goals, and program priorities firmly in place, the Investment Division is continually refining and reassessing its business plan to ensure that it is realistic and producing measurable results.

SBIC PORTFOLIO RISK MANAGEMENT INITIATIVES DURING FY 03

The Investment Division's policy and program priorities are focused on initiatives to:

a) Clarify and quantify the potential risks and rewards of taxpayers' "participation" in the SBIC program; and

b) Strengthen our portfolio risk assessment and management strategy, so as to preserve the program's self-financing capability over time frames that are consistent with venture capital investing.

Fund Performance Data/Annual Report. Thousands of portfolio companies depend on SBIC support to survive and grow in the current economic environment. To help guide our policy, we are developing a better understanding of the SBIC portfolio's performance dynamics through the publication of an Annual Report. The Annual Report is a starting point for better assessing SBIC portfolio performance, managing risk, fostering accountability, and demonstrating program results. In this report we will begin to clarify and quantify the potential risks and rewards of taxpayers' "participation" in the SBIC program.

> ***As this report will show, SBICs have helped generate billions of dollars in corporate revenues and income taxes, while creating millions of jobs and countless improvements to our health, safety, and way of life. That record of accomplishment will continue to pay America many times over for the costs of running the program.***

Patterned after comparable public company reports, the SBIC Program's annual report will include:

- Highlights from the year/Anticipated Changes
- Business Description
  - Venture Capital
    - Description of Venture Capital Industry and SBA's role
    - Explanation of venture capital process and investment cycle
  - SBIC Role
    - SBIC Program Overview
    - SBICs: Spanning the Gap
    - SBA Leverage Benefits
    - SBIC Program Description
- Impacts of Venture Capital and the SBIC Program to U.S.
- Financials for the SBIC Program
- Selected Consolidated SBIC Financials
- Key Metrics
- Glossary of Terms

SBIC Licensing. While not the focus of the OIG's report, licensing new SBICs is the most critical element of our risk management strategy. Important changes in our licensing operations have recently been made – reducing the risk of financial losses both to SBA and private investors. Specific program and managerial improvements to the SBIC licensing process include:

- <u>Licensing standards have been tightened</u>. The Investment Division has a clear, consistent approach toward licensing SBIC teams with above-average track records of managing venture capital funds.
- <u>New business development and licensing staff have been recruited</u>. The results are a higher degree of customer service, a more rigorous, fact-based approach to initial due diligence, a high level of coordination and teamwork, and clarity and consistency in licensing standards and decision-making.
- <u>Licensing staff have been organized into teams</u>. This has produced more effective communication, both internally and with prospective SBIC licensees, and more efficient processing of cases.

- Inactive or sub-standard cases are expeditiously resolved. To ensure quality control and protect the taxpayer against risk, our goal is to resolve outstanding cases – not just license new funds. While the number of new licenses issued is important, the work that goes into denials or dismissals constitutes a highly valuable contribution to program risk management.

SBIC Examinations. The Office of SBIC Examinations performed a record 326 annual examinations in FY 02. At the same time, the number of reports with compliance red flags has declined. Continuing an ongoing trend, there have been fewer improper financings, inappropriate distributions, less conflicts of interest and portfolio valuations that did not follow our guidelines.

SBIC Portfolio Risk Assessment Model. With the assistance of private industry, the Investment Division is designing and testing a more robust portfolio risk rating model to replace the current system of monitoring funds under financial strain. The goals of this new rating system are to:

- Provide SBA with more of an "early warning system" for individual SBIC oversight;
- Provide clear, standardized procedures for assessing risk at individual SBIC level;
- Provide SBA with more information regarding the scope and timing of total prospective portfolio losses, including where they fall in the range of SBIC program assumptions;
- Promote best fund management practices and conservative portfolio valuations

New Portfolio Risk Assessment and Valuation Branch. In conjunction with the development of the risk rating model, the Investment Division has created a specific branch dedicated to the creation and maintenance of the risk rating model (effective January 6, 2003). The Portfolio Risk Assessment and Valuation Branch will also provide support services to Division-wide activities related to SBIC portfolio valuations, when and as needed.

Reorganization of the Office of SBIC Operations. The Office of SBIC Operations is undergoing major change. We are dedicating more internal resources to risk management, better defining portfolio company value, and building more teamwork and consistency into our oversight and decision-making. To promote consistency and clarity in SBIC financial and regulatory oversight, three Areas have been reorganized, with two Areas now responsible for the Participating Securities SBIC "portfolio," and one Area responsible for the Debenture SBIC and non-leveraged SBIC portfolios. Additional financial analysts, with direct venture capital, valuation, and related expertise, have been recruited to support the expanding caseload in Operations and to augment staff analytical capabilities.

SBIC Liquidations/Restructurings. In FY 02, the Investment Division obtained $18.8 million in liquidation recoveries and closed 16 liquidation cases and 5 SBA-operated receivership cases. In FY 03, our performance targets call for more aggressive resolution of cases and the creation of better incentives for management of SBICs in receiverships, so that we expect to have results of:

a) An increase of at least 25% in the amount of total tax dollars recovered over the previous fiscal year
b) A cumulative AUPRP (recovery rate) on post-credit reform transfers for non-participating securities SBICs of at least 60%
c) Resolve 25 open asset accounts as of FYE 02 (or 30% of all open asset accounts)
d) Close 10 SBA-operated receiverships, a 100% increase from the prior fiscal year.

SPECIFIC ISSUES RAISED IN THE OIG REPORT

Managing Risk in Debenture SBICs versus Participating Securities SBICs. The OIG's report points to potential weaknesses in procedures used to identify and manage "impaired" SBICs. As we have outlined above, the Investment Division is executing a plan to strengthen its assessment and management of financial and regulatory risks inherent in the program. Nonetheless, with respect to the OIG's focus on the participating securities program, it is essential to recognize the distinctions between the two main "products" offered by the SBIC program: debenture SBICs and participating securities SBICs. Each type of fund has significantly different prospective financial performance and distinct investment models.

The portfolio of a debenture SBIC can usually be assessed with more certainty than the portfolio of a participating securities SBIC, since debenture SBICs generally make subordinated or mezzanine debt investments (with a current pay element that includes some potential equity appreciation). Debenture funds may often generate early positive cash flow and are less susceptible to the "J" curve phenomenon described above.

In contrast, the participating securities program is designed to be a private equity/venture capital program, where most – if not all – investments lack a current pay (debt) component. Its equity-only design entails both greater risk and, potentially, greater reward to investors than the debenture program. Moreover, participating securities SBICs typically make equity investments at an earlier stage in the life of the portfolio company.

As mentioned above, it is fully expected that a private equity fund will quickly lose a portion of its value during the initial years of investing. A fund may make approximately 15-20 investments over an initial five-year period, with the fund managers seeking to add value to these investments midway through the fund's life. Some losses may occur early in the fund's life, and the fund should realize the most significant portion of its return toward the end of the fund's life. In other words, all equity-type venture capital funds – including participating securities SBICs – are *expected* to have a significant level of "impairment," particularly in the early years of a fund's existence.

Here is an example of how impairment can occur in a healthy situation: An SBIC charges a management fee. This fee generally amounts to 2.5% of the sum of private capital, plus an assumed two tiers of SBA leverage – roughly 7.5% of private capital. Capital impairment is based upon private capital, so even assuming that a fund has no other expenses and incurs no portfolio losses, it will unavoidably have capital impairment of 7.5% at the conclusion of the first year. After five years of being in business, capital impairment *based solely upon payment of the management fee* will exceed 37%.

Participating Securities SBICs will also have organizational and other expenses and, as explained above, are likely to have incurred portfolio losses – losses that are projected to occur early in the fund's life and do not generate any income. Therefore, based upon the venture capital model – and barring any unexpected early winners – a Participating Securities SBIC will start its life with a significant level of capital impairment. As the SBIC program is currently structured, that same SBIC has little room to make mistakes going forward without triggering impairment thresholds.

If a fund cannot implement its investment plan, it cannot serve small businesses, nor can it provide SBA with a share of the returns that can accrue to a venture capital fund in its later years. An equity fund must make the full complement of investments in order to enhance the probability of having 2-3 "winners" that make the fund profitable overall. Failure to do so statistically diminishes the probability of success for the fund.

Limited History of Participating Securities SBIC Program. The participating securities program was developed in the early 1990s, with the first participating securities leverage not issued until 1995. As funds are raised with ten-year securities, the first maturity of a participating securities instrument is not until 2005.

The majority of the outstanding SBA participating securities leverage was not issued until the late 1990s and beyond. Given the short amount of program history, the lack of even a single cohort year reaching maturity, and the lack of sufficient business cycles over the short program history, the conclusions reached by the OIG were based upon an abbreviated time horizon.

The design of the program from a subsidy rate perspective reflects the long-term cyclical nature of private equity investing. Under the Federal Credit Reform Act, the program is expected to cover (through appropriations and fees) the presumed costs of the government guaranty. In the early years of the participating securities program, revenues substantially exceeded program credit costs.

Taking the above factors into account, the OIG raises substantive oversight issues that we agree need to be addressed. If there is any difference with respect to the OIG's focus and the SBA's plan of action, it may be in the SBA's treatment of the SBIC participating securities program as a private equity investment program, not a credit program. In managing a private equity portfolio, we accept the unique nature of private equity investing and the venture fund life cycle. SBA is tracking funds by "vintage year" (1985, 1986, 1987, etc.) and type/stage of investing (seed, early stage, late, etc.). We expect the returns associated with these different classes of funds to vary. For example, SBICs that were licensed in the 1999-2000 period generally made investments at comparatively high valuations. As a class, these funds will likely experience lower average returns than might be expected from comparable funds investing in the current market environment.

Creation of Robust Risk Assessment Tools. Concurrent with and independent of OIG's report, the Investment Division has sought to strengthen its assessment and management of program risk. For example, we concluded that the previously used "Watch List" was not a comprehensive enough tool to anticipate and help resolve issues affecting SBICs under financial strain. In 2001, the Investment Division began an effort to enhance its risk evaluation efforts. A series of meetings were held among Investment Division personnel, staff in the Office of General Counsel (OGC) and the Senior Counsel to the Administrator. The result of this effort was the Risk Assessment Profile (RAP). The RAP was an effort to consider factors in addition to capital impairment in evaluating a SBIC's risk. As such, it was a more comprehensive tool than the Watch List but still inadequate to address the more complex questions facing participating securities SBICs. The enhanced risk rating system described on page 15 of this report further strengthens the "early warning" necessary to handle troubled SBICs.

Policy Options Concerning Restricted Operations and Transfer to Liquidation. The Investment Division, with the assistance of OGC, has evaluated its options relative to its policy regarding (a) Restricted Operations, (b) transfers to the Office of SBIC Liquidation; and (c) treatment of prioritized payments.

[FOIA Ex. 5] the Investment Division could transfer SBICs already in Restricted Operations to the Office of SBIC Liquidation, thereby terminating payment of the quarterly interest payments due on participating securities (prioritized payments). [FOIA Ex. 5]

We feel it is important that the OIG be aware of certain key issues regarding placement of an SBIC into Restricted Operations and transfer of an SBIC to the Office of SBIC Liquidation. First, SBA's authority to make either decision currently *may* be based on a determination that the SBIC is capitally impaired. However, as explained above, impairment is a natural by-product of equity investing.

What this means is that SBA, before making a decision, must determine that the proposed transfer is based upon a *permanent* diminution in the value of the SBIC's portfolio companies – and not the typical progression of an equity fund through the "J" curve. A decision based solely upon a certain level of capital impairment, without the underlying portfolio analysis, would be inappropriate and potentially increase SBA's risk of loss.

In its report, the OIG suggests that capital impairment should remain the sole criteria for decisions regarding transfers to liquidation. However, the challenge we share as overseers of the SBIC program does not lend itself to such an easy solution.

Although the OIG report properly notes some of the difficulties the Investment Division is experiencing with a relatively new program, the report does not recognize the inherent risk associated with equity investing and the time needed to allow for a portfolio to develop and increase in value.

We now refer to the specific issues raised by the OIG:

Finding: SBA's Oversight of the SBIC Program did not Limit Financial Loss to the SBIC Program

We have outlined above how SBA's licensing and oversight of the SBIC program manages risk of ultimate loss, and how the Investment Division is taking steps to further strengthen its risk management tools and decision making. The Finding above is narrowly focused on certain procedural steps that OIG suggests should be revised in order to "limit financial loss." However, the Finding does not take into account:

(a) the unique equity-type structure of the SBIC program and the expectation that the participating securities will be treated as patient capital
(b) the effect of a transfer to liquidation on portfolio company value and thus the effect on broader program goals to support small business; and
(c) other factors that should weigh in the funds' favor (e.g., distributions to SBA, conservative valuation policies, reserves of co-investors that may support portfolio companies, and regulatory compliance).

The expectation is that funding of prioritized payments will continue – unless there is a significant and permanent diminution of portfolio value that makes recovery of the SBA's financial exposure unlikely, based on thorough analysis.

The OIG's Finding does not take into account the effect of a transfer to liquidation on portfolio value. Except perhaps in rare instances, transfers do not add value to SBIC portfolio companies. Moreover, the transfer decision by itself imposes no additional restrictions on the activities of the SBIC that are not already in place under Restricted Operations.

As a result of its own analysis, as well as input provided by the venture capital industry, the Investment Division believes that a number of factors must be addressed in making any transfer decision. These factors include the level of impairment, the age of the fund, its distribution history, the type of investing and other factors. For example, a fund with a high level of impairment but few investments (i.e., not fully invested) and leverage is less risky than a fund with the same level of impairment but with more leverage and fully invested.

With respect to forbearance in Section 107.1820(b)(1)(i), the Investment Division will request an opinion from OGC as to its proper interpretation. Heretofore, we have operated under the assumption that we are precluded from imposing the remedies available for Extreme Capital Impairment for a period of eight years. As such, we respectfully disagree with the OIG's statements relative to forbearance on pages 8-9 of its draft report. Unless advised otherwise by OGC, as long as the SBIC is within its first eight years, we understand that SBA has no right to seek a receivership or otherwise to replace SBIC management for capital impairment.

We attribute these restrictions in part to the design of the participating securities as patient capital.

The concept of forbearance in Section 107.1850 means that an SBIC does not have a condition of capital impairment for the first four years (five years in certain instances) from issuance of participating securities leverage unless its impairment level is 85% or more, regardless of the levels set in 107.1830. As such, the ability to place a SBIC into Restricted Operations (107.1820 (e)) and the resultant remedies (107.1820 (f)) are only available if the SBIC reaches the level of impairment set forth in 107.1830, as modified by 107.1850.

The OIG cites procedural issues requiring clarification and/or potential modification (e.g., in certain instances, supporting documentation is not readily apparent). We wholeheartedly agree with these comments and are taking steps to address the documentation issues. Once we execute our FY 03 business plan, we will turn to the resource-intensive yet important task of preparing new SOPs for the Division. Our preference is to take a comprehensive – rather than piece-meal – approach to revising the SOP for Operations (SOP 10 06) and addressing more clearly the financial issues related to SBICs.

We respectfully refer the OIG to certain procedural steps that do exist and may have been overlooked. For example, the OIG states that our analysis failed to include recommendations relative to certain SBICs. Recommendations for transfers are documented on SBA Form 327. This important decision as well as the decision to place an SBIC into Restricted Operations is only taken after exhaustive analysis of the SBIC and meetings both internally and with the affected SBIC.

The OIG report states that support for the forbearance period is not provided through documentation. That is true, and we will take steps to correct it. It should be noted, however, that the forbearance periods (and capital impairment) were determined only after publication of proposed regulations and a comment period. The concept of forbearance is one that we believe is clearly supported by the model of private equity investing. That model is premised upon the need to grow the value of venture investments over time, with the understanding that values will fluctuate. The statutory framework of the participating securities program places the SBA in the role of providing patient capital, while regulating the program and protecting the SBA's investment at the same time.

Recommendations

1.A. The Investment Division maintains that the concept of forbearance is inherent to the structure of a private equity investing program. We refer the OIG to the legislative and regulatory history for the necessary documentation. The regulations were adopted only after publication of proposed regulations and review of the subsequent comments.

1.B. The Investment Division will request the proposed opinion from the OGC.

1.C. The Investment Division generally concurs with this Recommendation, although we take exception to the comments regarding consistency. A draft SOP had previously been prepared, but it will need to be revised to reflect recent developments and initiatives within the Investment Division. We expect to begin the process of revising SOPs before the end of FY 03.

1.D. Please see comments on Recommendation 1.C. The new risk assessment model will incorporate the factors believed relevant in determining the financial condition of an SBIC and thus assisting in an appropriate course of action. It is important to note that the forbearance regulations do not preclude the imposition of Restricted Operations and its remedies. The forbearance regulations applicable to Restricted Operations deal with the levels of impairment that need to be reached before a SBIC can be placed into Restricted Operations.

In conclusion, let us emphasize that, regardless of the economic environment, we take our fiduciary responsibilities to the U.S. taxpayer very seriously. We are executing our plan to protect the government against

fraud or excessive financial risk in any individual fund. We have the benefit of hindsight to see that many venture capital investments should not have been made at such high valuations during the 1999-2000 peak of the market. As such, we are taking necessary action to preserve the public's capital invested in funds with little or no resources available to invest in small business.

Our job is to manage the program in a way that balances the risks of long-term venture investing with the enormous potential rewards to customers and communities across America. We hope this report presents to you that vision.

From: Haskins, Harry E.
Sent: Tuesday, May 27, 2003 10:37 AM
To: Hudson, James W.; Cole, Robin O. (O'Neal)
Subject: FW: Response to SBIC Oversight Audit Report

In our response to Recommendation 1A, the Investment Division referred the Office of the Inspector General to the legislative and regulatory history for documentation of the forbearance periods and the related percentages. As indicated in that response, the Investment Division believes the concept of forbearance is integral to venture capital investing. The forbearance period and the percentages were adopted after an extensive public comment period. The Investment Division is always open to suggestions on improving the program. However, changes to this concept will require a substantial investment of time and resources and we are not prepared to recommend specific changes at this time.

With respect to Recommendation 1C, the Investment Division expects the SOP to address the issues raised in your Recommendation as we believe we are currently addressing these concerns for the most part. However, the SOP is expected to provide a more detailed explanation of these requirements.

With respect to Recommendation 1D, the Investment Division believes the regulations address the levels of impairment that allow for imposition of Restricted Operations. These can be referenced in the SOP. The regulations do not require the placement of an SBIC into Restricted Operations even if the SBIC meets the threshold level spelled out in the regulations. That is a discretionary action on the part of the Agency. The decision is made only after the consideration of a multitude of factors, which are spelled out in the checklist used by analysts. The question of how long a SBIC should remain in Restricted Operations is a complicated one, particularly without any context, as it would be dependent upon the financial condition of the SBIC and the trends under which it has been operating. The SOP will provide as detailed guidance as possible given the subject. However, the SOP will not be a substitute for the detailed, comprehensive analysis that an analyst would provide. Similarly, the SOP will outline the remedies that the regulations provide. However, the SOP cannot confer new or additional remedies than the ones permitted by statute or regulation. Finally, we do not believe that the forbearance regulations generally preclude the imposition of Restricted Operations as stated in your report. Forbearance mentioned in 107.1850 does not preclude the imposition of Restricted Operations (except as noted below), it raises the threshold level of capital impairment before a SBIC can be considered capitally impaired for Restricted Operations purposes. In 107.1850 (c) the SBIC is allowed additional time to not be considered capitally impaired if it provides additional collateral for the leverage provided by the Agency.

-----Original Message-----
From: Hudson, James W.
Sent: Friday, May 09, 2003 9:10 AM
To: Pierson, Jeffrey D.; Haskins, Harry E.
Cc: Cole, Robin O. (O'Neal)
Subject: Response to SBIC Oversight Audit Report

Good morning gentlemen.

I am trying to synopsize your comments into the audit report and I need clarification for some of the responses. Please respond to the following questions as soon as possible.

- for recommendation 1A, your response states that you will provide support for the forbearance periods but it does not specifically say you will provide support for the impairment percentages. Do you intend to provide support for the impairment percentages or is it your position that support is not needed?
- for recommendations 1C and 1D your response states that you will be revising SOP 10 06, but the response does not state whether you agree that the points listed in the recommendations will be included in the revision. We need to know if these points will be included in the revision. If only some of the points will be included, we need to know which ones, and why the others will not be included.

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