November 3, 2015

Dear Representative,

On behalf of Americans for Financial Reform, we are writing to urge you to oppose HR 3868, the “Small Business Credit Availability Act”.¹ This legislation would deregulate Business Development Companies (BDCs) in a manner that would increase risk to retail investors and retirees by exposing them to greater leverage. Furthermore, other changes in the bill allow BDC funds to be diverted into other financial entities rather than used to fund the real economy small businesses that BDCs were created to support.

HR 3868 would make at least three major deregulatory changes in BDC oversight.

- First, the bill would double BDC leverage limits from the current 1-1 level (one dollar of borrowed money for each dollar of investor equity) to 2-1. In contrast, conventional closed-end mutual funds can only leverage 1-2, or borrow one dollar per two dollars of investor equity. Note that this fund-level leverage is in addition to the leverage that already exists in BDC portfolio holdings, due to investments in risky subordinated debt and structured products. For example, research from Wells Fargo shows that effective leverage at many large BDCs is already 5-1 or greater.² This means that a doubling of permitted regulatory leverage could lead to effective leverage of up to 10-1, or ten dollars in debt for each dollar in equity. These high leverage ratios expose retail investors and retirees to a greater likelihood of permanent investment losses.

- Second, the bill would divert BDC funds from operating companies into other financial entities. Currently, BDCs are required to invest 70 percent of their funds in ‘eligible portfolio companies’, meaning small or medium size operating companies with limited access to public markets. When Congress created BDCs, its intent was to provide funding for such operating companies, not financial firms. HR 3868 would reduce this requirement to from 70 percent to only 50 percent of funds. The legislation would thus permit BDCs to invest an additional 20 percent of their assets in financial companies such as broker-dealers, REITs, banks, consumer finance companies, leasing companies, and other financial entities. As financial companies tend to have higher leverage, this change would also increase total effective leverage of BDCs to even more dangerous levels.

¹ Americans for Financial Reform is an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of coalition members is available at http://ourfinancialsecurity.org/about/our-coalition/

• Finally, HR 3868 would force the SEC to expand permitted BDC ownership of asset managers and investment advisors. Ownership of asset managers by BDCs permits a serious conflict of interest in which BDC-owned investment advisors could steer customers into investing in the BDC which owns the asset manager. This conflict of interest would be difficult to manage in the best of circumstances, but HR 3868 does not grant the SEC a clear statutory mandate to control such conflicts of interest. Especially given the lack of clear SEC authority to address these conflicts of interest, we do not believe that Congress should mandate increased BDC ownership of asset managers or investment advisors.

BDCs are growing rapidly, with assets increasing from less than $23 billion in 2009 to almost $63 billion today. Since BDCs are heavily invested in leveraged loans and energy sector assets, which have lost value this year due to changes in commodity prices and poor underwriting, many funds are highly exposed to permanent losses. Many have delivered significant losses to retail investors and retirees already this year. While some BDC yields appear high, many BDC’s have had to cut dividends and analysts forecast additional dividend cuts in the near future. The fees BDCs charge investors are also much higher than those charged by other regulated funds. Average expense ratios for BDCs are well over 3 percent, versus 1 percent for high yield mutual funds and floating rate loan funds.

In light of the rapid growth, high risk, and excessive fees at most BDCs, we do not believe it is appropriate to deregulate these funds in order to permit additional borrowing. Such borrowing will only increase risks to investors. For example, a recent Fitch Ratings assessment stated that the current “strong regulatory framework, that limits the amount of leverage that can be assumed… is a key ratings consideration”. This implies that deregulation to permit additional leverage will lead to ratings downgrades, harming existing BDC investors.

If BDCs wish to attract more funds, they can do so by cutting their costs to investors in order to increase their value proposition and attract investment, rather than by additional borrowing. There is clear evidence that BDC’s with low fees and strong underwriting routinely trade at significant premiums to NAV, allowing them to grow by issuing equity capital in a manner that is accretive to existing shareholders. It is those BDC’s that have high fees or poor underwriting which find themselves unable to raise additional equity capital to increase their lending. Giving these funds the ability to add more leverage is likely to further harm retail investors and retirees.

In addition, we do not believe that the deregulation in HR 3868 will produce significant benefits to the small and middle market operating companies who were the motivation for creating BDCs as an investment class. Since HR 3868 would substantially increase the amount of investment permitted in financial entities, funds from additional borrowing are likely to flow to other financial entities rather than real economy operating companies.

Thank you for your consideration. For more information please contact AFR’s Policy Director, Marcus Stanley at marcus@ourfinancialsecurity.org or 202-466-3672.

Americans for Financial Reform

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