

Understanding The Uses Of Idle Funds Under SBIC Program

By **Bryan Bylica and Philip Kassel** (May 18, 2023)

In the first half of 2023, there has been a significant disruption in the U.S. and larger worldwide banking systems, highlighted by three of the largest bank failures in U.S. history — First Republic Bank, Silicon Valley Bank and Signature Bank, among others. This was followed by UBS, with the backing of the Swiss government, agreeing to acquire Credit Suisse, a designated global systemically important bank by the Financial Stability Board.

The banking crisis is ongoing and continues to make headlines as many regional banks in the U.S. have experienced sharp declines in their share prices following downgrades by credit rating agencies and clients withdrawing funds in favor of the perceived safety of larger financial institutions.

These failures have brought to the national attention the significance of insurance limits on deposit accounts at financial institutions, as the Federal Deposit Insurance Corp. only insures balances up to \$250,000. But as these failed banks have demonstrated, financial institutions often have a significant percentage of their depositors exceeding such insured limits.

In light of this ongoing economic turmoil and the significance of FDIC insurance limits on deposit accounts, it is important for fund managers operating under the Small Business Investment Company, or SBIC, program and their attorneys to review the permissible uses of so-called idle funds by SBIC funds and related requirements and implications.

The U.S. Small Business Administration, the federal agency that administers the SBIC program, has promulgated regulations that restrict the ventures that SBIC funds may undertake with their idle funds, defined as the funds that the SBIC fund does not currently have actively invested into qualifying small businesses.

Importantly, the restrictions on idle funds in the SBA regulations only apply to leveraged SBIC funds — and those that have applied for SBA leverage. If an SBIC fund does not have any outstanding leverage with the SBA and has not applied for SBA leverage, it is not subject to such requirements regarding their use of idle funds.

Under Title 13 of the U.S. Code of Federal Regulations, Section 107.530(b), leveraged SBIC funds must maintain idle funds in at least one of the following:

- Direct obligations of, or obligations guaranteed as to principal and interest by, the United States, which mature within 15 months from the date of the investment.
- Repurchase agreements with federally insured institutions, with a maturity of seven days or less. The securities underlying the repurchase agreements must be direct obligations of, or obligations guaranteed as to principal and interest by, the United



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States. The securities must be maintained in a custodial account at a federally insured institution.

- Mutual funds, securities or other instruments that exclusively consist of, or represent pooled assets of, investments described above.
- Certificates of deposit with a maturity of one year or less, issued by a federally insured institution.
- A deposit account in a federally insured institution, subject to a withdrawal restriction of one year or less.
- A checking account in a federally insured institution.
- A reasonable petty cash fund.

As is apparent in the above requirements, the SBA puts an emphasis on maintaining idle funds with properly insured financial institutions.

Although, even if the SBIC maintains its idle funds at federally insured institutions in accordance with the above, it must only do so under the federally insured limits at such institutions.

However, a leveraged SBIC fund may deposit idle funds in excess of the insured amount at a financial institution and still comply with the above requirements, but only if the bank is "well capitalized" in accordance with the FDIC regulations, per Title 13 of the Code of Federal Regulations, Section 107.530(c)(1).

In addition, the SBA regulations also allow an SBIC fund to make a temporary deposit up to 30 days in excess of the financial institution's insured amount in a transfer account specifically established to facilitate the receipt and disbursement of funds by the SBIC fund.

An insured depository institution is "well capitalized" if it significantly exceeds the required minimum level for each relevant capital measure, according to Title 12 of the U.S. Code, Section 1831o(b)(1)(A).

According to the FDIC regulations, a well-capitalized financial institution will have a total risk-based capital ratio of at least 10%, a tier-one risk-based capital ratio of at least 8%, a common equity tier-one risk-based capital ratio of at least 6.5%, and a leverage ratio of at least 5%, among other requirements, per Title 12 of the U.S. Code of Federal Regulations, Section 324.403(b)(1)(i).

For reference, an "adequately capitalized" financial institution — defined as a financial institution that meets the required minimum for each relevant capital measure under Title 12 of the U.S. Code, Section 1831o(b)(1)(B) — is defined as having a total risk-based capital ratio of at least 8%, a tier-one risk-based capital ratio of at least 6%, a common equity tier-one capital ratio of at least 4.5%, and a leverage ratio of at least 4%, per Title 12 of the U.S. Code of Federal Regulations, Section 324.403(b)(2).

Additionally, for an SBIC fund to maintain its active status under the SBIC program, the SBA regulations require that the SBIC fund's idle funds may not exceed 20% of the fund's total assets, per Title 13 of the U.S. Code of Federal Regulations, Section 107.590(a)(2).

An exception to this limitation exists if the idle funds are either (1) the result of the receipt, within the previous nine months, of realized gains, repayments, additional capital contributions or SBA leverage; or (2) it is necessary for the SBIC fund to maintain idle funds to conduct its operations because its unfunded commitments from its investors are less than 20% of its regulatory capital and the SBIC fund cannot receive additional SBA leverage solely because the SBA has insufficient funds available, per Title 13 of the U.S. Code of Federal Regulations, Section 107.590(b).

Due to the complex legal and financial requirements in the SBA regulations regarding the permitted uses of idle funds by SBIC funds, it is important for fund managers, their attorneys and advisers to not only know and comply with the permitted uses of such idle funds, but also conduct due diligence on the financial institutions in which it maintains its idle funds in order to ensure it is well capitalized within the meaning of the FDIC rules.

This is important because it is possible or even likely, depending on a financial institution's particular circumstances, that its deposits of idle funds will exceed the \$250,000 FDIC insurance limit.

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