

GAO

Testimony

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House of Representatives

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# SMALL BUSINESS ADMINISTRATION

## Status of Small Business Investment Companies

Statement of Jim Wells, Associate Director,  
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Madam Chair and Members of the Committee:

We are pleased to be here today to discuss the Small Business Administration's (SBA) Small Business Investment Company (SBIC) and Specialized Small Business Investment Company (SSBIC) programs. Licensed and regulated by SBA, these investment companies are privately owned and managed firms that provide funding to small businesses through equity investments (stock purchases) and loans for starting, modernizing, or expanding operations. SBICs and SSBICs use their own funds and funds obtained by borrowing at favorable rates with an SBA guarantee and/or by selling preferred stock to SBA. SSBICs, which are generally smaller firms, must fund only businesses owned by socially or economically disadvantaged persons. At the end of fiscal year 1994, 186 SBICs and 94 SSBICs provided \$947.8 million in financial support to small businesses under the two programs.

Over the years, we have reported on problems with SBA's oversight of the SSBIC program, such as inadequate documentation of eligibility and prohibitive financial transactions of the program's requirements. You asked us earlier this year to begin a comprehensive assessment of the SBIC and SSBIC programs. At your request, our testimony today, which is based on our ongoing work and our preliminary findings, will focus on SBA's oversight and examinations, licensing, and liquidation. We will also address the implementation of the Three Percent Preferred Stock Repurchase Program.

In summary, we have found the following:

- SBA identified 111 SBICs and SSBICs that are active or currently in liquidation that have engaged in regulatory violations and misconduct, such as giving loans improperly to business associates and making prohibited investments in real estate. At least 20 licensees or their small business investments are currently under investigation either by the

SBA Inspector General or the Justice Department for criminal misconduct.

- SBA successfully increased the frequency of examinations of SBICs and SSBICs--from every 22 months to every 14 months on average. In 1994, 220 examination reports cited 552 violations, and problems that were unresolved from one examination period to the next. Furthermore, the current placement of the examination function--in the office that also manages the programs--may impede its independence.
- Under recently revised procedures intended to strengthen its program, SBA licensed 37 new SBICs but no new SSBICs. The new SBICs are heavily capitalized--with an average of about \$16.1 million in private funds compared to earlier averages of \$4.8 million.
- The 192 SBICs and SSBICs currently in liquidation owe SBA \$790 million, of which the agency projects to recover \$443 million, or 56 cents on the dollar.
- Finally, under the stock repurchase program, 15 SSBICs have repurchased \$41 million (par value) in preferred stock from SBA for \$14 million. The Congress authorized SBA to allow repurchase at a price less than its par value.

SBA has responded to many criticisms of the SBIC and SSBIC programs in recent months by changing its rules, regulations and procedures to focus on licensing larger, better capitalized, and more experienced applicants. SBA officials believe that these recent front-end changes will go a long way to ultimately strengthen the program and reduce its loss rates in the future. Because these changes are relatively new, it is too early to measure their impact.

## BACKGROUND

The SBIC and SSBIC programs, administered by SBA's Investment Division, are the federal government's vehicles for making financing and management assistance available to small businesses that historically may not have been able to obtain financing from either conventional lending institutions or private venture capital firms. SBA points out that a number of major U.S. companies trace their initial financing to SBICs, including Apple Computer, Federal Express, and Intel Corporation. In providing this financing, SBICs and SSBICs use their own private funds and moneys guaranteed by SBA. The law requires SBICs and SSBICs to have a minimum of \$2.5 million and \$1.5 million in private capital, respectively. SBA can provide leverage of up to \$3 for every \$1 of the private capital for an SBIC and \$4 for an SSBIC.

The Offices of Operations, Examinations, Licensing, and Liquidation are all in SBA's Investment Division. Analysts in the Operations office monitor, regulate, and provide operational assistance to SBICs and SSBICs. The Examinations office was created in 1992, when the Congress transferred responsibility for periodic examinations of SBICs and SSBICs from the Office of Inspector General (OIG) to the Investment Division.

The Office of Licensing, in April 1994, began using revised procedures for licensing SBIC and SSBICs. The changes were intended to strengthen the licensing process and provide a greater assurance that licensees would be successful. The Liquidation office oversees the disposal of assets of failed SBIC and SSBICs that are placed in liquidation by SBA for willfully or repeatedly violating the program's requirements; surrendering their license when they cannot repay funding owed to SBA; or voluntarily assigning their assets to SBA in exchange for forgiveness of the debt owed to SBA. The disposal of assets may be done through a receivership or directly by SBA.

According to SBA, over the past 35 years, the SBIC and SSBIC programs have provided approximately \$12 billion in financing to over 75,000 small businesses, and have created over a million jobs in the manufacturing and service sectors of the economy.

PROHIBITED BUSINESS PRACTICES  
HAVE OCCURRED AT SBICS AND SSBICS

In March 1994, our Office of Special Investigations reported on an SSBIC that engaged in prohibited transactions, including giving loans to the owner's business associates, making loans for purchasing real estate, and providing loans to business ventures owned by individuals with questionable eligibility.<sup>1</sup> At our request, SBA examiners identified 111 SBICs and SSBICs--half active and half currently in liquidation--that have engaged in regulatory violations and misconduct, including the following examples:

- One SBIC was cited in three examinations since 1990 for having financial and operating interests in real estate, oil, and gas ventures--all prohibited investments. The SBIC anticipates executing a divestiture plan in March 1995.
- Another SBIC knowingly submitted false and misleading financial information to SBA. The SBIC is in liquidation and SBA expects to lose over \$700,000.
- The president of one SBIC and his family charged over \$200,000 in personal expenditures to the SBIC's travel and entertainment account. The SBIC is in liquidation, and SBA expects to lose \$2.2 million.

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<sup>1</sup>Small Business Administration: Inadequate Oversight of Capital Management Services, Inc.--an SSBIC (GAO/OSI-94-23, Mar. 21, 1994).

- One SSBIC financed a small business that was owned and managed by an associate. An earlier examination cited a similar conflict-of-interest financing to the same small business. The SSBIC is in liquidation.
- Another SSBIC made a \$260,000 loan to a liquor store owner, part of which was used to purchase a \$250,000 home. This SSBIC is in liquidation and SBA expects to lose \$1.6 million.

At least 20 SBICs, SSBICs or their small business investments are currently being investigated by the SBA Inspector General or the Department of Justice for criminal misconduct, including food stamp fraud and money laundering. In large part, these prohibited business practices occurred because of problems in the programs' oversight and licensing. Because SBA has made recent changes in these areas, we are continuing our review to assess the potential impact of these changes in preventing future problems of this nature.

#### SBA'S OVERSIGHT OF SBICS AND SSBICS

The Offices of Operations and Examinations are currently responsible for overseeing the SBIC and SSBIC programs. Since 1992, when the examination function was moved out of the OIG, the frequency of examinations has steadily improved--from every 22 months to every 14 months on average and the goal is to examine each SBIC and SSBIC in which SBA has a financial interest once a year. The examiners, in fiscal year 1994, reported over 500 regulatory violations.

## The Organizational Placement of Examinations May Impede Independence

While we found no indication of efforts to restrict or influence examinations, the current organizational placement of the Office of Examinations within the Investment Division, with all examiners responsible to the Associate Administrator for Investment, may create a question about its independence. The Associate Administrator for Investment is also responsible for all other aspects of the SBIC and SSBIC programs, including licensing and monitoring. As head of the division that administers the SBIC and SSBIC programs, the Associate Administrator is the advocate for the programs--internally to SBA and externally, to the small business investment communities.

Since the ultimate responsibility for ensuring that examination findings are adequately resolved rests with the Associate Administrator for Investment, this arrangement may not be the most appropriate to ensure that examinations are conducted in an independent environment.

## Violations Are Reported But Many Go Unresolved

In fiscal year 1994, the Office of Examinations issued 220 reports citing 167 SBICs and SSBICs for 552 violations of 36 different regulations. The greatest number of violations--79--were related to the SBICs' and SSBICs' internal controls. Other frequently cited violations involved prohibited uses of funds, conflicts of interest, and not having or following portfolio valuation procedures.

Over the 12 months ending February 28, 1995, 136 reported violations were unresolved from previous examinations. For example, two separate examination reports cited an SBIC for failing

to maintain adequate controls over portfolio valuations. As a result, the SBIC may have materially overstated the value of its portfolio and therefore, failed to notify SBA of its regulatory capital impairment. In another instance, an SSBIC had an outstanding violation for making a loan to a former board member to pay personal income tax, within 6 months of the board member's resignation. This same SSBIC in consecutive examinations was cited for providing financing to a business owner who was not a member of a designated disadvantaged group.

Relating to this issue, SBA is having trouble verifying that the SBICs and SSBICs invest in businesses that meet the program's eligibility criteria. SBA does not collect data on the gender, ethnicity, or economic status of the small businesses in the SSBICs' portfolios. In April 1994, we reported that SSBICs often do not comply with SBA's guidance for documenting the eligibility of the small businesses they finance.<sup>2</sup> We estimated that for more than a third of all the small businesses financed, SSBICs did not prepare eligibility profiles to document that the businesses were owned by persons who were socially or economically disadvantaged. SBA officials told us that forms have been designed to better collect this information; the revised forms are currently being reviewed by the Office of Management and Budget.

#### CHANGES IN SBA'S LICENSING PROCEDURES

The procedures used by SBA to license an SBIC or SSBIC before 1994 focused little attention on the background and expertise of the prospective licensee. SBA's April 1994 new licensing procedures encourage admission to the program for more highly capitalized and experienced applicants. For example, the 37 SBICs licensed under

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<sup>2</sup>Small Business Administration: Inadequate Documentation of Eligibility of Businesses Receiving SSBIC Financing (GAO/RCED-94-182, Apr. 26, 1994).



the new procedures averaged \$16.1 million in private capital compared with an average of \$4.8 million at the beginning of fiscal year 1994. While it is too early to tell for certain, these changes are intended to create a more financially stable class of SBICs and SSBICs and reduce SBA's losses.

#### No SSBICs Were Licensed in 1994

The 1972 amendments to the Small Business Investment Act of 1958 require that SSBICs invest only in small businesses owned by persons whose participation in the free enterprise system is hampered because of social or economic disadvantage. But neither legislation nor SBA's regulations define social or economic disadvantage--though SBA has established criteria for determining whether a small business is socially or economically disadvantaged.

The need for a definition of participants in the SSBIC program was a reason that SBA officials cited for the establishment of an advisory committee of experts to review all aspects of the program. The committee is expected to report its findings and recommendations in May 1995.

#### LIQUIDATION RECOVERIES ARE PROJECTED TO DECLINE

Since December 1966, 584 SBIC and SSBICs with funding of \$1.18 billion owed to SBA have been transferred to the Office of Liquidations. Of the 192 SBICs and SSBICs currently in liquidation, owing \$790 million to SBA, SBA projects to recover 56 cents on the dollar. In contrast, SBA recovered 70 cents on the dollar in prior years from completed liquidations.

In May 1993, we reported that most SBICs entering liquidation were not in compliance with SBA's regulations pertaining to overall

financial performance.<sup>3</sup> Specifically, 81, or nearly two-thirds, of the 126 SBICs that entered liquidation between January 1986, and March 1991, did so because (1) their losses, in comparison to their private capital, exceeded an acceptable level (capital impairment); (2) they defaulted on their agreement for repaying funds owed to SBA; or (3) they were bankrupt. In other instances, liquidations occurred because SBICs voluntarily surrendered their license to withdraw from the program or committed regulatory violations such as making ineligible investments.

Most Future Losses Are Projected  
From SBICs and SSBICs Liquidated  
Through Receiverships

A receivership is a process by which the court takes control of assets. SBA places SBIC and SSBICs in receiverships when officials determine that the receivership process is the most appropriate means to recover SBA's money. The receivership process is done under court order in which a U.S. District Court generally appoints SBA as receiver to sell off the assets of the SBIC and SSBIC.

As of December 31, 1994, 71 SBIC and SSBICs with \$264 million in funding from SBA were in receivership. These companies account for \$146 million, or 42 percent, of the losses SBA expects to incur from all of those currently in liquidation.

Under the receivership process, SBA as receiver retains independent contractors on a noncompetitive basis to operate the receivership, but in some instances, SBA staff operate the receivership. Receivership contractors are generally paid out of funds generated from the liquidation of the investment company's assets. With the permission of the receiver, the contractors

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<sup>3</sup>Small Business: Financial Health of Small Business Investment Companies (GAO/RCED-93-51, May 5, 1993).

generally hire accountants, lawyers, auctioneers, and others needed to carry out the liquidation. All other creditors of the SBIC or SSBIC and all receivership expenses are paid before SBA receives any proceeds.

The receivership process can be lengthy, costly, and in some cases not financially beneficial because often SBA does not know the extent of the SBICs/SBICs financial strengths or the extent of other creditor at the time it must make a liquidation decision. Of the 71 SBICs currently in receiverships, 23 have been in receiverships for 5 or more years--2 have been in receiverships for over 25 years. One SBIC we reviewed was placed in receivership in April 1984 to recover SBA's investment (including interest) of \$7.8 million. The receivership received an advance of \$30,000 from SBA to conduct the receivership. The final receivership report submitted to the court in May 1993, showed that the contractor incurred cost of \$103,900 and recovered \$115,300, which left a net balance of \$11,400--not enough to cover the \$30,000 advance SBA made to the receivership. Most assets of this SBIC were found to be worthless or uncollectible. In another instance, a receivership contractor incurred \$70,000 in expenses to liquidate assets of an SBIC that owed SBA over \$1 million; the receivership recovered only \$79,000.

Liquidation Can Occur Through  
Transferring Assets to SBA  
Involve Numerous Asset Write-Offs

SBICs and SSBICs that voluntarily assign their assets to SBA for liquidation account for \$63.8 million, or 18 percent of all losses expected from the investment companies currently in liquidation. Under this approach, SBA assumes ownership of the investment company's assets in exchange for forgiving the outstanding debt owed to SBA. According to SBA officials, this approach is preferred when they believe the cost of liquidating through a receivership may outweigh the benefits.

Assigned assets often include unsecured notes and equity investments in small, closely held businesses, neither of which are readily marketable. In the case of securities, often the only course is to sell the securities back to the small businesses. SBA acquired 759 assets from 55 SBICs and SSBICs as of December 31, 1994. Of these assets, 529 have been identified as potentially having no value and may ultimately be written off as uncollectible.

According to SBA officials, SBA is not able to recover its funding from assigned assets because in many instances the assets are not worth as much as originally claimed by the SBIC and SSBIC or the assets no longer exist. Since SBA does not normally gain access to an SBIC's or SSBIC's financial records when asset assignments are made, it has no way of knowing whether the investment company fully disclosed all of its assets.

#### THE THREE PERCENT

#### PREFERRED STOCK REPURCHASE PROGRAM

In November 1989, Congress authorized SBA to allow SSBICs to repurchase from SBA, at a price less than its par value, their outstanding preferred stock held by SBA.<sup>4</sup> In 1992, SBA announced the start of the Three Percent Repurchase Pilot Program, stating that the primary purpose of the program was to maximize the capacity of SSBICs to provide financing to businesses owned by persons whose participation in the free enterprise system is hampered by social or economic disadvantage. In addition, SBA stated that its policy was to be executed without providing windfall opportunities to SSBICs, their management or owners, and without encouraging the transfer of

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<sup>4</sup>In 1972, Congress authorized SBA to purchase 3 percent preferred stock from SSBICs at par value with no mandatory redemption requirement. The SSBICs were not required to pay SBA accrued dividends on this stock; although distribution to other shareholders cannot be made until those dividends are paid. On November 21, 1989, Public Law 101-162 authorized SBA to establish a repurchase program.

cash from SSBICs into SBA to the detriment of the program's effectiveness and liquidity.<sup>5</sup> As part of the pilot, SBA offered the stock repurchase program to nine SSBICs, six of which participated.

In April 1993, the then-Associate Administrator for Investment established a committee to evaluate the operation of the pilot so that the agency could establish final regulations to implement the program. The two major issues under discussion were the price of the repurchase and the eligibility of "non-distressed" or financially healthy, SSBICs for the program. The committee held its last meeting in June 1993. In September 1993, after the Administrator and other SBA officials met with industry representatives, the Administrator decided to go forward with the stock repurchase program and opened the program to all SSBICs without further input from the committee.

The terms of the program provide that all SSBICs can repurchase their 3-percent preferred stock at 35 percent of its par value and that only distressed firms would be forgiven the accumulated dividends at the time of the repurchase agreement. As of January 1995, 15 SSBICs (including the 6 in the pilot) had purchased \$41 million in 3-percent preferred stock from SBA for \$14 million. In addition, the 15 SSBICs were forgiven \$14 million in accumulated dividends.

To date, neither we nor SBA has analyzed the financial operations of all the SSBICs that participated in this program and therefore we cannot determine whether the program has achieved its objective of generating new capital for investment in businesses owned by disadvantaged persons.

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<sup>5</sup>At the initiation of the pilot, it was estimated that approximately \$153 million of 3 percent preferred stock was outstanding to 75 SSBICs, with accumulated dividends of approximately \$35 million.

This concludes my prepared remarks. We look forward to continuing our work with the Committee. Madam Chair, we will be pleased to respond to any questions that you and other Members of the Committee may have.

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