Industry Canada Industrie Canada

Supporting Small Business Innovation:

Review of the Business Development Bank of Canada

Canada

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Executive Summary

The Business Development Bank of Canada (BDC) is a Crown corporation dedicated to providing financial and consulting solutions that meet the needs of small businesses. It was created in 1995 by an Act of Parliament that streamlined and modernized the structure and mandate of its predecessor, the Federal Business Development Bank (FBDB). The purpose of the BDC remained essentially the same as that of the FBDB: to support Canadian entrepreneurship by providing financial and management services. The principal changes in the new Act involved transforming the role of the BDC so that the Bank would be a complementary source of small and medium-sized enterprise (SME) financing, and giving the Bank the power to provide financial and management services jointly with other institutions.

Section 36 of the *Business Development Bank of Canada Act* states that five years after it comes into force, and every 10 years afterward, the designated Minister — the Minister of Industry — must have a review of the provisions and operations of the Act undertaken in consultation with the Minister of Finance. Within one year after the review is undertaken, the Minister of Industry must submit a report to Parliament on the review. As such, the Minister of Industry respectfully submits to Parliament this report summarizing the results of the research and consultations undertaken in support of the review. Once the report is tabled, the BDC Act stipulates that it must be reviewed by a parliamentary committee.

The development of this report was led by a committee with members from Industry Canada, the Department of Finance Canada, the Treasury Board of Canada, Secretariat and the BDC. The research and consultations focussed on trends and developments in the last five years in the small business financial marketplace. The goal was to look at the marketplace gaps identified in 1995 — the risk, size, flexibility and knowledge gaps — and to gauge how relevant they remain today. The BDC's structure and mandate were designed to help the Bank fill these gaps, as were the provisions of the BDC Act itself. A continued existence of these gaps would indicate a continued need for the BDC within the financial services sector.

The review also focussed on the performance and operations of the Bank over the review period as it migrated from being a "lender of last resort" to a "complementary lender." The key question was the Bank's ability to balance its public policy mandate with its mandate to operate as a commercial institution — to earn a rate of return at least equal to the federal government's cost of funds.

Research Results and Recommendations

This report concludes that small businesses continue to face significant difficulty accessing the kinds of financing they need for growth. This conclusion refers to both the Bank's traditional clientele and to young, knowledge-based, fast-growing businesses. SMEs make significant contributions to Canada's gross domestic product, economic growth and job creation. However, most of Canada's SMEs continue to lag behind their U.S. counterparts in adopting new technology, processes and practices, which partially explains, among other things, Canada's ongoing "innovation gap." Access to appropriate term financing is a critical factor in being able to adopt new technology, and there is a strong public policy rationale for maintaining a Crown corporation dedicated to serving the financing and consulting needs of Canadian SMEs. Therefore, the BDC's continuing objective — to serve the emerging capital needs of SMEs that have difficulty obtaining financing from traditional sources — remains a highly relevant ongoing public policy objective.

As a complementary lender, with a commercial mandate and a public policy role, the BDC will pioneer new services in Canada and fill marketplace gaps that prevent SMEs from reaching their full economic potential. The Bank will do so while serving segments of the market that are currently under-served by the private sector. These market segments cover all regions of the country, and include Aboriginal, women and young entrepreneurs; cultural industries; and tourism.

The question of whether the BDC's legislation needs significant amendments has also been considered. The conclusion is that since Canadian SMEs continue to face underlying marketplace gaps and since during this period the BDC has had sufficient tools to implement its objectives, no substantive adjustments are required to its legislation.

Over the last five years, the BDC has developed a strong foundation that can now benefit its clientele, including both knowledge-based industries (KBIs) and traditional firms across the country. At the core of the BDC's offering lies its ability to provide case-by-case financing, consulting and mentoring. Considering that it is a long-term financial services provider, five years is a relatively short time frame within which to assess the impact of its contribution to economic development.

The BDC's Outlook

To contribute to the government's objective of making Canadians more innovative and competitive in the knowledge-based economy, the Bank must continue to ensure that SMEs have options when they seek business advice or financing. Given that new technologies and the globalization of markets are creating an increasingly competitive environment for SMEs, it will be more important than ever that this critical segment of the economy be equipped with the tools to continue to play a leading role in Canada's innovative economy.

To deliver properly on its mandate, the BDC will have to adjust its service offerings to the evolving needs of targeted SMEs, including the young, fast-growing, knowledge-based firms whose risk and credit profiles fall outside the scope of most private sector institutions. The BDC must do this while also serving the needs of its traditional clientele. The Bank's relevance will be determined by its ability to adapt to changes in the marketplace and to create value for its customers and its shareholder.

Customer focus will remain at the core of BDC operations. The BDC, with approximately 2 percent of the term lending market in terms of number of clients and 5 percent of the venture capital market in terms of number of transactions, is a niche player and must stay focussed to be successful. Its success will continue to depend on its ability to have a value proposition that fulfils the needs of its clients. The Bank will also develop the capability to understand how customer experience is determined and how best to adjust and continue to provide personalized services whereby the client feels the Bank and its staff understand his or her uniqueness.

To deliver on its mandate while balancing its public policy role with its role of operating in a commercially responsible manner, the Bank aims to be more efficient and effective in its operations and to apply proven business principles that have led to its success in serving Canadian SMEs. To ensure the commercial viability of the institution, the BDC will strive to achieve a financial performance that allows it to generate a return at least equal to the long-term cost of shareholder funds. This objective is key to the BDC's delivering on its public policy mandate while generating sufficient earnings to sustain future growth. Highlights of its financial performance are noted below.

As the Bank responds to SME financing demands over the next 5 to 10 years, it will continue to refine its credit system to accommodate new demands and changes in the SME environment. Furthermore, recognizing that it has a relatively risky portfolio that could be more seriously affected during economic downturns, the Bank will ensure that its reserves for losses are fully adequate to cover write-offs through all economic cycles.

Highlights of Financial Performance: 1995–96 to 1999–2000

The BDC has earned a rate of return greater than the government's cost of funds over the review period. These earnings have supported the continued growth of the Bank and a growing stream of dividends for the shareholder. To sustain the strong growth of the institution since 1995, the federal government has made additional investments in the BDC by purchasing $230 million in dividend-paying preferred shares.

As well, the BDC:

- provided lending solutions to more than 30 000 SME clients over the review period;
- paid a total of $24.3 million in dividends to the government;
- established provisions for losses that should ensure that the Bank will be able to weather an economic downturn without seeking assistance from the shareholder;
- eliminated, in fiscal year 1997–98, parliamentary appropriations to support provision of management services to small businesses;
- provided a combination of financing and consulting services to almost 1200 clients in fiscal year 1999–2000; and
- established more than 40 alliances with other financial institutions and with private, government and other organizations to expand BDC's reach among SMEs.

In the Loans Group:

- there was a 69-percent increase over the review period in loans committed to BDC clients;
- the total amount of new loans authorized by the BDC during fiscal year 1999–2000 was $1372 million, an 88-percent increase over the amount of new loans that were authorized during fiscal year 1994–95 ($729 million);
- of the loans authorized in fiscal year 1999–2000:
  - 10 percent were authorized to KBIs and 34 percent to exporters;
  - BDC loans complemented $1266 million of financing from other sources, bringing the total value of SME projects financed to $2638 million; and
  - 56-percent were for amounts under $100 000 and 88 percent were for amounts under $500 000.

In the Venture Capital Group:

- total venture capital commitment was $44 million to 36 SMEs in fiscal year 1994–95;
- in fiscal year 1999–2000, the Bank authorized 62 investments for $63 million, bringing the Bank's total venture capital commitment outstanding to $195 million; and
- BDC investments in fiscal year 1999–2000 leveraged another $301 million in investments from other sources, representing a 4.8 investment ratio.

In the Consulting Group:

- more than 30 000 clients have been served since 1995;
- the service offering was completely revamped to focus on value-added consulting services related to quality, growth (e.g. Growth Potential Assessment), export and e-business; and
- the national network of private consultants was streamlined to better meet the needs of Canadian SMEs.

These results demonstrate that the BDC has implemented the transition from being a "lender of last resort" to being a "complementary lender." It has delivered on its mandate to support Canadian entrepreneurship by providing financial and management services. The Bank has become a complementary source of SME financing and has provided financial and management services jointly with other institutions.

Structure of the Report

The report has three main parts. Part I reviews the activities and performance of the BDC between fiscal years 1995–96 and 1999–2000. Part II presents and discusses the conclusions and recommendations based on the research and consultations. Finally, Part III deals with the outlook for the BDC over the next 10 years and provides perspectives on how the Bank will continue to fulfil its mandate, a task that will include increasing its reach to SMEs across the country, addressing the needs of developing markets, and supporting Aboriginal, women and young entrepreneurs.

Part I

Provisions and Operations of the BDC Act

1995–2000

1.0 Introduction

The *Business Development Bank of Canada Act* (BDC Act) was passed by Parliament in July 1995. Section 36 of the Act states:

> ***36.*** *(1) Five years after this Act comes into force, and every ten years afterward, the Designated Minister must have a review of the provisions and operation of this Act undertaken in consultation with the Minister of Finance.*
>
> *(2) Within one year after the review is undertaken, the Designated Minister must submit to Parliament a report on the review.*
>
> *(3) The report must be reviewed by any committee of the Senate or of the House of Commons, or any joint committee, that may be established for the purpose of reviewing the report.*

As such, the Minister of Industry respectfully submits this report.

The Review

This review was conducted in consultation with an interdepartmental committee composed of representatives from Industry Canada; the Department of Finance Canada; Treasury Board of Canada, Secretariat; and the Business Development Bank of Canada (BDC). It includes various studies and analyses of BDC operating data. The studies include the 1999 special examination of the Bank's operations carried out by the Auditor General of Canada in collaboration with the firm of KPMG. The examination assessed BDC's performance over the previous five years in the context of its governing legislation and operating mandate.

This review also includes the results from two independent studies of the Canadian small and medium-sized enterprise (SME) financing market. The first study, conducted by the Angus Reid Group, looked at the market from the perspective of SMEs. The second, conducted by SECOR, looked at the same market from the perspective of financing suppliers. In addition, various existing data, such as the Canadian Bankers Association (CBA) data on SME loans and the findings of the MacKay Task Force on SME financing in Canada, were used in the review.

This first part of the review presents the provisions and operations of the BDC Act between fiscal years 1994–95 and 1999–2000. It begins with a discussion of the main events leading to the passage of the Act in 1995. It then presents the principal features of the BDC Act and its mandate, discusses how the Bank has responded to these changes and the demands of its SME customers, and summarizes the results of the recent special examination of the Bank.

2.0 A New Mandate: Response to the SME Financing Challenges of 1995

In 1994 much attention was focussed on the challenges facing small businesses in accessing the financing they needed in order to grow. Ministers recognized the importance of small business to job creation and growth, and committed to improving the environment for small businesses through the reshaping of policies and programs, including those designed to improve access to financing. A first step was to look at existing mechanisms for supporting small business, like the Federal Business Development Bank (FBDB — the predecessor of the BDC), and to determine how they might be reworked to better respond to the needs of small business.

The 1994 federal budget noted the major role of chartered banks in providing financing for small businesses and challenged them to be more innovative and aggressive. The government also called for a review of the FBDB, stating that the institution needed to evolve with changing small business needs and the business environment. Since its establishment in 1975, the FBDB had become one of the federal government's primary policy instruments for responding to the financing and management services needs of small business. However, in response to increased globalization, a rapidly evolving financial services sector, a growing demand for venture capital, and the shift from a resource-based economy to a knowledge-based economy, it became necessary for policy makers to revisit the Bank's role.

Also in 1994, the House of Commons Standing Committee on Industry (Industry Committee) conducted an extensive review of the SME financing environment, which led to the tabling, in October 1994, of a report entitled *Taking Care of Small Businesses*. The report presented findings from the Industry Committee's inquiry into access by small and medium-sized businesses to traditional and new sources of financing. In exploring the question of the perceived scarcity of credit and its causes, the Industry Committee recognized the more demanding economic environment for small businesses of the early 1990s.

The Industry Committee made a series of recommendations for improving SME access to financing, particularly stressing the need for improved relations between chartered banks and their SME clients. The Industry Committee made a key recommendation that dealt specifically with the FBDB and echoed the direction indicated in the federal budget earlier that year — that the mandate of the FBDB be confirmed and refocussed as a complementary lender for SMEs, and that the FBDB be authorized to use new financial instruments to fulfil its mandate.

The federal government undertook this review using a framework consisting of four identified gaps in the financing marketplace for small business relating to risk, size, knowledge and flexibility. These are discussed in section 4.0.

Given the scope of these gaps, it was clear that government policy or programs could not address all the issues — nor should they — but there was a role to be played with respect to financial market leadership and innovation. To respond to this challenge a "refocussed" mandate for the FBDB was established that outlined the public policy goals of the institution, streamlined its capital structure, and clarified its nature as a commercially driven institution required to earn a rate of return at least equal to the federal government's cost of funds. The newly mandated BDC was to move from being a "lender of last resort" to being a commercial financial institution that offered products and services complementary to those offered by traditional financial institutions. It was to become a path breaker, introducing new approaches to addressing the identified market gaps. Bill C-91, the *Business Development Bank of Canada Act,* was introduced in Parliament in 1995. The Act received royal assent and came into force July 13, 1995.

Under the new name, the goals of the institution were to:

- increase activity in smaller loans, higher-risk term lending and venture capital (with an emphasis on deals under $1 million);
- increase activities in "Patient Capital" and working capital financing;
- focus on knowledge-based industries (KBIs) without abandoning traditional sectors of the economy; and
- find a balance between the BDC's public policy mandate and its requirement to be a commercial financial institution.

The main purpose of establishing the BDC as a complementary financial service provider was to create a bank that would operate where the market failed to provide access to financing for promising ventures — not competing with private sector lending institutions but focussing on market gaps. The Bank was encouraged to increase cooperation and build partnerships to fulfil this mandate of complementarity.

In 1995, analysts and policy makers were beginning to see the importance of KBIs in terms of competitiveness and productivity growth. A key to the success of the sector would be to have investors operating across the entire spectrum of business development — from start-up through growth, consolidation and globalization. Innovation became key in designing products and services for this sector, given that KBIs posed important SME financing challenges due to the lack of tangible assets to support traditional bank loans. SMEs from this sector were looking for equity, or at least for financing that would be structured around flexible and innovative equity or debt instruments, such as seed or venture capital. Small businesses involved in knowledge-based or highly technical and specialized areas (e.g. bio-technology) found it particularly difficult to obtain equity financing. This difficulty was compounded if the firm required investments of less than $1 million or was located outside major business centres.

The government determined that the BDC could provide leadership in filling the gap by designing and implementing services targeted to the needs of this sector. A refocussed BDC would be in a position to offer equity financing and new innovative financing techniques aimed particularly at the smaller end of the market, where the risks were seen to be the greatest, and at KBIs that had to move fast to create market share. The BDC was also positioned to establish a team of experienced venture capitalists specializing in knowledge-based and highly technical areas and willing to enter into deals of less than $1 million. It is important to note that the BDC's mandate continued to include products and services required by the Bank's more traditional clientele — businesses other than KBIs that nevertheless represented more risk than most private sector lenders were comfortable investing in.

The BDC's challenge was to direct its new strategic vision into an action plan, to build partnerships, and to develop products and services to better serve small business. As demonstrated in the following sections, major hurdles had to be surpassed to turn the FBDB, an institution that had incurred significant losses in the past, into a profitable gap filler with specialized expertise to meet the needs of the knowledge-based economy.

3.0 Principal Features of the BDC Act

The 1995 BDC Act streamlined and modernized the former *Federal Business Development Bank Act* (FBDB Act), which was enacted 20 years earlier. The new Act also continued basic commercial features of the former Act, some with only minor changes. The following section will provide a brief overview of the principal features of the BDC Act.

BDC Powers and Mandate

Section 4 of the Act states:

> ***4.*** *(1) The purpose of the Bank is to support Canadian entrepreneurship by providing financial and management services and by issuing securities or otherwise raising funds or capital in support of those services.*
>
> *(2) In carrying out its activities, the Bank must give particular consideration to the needs of small and medium-sized enterprises.*

The purpose of the BDC remained essentially the same as that of the FBDB, that is, to support Canadian entrepreneurship by providing financial and management services. While the FBDB Act stipulated that the Bank was to focus on small businesses, the BDC Act extended this focus to include medium-sized enterprises.

Subsection 14(1) of the Act specifies the powers of the Bank:

> ***14.*** *(1) The Bank may make loans to, or investments in, any person, or give guarantees in relation to any person.*

Subsection 14(2) explicitly allows the Bank to provide financial and management services jointly with other institutions, public and private. This power did not exist in the FBDB Act; each initiative with other institutions had to be evaluated on a legal basis to determine compliance with the relatively restrictive Act.

Subsection 14(3) continues one of the main features of the FBDB Act, allowing the Bank to provide financing only in cases where the enterprise is expected to prove successful and where there is continuing commitment to the enterprise by its owners.

One of the principal features of the BDC Act is subsection 14(4), which specifies that the financial services offered by the Bank are to be complementary to those offered by commercial institutions:

> *(4) The loans, investments and guarantees are to fill out or complete services available from commercial institutions.*

To accomplish this, the Bank has designed its business solutions to complement those of commercial financial institutions, and the main financial institution of each client is notified of his or her approach to the BDC. The new role has led to more efficient service and a high level of satisfaction among Bank clients.

Finally, section 17 of the Act specifies the management services that can be offered by the Bank:

> ***17.*** *The Bank may provide, or enter into agreements for the provision of,*
>
> *(a) business planning services;*
>
> *(b) management counselling and training, including seminars, conferences and meetings; and*
>
> *(c) information.*

The BDC Act continued to allow the Bank to provide management services but removed the requirement that the services complement those offered by the private sector. As will be shown later, these services are offered by private consultants who comprise the network established by the BDC and are focussed on specific areas.

In addition to the provisions laying out the new BDC mandate, the Act contains several important changes, as described below.

Name Change

The name of the Bank was changed to the Business Development Bank of Canada to reflect the streamlining and modernization of its governing Act.

Capital Structure

The Bank's capital base was restructured through the creation of various classes of capital. The Bank's capital now includes common shares and preferred shares that can be issued only to the designated minister to be held in trust for the Crown. The Act also allows for the issuance of hybrid capital to persons other than the Crown, with the approval of the Governor in Council on the recommendation of the Minister of Finance.

The Act stipulates that the total capital paid in to the Bank in the form of common shares, preferred shares, hybrid capital and any contributed surplus cannot exceed $1.5 billion. However, additional equity may be paid in to the Bank in the form of parliamentary appropriations.

Capital and Liability Ceiling

The BDC Act allows the Bank to lever its total equity by a factor of 12. In other words, with the appropriate approvals from the Minister of Finance, the Bank may borrow up to 12 times its equity for relending to its SME clients. In effect, the Bank's total financing to SMEs could reach $19.5 billion and it could surpass this amount if the Bank receives capital by way of parliamentary appropriations. This far exceeds the $3.2-billion financing ceiling in the FBDB Act, which had been reached in 1995.

The BDC Act also modernized the Bank's borrowing powers to allow it to use new financial instruments in capital and money markets. These instruments have allowed the Bank to reduce its costs and to ensure that it is not unduly exposed to risks in capital markets.

4.0 Operating Mandate

After establishing the BDC's legislated mandate in 1995, the government regularly refined the operating mandate for the Bank. These refinements were made through the BDC's corporate plans and ministerial communications (see Appendix I for copies of the 1997, 1998 and 1999 Minister's letters to the chairman). The principal features of the new operating mandate, which continues to govern the Bank's operations today, are as follows.

Fill the Four Gaps Identified in the Marketplace

The government instructed the BDC to complement financial services offered by commercial institutions. In this respect, the BDC was mandated to fill four financing gaps to compensate for market imperfections. These are:

- the risk gap, resulting from a general unwillingness of conventional lenders to provide financially riskier loans even at higher interest rates;
- the size gap, resulting from the higher relative costs involved in preparing and assessing small-amount business loans;
- the flexibility gap, resulting from the lack of flexibility in tailoring repayment terms and conditions to a company's growth and revenue streams; and
- the knowledge gap, reflecting lenders' reluctance to provide loans to KBIs because of entrepreneurs' lack of tangible assets to secure a loan and lenders' lack of industry knowledge.

To specifically address the knowledge gap, the BDC's mandate was modified to focus on the financing requirements of SMEs in KBIs and exporting, while continuing to support traditional sectors. This new focus was believed to be important in the context of an emerging new economy, the transformation to high technology- and information-based industries, freer trade within North America and globally, and greater potential for Canadian SMEs. To satisfy this aspect of its operating mandate, the Bank implemented a performance indicator with the aim of having 50 percent of all new financings go to KBIs and exporters over the long term. A list of those industries considered to be KBIs was developed in cooperation with Industry Canada (see Appendix II for details).

The KBI designation is based on work performed by the Organisation for Economic Co-operation and Development (OECD) in the 1980s and by Industry Canada economists in 1995. The list is two-tiered, with Tier I consisting of very high technology firms and Tier II of high knowledge firms. The designation applies mainly to industrial sectors that are among the top third of all industries in terms of their ratio of research and development (R&D) expenditures to sales, and to a lesser extent in terms of their human resources allocation (education level, number of knowledge workers and number of scientists). The Tier I component of the list is identical to the KBI definition list developed jointly by the Canadian Bankers Association (CBA) and the Industry Committee.

Provide Innovative Solutions to Canadian SMEs

Part of the BDC's mandate is to be a path breaker for the financial services industry in developing innovative solutions to meet small businesses' needs. A key part of this role is to experiment with new ways of improving access to financing and filling the gaps identified earlier. On the consulting front, the innovative solutions are aimed at addressing the specific emerging needs of fast growing SMEs. Adopting innovative approaches is an important component of the complementary role played by the Bank. If the BDC succeeds with these innovations, it will demonstrate commercial viability, thus encouraging the private sector to do likewise.

Increase Awareness of the BDC Among SMEs

With new governing legislation and a new name, the Bank was given the mandate to increase its awareness among SMEs. This aspect of the mandate reflects the need for SMEs to know what services the Bank can offer them.

Earn a Return on Equity

To ensure that the Bank operates on a commercial basis, its mandate requires it to earn a return on equity that is at least equal to the government's cost of capital. This part of the mandate recognizes that economic events and cyclical fluctuations can severely affect annual earnings. Accordingly, the Bank is required to ensure that it has prudent and sufficient allowances for loan and investment losses to sustain the adverse effects of a full economic cycle. This protects both the Bank and the shareholder from any potential shortfall in equity that could result in a requirement for an additional infusion of equity. The Bank is also required to maintain specific debt-to-equity ratios for different asset classes, and to reinvest retained earnings to further support Canadian small business by building up the Bank's equity base while continuing to earn an appropriate return on equity.

Revise Management Services

The Bank's mandate required the BDC to transform the Management Services Group to better respond to the evolving needs of small businesses. It also required the Group to operate on a cost-recovery basis over the long term, as government appropriations for the Group ceased in fiscal year 1997–98.

Establish a Charter of Client Rights and Create an Ombudsman Position

Consistent with recommendations contained in the report *Taking Care of Small Business* by the Industry Committee, the BDC mandate required the Bank to establish a Charter of Client Rights, incorporating standards for client service and information disclosure, and to appoint an ombudsman to monitor compliance with the Charter. Both the Charter of Client Rights and the ombudsman position were implemented soon after the mandate was received.

Provide Services to Aboriginal, Women and Youth Entrepreneurs

While the Bank is required to focus on KBIs and exporters without abandoning traditional sectors, the operating mandate also requires it to increase emphasis on the financial and management services needs of Aboriginal, women and youth entrepreneurs. To address this aspect of its mandate, the Bank has worked with various groups from these sectors and has implemented specific programs to meet their needs.

5.0 BDC Governance

Various mechanisms are in place to ensure accountability of Crown corporations such as the BDC. The most notable are the legislative and regulatory frameworks that centre on the *Financial Administration Act* (FAA) and the BDC Act. Together these define the overall governance structure of the BDC, including its audit and reporting requirements and its financial structure. The FAA requires that the monitoring and evaluation tools of the corporate planning cycle be available, as well as the annual report. The BDC Board of Directors is mandated to ensure accountability while also ensuring delivery of the Bank's public policy and commercial objectives. Internal to the Bank is the conflict of interest and ethics framework, which governs the everyday activities of the employees and sets the tone for corporate conduct.

Legislative and Regulatory Controls

The FAA outlines the specific control mechanisms that the government has put in place to ensure that all Crown corporations safeguard assets and manage resources economically and efficiently. These mechanisms include specific requirements of the audit cycle and the corporate planning process.

In addition to annual audits, the FAA requires that every five years the Auditor General of Canada carry out, with an outside auditor, a special examination of the financial and management control and information systems and management practices maintained by the BDC. The BDC is required to maintain these systems and practices in such a manner as will provide reasonable assurance that the assets of the Bank are safeguarded and controlled; that the financial, human and physical resources of the Bank are managed economically and efficiently; and that the operations of the Bank are carried out effectively.

The BDC Act outlines financial controls, such as the limit on borrowings and guarantees through the debt-to-equity ratio of 12:1; the powers and obligations of treasury activities; the rules relating to the issuance of shares and dividend payments; and the requirements for reporting, such as the 10-year mandate review and report to Parliament.

Corporate Planning

The government uses the corporate planning process as a mechanism to ensure that all Crown corporations adhere to their mandates. The process allows for an annual review of performance and a review of future direction through the five-year forecast. In its corporate plan the BDC lays out its objectives, its strategies for attaining these objectives and its financial plan for the period, including its borrowing plan. It also includes specific (quantified) performance targets that correspond to the Bank's mandate. This plan is reviewed by Industry Canada, the Department of Finance Canada and Treasury Board of Canada, Secretariat to ensure concurrence with the stated mandate objectives. It is then submitted to Treasury Board ministers for approval, based on the recommendation of the Minister of Industry and the concurrence of the Minister of Finance, and a summary of the plan is tabled in Parliament.

Annual Report

The BDC's annual report provides Parliament and the public with a review of all activities, along with financial statements. This provides an opportunity to report on the Bank's performance against the performance targets established in the annual corporate plans.

Board of Directors

The Board of Directors is composed of the Bank's chairperson, its president and no more than 13 other directors. The Board includes two representatives from the Public Service of Canada: the Deputy Minister of Industry and one of the heads of a regional development agency (the current representative is from Western Economic Diversification Canada).

Directors are appointed by the government to oversee the Bank's implementation of its mandate in light of the government's emerging public policy priorities. Board members are required to provide informed advice and guidance, to analyse and question the Bank's strategic direction, and to stimulate healthy debate and discussion. The Board is there to ensure the appropriate accountability of Bank management and to make decisions taking full account of the interests of the shareholder, the Government of Canada. A key challenge for BDC directors is maintaining a balance between the Bank's public policy and commercial objectives.

Conflict of Interest and Ethics Framework

In addition to the provisions of the FAA that deal with duties of directors and officers, the BDC Act (section 33) and internal guidelines also provide a series of measures to prevent potential conflict of interest arising from the conduct of the Bank's operations. Among other measures, the Act states that the Bank shall not grant a loan, investment or guarantee to a director or officer of the corporation. As well, directors who are related to a person applying for BDC assistance must not be present when the Board considers the application. Directors themselves are subject to restrictions on making and divesting of investments in companies in which the Bank has an interest.

The BDC has maintained internal guidelines, dating back to the early 1960s on how to handle requests or inquiries regarding financial and consulting services when these are made by a member of the House of Commons, a senator or a BDC director. The main goal behind these guidelines is to have full transparency of these interventions, specifically through written communications outlining the contact. The guidelines specify that such requests should immediately be reported to the Bank's corporate secretary. No application or amendment to existing credit may be authorized by a BDC representative who has been directly in contact with the person who has made the referral or intervention. When the contacts involve the president of the Bank, the president is required to inform the Bank's chairperson and the corporate secretary in writing. When the contact involves a senior BDC executive, the president is to be informed in writing. These guidelines were reviewed by the BDC Board of Directors in 1987 and again in 2001.

In addition to the provisions of the BDC Act dealing with conflict of interest, the Bank has implemented an internal code of conduct, which defines the manner in which all BDC employees are expected to conduct themselves in the pursuit of their work. BDC employees are expected to uphold the highest ethical standards so that the public has a high level of confidence in the integrity, objectivity and impartiality of the Bank. The code ensures that BDC employees act with honesty and integrity at all times, and share the organization's commitment to high legal, ethical and moral standards. All employees must acknowledge in written form their understanding of and agreement with the provisions of the code of conduct, and must renew this acknowledgment annually.

6.0 From Lender of Last Resort to Complementary Lender

To implement the provisions of the BDC Act effectively and to meet the requirements of its new operating mandate, the Bank had to make many operational changes. This meant changing the way business was done at the Bank, and developing new core capabilities to meet the requirements of the new mandate and address the needs of the Bank's SME customers, especially the non-traditional needs of sectors the Bank was now required to focus on.

The following section will briefly describe the major operational changes that took place following passage of the BDC Act: the implementation of new mission and vision statements, renewed customer focus and changes to delivery channels.

Mission and Vision

The road to becoming a complementary lender began with the adoption of a new mission and vision for the BDC. The Bank's mission is to help create and develop Canadian SMEs through timely and relevant financial and management services. The mission consists of seven sub-components focussing on clientele, products and services, human resources, organization, communications, partnerships and financial responsibility. The BDC's vision is to make a significant contribution to the success of dynamic and innovative entrepreneurship for the benefit of all Canadians.

Renewed Customer Focus

Making the transition from being a lender of last resort to being a complementary lender required a significant number of changes in the way the Bank was operating. The new mandate implied that the Bank now had to become an innovator, anticipating the needs of its SME clients, all the while achieving the operational excellence necessary to be able to interact with and complement other financial services providers. Many initiatives have been implemented since 1995 with one objective in mind: to meet the financing and consulting needs of Canadian SMEs.

The Bank updated its corporate performance indicators to add customer satisfaction as one of its primary operating objectives. By measuring customer satisfaction quarterly, the Bank could quickly make adjustments when warranted.

Customer Satisfaction

The 2000 customer satisfaction survey performed by an independent firm showed results that remained strong: 88 percent of BDC customers were satisfied (or very satisfied) with the overall service they received from the BDC. This is slightly higher than the 87-percent rate for the previous year. Most clients were satisfied with all aspects of the Bank's services except one — interest rates. About half of all loan clients expressed dissatisfaction with the level of interest charged on their BDC loans. While loan clients would like to have lower interest rates, the rates help to ensure the complementary nature of BDC's financing and to compensate for higher financing risks. Customers have also shown lower satisfaction in the area of loan turnaround time, with respect to processing and disbursements, as well as with account manager turnover. Nonetheless, 84 percent of all clients would recommend the BDC to others. The Consulting Group's overall customer satisfaction ratings reached 83 percent in fiscal year 1999–2000.

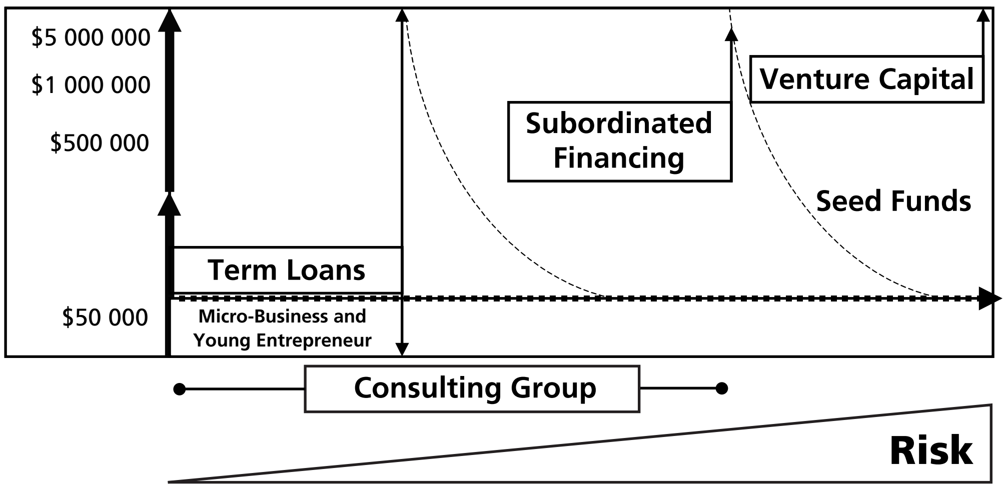
A similar measurement done by the Thompson Lightstone firm for Canadian chartered banks shows an average 69-percent customer satisfaction level among their SME clients.[1]

Responding to the Evolving Needs of SMEs: BDC Total Solution Package

Throughout its history, the BDC has been in the forefront of recognizing SME needs in the marketplace and addressing them with a variety of innovative solutions (e.g. venture capital in the early 1980s and the unique venture loan in the early 1990s). After receiving the new mandate in 1995, the Bank continued to build upon its small business expertise and revamped its product and service offerings to provide a total solution package of financing and consulting services for each stage of development of its small business customers. This innovation has allowed the Bank to fulfil its complementary role and to further address the four financing gaps in the marketplace. Figure 1 illustrates how the BDC total solution package is designed for each development stage.

1 Thompson Lightstone & Company Limited, *Small and Medium-Sized Businesses in Canada: An Ongoing Perspective of Their Needs, Expectations and Satisfaction with Financial Institutions* (1998), Volume I, p. 107.

Figure 1: Structure of BDC Total Solution



The new mandate in effect required the BDC to take on higher and different kinds of risks (these higher risks are compensated for by the higher interest rates the BDC charges for its financings). This meant financing young KBI companies with growth potential (often not readily evident) but with little or no track record and no tangible security to offer as collateral. For exporters it meant financing expansion and working capital that could not be provided by financial institutions. For Aboriginal and youth-owned businesses it meant providing flexible, less secure financing for fledgling businesses. For rapidly growing businesses, it meant providing working capital as a substitute for equity, through subordinated financing or working capital loans. For other businesses in traditional sectors, it meant providing financing to overcome difficult situations as well as providing unsecured financing. The following is a sampling of innovative business solutions the Bank has introduced since 1995, grouped in accordance with the relevant SME development stages.

Seed Stage

The BDC established four seed capital funds across Canada with various partners to finance the pre-start-up phase for young companies developing new technologies. This type of financing precedes venture capital financing, and remains very scarce in the Canadian financial market. A key feature of the funds is the management support they provide throughout the development stage. The BDC and its partners have invested a total of $112.5 million in four seed capital funds that are available across Canada.

Start-Up

Young Entrepreneur Financing Program

In response to the difficulties encountered by young entrepreneurs in finding adequate financing to launch their businesses, the BDC developed its unique solution, the Young Entrepreneur Financing Program. This program is aimed at giving the youth entrepreneur a solid foundation to build a new business by providing a package of term loans of up to $25 000 coupled with 50 hours of management support. The financing can be used to purchase assets, as working capital or to purchase a franchise. While this program focusses on youth-owned businesses, these businesses also have access to all other BDC financing solutions.

Micro-Business Loan

To better address the difficulty faced by Canadian SMEs in accessing small amounts of financing, the BDC developed the Micro-Business Loan program. This program supports the growth and development of some of the smallest innovative businesses by providing a total solution to their business needs. The program combines personalized management support with term financing of up to $50 000 for existing businesses and up to $25 000 for start-ups. To further support growth during the critical early years, the program also features two years of follow-up mentoring and management support.

Growth

Rapidly growing SMEs have special working capital needs. The BDC responded with the following solutions.

Innovation Loans

This is a special category of loans to help innovative businesses position themselves to take advantage of new markets and new technologies. The loans can be used for a variety of purposes, including developing or implementing an innovation strategy, conducting R&D, implementing quality management processes, providing bridge financing and filling shortfalls in working capital. Generally unsecured, these loans have flexible repayment terms and are available in amounts up to $250 000.

Techno.net Loans

Techno.net loans finance the costs of implementing e-commerce strategies without delay and without straining current operations. Their uses may range from establishing a Web site for the business to implementing a fully integrated business-to-business transaction site. These loans, which can vary from $25 000 to $500 000, may cover the costs of equipment, consultants and programmers, computer systems, marketing and advertising. The loans are generally unsecured and principal repayments begin only after the project is fully operational.

Productivity Plus Loans

Productivity Plus Loans are designed for manufacturing and processing companies that want to increase their productivity but need financing to acquire new equipment. To accommodate costs related to installing and assembling the new equipment, financing can be as high as 125 percent of equipment costs, up to a maximum of $5 million. Repayment terms are flexible and principal repayments can be postponed for up to 12 months to allow the equipment to reach optimal productivity.

Other Solutions

Growth Capital for Aboriginal Business
A program for Aboriginal-owned businesses provides loans for business start-up, the purchase of fixed assets or a franchise, and general working capital purposes. Financing can be up to $100 000 for existing businesses and $25 000 for start-up situations. Management support is also available through a special alliance with Canadian Executive Services Organization Aboriginal Services, including management counselling for the first two years following loan approval.

Tourism Investment Fund
The Tourism Investment Fund recognizes the long-standing support the Bank has provided the tourism industry over the years. In collaboration with the Canadian Tourism Commission, the Bank provides financing to acquire facilities to meet increased demand or to improve existing facilities to meet internationally competitive standards. Financing may also be used to bolster working capital, to improve employees' service skills, to enhance the use and quality of technology, to cover marketing costs, and to finance other initiatives to improve service and attract international visitors. Term loans of up to $10 million with flexible repayment terms are available from the fund.

Global Line of Credit
Offered through BDC Connex, the Bank's virtual branch, a Global Line of Credit can allow a client to expand his or her line of credit by $2000 to $50 000, depending on the company's stage of development and the owner's and company's financial situation. The line of credit, which is credit card-based, has no monthly or annual fee attached, nor are there any chequing fees.

Consulting Solutions

The BDC Consulting Group also revamped its integrated solutions in response to the Bank's new mandate and in order to better assist SMEs to improve their productivity. These solutions are focussed on four main lines of business identified as key areas for Canadian SMEs: growth, quality, exports and e-commerce. Several innovative solutions were introduced:

- **Growth Potential Assessment** provides small business owners with a comprehensive review of their firm's strengths and weaknesses associated with 16 major business elements.
- **Strategic Planning** services allow small business owners to develop comprehensive long-term action plans based on the company's strengths and market trends.
- The **Tech-Strategy** solution helps small business owners develop strategic and operational technology plans.
- The **ISO 9000, 14000** and **Hazard Analysis Critical Control Point** solutions allow small business owners to become accredited to satisfy most buyer quality standards or to address their environmental risks.

- The **New Exporter Program (NEXPRO)** and **market study** services allow small business owners to more effectively expand their markets.
- **E-Business** solutions allow small business owners to assess their e-commerce needs and to establish e-commerce strategies to take advantage of Internet-related technologies.

Customer Commitment: BDC TOTAL CARE Program

Another important action the Bank took to carry out its new mandate and renew its customer focus was to implement the TOTAL CARE (Customer Assistance, Resolution and Efficiency) program. The program is based on a detailed Charter of Client Rights outlining the standards the Bank has committed to meet. It also includes a process for the handling of customer complaints and offers the services of an ombudsman to monitor compliance with the Charter.

In handling complaints, the Bank pledges to respond quickly and fairly to client complaints, acknowledging them within two business days and keeping the client regularly informed regarding the resolution of the complaint. It is a progressive process that starts with the local branch, where the vast majority of complaints can be resolved. If an issue remains unresolved after this step, the client has access to an area vice-president and then to the Bank's ombudsman. An average of 84 complaints per year have been handled since the appointment of the ombudsman in August 1995. Of the complainants, 40 percent were satisfied with the resolution of the complaint, 27 percent acknowledged the Bank's position and 33 percent remained dissatisfied with the ombudsman's response.

To ensure fairness in difficult circumstances, the Bank provides access to an independent mediator. This voluntary process is available to any BDC client, provided the complaint is about the calling of a loan. The complaint-handling process must be followed beforehand, and the co-lender (if any) must also agree to the mediation. The mediation process can be initiated through the office of the ombudsman. Since 1995, only three clients have availed themselves of this service.

The elements and principles of the BDC's TOTAL CARE program are consistent with the recommendations contained in the 1994 report of the Industry Committee, entitled *Taking Care of Small Business*.

Under its Charter of Client Rights, the Bank pledges to provide high standards of conduct and exemplary service in all dealings with its clients. The Charter lays out the principles governing the Bank's relations with its clients. Among them are pledges to each client to:

- communicate in plain, understandable language;
- disclose client information only when permitted by law or with the written consent of the client, and otherwise to keep all such information confidential;
- provide clear concise information on how to apply for and access all Bank services;

- respond to all loan applications within 10 business days of receiving all required information (should there be a delay in processing the application, the client will be given the reason and informed when a response can be expected);
- issue a written letter of offer outlining in plain language the terms, conditions, security and fees applicable to each loan the Bank is offering;
- provide, under normal circumstances, at least 15 days, notice prior to calling a loan; and
- ensure that there are two levels of review before a loan is called.

The Charter of Client Rights is available to each client at any BDC office throughout Canada or on the Bank's Web site.

Changes to Delivery Channels

To meet the requirements of the new mandate, the Bank upgraded its delivery channels to support Canadian entrepreneurship. The Bank focussed on three core elements: the employees delivering the services, the Bank's multi-channel distribution network, and an increased awareness of the BDC.

Renewed Work Force

Given that BDC employees are central to the Bank's capability to deliver on its mandate and meet the needs of Canadian SMEs through quality customer service, the Bank undertook to upgrade the skill set of its staff, especially all front-line personnel. Starting with the recruitment process, the Bank set specific professional and academic qualifications for each position.

The Bank also moved to stem the number of departures of experienced employees and managers who were being attracted to other financial institutions. Compensation policies and practices were aligned with peer institutions to help the BDC retain qualified personnel and thus be able to deliver the Bank's mandate. As an example, the Bank implemented a performance pay mechanism that ensures that all employees have a proportion of their salary directly linked to their individual performance as well as to the overall performance of the Bank.

In 1989, the Venture Capital division put in place a Long-Term Incentive Plan (LTIP) to ensure that BDC compensation was comparable to the overall compensation package of its peers in the market. The objectives of the LTIP were to ensure market competitiveness so that the BDC could attract and retain competent and committed employees. While aiming to be market competitive, the BDC LTIP is at the lower end of comparable plans in the market and is more stringent. Payments, which began in 1996, are spread over four years (thus encouraging retention). They are more modest and provide smaller awards than are generally found in the market.

To constantly improve its employees' ability to better serve Canadian SMEs , the Bank implemented a number of internal training programs, focussing on better delivery of BDC business solutions and improved client relations. Building Relationships to Create Customer Value, Commercial Lending, Due Diligence, Venture Capital Approach to Financing, Working With People and Mentoring Training are examples of courses that BDC employees take each year. Consulting Group employees have completed, or are in the process of completing, training to obtain their Certified Management Consultant designation. During fiscal year 1999–2000, the Bank's employees pursued 3800 person-days of formal in-class training, for an average 3.3 days of training per employee. The Bank also offers an internship program to employees interested in diversifying their skills. In fiscal year 1999–2000, BDC invested twice as much as other financial institutions in corporate training per employee.

In addition, the Bank supports the personal development of employees interested in external continuing education, seminars and language training programs.

The Bank's human resources actions have paid off in terms of high customer satisfaction ratings and higher productivity. The Bank has almost doubled the volume of new financings between fiscal years 1994–95 and 1999–2000, with essentially the same number of staff members.

With its diverse internal programs that focus on having highly qualified staff who can deliver first-class customer service and who are recognized for their contributions to the Bank's overall results, the Bank reinforces its commitment to being an "employer of choice."

Multi-Channel Network

The Bank restructured its network soon after 1995 to ensure that Canadian entrepreneurs could reach the BDC via the branch network, through the virtual bank, or by phone or fax through the call centre. The new multi-channel structure of the Bank's delivery network was designed to ensure that decisions regarding clients were made with maximum local BDC input. A number of initiatives were also implemented with a view to increasing awareness of the BDC throughout Canada.

BDC Connex

As part of the on-line initiative launched by the federal government, the BDC was one of the first financial institutions to provide full electronic access to all its financing business solutions and services. Created in 1998, BDC Connex uses information technology to circumvent the time and location limitations of traditional banking. Through BDC Connex, SMEs anywhere in Canada have secured access to the BDC 24 hours a day, 7 days a week. This service is especially practical for SMEs in rural and remote areas and for entrepreneurs whose days are fully taken up with managing their business. At the end of fiscal year 1999–2000, Connex was involved in 30 percent of the Bank's lending transactions.

BDC Connex may be a virtual bank but it also has a human face as it is supported by the BDC call centre, which has handled more than 400 000 calls since its establishment in 1996. It is staffed with its own team of commercial financing professionals who will not only process loan applications but will also assist entrepreneurs in filling out the applications. If at any point a client prefers to deal face to face with a BDC officer, BDC Connex will assign a local BDC account manager to meet with the client. Through BDC Connex, SMEs can access financing from as little as $5000 to as much as $5 million.

Increased Awareness of the BDC

With a new operating mandate and a new name, the Bank developed and implemented a multi-faceted awareness campaign to increase awareness of its services and its visibility among SMEs. One element was a media campaign that involved not only placing advertising material in various media, but also arranging press interviews on SME matters and profiling clients. The media also provided wide coverage for BDC-related news such as new business solutions and services, financing activities and the Bank's Small Business Week activities. In another element of the awareness campaign, local BDC managers became more involved in community business associations and events, and sought out opportunities to present the Bank's services to local businesspeople.

To increase local visibility and accessibility to its services, the Bank expanded its branch network by opening 4 new offices, bringing the total to 85. It also moved branch offices from office towers to storefront locations in central business areas. Since 1995, 31 BDC branch offices have been moved to more visible locations.

With these initiatives, the Bank has increased its visibility and awareness among SMEs and has made its services more accessible. This increased awareness has also allowed Canadians to understand the Bank's role and mandate as a Crown corporation. The significant growth in BDC services, presented later in this review, is proof of this progress. Furthermore, an internal survey conducted for the BDC indicated that more than 90 percent of SME owners in Canada are very familiar (63 percent) or somewhat familiar (30 percent) with the Bank.

All of these changes were designed to enhance the Bank's capabilities so that it could satisfy all aspects of its new mandate. The next section of the review presents the results of these changes in the context of the Bank's mandate.

7.0 Assessment of BDC Performance: Achievements for 1995–2000

The BDC's mandate requires that its performance be considered from two major perspectives: the accomplishment of its public policy mandate to provide complementary services to small business and of its commercial mandate to earn a rate of return at least equal to the federal government's cost of funds.

This section deals primarily with the financial performance of the BDC since its new legislation was passed. Under the previous legislation, the FBDB was asked to recover the costs of the financial services that it provided. An ongoing subsidy supported the provision of management consulting services. However, under its new mandate the BDC was expected to operate its financial services on a for-profit basis and to move towards recovering the costs of its consulting services. These objectives have been met. The BDC has been profitable in each year of its operation, and while full cost recovery of the Consulting Group has not yet been achieved, the operating subsidy provided by the government for this service was eliminated in 1998.

The Bank's financial performance has shown that it can balance its public policy and commercial objectives. Through its successful implementation of a business plan based on complementing the services offered in the private sector while developing a particular expertise in serving knowledge-based and exporting small businesses, the BDC has demonstrated its public policy role. The BDC has demonstrated the commercial element of its mandate by achieving its return on equity targets and by paying dividends to the government since 1997.

Financial Performance

The BDC has earned a rate of return greater than the government's cost of funds over the review period. These earnings have supported the continued growth of the Bank and a growing stream of dividends provided to the shareholder.

Figure 2 shows that the BDC has had positive net income from its activities in each of the years since it was created. Figure 3 shows that return on equity has ranged between 3.2 percent and 18.7 percent, with three of the years producing returns of greater than 10 percent (note that as the BDC is not taxable under the *Income Tax Act*, all of these figures could be considered to be "before tax" for comparison with private sector companies). The large increase in profits in fiscal year 1999–2000 was due to the divestiture of a number of mature venture capital investments after investee companies had their initial public offerings. It should be noted that the review period 1995–2000 was generally a strong one for the Canadian economy. The BDC and its clients certainly benefited from these favourable conditions. The decline in the contribution of the Loans portfolio and the Consulting Group in fiscal year 1999–2000 was not due to any weakness in actual results, but due to a decision to increase the provision for loan losses by $33 million. This was mostly because of an increase in the general allowance for credit losses to better reflect general economic and business conditions as well as trends in the credit quality of the loan portfolio.

Prior to fiscal year 1997–98, the BDC had been receiving as much as $27 million per year in parliamentary appropriations to support provision of management services to small businesses. In fiscal year 1997–98, these appropriations were eliminated. Since then, the BDC has fully funded the investments required to transform these services as well as the Consulting Group's operating shortfall. Cost recovery has increased from 56 percent in fiscal year 1994–95 to 82 percent in fiscal year 1999–2000. Even though the prime objective of the Consulting Group is to assist SMEs to the greatest extent possible, the Group is nevertheless expected to fully recover all its costs in the medium term and to be financially self-sustaining thereafter.

The BDC has implemented a risk management strategy and has made prudent provisions for losses as demonstrated by the actions taken during fiscal year 1999–2000. These should ensure that it will be able to weather an economic downturn without seeking assistance from the shareholder. Final results for fiscal year 2000–01 (which ended March 31, 2001) are not yet available; preliminary indications are that it was a strong year.

Figure 2: BDC Net Income

Fiscal Years 1994–95 to 1999–2000

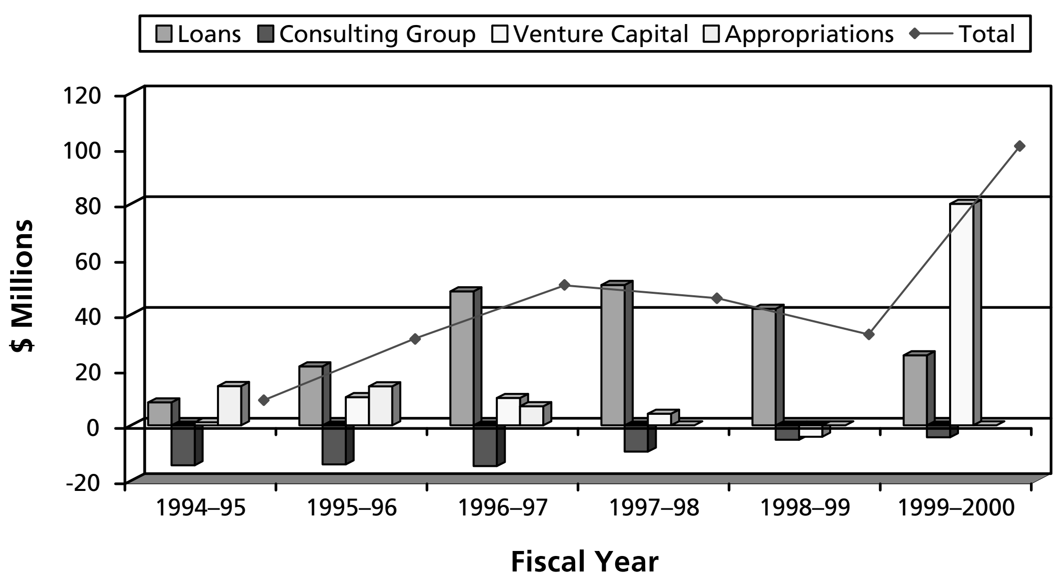
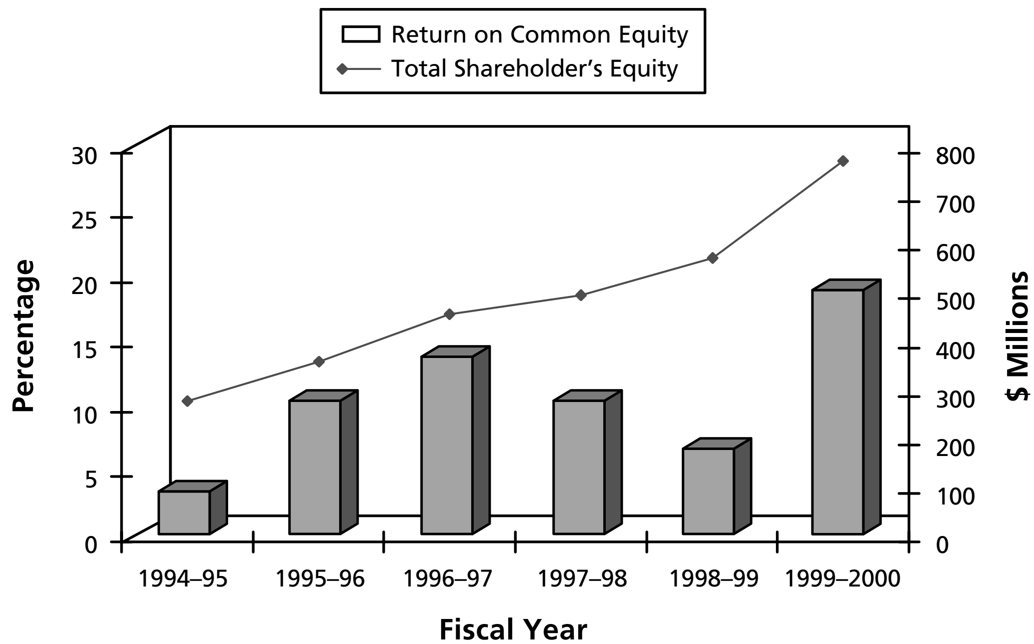


Figure 3 shows that the Bank has met its financial mandate with respect to earning a return on equity over the 1995–2000 review period.

Figure 3: Shareholder's Equity and Return on Common Equity

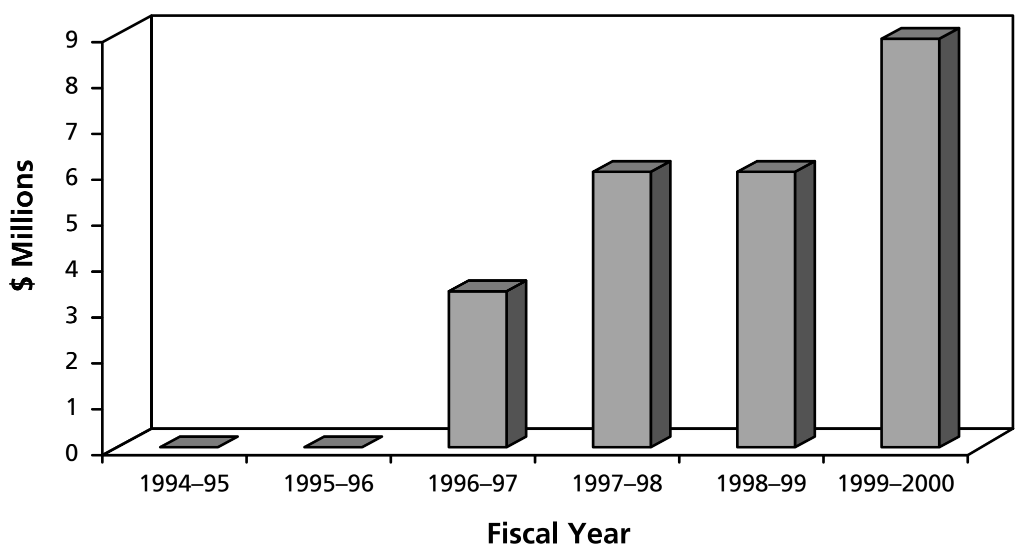
Fiscal Years 1994–95 to 1999–2000



The Bank's net income is applied to annual dividends to the government and to its capital base to support future growth in financing SMEs. As shown in Figure 4, the Bank has paid a total of $24.3 million in dividends to the government in the past four years.

Figure 4: Dividends Paid by the BDC to the Government of Canada

Fiscal Years 1994–95 to 1999–2000



BDC Capitalization

Under the BDC Act a new share structure was created. The equity of the former FBDB was converted into BDC common shares, which are held by the Minister of Industry in trust for the Crown. Since 1995, the federal government has been able to make additional investments in the BDC by purchasing $230 million in dividend-paying preferred shares. As the capital necessary to support the loan portfolio growth was self-funded from retained earnings generated by the Bank, most of the new capital was required to sustain the additional venture capital and subordinated financing provided to KBIs and high growth firms, given that these solutions are more capital intensive than traditional lending.

Divisional Results

The following section looks at the results achieved by BDC's three operating groups: the Loans Group, the Investment Group and the Consulting Group. The structure of this section is based on the components of the BDC mandate as laid out in the BDC Act and the operating mandate.

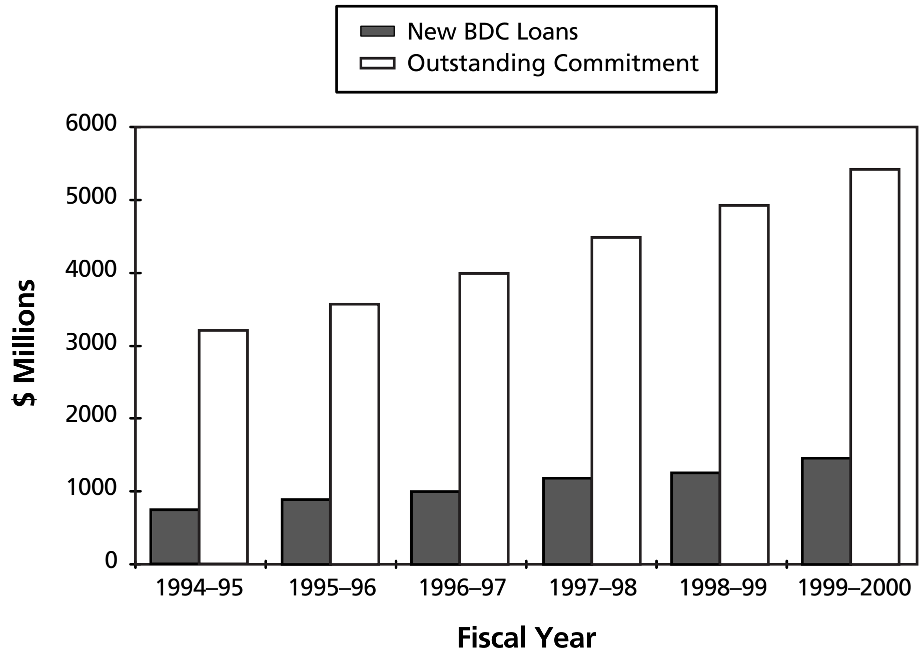
Loans Group

A new BDC Act, a new mandate, a modernization of the Bank's operations, favourable economic growth, and the development and adoption of new technologies by SMEs have collectively contributed to the recent significant growth in BDC lending. Since 1995, the BDC has provided lending solutions to more than 30 000 SME clients. The total amount of new loans authorized by the BDC during fiscal year 1999–2000 was $1372 million, an 88-percent increase over the amount of new loans that were authorized during fiscal year 1994–95 ($729 million) (see Figure 5). In fiscal year 1999–2000, BDC loans complemented $1266 million of financing from other sources, bringing the total value of SME projects financed to $2638 million.

With the steady growth in new loans, the Bank had $5446 million in loans committed to its clients at the end of fiscal year 1999–2000. As stated above, all of the capital necessary to sustain this growth was self-funded through retained earnings. This compares to $3215 million committed at the end of fiscal year 1994–95, just prior to the Bank receiving its new mandate — a 69-percent increase over the five-year period. When venture capital financing was added, the Bank's total financing commitment to Canadian SMEs amounted to $5641 million at the end of fiscal year 1999–2000.

Figure 5: Amount of New BDC Loans and Outstanding Commitment

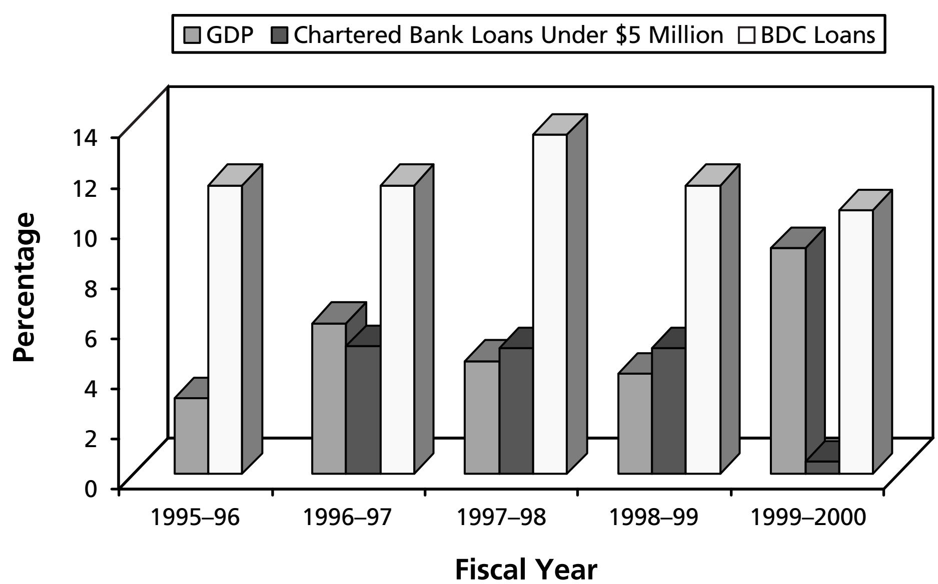
Fiscal Years 1994–95 to 1999–2000



For comparative purposes, Canada's gross domestic product (GDP) grew by 26 percent in current dollar terms over the 1995–2000 review period (see Figure 6). According to CBA statistics, over the 1996–2000 period, outstanding loans to SMEs by Canada's major chartered banks for amounts under $5 million grew by 16 percent.

Figure 6: BDC Financing Commitment, Chartered Bank Loans Under $5 Million and Canadian GDP Annual Growth Rates

Fiscal Years 1995–96 to 1999–2000



Note: Growth rates for chartered banks' loans are available only from 1997.

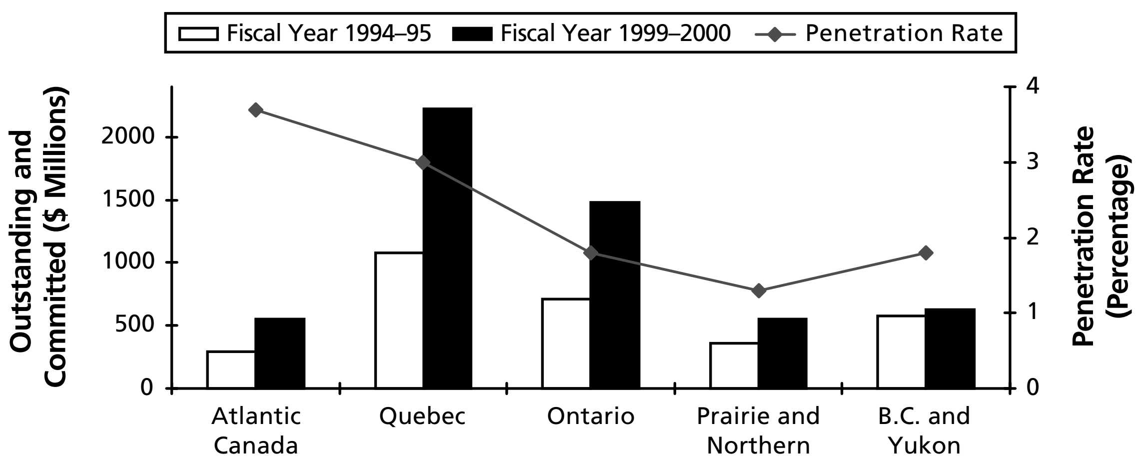
Geographical Distribution

The BDC is active in all regions of the country. Figure 7 shows two dimensions of the regional distribution of the Bank's activities. The solid bars show the total loans outstanding, by region, at the end of fiscal years 1994–95 and 1999–2000. There has been growth in all regions, but particularly in Quebec, Ontario and Atlantic Canada. Also shown in Figure 7 is the penetration rate, that is, the number of BDC customers as a proportion of the total number of small businesses in the region. By this measure, the BDC's presence is most significant in Atlantic Canada, followed by Quebec. The Ontario and the British Columbia and Yukon regions each have a 1.8-percent share of the market. The BDC has put a priority on expanding its activities in the West and in Ontario. The Bank has a strong market share in the more rural localities of the Yukon, the Northwest Territories and Nunavut.

Figure 7: Regional Distribution of BDC Lending Portfolio

Fiscal Years 1994–95 and 1999–2000

and Penetration Rate*

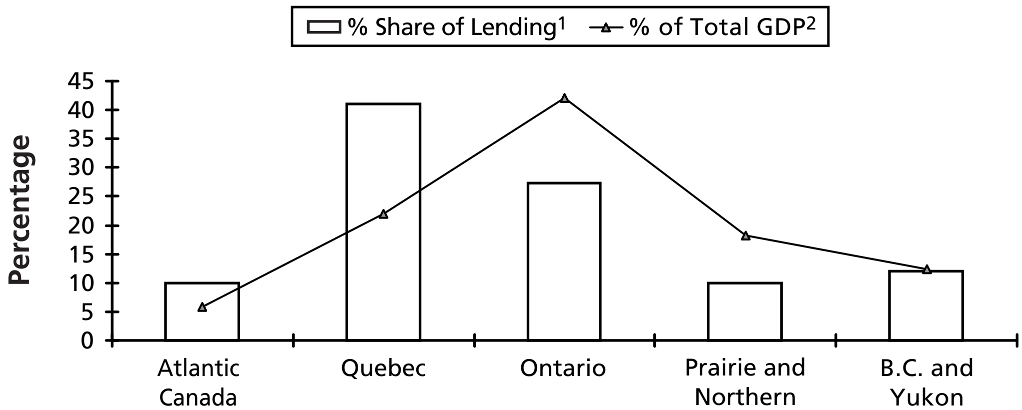


* Penetration rate based on Statistics Canada 1999 business registry data and number of BDC customers as at March 31, 2001.

Figure 8 shows the proportion of the portfolio by region in relation to the individual contribution to the national GDP. Quebec and Ontario have strong representation in terms of their economic contribution to GDP and in the BDC portfolio, representing 41 percent and 27 percent respectively of the BDC dollar portfolio at the end of fiscal year 1999–2000. While these provinces are well represented in the portfolio, it is interesting to note that in terms of market share, the BDC's penetration rate (see Figure 7) is not exceedingly high in either province.

Figure 8: Regional Contribution to Total GDP Compared With Share of BDC Lending Portfolio

Fiscal Year 1999–2000



Notes:

1. Percentage share of loans outstanding and commited, fiscal year 1999–2000.

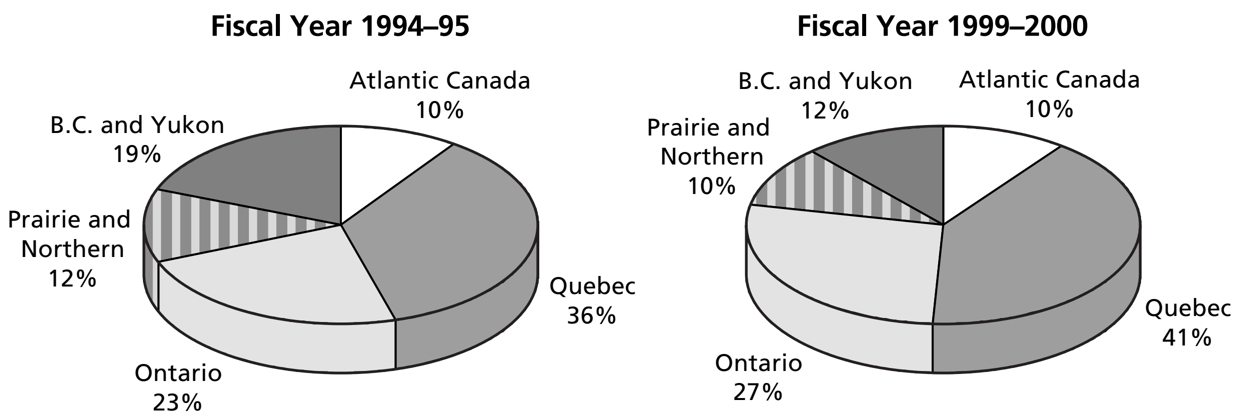
2. Regional contribution to total GDP at 1992 prices (1999).

The Western Canada proportion of the Bank's portfolio has not changed significantly over the last five years. However, in terms of market penetration in the region, the Bank has close to the national average in Manitoba, Saskatchewan and British Columbia. The Bank has recently implemented a number of initiatives in Ontario and the West to ensure that its presence reflects the nature of the Canadian economy. Early results of these initiatives demonstrate that the Bank's presence in these markets is growing.

Figure 9 shows the regional distribution of BDC loan clients based on amounts committed in fiscal years 1994–95 and 1999–2000.

Figure 9: Distribution of BDC Portfolio, by Region

Fiscal Years 1994–95 and 1999–2000



Achieving the Complementary Mandate

BDC lending activities aim to complement those of private financial institutions by filling in the four gaps that were identified in the marketplace. The BDC has developed strategies to specifically address those four gaps.

Filling the Four Gaps

The Risk Gap

Given its mandate, the BDC has over the years developed its capacity to underwrite credit applications that are beyond the risk appetite of many Canadian institutions. In this respect, the BDC is one of the few financial institutions in Canada interested in "pricing to risk" at interest rates exceeding the prime lending rate plus 300 basis points. Thus, the BDC has developed the expertise of its staff and embodied this knowledge into its credit assessment policies and analysis. The following are examples of BDC policies that allow consideration of transactions that are viewed as too risky by other institutions:

- taking less security and fewer personal guarantees;
- financing a higher percentage of a capital investment;
- financing start-ups;
- financing developing niches such as cultural industries, tourism and businesses run by youth, Aboriginal People or women;
- financing working capital needs on a long-term basis as opposed to a demand basis;
- financing small loans as business and not personal loans; and
- supporting subordinated-financing activities.

One of the main impacts of the riskier nature of BDC lending activities is that the Bank's loan loss experience (LLE) is at least double that of its industry peers, and can even be three times higher in riskier product categories.

In order to be financially sustainable and able to sustain this higher level of risk, the BDC has developed its expertise in ensuring that its interest rates adequately reflect the level of risk underwritten for each transaction. This has been an ongoing journey. The Bank has over a long period gathered data on its loan loss experience. For the past 16 years this activity has included matching loan losses to internal credit rating systems. Policies encouraged the principle of charging a higher interest rate variance for loans when the internal risk rating on individual loans indicated a higher risk of loan losses. This was formalized shortly after 1995, in that Bank budgets (segmented down to the branch level) not only included forecast risk levels but also stipulated average interest rate levels per risk rating group. Individual objectives and performance measures included this principle of pricing for risk. This was a long process because for several years the spread in interest rates between lower and higher risk loans was gradually increased to ensure that each risk rating level truly coincided with its projected loss rates.

This process was further improved in 1997 when a new risk rating system with more risk levels was implemented, thereby allowing more pricing levels to match the increased segmentation of risk levels.

A further major step forward was implemented in 2000 with the Bank-wide implementation of a Fair Pricing Tool. This internally developed software tool is based on an extensive study of loan loss experience, which quantified the internal risk rating system as well as numerous other factors that were statistically proven to influence risk. This tool now permits the Bank to price each loan for its myriad risk factors, as opposed to placing it in an overall risk group. The Fair Pricing Tool assigns a pricing element for a borrower based on each of the following factors:

1. overall internal credit risk rating;
2. borrower's profit level;
3. industry group;
4. stage of business development (e.g. start-up, growth, mature);
5. loan purpose (e.g. realty, inventory, equipment);
6. repayment period;
7. cost of capital required to fund the volatility of expected losses;
8. physical security level;
9. type of security; and
10. loan size.

Given that 50 million combinations are possible, it can be stated that the Fair Pricing Tool develops a price specifically tailored to the risk inherent in each individual loan.

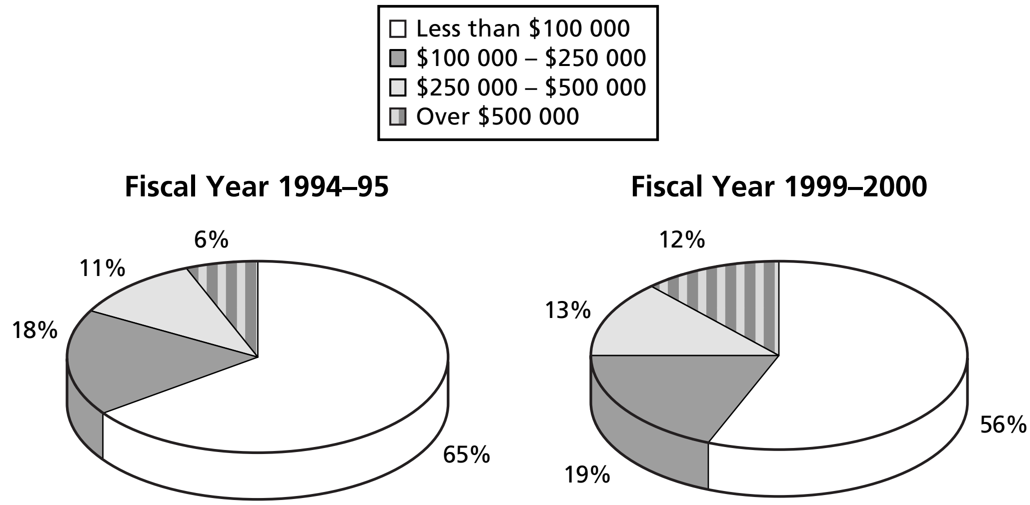
The Size Gap

BDC is one of the few providers of term financing in the early stages of a company's development. As will be shown later in this report, most Canadian financial institutions are moving away from term financing towards demand financing such as credit cards and lines of credit. In order to fill this expanding gap in the marketplace, the BDC has developed specific solutions and has adapted its distribution network to cater to the needs of small businesses in need of term financing below $250 000. The Bank fills the size gap by financing small businesses through dedicated Entrepreneurship Centres and by providing lending solutions that are supplemented with consulting mandates.

Figure 10 shows that the vast majority of BDC loans continue to be smaller than $100 000. In fact, 56 percent of all new loans authorized during fiscal year 1999–2000 were for amounts under $100 000, and 88 percent were for amounts under $500 000. Furthermore, the size distribution of BDC loans has not changed appreciably under the Bank's new mandate, especially after taking into account the higher levels of investment required by KBIs and exporters, and by SMEs generally, to remain competitive.

Figure 10: Distribution of BDC Lending, by Loan Size

Fiscal Years 1994–95 and 1999–2000



That being said, it is important to note that addressing the needs of this market segment poses a constant challenge to the BDC in terms of operating costs and efficiencies.

The Knowledge Gap

The evolution towards the knowledge-based economy poses a number of financing challenges. For instance, financial institutions are faced with the challenge of taking on assets that are increasingly intangible. How can one attach and realize the value of an intangible asset for which a market may not yet exist? How can a financial institution assess the industry risk and likelihood of survival if the industry itself is still in its infancy?

Having recognized these challenges, the government mandated the BDC to dedicate specific resources to KBIs and exporters with a view to ensuring that these businesses have access to the financing needed for creation and growth.

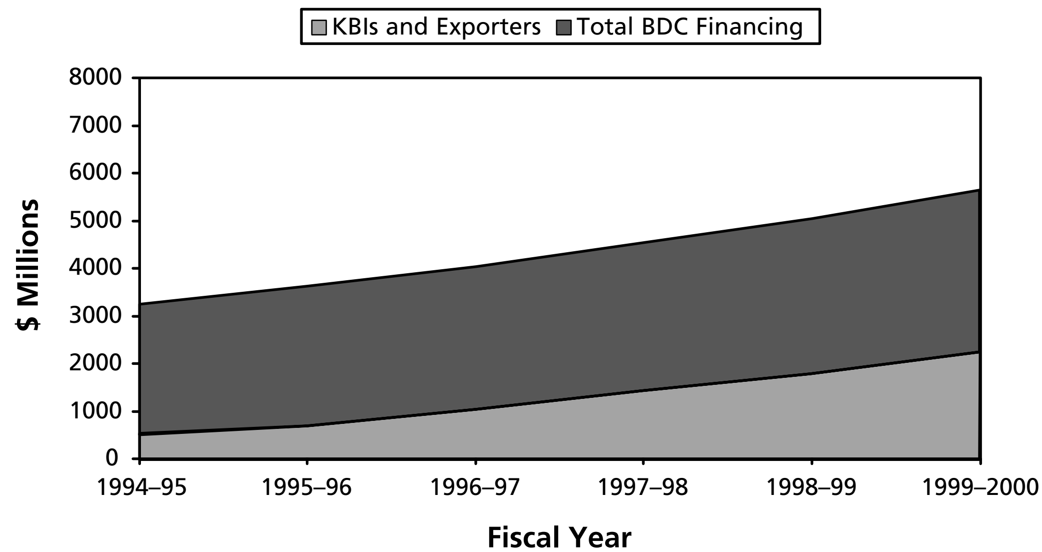
To deliver on this part of the mandate, the BDC had to develop internal competencies and know-how to properly serve these businesses. BDC employees received special training, and the support accorded to these businesses became a performance indicator for the Bank in 1997. The objective is to increase the share of total new financings to KBIs and exporters to 50 percent over the long term. Since fiscal year 1994–95, the Bank has made constant progress towards this objective in its loans operation, even as it has increased total new lending.

Of the total $1372 million in new loan authorizations made during fiscal year 1999–2000, $609 million (44 percent) went to KBIs and SME exporters. Of this amount $135 million (10 percent) was authorized to KBIs and $474 million (34 percent) to exporters. In comparison, the Bank authorized $729 million in new loans in fiscal year 1994–95, of which $155 million, or 21 percent, went to KBIs (6 percent) and exporters (15 percent).

As a result, the total amount of financing committed (loans and venture capital) to KBIs and exporters increased almost fourfold from $541 million in fiscal year 1994–95 to $2182 million in fiscal year 1999–2000 (see Figure 11).

Figure 11: Total Amount of BDC Financing Committed to KBIs and Exporters

Fiscal Years 1994–95 to 1999–2000

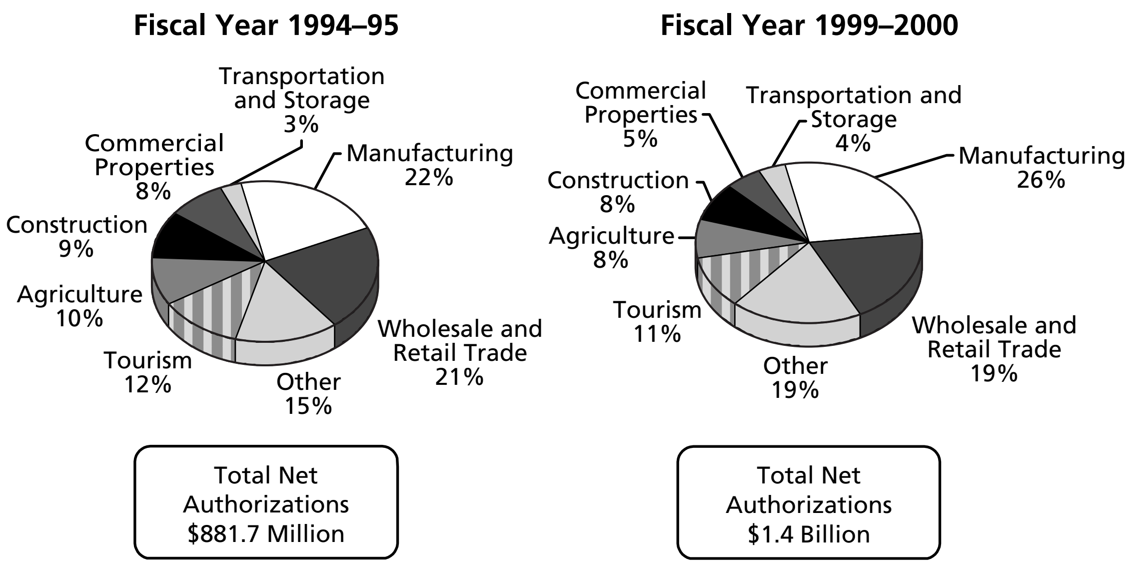


KBIs represent only 6 percent of all SMEs but they account for 10 percent of all new BDC financings. Among chartered banks, KBI lending accounts for about 2.5 percent of all SME lending (when comparing the Tier I component of the definition).

While the Bank has a mandate to focus on specific sectors, it also has to continue support to traditional sectors. Figure 12 shows the industry distribution of the Bank's lending portfolio as of the end of fiscal year 1999–2000. The breakdown of the Bank's lending activity by industry groupings has changed little since 1995: the majority of new BDC loans are extended to borrowers in manufacturing and wholesale and retail trade industries.

Figure 12: Lending Authorized, by Type of Business

Fiscal Years 1994–95 and 1999–2000



Note: "Lending Authorized" excludes Global Lines of Credit.

The Flexibility Gap

The BDC fills the flexibility gap by tailoring its individual financing packages to each of its clients. The BDC's project financing approach distinguishes it from other term lenders who rely on credit-scoring formulas to determine whether a loan should be granted. The Bank considers each business plan according to its merits. Flexibility in the BDC's terms and conditions also lets clients better manage their cash flows and increase their chances of success. Thus the Bank has had to make substantial investments in its technology platforms to be able to customize its applications to meet its clients' needs.

Initiatives Undertaken to Complement Other Institutions

The BDC has implemented a broad list of strategies to ensure that its services complement services offered by commercial financial institutions. These strategies are:

- encouraging more localized decision making and greater presence in rural areas;
- addressing cyclical situations;
- addressing the needs of developing niches such as tourism, cultural industries, and businesses run by youth, Aboriginal People, or women; and
- partnering with private, government and other organizations to meet the needs of SMEs and to increase BDC reach.

The following provides a brief description of the results achieved under each strategy.

Localized Decision Making and Rural Area Presence

In order to make the best credit decisions, the BDC has developed its branch network and authorizing structure so as to favour local decision making whenever possible. Consequently, nearly 90 percent of BDC credit authorizations are done at the local level. This ensures that local knowledge is used when assessing the risks associated with particular transactions. In many instances, this local knowledge makes the difference in approving a transaction.

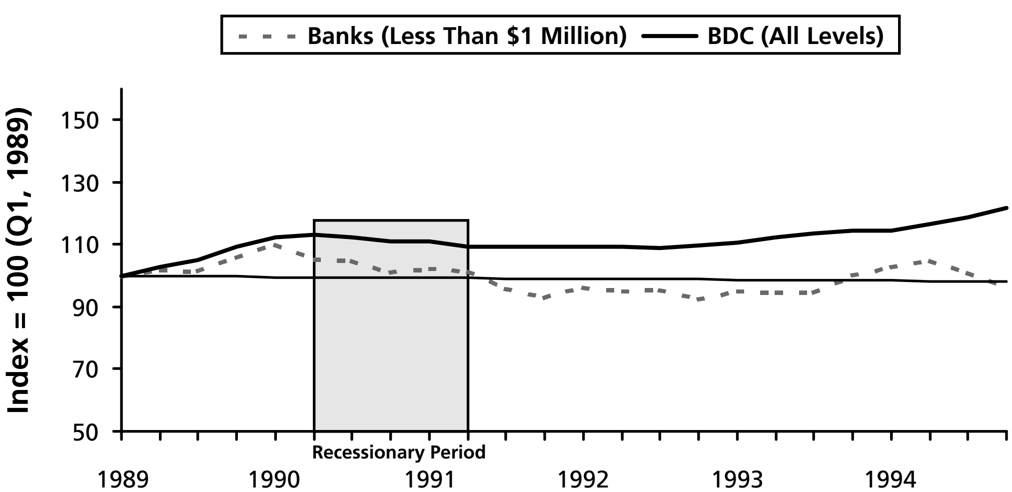
Throughout its history, the BDC has had significant presence in rural communities. Indeed, two of every five BDC branch offices are located in rural areas, and 17 of these branches have been converted into business development centres to ensure greater market presence in these communities. Examples include Grand Falls, Newfoundland; Kenora, Ontario; and Terrace, British Columbia. Moreover, many of the Bank's customers are located outside of the towns in which the Bank has a branch. Fully 44 percent of BDC loan customers are located in non-metropolitan areas, versus 38 percent of the Canadian population (based on 1996 census distribution of the Canadian population outside 25 census metropolitan areas). BDC Connex also serves as a contact point for SMEs in rural communities, and through it, account managers from the closest branch office can deliver BDC services.

Addressing Cyclical Situations

Besides addressing SME financing gaps, which are structural in nature, the BDC must also address cyclical situations as part of its complementary role. Chartered banks tend to have credit policies that are restrictive at times for some financing needs, or practices that can change depending on the nature, location and timing of loan applications (see Figure 13).

Figure 13: Loans Outstanding to Businesses

1989 to 1994



Note: Bank lending excludes loans to agriculture and loans under the *Small Business Loans Act*.
Source: *Bank of Canada Review*.

These realities have led many SMEs to diversify their sources of financing so they can call on alternative sources when their principal financier cannot meet their requirements. In light of the BDC's capacity to price according to risk, and given its recovery practices and its different approach with clients in default, its role can become critical to an SME's survival or continued growth during these downturns. The BDC's unique approach to recovery often focusses more on curing the problem and favouring the survival of the business than liquidating it.

Developing Markets

In keeping with its mandate, the BDC has accorded special attention to Aboriginal and young entrepreneurs, as well as other developing markets such as women entrepreneurs, tourism and the cultural industry. The following provides a brief overview of the results achieved for each market.

Aboriginal Businesses

Aboriginal businesses represent a sector where specific BDC resources are assigned with a view to meeting specific client needs. The amount of BDC loans committed to this sector increased by 68 percent between fiscal year 1994–95 and fiscal year 1999–2000, from $22 million to $37 million. The number of Aboriginal clients also increased 50 percent from 108 to 162.

In addition to developing customized solutions for Aboriginal entrepreneurs and negotiating partnerships with chartered banks to serve this market in fiscal year 1998–99, the BDC sponsored and delivered a series of presentations entitled "How to effectively deal with banks" through on-reserve economic development organizations. The BDC also launched a newsletter that focusses on issues relevant to Aboriginal economic development. The newsletter is distributed to all BDC branches, First Nations communities and Aboriginal organizations across Canada.

Young Entrepreneurs

Youth-owned businesses represent another sector where BDC emphasizes its services. Between fiscal years 1994–95 and 1999–2000, the amount of BDC loans committed to youth-owned businesses increased by 41 percent from $263 million to $371 million. The number of young clients also increased by 56 percent from 1539 to 2397. In addition, the BDC administers the Student Business Loans (SBL) program on behalf of Human Resources Development Canada. These loans are used to operate businesses during the summer months and are repaid before the end of the BDC's fiscal year. The number of SBLs reaches approximately 700 each summer for an average loan amount of $2800. In addition, the Bank continues to honour, since 1988, outstanding young entrepreneurs from each province and territory. The 13 winners receive public recognition as well as individual mentoring to support them in growing their business. They are chosen by a panel of judges from the business world that includes successful entrepreneurs, members of local boards of trade and chambers of commerce, and representatives from the Export Development Corporation (EDC) and the BDC. The awards are presented at the national launch of Small Business Week.

Women Entrepreneurs

Women-owned businesses represent a growing economic force among Canadian SMEs and an important market segment for the BDC. The amount of BDC loans committed to women-owned businesses (50 percent or more ownership by women) increased by 116 percent between fiscal years 1994–95 and 1999–2000, from $428 million to $923 million. The number of female clients also increased by 64 percent from 2468 to 4054.

In addition to directly financing women-owned businesses, the Bank has been involved in research studies and has been a major sponsor and participant in several businesswomen's activities. In 1997, the Bank sponsored a survey conducted by CROP Inc. entitled *Canadian Women Entrepreneurs in Growth Sectors.* This survey showed that women are moving with confidence into growth sectors such as KBIs, communication, transportation and manufacturing. The BDC is currently working with Mount Saint Vincent University to gather current data and identify gaps and opportunities for women-owned businesses.

The Bank was a sponsor of both the first International Women Business Owners Conference held in Canada and the first women-owned business international trade mission to Washington in 1997. In February 2000, the BDC was a partner of the United Kingdom Trade Mission for Women.

The BDC also participates in the Rural Enterprise Fund operated by the Ontario-based organization Women and Rural Economic Development (WRED). The Fund seeks to empower rural residents to develop business skills, realize profits and move towards self-sufficiency. The fund has arranged for financing to 74 women-owned businesses in rural areas of southwestern Ontario since 1996.

Tourism Industry

The Bank has long been a principal financing source for Canada's tourism industry, owing to the generally riskier nature of that industry's financing demands. To ensure continuing support for tourism in light of its new mandate, the Bank collaborated with the industry and with the Canadian Tourism Commission to create the Tourism Investment Fund. While the tourism client base has remained stable since fiscal year 1994–95, total BDC financial commitment to the industry has increased from $699 million in fiscal year 1994–95 to $907 million by the end of fiscal year 1999–2000.

Cultural Industries

The BDC supports Canada's cultural industries by delivering the Cultural Industries Development Fund (CIDF) on behalf of Canadian Heritage. The program, which ran for an initial period until fiscal year 1997–98, restarted during fiscal year 1999–2000 under a new agreement with Canadian Heritage. In its initial phase, between fiscal years 1994–95 and 1997–98, the amount of CIDF financing commitment to this sector increased by a third from $21.9 million to $29.3 million. At the end of fiscal year 1999–2000, the commitment stood at $21.4 million, as existing loans were repaid before the restart of the program.

Partnership and Strategic Alliances

Partnership arrangements with other institutions represent another aspect of the Bank's new mandate. These arrangements have allowed the BDC to expand its reach among SMEs by levering the networks and resources of other institutions with missions and target markets that complement the BDC's. Thus, they have supported not only the Bank's complementary role but also access to its target sectors. The Bank has signed more than 40 strategic alliances with financial institutions such as Canada's chartered banks, other private organizations such as specialized venture capital investment funds, government departments such as Human Resources Development Canada and other financial Crown corporations. The following provides a brief overview of these alliances.

Financial Institutions
The Bank has long had informal partnerships with financial institutions. They are the main source of client referrals to the BDC and they participate with the BDC in joint SME financings. As each client is usually a chartered bank client, both the BDC and the chartered bank have a common interest in working together to the client's benefit. In addition, to ensure that it fulfils its complementary role, the BDC has signed partnership agreements with all of Canada's major chartered banks.

Some of the formal partnership agreements with other financial institutions were designed to address the needs of specific interest markets. For example, agreements have been struck with chartered banks to focus on serving the needs of Aboriginal entrepreneurs. Through these arrangements, the clients of both banks have access to each other's services, but a key feature is that chartered bank clients are referred to the BDC's line of complementary financing business solutions and management services. Another type of chartered bank alliance is the one with Toronto-Dominion Bank (TD) that allows the BDC to offer its Global Line of Credit business solution. Under this agreement, TD handles all administrative and back-office functions, and issues the line of credit.

The BDC recently signed a new partnership with the National Bank of Canada to provide a comprehensive range of financial products and services to innovative businesses that are focussed on growth and exporting. These include SMEs operating in the knowledge-based sector, exporters and manufacturers with innovative approaches, and those who wish to improve their productivity. This alliance will be delivered via the National Bank's national network of commercial centres and BDC branches in major centres across the country.

The Bank has also worked with credit unions that refer SME clients to the BDC when they cannot meet all of a client's financing requirements. And under an arrangement with Sun Life of Canada, the Bank can offer insurance on BDC loans. As in the arrangement with TD, all administrative functions are handled by Sun Life.

Other Private Organizations
The BDC has been instrumental in creating a new type of venture capital partnership. In these arrangements, the Bank and its partners provide the capital for independently managed venture funds focussing on very early-stage ventures. These "seed funds" extend to all of Canada. The $25-million Western Technology Seed Investment Fund is capitalized by the BDC, Ventures West and the B.C. Pension Fund. The $25-million Eastern Technology Seed Investment Fund is capitalized by the BDC and the Bank of Montreal. The $62.5-million Technology Transfer and Commercialization Capital (T^2C^2) funds in Quebec are capitalized by the BDC, Sofinov (a division of the Caisse de dépôt et placement du Québec) and two venture capital firms, Innovatech and MDS.

The Bank also has partnership agreements with several business associations. Some of these are service agreements whereby the BDC provides consulting services to the associations' members. For example, training in the Hazard Analysis Critical Control Point (HACCP) system is provided to members of the Association des manufacturiers de produits alimentaires du Québec. (HACCP is a system that ensures the consistency of food safety programs by analysing hazards and controlling them at critical points.) The BDC Consulting Group also became a member of the Canadian Association of Management Consultants and l'Ordre des administrateurs agréés du Québec.

Government Departments

The BDC has two types of partnership agreements with government departments. The first type includes arrangements for increased cooperation, the provision of technical support to each other and cross-referral of clients. Agreements with the Canadian Tourism Commission, the National Research Council of Canada and regional economic development agencies are of this type.

Under the second type of agreement, the BDC uses its network and staff for cost-effective delivery of commercially based financing programs. As mentioned earlier, the BDC delivers the Student Business Loan program on-line via BDC Connex on behalf of Human Resources Development Canada. This program provides (repayable) loans of up to $3000 to students establishing businesses during the summer months. The BDC also delivers the Cultural Industries Development Fund, as a result of a partnership agreement with Canadian Heritage.

Crown Financial Institutions

Over the years, the BDC has maintained a number of formal and informal partnerships with its sister financial Crown corporations. These relationships were formalized in 1996 with the establishment of the Council of Crown Financial Institutions (CCFI), which comprises BDC, the Canadian Commercial Corporation (CCC), the EDC and the Farm Credit Corporation (FCC). The CCFI was established following recommendations from the Standing Senate Committee on Banking, Trade and Commerce concerning the relationship between Crown financial institutions, regional agencies and commercial financial institutions on one hand and the government's activities in financial markets, access to capital, and export and farm financing on the other. The government's intentions for the CCFI were to:

- minimize overlap and duplication while seeking practical opportunities for collaboration among the CFIs;
- cooperatively develop reporting standards for these financial institutions;
- report on concrete progress and develop a framework for further action; and
- deliver services to customers seamlessly.

The mandate of the CCFI is to foster cooperation and joint initiatives among the financial Crown corporations, to enhance the sharing of information and to ensure the coordinated delivery of services to clients. To fulfil this mandate, the CCFI focusses on improving customer service and avoiding or reducing overlap and duplication among the Crown corporations. Other initiatives include collaboration to improve marketing and operations, to seek practical solutions that respect the institutions' primary focus on meeting customer needs on an ongoing basis, to improve communications and to share information.

The first initiative of the CCFI was to undertake a study to examine the mandates of the four institutions and to determine whether overlap existed. This study showed that each institution serves distinct business needs and niches in the market, and that each offers different services. The skills and knowledge required to deliver these services are also distinct. The institutions' services can be summarized as follows.

- The BDC promotes entrepreneurship by providing financial and management services to small businesses, in particular KBIs and export-oriented firms. Financial services include debt and equity-based products, but do not include deposits or chequing services. One hundred percent of the BDC's clients are SMEs.
- The CCC provides foreign buyers with a government-backed guarantee of contract completion, which enhances access to foreign markets for exporting firms.
- The EDC's customer base consists of Canadian companies active in exporting that require risk management and export financing services. The EDC also provides risk management services such as credit insurance, performance insurance and guarantees, enabling Canada's exporters to increase their business abroad. Approximately 85 percent of the EDC's clients are SMEs.
- The FCC provides financing to primary agricultural and farm-related businesses, all of which are SMEs, with the vast majority being primary agricultural producers. As well, the FCC is involved in the delivery of various agriculture-related government programs.

The BDC has separate memoranda of understanding with the EDC and the FCC. The aim of the FCC partnership agreement is to coordinate the services that each corporation provides to help agri-businesses and farm-related businesses grow and prosper and to ensure that there are no real or perceived overlaps or duplication between the two corporations.

The CCFI members have also initiated cross-training of employees so that they become conversant with services offered by the other CFIs. A new system for cross-referral of clients was implemented along with linkages between respective call centres and Internet sites. Furthermore, the four Crown corporations have collaborated to produce publications and to provide cross-references in each other's publicity brochures. Following a recommendation by the Industry Committee that chartered banks publish data on their small business activities, the CCFI has published its report on the SME activities of the four Crown corporations.

Further actions by the CCFI have led to new bilateral arrangements that have enhanced market reach for the participating Crown corporations. For example, the BDC and the FCC have collaborated and provided capital for the Rural Enterprise Fund operated by WRED in southwestern Ontario. This privately run organization uses the fund to provide small business loans to women establishing and running businesses in rural areas. A joint BDC-FCC Agri-Tech Development Fund increases the amount of lending available in this sector. Deals typically include FCC term loans and BDC venture loans coupled with BDC consulting services. The EDC has become a major sponsor of Small Business Week, an annual event produced by the BDC and chambers of commerce in communities across Canada. These initiatives have increased EDC's exposure among small businesses. The BDC and the EDC each have hotlines, to which their respective call centres refer clients who could be better served by the other organization.

The presidents and senior managers of the financial Crown corporations meet regularly to ensure ongoing collaboration and develop common approaches to common problems.

Investment Group

Since receiving its new mandate, the Bank has expanded both its venture capital and subordinated financings to fledgling Canadian SMEs operating in knowledge-based sectors. These financing solutions are now consolidated under the BDC Investment Group, whose focus is to support high growth small businesses whose financing requirements cannot be met through traditional financing tools. Each of the following sections will provide an overview of the results achieved since 1995.

Venture Capital

Equity investment is often critical to technology companies whose main assets are intangible and who are thus unable to obtain traditional financing and are lacking any debt repayment capacity. Yet these companies require significant capital to fund their R&D, build their team, and implement sales and marketing strategies until they can self-finance their operations or get financial backing from public markets. A recent survey of venture capital-backed companies showed that, on average, a business will use $23 million of venture capital before going public.[2] For example, data for 1999 showed that a computer-related company required $13.3 million in development capital before being able to access public markets. Development capital for a life science company could easily run to $21.5 million before an IPO is obtained.[3] Venture capitalists have been key players in addressing the financing needs of fast-growing technology businesses, in addition to allowing investee companies to benefit from their experience and network of contacts.

Surveys have shown that venture capital-backed companies outperform the economy. From 1995 to 1999, these companies increased their employment by an average rate of 39 percent annually, sales by 31 percent annually, exports by 38 percent annually and R&D expenditures by 52 percent annually.[4]

With its official establishment in 1983, BDC's Venture Capital division has been at the forefront of the Canadian venture capital industry. In fact, since its inception, BDC Venture Capital has been the only

2 For more details, see *Economic Impact of Venture Capital,* a survey sponsored by the BDC and prepared by M. Macdonald & Associates Limited, 2000.

3 For more details, see *Economic Impact of Venture Capital,* a survey sponsored by the BDC and prepared by M. Macdonald & Associates Limited, 1999.

4 *Economic Impact of Venture Capital,* 2000.

Canadian venture capital investor active from coast to coast. In 1995, the Bank expanded its physical presence by opening two new offices, in Calgary and Halifax.

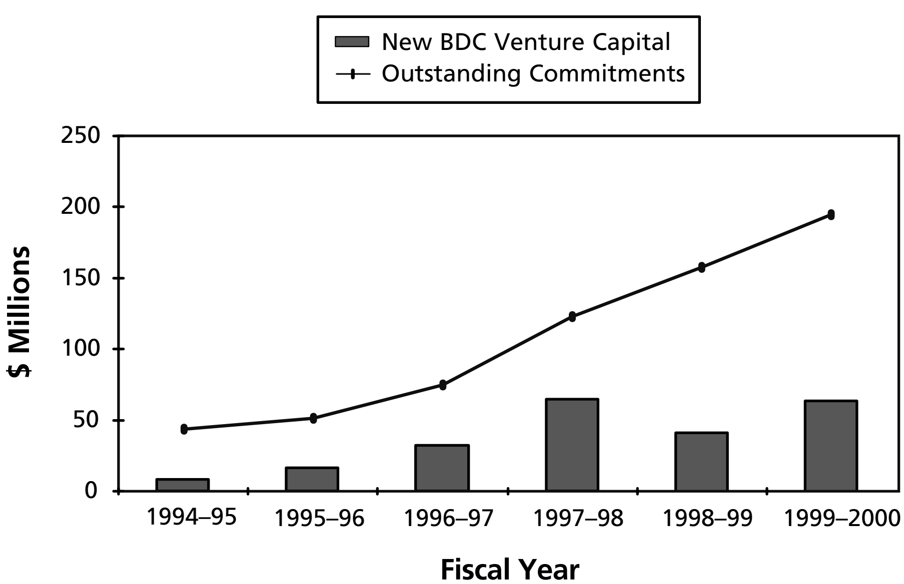
To better serve its clients and fulfil its mandate, the Venture Capital division also had to raise the skill level of its work force to be able to offer value to its KBI clients and help them build their companies. The more than 30 investment specialists of the division have doctoral and master's degrees in fields such as life sciences, software and electronic engineering, medical technology, telecommunications and networking, information technology services, computer hardware and industrial applications. These specialists continue to develop their expertise. They also bring considerable private sector experience to their work with SME clients.

In the same vein, BDC Venture Capital will invest up to $50 million in specialized venture funds that share BDC's investment focus in early-stage technology companies. The initiative will support the growth of established and successful venture capital groups as well as help launch new venture capital groups. This will benefit Canada's innovation strategy by providing KBIs and SMEs with access to early-stage capital and by supporting the growth of Canada's venture capital industry.

Since the inception of the division, BDC Venture Capital has invested close to $400 million in more than 300 companies. As demonstrated in Figure 14, the Bank authorized 62 venture capital investments for $63 million in fiscal year 1999–2000, which brought the Bank's total venture capital commitment outstanding to $195 million. These commitments are to 100 fast-growing SMEs, almost all of them KBIs. In comparison, during fiscal year 1994–95, the Bank authorized only nine new investments for $7 million, and total venture capital commitment was $44 million to 36 SMEs. Thus there has been more than a fourfold increase in BDC's venture capital financings during the last five years.

Figure 14: Amount of New BDC Venture Capital and Outstanding Commitments

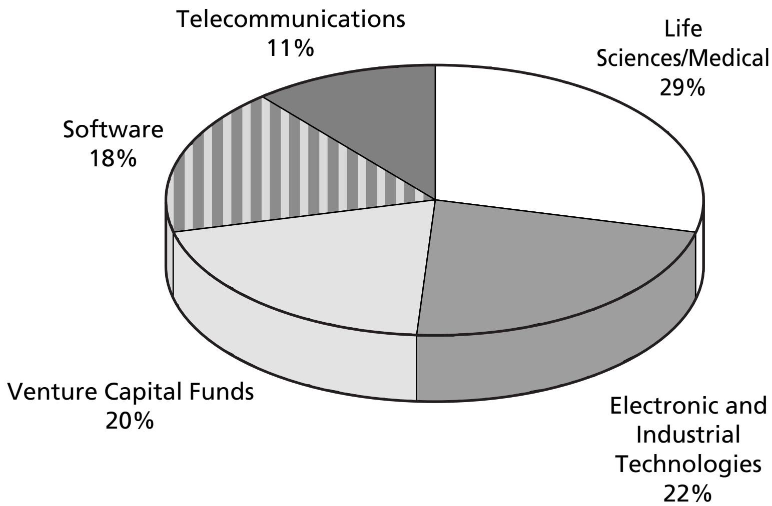
Fiscal Years 1994–95 to 1999–2000



The Bank's venture capital operation represents only about 2 percent of total capital under management by Canadian venture capital firms. But this percentage is clearly different in nature from the industry average. First, in keeping with its mandate to focus on KBIs, the Bank's venture capital operation is more active in high technology sectors than the Canadian venture capital industry average. Overall, 97 percent of the BDC investment portfolio is committed to KBIs (see Figure 15).

Figure 15: Investment Portfolio, by Industry Sector

As of March 31, 2000



Secondly, the Bank focusses on the financing needs of companies at the early stage of development (see Figure 16) and in recent years has even targeted seed-stage investments in cooperation with partners. Thus the Bank's venture capital portfolio contains twice as many early-stage companies as the industry average, as estimated in a KPMG study.

Figure 16: BDC Mainly Supports Early-Stage Companies

As of March 31, 2000

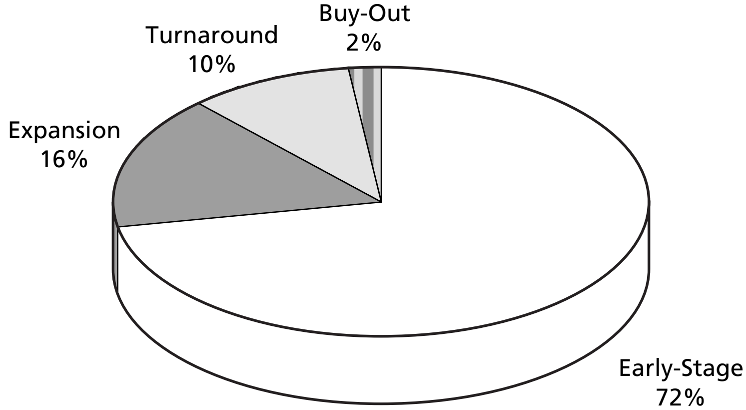
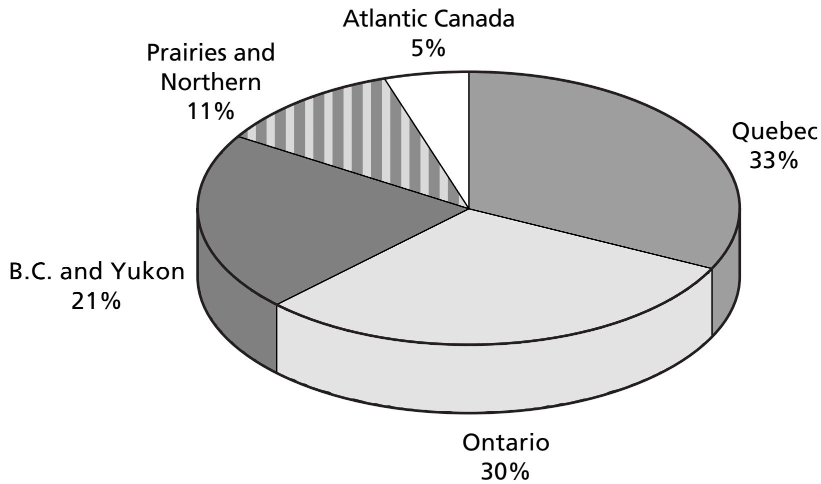


Figure 17 shows the regional distribution of BDC venture capital investee companies, as at the end of March 2000. These activities contributed to the success stories of Creo Products in B.C., AudeSi Technologies in Alberta, Tundra Semiconductor Corporation and PixStream in Ontario, and Conjuchem Inc. in Quebec.

Figure 17: Regional Distribution of BDC Investee Companies

As of March 31, 2000



Another important element underscoring the Bank's complementary role in the venture capital industry is the fact that BDC investments often leverage investments by other partners. For instance, the $63 million invested by the BDC in fiscal year 1999–2000 leveraged another $301 million in investments from other sources into clients' businesses, representing a 4.8 investment leverage ratio.

Another example of the BDC's role was the successful pooling of $112.5 million to establish four regional seed funds. The BDC is a co-manager of two of these funds and was their single most important contributor, with a total commitment of $50 million. The two funds are the Western Technology Seed Investment Fund (with Ventures West and the B.C. Pension Fund) and the Eastern Technology Seed Investment Fund (with the Bank of Montreal). The BDC also partnered with Technology Transfer and Commercialization Capital (T^2C^2) and Sofinov, a subsidiary of the Caisse de dépôt et placement du Québec, to invest $62.5 million into the T^2C^2 Bio and T^2C^2 Info funds. All of these funds have now been fully allocated to 71 start-up businesses.

Given its public policy mandate, BDC's venture capital portfolio is much riskier in nature than that of traditional venture capitalists in Canada. The fact that its portfolio is invested almost exclusively in KBIs, mostly at the seed or start-up stages, means that the risks of successfully bringing a company to IPO are greater than average. However, the riskier nature of the activities of the group has not prevented it from contributing a greater share of the profitability of the Bank as demonstrated earlier. In terms of relative financial performance, a recent study conducted by KPMG concluded that BDC's Venture Capital division results were comparable to those of other similar-sized venture capital groups in Canada.

Subordinated Financing

Subordinated financing is a hybrid financing instrument incorporating elements of both debt financing and venture capital. This type of financing is generally sought by a company that has little or no collateral backing it, but that does not want to dilute its ownership. Whatever collateral is available is subordinated to other creditors. In the event of default, these obligations are repaid only after other creditors have been repaid.

As this segment of the financial services industry is relatively less developed in Canada than in the U.S., the BDC's role has always been that of innovator. In fact, the Bank has constantly remained at the forefront of this specialized market. It complements the small number of lenders in this market by focussing its attention on fast-growing, innovative exporters, mainly in the manufacturing sector. While the success achieved by some of these new solutions did not always reach expectations, they nevertheless allowed the Bank to develop a unique expertise in this area. As this expertise is further refined, the BDC can demonstrate the commercial viability of this market segment in Canada.

During the 1995–2000 review period, the amount of new subordinated financings authorized by the BDC increased by about two thirds from $65 million in fiscal year 1994–95 to $109 million in fiscal year 1998–99. (In fiscal year 1999–2000, the total amount authorized decreased to $87 million because of an overall industry decline, a change in the delivery structure for this business solution and a realignment of BDC solutions.) The increased level of activity in the earlier years was due to the venture loan business solution and its derivative, Patient Capital.

The BDC is the most active supplier in the Canadian subordinated financing market for transactions below $5 million. It accounted for 73 percent of all new subordinated deals in the first three quarters of 2000 (accounting for 82 percent of transactions below $1 million). The BDC's focus is smaller than the industry average as it concentrates on first-round financing averaging $650 000 (compared to the industry average loan size of $1 million). Thus the BDC accounts for three of every four dollars of SME subordinated financing in Canada for amounts under $1 million. The BDC also continues to be one of a few providers that bases repayments on future royalties, as well as, for example, sales or cash flow. Other suppliers are more likely to charge premium interest rates plus fees on their deals and to cover the upside with equity options.

Consulting Group

Management Services Transformation

Prior to 1995, the Bank provided training and Counselling Assistance to Small Enterprises to businesses that otherwise could not have been served nor could have afforded the services. These management services were largely paid by government appropriations.

Following the 1995 mandate to revise its management services, the Bank undertook a full-scale review of its services to better respond to the new needs of small business and align its consulting and financial services. The review revealed that the Bank's role in the marketplace was becoming increasingly redundant as new private and public sector entrants appeared, particularly in providing training, counselling and business plan advice. In addition, new unaddressed needs were emerging for fast-growing SMEs whose size or contract value might not have been lucrative enough for larger consulting firms. The review found that better synergies could be attained by targeting SMEs that were similar to the clientele of the Bank's financial services — knowledge-based, high tech, export and growth-oriented businesses. As a result of the review, the Bank revamped its management services to provide relevant business solutions matched to SME needs throughout their various stages of development. In addition, some of the tools were also specifically aimed at complementing the financial services offered by the Bank.

The transformation of management services — renamed the BDC Consulting Group — presented special challenges. It required the complete dismantling of local practices, substantial replacement of human resources, market repositioning and the development of an almost entirely new line of business solutions to fit the needs of the target sectors. Today's Consulting Group solutions are well adapted to the modern needs of SMEs and at times are the only reliable and affordable national source of supply for some of these services.

The Consulting Group levers the best of small and mid-sized consulting firms across the country by partnering with them to add consistency and quality standards to their expertise. In addition, by sharing local best practices and solutions on a national basis, BDC ensures that both its clients and its network partners employ the latest, proven solutions to SMEs' needs.

Consulting Group Results

The Consulting Group has dealt almost exclusively with SMEs by supporting their development in four key areas — quality, growth, export and e-business. The breakdown of the BDC's consulting revenues reflects the distribution of demand for these services. In fiscal year 1999–2000, total consulting revenues reached $19.4 million, a 9-percent increase over fiscal year 1998–99. Of the total, 37 percent was from ISO and quality consulting, 30 percent from consulting for growth (including e-commerce), 6 percent from export-related consulting and another 27 percent from other consulting.

In addition to the fully customized consulting services provided to these clients, the Consulting Group offers a range of unique and proven business solutions, including Tech-Strategy, ISO services, HACCP for quality control in the food industry, strategic planning and the Growth Potential Assessment. And while the focus has been on SMEs in the Bank's target markets, entrepreneurship support for individuals and smaller SMEs is still provided via BDC Connex and BDC's Micro-Business and Young Entrepreneur programs, which combine financing and consulting advice.

The percentage of Consulting Group KBI and exporting clients has increased from less than 1 percent to 22 percent in fiscal year 1999–2000. Furthermore, in fiscal year 1999–2000 almost 1200 BDC clients used both financing and consulting services. While the Group's target market is still very price sensitive, financial sustainability is, in time, an achievable objective. Since 1995, the Group's cost recovery has increased from 56 percent to 82 percent. Thus, the combination of financial and consulting services is allowing the Bank to optimize its support for the development and success of the Bank's SME target markets as they evolve in response to technological and global changes.

The Consulting Group also levers strategic partnerships with public and private sector organizations to extend the reach of its services. Furthermore, the Group was accepted as a member of the Canadian Association of Management Consultants and the Ordre des administrateurs agréés du Québec. The Group is supporting all of its employees in obtaining the professional designations offered by these organizations so as to further improve their ability to provide value-added and relevant consulting solutions for the Bank's target market SMEs.

Critical Assessment of the BDC

BDC Special Examination Results for 1999

The Office of the Auditor General of Canada, in collaboration with the firm KPMG, completed its latest special examination of the Bank in 1999. The office's responsibility was to express an opinion on whether there was reasonable assurance that there were no significant deficiencies in the systems and practices examined.

The special examination evaluated practices at the Bank against criteria that reflected the examiners' knowledge of and experience with value-for-money auditing, legislative and regulatory requirements, and standards and practices followed by the Bank and other organizations. The examination was also carried out in the context of the new BDC Act and new mandate of 1995, the principal elements of which were presented earlier in this review.

The examiners' conclusion was as follows: "In our opinion, with respect to the criteria established, there is reasonable assurance there are no significant deficiencies in the systems and practices examined."

The examiners cited a number of initiatives that the Bank had implemented to address its mandate. They noted that one of the ways the Bank seeks to meet the needs of SMEs is by being a flexible lender, capable of adjusting its business solutions to the particular needs of a borrower or specific sector of the economy. By providing this financing, it is able to supply custom financing to help an enterprise carry out its projects. The examination noted the special attention the Bank pays to client service, having adopted a Charter of Client Rights, having appointed an ombudsman and regularly conducting client surveys to enhance service. Also noteworthy were the partnership agreements the Bank has signed, its effort to enhance visibility and accessibility, and its attention to corporate governance.

However, the examiners did make some observations related to integrated management of business risks. They noted that the business environment of the Bank is subject to rapid transformation and although it can produce large-scale opportunities, it also involves greater risk.

The examiners observed that while the Bank has developed and continues to improve risk management tools for its key activities, more integrated management of risk for the Bank as a whole is needed to ensure that the serious risks it faces are considered objectively and globally.

More specifically, the examiners focussed on the following four areas.

1. New and improved information systems and skills
   - The examiners cited risks associated with the changeover of the Bank's critical information systems, primarily to prepare for Y2K, and challenges in recruiting and retaining staff in the systems and technology department.
   - The examiners also cited some risks associated with the significant movement of human resources at all levels. They reiterated the importance to the Bank of attracting and retaining the human resources needed to provide quality customer service.
2. Growing and targeted portfolio
   - The examiners reiterated the importance to the Bank of constantly updating and refining its loan portfolio and investment management practices with a view to improving the overall performance of the portfolio.
3. Sufficient profitability
   - The examiners noted: "It is imperative that the Bank maintains sufficient profitability to achieve its public interest mandate to support Canadian entrepreneurship, and particularly small and medium-sized enterprises."
4. New and improved products and services
   - While it is recognized that the Bank was successful in developing new products and services, the examiners noted that a more structured approach to market research could improve the process through which innovations are launched.

Implementation of Recommendations

The Bank's management has responded to these observations, and the Bank is now in the process of enhancing its integrated risk management system and other operational procedures to address the examiners' concerns.

Following the special examination, management enhanced its existing development plans with action steps designed to include activities to specifically address examination observations. These activities have been followed up regularly. Currently, 75 percent of the observations have been addressed. Most of the remaining concerns are expected to be satisfied this fiscal year, leaving only a few issues related to longer-term projects.

In the context of sound risk management, the detailed preparations that the BDC developed to navigate Y2K did ensure the corporation's success. They also resulted in an improvement and renewal of information systems and of employees' skills to better respond to the growth and transformation of the Bank's operations. The Y2K contingency plan also served as the basis for a broader business continuity plan that has been successfully developed and tested.

A project has been completed that evaluates integrated risk management and credit portfolio risk management, and how they would specifically relate to the BDC as a small business development agency. Development plans are under way for identified opportunities to further integrate risk management practices into BDC activities and to increase awareness of risk management opportunities. Senior management is finalizing work plans to develop and implement a process to oversee the integration of business risk that would enable the Board of Directors and management to identify, measure and monitor key business risks and take them into account in strategic decision making. It is expected that knowledge will be enhanced by applying expected loss and economic capital concepts to credit portfolio risk management. This will aid the BDC's business plan development by providing added insight to loan pricing, business and new product development, and portfolio management, as well as providing a better understanding of the implications of the Bank's mandate.

The BDC has recognized the need to better assess the achievement of its mission and objectives. It has developed measurable objectives that allow for performance assessment against growth and profitability objectives. The Bank is currently considering alternatives to improve the gathering of data on important industrial sectors. A new evaluation framework based on a balanced scorecard will be developed to assess the Bank's performance.

All the examiners' concerns related to staff turnover and filling of senior positions have now been addressed. Additionally, the Bank's human resources policy is reviewed continuously to respond to strategic and environmental change. An "Employer of Choice" initiative has been launched.

Summary of Critical Assessment

The following conclusions emerge with respect to the achievements that the BDC has made since 1995.

The BDC has successfully implemented the transition from being a lender of last resort to being a complementary lender. It has successfully fulfilled its mandate — and, more specifically, met the needs of KBIs — has earned a return on equity at least equal to the federal government's cost of funds, has established an ombudsman, and has implemented a Charter of Client Rights, while achieving awareness of its services throughout the country.

Looking to the future, the Bank needs to build on the foundations it has established since 1995 by doing more in the areas of consulting, partnership agreements and support to developing markets. From an operational perspective, the Bank will also have to refine its risk and portfolio management practices if it is to continue to play a leading role as a development bank.

Part II

Continuation of the BDC's Mandate

1.0 Issue: Whether to Renew the BDC's Mandate

This section provides a summary of the key recommendations coming from this mandate review. These recommendations and the accompanying questions and answers are drawn from the findings outlined in Part I of this report as well as from the analyses contained in the following pages, which provide an overview of recent trends in the SME financing and consulting markets, and an assessment of their impact on Canadian SMEs.

Recommendation

It is recommended that the BDC's current mandate be reconfirmed and that the BDC Act be maintained without amendment.

In light of this recommendation, the Bank would continue to implement the mandate that it was given through the adoption of the BDC Act and as further defined through subsequent decisions of the government and the BDC Board of Directors. In making this recommendation it is understood that both the Government of Canada and the BDC will continue to monitor the SME financing and consulting environment with a view to adapting the Bank's strategies to changes in its operating environment.

The next mandatory review of the BDC's mandate, pursuant to section 36 of the BDC Act, is to be tabled by July 2011. In the meantime, the Minister of Industry and the BDC will keep Parliament informed of changes to Bank strategies and goals through the annual submission of the corporate plan summary and the Bank's annual report. Should business conditions change significantly before 2011, it may be appropriate to come back before Parliament to address BDC mandate issues.

Rationale

As detailed in Part I of this report, the BDC Act made major changes in the direction of the BDC, and the Bank successfully migrated from being a lender of last resort to a complementary lender. It has achieved this in a commercially responsible manner while fulfilling several public policy objectives. These include developing innovative ways of serving Canadian SMEs, and serving Canada's growing KBIs and exporters, while continuing to serve its traditional clientele and placing more emphasis on serving smaller firms. Implementing this mandate required very substantial organizational change and market repositioning. It is reasonable to assume that the role the BDC plays as a contributor to the development of economic capacity in Canada has not yet reached its full potential and impact, particularly in light of the evolution of the market. Therefore, this review has concluded that the elements of the BDC's mandate remain as relevant today as they were when the mandate was established, and that no changes are needed at this time.

Adequacy of the BDC Act

Fundamental to the Bank's mandate is the BDC Act. This mandate review has considered a number of basic questions that are at the heart of determining the relevance of this legislation and of the BDC as an ongoing Crown-owned financial institution.

Is there a continued need to have a Crown corporation dedicated to providing financing and consulting services for Canadian SMEs?

The analysis provided in the following section concludes that a certain segment of Canada's SMEs continues to face significant difficulty accessing the kinds of financing needed for growth. As will be shown, SMEs make significant contributions to Canada's GDP, growth and job creation. However, most of Canada's SMEs continue to lag behind their U.S. counterparts in adopting new technology, which partially explains, among other things, Canada's ongoing "innovation gap." Access to appropriate term financing is a critical factor in being able to adopt new technology, and there is a strong public policy rationale for maintaining a Crown corporation dedicated to serving the financing and consulting needs of Canadian SMEs. Therefore, the BDC's continuing effort — to serve the emerging capital needs of SMEs that have difficulty obtaining financing from traditional sources — remains a highly relevant ongoing public policy objective.

Does the BDC continue to serve the needs of the small business community?

In answering this question the mandate review has re-examined the policy rationale for the BDC and compared this to the emerging needs of Canadian small businesses. The review concluded that despite a period of rapid change in the marketplace, there is still a public policy rationale for the BDC to continue to serve small businesses. The question of whether the BDC's legislation needs significant amendments has also been considered. The conclusion is that since the underlying marketplace gaps facing Canadian SMEs are still present, and since the BDC has had sufficient tools to implement its objectives, no substantive adjustments are required to its legislation (this issue is discussed further in the following section on trends in SME financing and consulting). Should conditions change before the next review, policy proposals to deal with these conditions would be prepared for Parliament's consideration.

Should the BDC be maintained?

Private financial institutions have announced a number of initiatives aimed at better meeting the needs of their SME clients. While many of these initiatives have only recently been implemented and will take more time to fully materialize, early indications seem to show that they will have greater impact on those SMEs that are already well served by private institutions. This implies that the gaps identified when the BDC Act was adopted unfortunately remain as apparent today as they were five years ago.

In view of these developments there is still a public policy rationale for maintaining the BDC in its present form. As a complementary lender, with a commercial mandate and a public policy role, the BDC will pioneer new services in Canada and fill marketplace gaps that prevent SMEs from reaching their full economic potential, while serving segments of the market that are currently under-served by the private sector. Although it may appear that this recommendation is a request for the status quo, the implementation of the operating mandate of the BDC is far from that. Over the last five years, the BDC has developed a strong foundation that can now benefit a certain segment of Canadian SMEs. At the core of its services lies its ability to provide case-by-case financing, consulting and mentoring. For a long-term financial services provider, five years is a relatively short view of the impact of its contribution to economic development.

Should the BDC be privatized?

The evidence presented later in this report suggests that, if anything, recent developments have not materially changed the gaps identified in 1995. This being the case, the policy rationale continues for maintaining the BDC in the public sector where it can meet both the commercial and public policy goals.

2.0 Trends in SME Financing and Consulting

The recommendation to continue the BDC's existing mandate is based on a thorough assessment of recent trends affecting the SME financing and consulting environment. This section provides a detailed perspective on these trends, based on an analysis of a number of recent studies of the current state of the SME financing market in Canada, including a study by the Conference Board of Canada,[5] the MacKay Task Force report,[6] a recent survey by the Canadian Federation of Independent Business (CFIB),[7] a special study of SME perspectives by the Angus Reid Group that looks at the provision of financing from the perspective of SMEs[8] and a special study by SECOR that looks at SME financing from the perspective of financing suppliers.[9] It is important to note that these last two studies were specifically commissioned for this review. Detailed summaries of these studies are provided in Appendix III of this report.

The review of the recent research on the SME financing environment provides useful perspectives on SMEs' access to financing and consulting and how it affects the BDC's future role and outlook. Based on the research findings, this section provides a forward-looking interpretation of what these recent trends — in both supply and demand — mean with respect to the industry providers of SME services, the types of services they offer and the delivery mechanisms they use.

Supply-Side Trends

Reduction in Usage of Authorized Credit

Until more complete data on total debt financing provided to SMEs in Canada become available as a result of the Financing Data Initiative being undertaken by Industry Canada and Statistics Canada, the only reliable sources of information on SME debt financing are the Bank of Canada's *Banking and Financial Statistics* report, the data for which are provided by the Canadian Bankers Association, and the bi-annual Conference Board of Canada reports.

5 Conference Board of Canada, *A Changing Demand for SME Debt Financing?* (January 2001).

6 Task Force on the Future of the Canadian Financial Services Sector, *Report of the Task Force* (September 1998).

7 Canadian Federation of Independent Business, *Banking on Entrepreneurship* (March 2001).

8 Angus Reid Group, *Financing Services to Canadian Small and Medium-Sized Enterprises: Report on Focus Group Research* (July 2000).

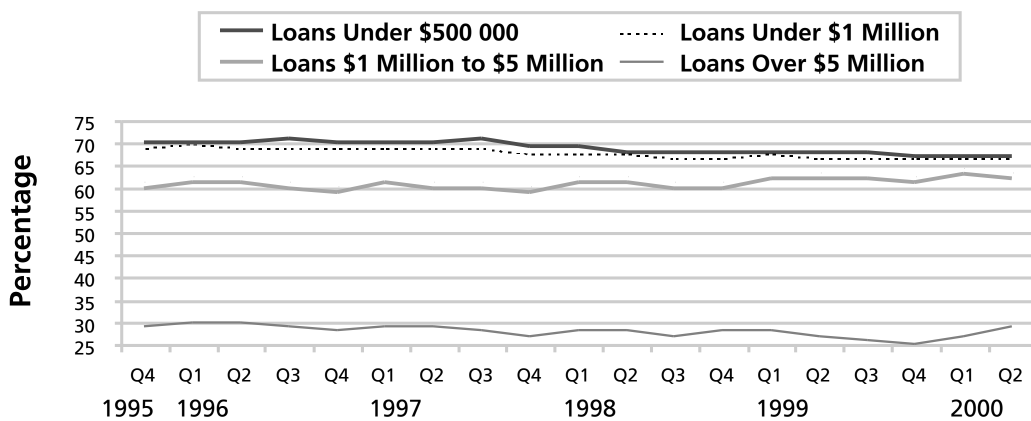
9 SECOR, *Recent Developments in SME Debt Financing: The Supply Side* (July 2000).

These statistics show the following:

- Total credit authorized by chartered banks to SMEs (as a proxy, authorization to SMEs is defined as having authorized credit limits of under $1 million) stood at $71.6 billion in the second quarter of 2000.
- Credit outstanding has risen by 5 percent since the beginning of 1996, reaching $47.7 billion.
- KBIs represent about 2 percent of outstanding bank credit.
- While there have been steady increases in the amount of credit extended by the banks, the percent utilization of credit (i.e. outstanding credit divided by authorizations) for loans under $1 million has decreased from 70 percent to 67 percent, as demonstrated in Figure 18. This decrease in credit usage likely indicates that businesses are reaping the benefits of good economic times and have not needed to draw down credit. Only the category of loans between $1 million and $5 million saw an increase in percent utilization during this period.

Figure 18: Outstanding Loans as a Percentage of Authorized Amounts

Seven-Bank Aggregate



Source: Canadian Bankers Association.

Shift From Term to Demand Lending

As shown in Figure 19, when one examines the lending data for the period 1995–2000 for term loans below $250 000, the following can be observed: term loans in the $0–$24 999 size band have declined by 44 percent, while loans in the $25 000–$49 999 size band have declined by 22 percent. These same bands showed increases of 13 percent and 14 percent respectively during the same period for operating (demand) credit. The gains in operating credit are likely due to the advent of the small business credit card (credit card activity is included in these statistics but cannot be separated out), which has become a fast and convenient way to obtain money in these credit ranges. However, it is worth noting that the growth experienced in operating credit outstanding did not make up for the decrease in term lending. This seems to indicate both a shift from term lending to demand lending and a net reduction in financings below $250 000.

Figure 19: Bank Lending Under $250 000

Percentage Change Between Q4 1995 and Q4 2000

Size Band	Authorizations (percentage)	Outstandings: Term Credit (percentage)	Outstandings: Operating Credit (percentage)	Customers (percentage)
$0 to $24 999	9.5	-43.6	13.3	31.4
$25 000 to $49 999	9.5	-21.8	14.3	10.9
$50 000 to $99 999	7.1	-11.1	9.3	11.1
$100 000 to $249 999	6.1	0.8	1.6	6.8
Total (Less Than $250 000)	7.0	-7.5	6.1	19.9

Notes:

Banks: Bank of Montreal, Bank of Nova Scotia, Canadian Imperial Bank of Commerce, Royal Bank of Canada, TD Bank Financial Group, HSBC Bank Canada

Authorizations: Maximum amount that a customer is authorized to borrow under a negotiated line of credit.

Outstandings: Principal amounts of money that a customer has actually borrowed from the bank under the authorizations level.

Term Credit: Includes non-revolving credits, leases, commercial mortgages and any government-guaranteed loans that are in these product groups.

Operating Credit: Credit with a fixed limit and no fixed repayment schedule, that can be drawn up and down.

Source: Canadian Bankers Association.

Streamlining of Financial Products Offered to SMEs

Respondents in the SECOR study indicated that many financial institutions have started streamlining their financial services offerings to SMEs. For instance, they have selected products such as overdraft protection, current account services and the small business credit card, and bundled them to replace the less cost-effective term loan. This streamlining favours the introduction of financial products that are more standardized and cost efficient to deliver. However, an important question is whether these streamlined solutions in fact meet the financing needs of SMEs or will simply lead them to finance long-term assets with short-term financial solutions.

Migration of SME Customers From Business Banking to Retail Banking

Respondents in the SECOR study confirmed that many financial institutions, especially chartered banks, are seeking to increase revenue growth by cross-linking their small business products with personal financial products for SME owners. This shift of SME customers from the commercial banking side to the retail banking side is perceived by these respondents as having a positive impact on increasing access to financing for SMEs.

Emergence of Specialized Finance Companies

According to the Conference Board of Canada study, the overall market share for SME financing by chartered banks remained relatively stable in the period 1996–1998, while other players, such as specialized finance companies (e.g. leasing and credit card companies), increased their share of the SME credit market from 13 percent in 1994 to 20 percent by 1998. Leasing companies alone increased their share of SME credit from 9 percent to 15 percent in the same period. This was confirmed by respondents in the Angus Reid Group study, which indicated that leasing companies were an alternative to traditional financing and represented an option as a secondary source of financing, but at a higher cost.[10] This is in line with the growing trend for asset-based financing to be a viable alternative to traditional debt financing mechanisms. This trend has certainly bolstered the significant investments made in machinery and equipment in Canada since 1995.

Competition and Consolidation

The financial services industry is undergoing significant and rapid change worldwide. Consolidation continues through mergers and acquisitions between banks and non-banks. Large financial conglomerates are being established in different regions of the world. The U.S. leads this restructuring, and recent changes made to its legislative framework will most likely lead to a significant consolidation of its industry and possibly support the creation of large international financial conglomerates.

In Canada, the trend towards consolidation is also continuing and many significant changes are expected should the financial sector reform legislation (Bill C-8) be implemented. This new policy framework is expected to increase competition in the domestic marketplace by encouraging new entrants through liberalized ownership rules, by expanding access to the payment system, and by establishing more flexible regimes for credit unions and foreign banks.

What will this all mean for the consumers of financial services? There is no question that increased competition will have a positive impact on financial services in general. However, the main issue will be whether this increased competition will result in increasing access to financing for SMEs that currently fall outside the credit and risk appetite of private institutions.

Maximizing Shareholder Value

Another major trend affecting the financial services sector in Canada is the practice of focussing corporate resources on achieving a single overarching objective, that of maximizing shareholder value through aggressive return on equity targets. Recent advancements in risk management as well as in capital allocation are now enabling financial institutions to focus their activities primarily on customers that meet specific profitability levels. As many institutions restructure to focus on more profitable activities

10 Angus Reid Group, p. 20.

such as wealth management, less profitable customers will inevitably start witnessing a difference in the way they are treated by their institutions.

While it is still too early to fully assess the impact that this practice will have on SMEs' ability to access the financing and business advice that they need to grow, one trend seems to emerge: the less profitable customers will find it more and more difficult and expensive to access the financial services they need.

Service Delivery and New Technologies

The most significant trend affecting the distribution of financial services is that of new technologies, especially Web technologies. These new technologies offer a wide range of possibilities for improving service quality while reducing processing costs. These changes are affecting the distribution networks used by Canadian institutions and are reshaping the way financial services are being delivered to Canadian SMEs. As reported in the SECOR study, many financial institutions have scaled down their branch networks and diversified their distribution networks by using telephone or Internet banking. These technologies have also brought along a form of standardization of processes; however, it remains unclear whether these changes will improve or reduce accessibility to financing from an SME perspective.

Another important development related to technological changes is the emergence of centralized loan recovery units within certain financial institutions. This automated approach will accelerate the reactions of lenders when loans are in default. It will be important to monitor this development to assess its impact on Canadian SMEs.

Demand-Side Trends

SME Environment

Through 2000, the Canadian economy experienced one of its longest cycles of economic growth since the mid-1960s. Canada's real GDP is estimated to have expanded by 5 percent in 2000 — the second-fastest rate among G-7 countries — and by the end of the year, the unemployment rate was down to 6.8 percent, the lowest level in nearly 24 years. In 2000, 378 500 full-time jobs were created. The OECD expects Canada to have the fastest economic growth among G-7 countries in 2001 and to lead in job creation.

To better understand the link between economic growth and small business activity, the Canadian Imperial Bank of Commerce (CIBC) published a report in March 2000 entitled *Small Business in Canada, Trends and Prospects,* which introduced the Small Business Economic Activity Index.[11] The index shows that while small business activity is correlated with overall economic activity, it grows faster when the overall economy is in the early stages of recovery and declines faster in the early stages of slowdown. For 1999,

11 CIBC Economics Division, *Small Business in Canada, Trends and Prospects* (March 2000).

small business activity grew by an estimated 4.2 percent, compared to 3.8-percent growth in the overall economy. For 2000, the report projected that small business activity would grow by 3.8 percent, compared to a projected 3.6-percent growth in the economy. These data indicate a continued strength in overall economic activity.

The pace of small business formations has followed the growth in small business activity. The CIBC report estimates that the number of firms with fewer than 10 employees rose by about 20 000 during 1999, a 2.5-percent increase from 1998.

An important trend is the increasing contribution of SMEs to overall economic activity and job creation. Canada's SMEs benefited from and contributed to this sustained economic growth by accounting for 75 percent of new jobs created in the 1996–1997 period.[12] Many of these jobs were created by self-employed workers, whose numbers increased steadily in the 1990s, growing on average about 3 percent per annum. At the end of 1999, the total number of self-employed people in Canada reached close to 2.5 million, accounting for 18 percent of all Canadian workers. Many factors, such as increased outsourcing by larger corporations, underlie this phenomenon. In addition, the increasing importance of new open technologies, such as Web technologies, is levelling the playing field for many Canadian small businesses.

SMEs have also become an important source of innovation and are often the driving force behind new products and technologies in fast-growing industries. This is especially true for start-up companies, which are among the strongest job creators and innovators in today's economy.

Increasing Sophistication of SME Financing Needs

Respondents in both the SECOR and Angus Reid Group studies have confirmed that SME financing needs are in step with the increased sophistication of the Canadian economy. For instance, while debt financing remains important in the overall sphere, other types of financing, such as leasing, venture capital and quasi-equity, are becoming more common and sought after. Given that SMEs' capital structures are increasingly complex, it is now commonplace for businesses to use multiple sources of financing, including term borrowing, demand financing, leasing, personal loans, love money and venture capital.

This trend is underscored as service industries become increasingly important economically, and the share of intangible assets increases in proportion to total assets. This latter trend will inevitably have a long-term impact on the ability of SMEs to access financing, when a greater proportion of assets cannot be secured by traditional methods, thus requiring innovative financing approaches.

Another emerging trend that will reshape our economy relates to the transfer of ownership of small businesses owned by the baby-boomer generation. Given current demographics in Canada, it is expected that a large number of these transfers will happen over the next 10 years and will be very difficult to

12 Statistics Canada, *1997 Employment Dynamics* (excludes government services).

finance. In addition, it will be important to monitor the impact that these transfers will have on the ability of SMEs to attract and retain human resources in an ever-tightening market.

Levelling Off in SMEs' Use of Authorized Credit

The 2001 Conference Board study showed that financing provided to SMEs between 1996 and 1998 did not grow as fast as financing did in the 1994–1996 period, despite the continued growth in the economy. This is evidenced, in part, by the choice of the title of the report: *A Changing Demand for SME Debt Financing?* Not only did new sources of financing emerge, but the percentage utilization of credit authorized to SMEs also went down between 1996 and 1998. The study cites the following factors as a possible explanation for this trend:

> *There are a number of possible explanations for the lack of growth in loans outstanding between 1997 and 1998, including increased profitability of SMEs, the stage of the economic cycle, securitization and the greater availability of non-traditional sources of debt not covered by this report.*[13]

The CFIB study provides a different perspective on this issue. It confirms that fewer SMEs are applying for financing, despite a strong economy. In fact, only 60 percent of respondents indicated that they had applied for a term loan, line of credit or increase in an existing line of credit in the last three years. Of those that had applied for financing, 66 percent were young firms (respondents in business for 10 or fewer years). Only half of the firms with fewer than five employees had applied for financing over the last three years.

The CFIB survey states that this trend does not appear to be related to business cycles since the number of businesses seeking financing began to decrease during the early 1990s recession and continued to fall during the good economic times of the latter 1990s. The survey notes that:

> *. . . the continuance of this trend throughout a period of strong economic growth raises serious concerns. It is particularly troublesome since it is more pronounced among the smallest firms where only one in two applied for financing in the past three years.*[14]

A fundamental question that needs to be answered is the following: Are these shifts demand or supply driven? The Conference Board study concludes that the reduction in financings and the shifts in the offering of financing were probably demand driven, while the CFIB argues that the gap between the supply and demand is widening for small business credit financing.[15]

13. Conference Board of Canada, p. 28.
14. CFIB, p. 9.
15. *Ibid.* p. 10.

Conclusions

Private sector institutions have undertaken a wide number of initiatives to better address the needs of this market segment since 1995. While these initiatives have allowed many Canadian financial institutions to improve the overall satisfaction level of their existing clients, as recently confirmed by the CFIB survey, they did not have a material impact on improving accessibility to financing for those entrepreneurs who felt that their financial needs were not being addressed properly.

In fact, financial providers surveyed in the SECOR study indicated that lending criteria have not changed since 1995 and may in fact have been tightened as a result of the introduction of credit scoring and centralized risk management. Despite a levelling off in the use of authorized credit, financing gaps continue to exist for a segment of the SME population, especially for the young, high technology, fast-growing businesses whose risk and credit profiles fall outside the market targeted by private financial institutions.

These conclusions are detailed below.

1. Private Sector Advances

Since 1995, financial institutions have undertaken several initiatives to better address the needs of this market segment and improve relationships with SMEs, such as setting up specialized units and dedicated resources. As discussed previously, one consequence is the migration of small business portfolios into retail banking divisions. A positive outcome of such a practice is that more small business owners now deal with their local bank branch for all their banking needs, business as well as personal. By seeing the total value of a portfolio, the account manager has a greater appreciation for an entrepreneur's banking business, and this provides an opportunity to increase financing accessibility for some SMEs. This is especially true for SMEs owned by retail clients who represent valuable revenue growth potential from a wealth management perspective. There are also fewer turnovers of account managers and branch managers in retail banking, so this move reduces one of the main irritants for SME owners: account manager turnover. Moving small business portfolios to retail banking may also increase the amount of personal loans and credit card lines of credit being substituted for business loans that have been declined.

While these changes can be perceived as positive for some SME owners, they will not increase access to financing for SME owners whose personal wealth is not significant or whose personal assets have already been pledged to their maximum. In addition, the value of services that a retail account manager provides to a SME owner often does not match the quality of services and business advice that commercial account managers traditionally provide. Migration will also prevent business owners from fully utilizing the financial leverage potential residing in their companies' assets. For instance, the credit scoring of smaller financing will often be limited to an assessment of the business owner's financial situation and credit history, not that of the business.

2. Satisfaction Versus Access

While many Canadian financial institutions have succeeded in improving the overall satisfaction level of their existing SME clients, they have not had a material impact on improving accessibility to financing for those entrepreneurs who feel their financial needs are not being addressed properly.

SME participants in the Angus Reid Group study say they have seen no improvement in access to financing. If anything, a significant proportion believe that access to financing has become more difficult over the last five years. In the same vein, the recent CFIB survey on financial institutions found that:

> *More than a quarter (28.6 percent) of firms that have been in business for 10 years or less (i.e. less established) are considered to be under-financed. This figure is significantly lower for firms that have been in business for 11 years or more (i.e. more established), at 16.4 percent. However, the under-financed portion of those less established firms with very strong revenue growth in the past three years is the highest, at 30.8 per cent.*[16]

This confirms that it is Canada's smallest, youngest, fastest-growing businesses that are finding it increasingly difficult to get adequate financing to nurture their companies.

While the introduction of Internet banking has increased the reach and accessibility of financial services, this technology has not yet revolutionized the financing market. Until security concerns of customers are appropriately addressed, Internet-based distribution channels will not replace traditional channels. While respondents in the SECOR study indicated that they expect Internet banking to have a major positive impact on SME access to financing (p. 19), the CFIB survey indicated that two thirds of respondents do not believe that on-line banking is a substitute for branch banking, while 28.5 percent feel that it is a partial substitute. Only the remaining 6 percent view on-line banking as a full replacement for branch banking. Even among those respondents who currently use on-line banking services, only 14.4 percent view it as a full substitute for branch banking (p. 17).

3. No Improvements in Loan Criteria Since 1995

Suppliers of financial services surveyed for the SECOR report indicated that business loan criteria have not changed since 1995; they have only become more standardized and evenly applied through the use of credit scoring models. Suppliers of SME financing have also pointed to the use of credit scoring as a means of reducing portfolio risk.

In fact, the provision of commercial loans through the Internet using credit scoring models may point to a complete automation of the credit authorization process. Those with sound businesses and substantial personal wealth, who can access the financing they need today, will most likely preserve this

16 CFIB, p. i.

access through credit scoring. Credit scoring is not designed to increase access but rather to reduce the cost of doing business and to standardize procedures. While such offerings could increase the availability of sources for a certain category of SMEs, these tools are not designed for transactions for borrowers with credit challenges, who would need to provide security, for instance. Furthermore, given that these tools base their scores on past performance, they are not appropriate for assessing the potential of a business. It is, therefore, very likely that high growth, knowledge-intensive SMEs would not qualify for financing authorized through credit scoring mechanisms, since their balance sheets would have a tendency of showing a disproportionate amount of debt to equity.

Suppliers will argue that the introduction of new technologies will render access easier by reducing the cost of delivery and taking away the human factor. On the other hand, some users will complain about the fact that decisions made by computers take away the human factor, which can often be key to determining accessibility. There is no question that credit scoring will become an increasingly important tool in the future. However, it should be kept in mind that this tool will probably not increase access to financing for those businesses that already have difficulty obtaining the financing they need to grow.

4. Financing Gaps Continue to Exist

Despite a levelling off in the used percentage of authorized credit, financing gaps continue to exist for a segment of the SME population, especially for the young, high technology, fast-growing businesses whose risk and credit profiles fall outside the market targeted by private financial institutions.

The emergence of specialized financial institutions represents the single most important positive development in terms of increasing access to financing for Canadian SMEs. However, this positive development has certain limits. Specialized finance companies are not a blanket alternative to traditional financing, as these providers focus on financing specific assets, and do not take a holistic approach to the financing needs of SMEs. They come in for one purpose only and will take back their secured asset in the event that the SME is in payment default, without special consideration to the overall impact this could have on the business.

The **risk gap** has changed little over the last five years. If anything, it may have widened somewhat as financial institutions rely more heavily on credit scoring models and seek to contain risk. Despite the fact that in 1998 the MacKay Task Force urged financial institutions to make credit available to higher risk borrowers through more innovative financing packages and appropriate pricing, the situation has not materially changed. In the SECOR study, suppliers of SME financial services even suggested that pricing to risk was not a commercially viable strategic option for them. Few suppliers are willing to take on more risk, even at a higher price, as they have indicated that the costs of managing the risks and the probability of default outweigh the margins.[17]

17 SECOR, p. 17.

Another important aspect of the risk gap is the advent of credit scoring. While this method has the benefit of standardizing the application of credit criteria so that there is more equal treatment of SMEs in all parts of the country, it can also mean that SMEs that lie slightly outside the scoring range are automatically rejected and receive no further consideration. Another important issue relates to the introduction of sophisticated risk management tools by financial institutions. While these tools have now become an essential component of responsible and sophisticated management, they have also allowed financial institutions to better measure how different risk categories specifically contribute to supporting aggressive return on equity objectives. This enhanced capability, while improving the quality of assessment, may also negatively affect those businesses not meeting a specific risk-adjusted return on capital.

It is difficult to anticipate whether financial institutions will change their attitude towards risk in Canada. The recent introduction of the foreign bank branching regime has not yet had any major impact on SME financing in Canada or on financial institutions' appetite for risk in this market segment. However, this may become an important factor, as pricing to risk is a strategy that financial institutions in many countries have followed successfully.

The **size gap** may have widened during the last five years. Despite the fact that more small companies started operations to take advantage of strong economic conditions, the data for term lending below $250 000 since 1995 show a significant reduction. While some of this reduction was offset by an increased use of personal loans and credit cards for business purposes and of other sources of financing such as leasing, the CFIB survey seems to indicate that the number of under-financed SMEs has increased:

> *There is a significant small business financing gap, particularly for the young, high performing SMEs* (p. 21).
>
> *Hence, it is the young, high performing businesses that are experiencing the greatest difficulty in obtaining financing. These findings are quite troublesome. Not only does it compromise the growth potential of the small business sector, it limits the overall performance of the economy. Furthermore, the fact that the issue of access to financing is more severe among the smallest and youngest firms indicates that the job-creation ability for the vast majority of businesses has yet to be fully unleashed* (p. 10).

While the increased use of demand financing represents a more efficient way for financial institutions to administer smaller loans, this method of financing should not lead to the complete demise of the demand for term loans. It is not advisable to use short-term money (credit cards and credit card lines of credit) to finance long-term assets. This puts additional pressures on small businesses when interest rates start rising, and may also lead to the reduction of the amount of credit available for short-term needs and operating purposes.

Financial institutions have implemented some initiatives to address the **knowledge gap**. The establishment of specialized KBI teams in certain institutions, including venture capital groups, and partnerships with government agencies are examples of these initiatives. Such actions have responded to KBI demands for financing, albeit in a selective way. KBIs participating in the Angus Reid Group study felt that financial institutions did not accommodate their financing needs. The Thompson Lightstone survey done for the CBA also found that small KBI enterprises have the hardest time obtaining financing.[18] Even though the KBI sector is growing faster and is more investment intensive than other SME sectors, the share of chartered bank SME loans going to KBIs has remained fairly steady — between 2 and 2.5 percent — over the last four years.

The knowledge-based firms surveyed in the Angus Reid Group report stated that knowledge-based lending is rare in the banking system and that they have to rely on other sources of financing, such as the venture capital industry.

As the economy continues its structural shift to knowledge-based companies and as companies' assets become increasingly intangible, there will be increasing demands for knowledge-based financing and more firms will likely face difficulties of the knowledge gap type.

The growth of KBIs and the increased sophistication of SME financing needs could also widen the **flexibility gap**. Flexible, customized and innovative financial instruments associated with today's reality will certainly create a tension with the policy of financial institutions to bundle their product and service offerings to favour standardization. For example, some of the SME owners surveyed by the Angus Reid Group indicated that the introduction of credit scoring is not seen as flexible and does not allow exceptions. This formulistic approach was not interpreted positively by those surveyed.[19]

Gaps in the Venture Capital Market

As indicated earlier, Canada's venture capital industry continues to expand to record levels of investment activity each year. In fact, venture capital investment has doubled in the past five years. The significant growth achieved by this relatively new segment of the financial industry represents a major achievement. Despite these successes, many analysts agree that access to sufficient venture capital remains a key issue if Canada wants to remain an active player in the "new economy."

Even with the maturing of the Canadian venture capital industry, there remain many gaps that need to be filled if the country is to foster the emergence of innovative firms. These are the:

1. **early-stage gap**, whereby investments in small, early-stage companies are not the strategic focus of most private investors;

18 Thompson Lightstone & Company Limited, *Small and Medium-Sized Businesses in Canada: An Ongoing Perspective of Their Needs, Expectations and Satisfaction with Financial Institutions,* (1998), Vol. I, pp. 171-174.

19 Angus Reid Group, p. 22.

2. **dollar gap**, whereby per capita venture capital investment will have to be increased if Canada is to meet the federal government objective of moving from the number 10 spot to the top 3 among industrialized countries;
3. **institutional gap**, whereby Canadian institutional investors are not playing an active role when compared to their American counterparts; and
4. **smaller appetite for IPOs** in Canada.

The first gap relates to the fact that Canadian venture capital investors are generally reluctant to invest in small early-stage technology companies given the high risks associated with such investments. This gap, which also exists in many other OECD countries, is at the root of many OECD governments' interest in the venture capital industry. While the figures for 2000 show a greater appetite for early-stage investments (i.e. seed and start-up funding) in Canada than in previous years, it should be noted that financings exceeding $5 million represented 78 percent of disbursements to early-stage companies, versus 57 percent in 1999. Investments in start-up companies averaged $3.8 million in 2000.[20] These trends are very positive for the Canadian economy. However, one must keep in mind that while these numbers were high in relative terms, they nevertheless were largely dominated by a limited number of larger transactions.

The second gap relates to the fact that Canada currently ranks tenth among developed countries in venture capital funds raised per capita. If Canada is to achieve the federal government's goal of ranking among the top three industrial countries in the level of per capita new venture capital investment, the industry must accelerate its growth rate to surpass that of many other industrialized countries.

For example, Figure 20 shows the gap in the level of activity when Canada's performance is compared with that of its main competitor, the U.S. The reality is that if Canada wants to be a hotbed for the creation of new start-up firms in high technology sectors, it must increase venture capital activity to levels comparable to those of the U.S. figures for 2000.

Figure 20: Canada–U.S. Venture Capital Statistics

Fiscal Year 2000

	Canada	U.S.
Total Investment	$6.3 Billion	US$103 Billion
Investment per Capita	$210	US$380
Number of Deals (or Financings)	1441	6904
Average Deal Size	$4.4 Million	US$15 Million

Sources: M. Macdonald & Associates Limited and *Venture Capital Journal.*

20 For more details, see *Economic Impact of Venture Capital,* a survey sponsored by the BDC and prepared by M. Macdonald & Associates Limited, 2000.

The third gap in the Canadian venture capital industry relates to the relatively small involvement of institutional investors. For example, 1998 data showed that pension funds accounted for only about 5 percent of venture capital investment in Canada versus 60 percent in the U.S. Comparative data for 1999 showed an increase in Canada to 5.6 percent and a reduction in the U.S to 23 percent. Data for 2000 showed an increase to 24 percent in Canada. While these developments are encouraging, the fact remains that Canadian pension funds still allocate a much smaller proportion of their assets to venture capital than do their U.S. counterparts: less than 0.5 percent in Canada compared to 2.5–3 percent in the U.S.[21]

Several factors, such as lack of knowledge of the asset class by pension fund managers and the absence of reliable data on relative performance of Canadian venture capital funds, explain this gap. Another important factor is the absence of "fund of fund" activities in Canada, whereby capital is pooled from different sources to be invested in a fund, which then invests in different venture capital funds.

Most U.S. institutional investors have neither the resources nor the expertise to manage and invest in many funds, so they delegate the task to an investment advisor or so-called "gatekeeper." This advisor pools the assets of its various clients and invests these proceeds as a limited partner in a venture or buy-out fund currently raising capital, allowing institutional investors the opportunity to tap into the wealth creation associated with venture capital without having to develop internal sophisticated market expertise. Many of these funds exist in the U.S. and represent a favourite avenue for venture capital investment by institutional investors.

Finally, the last gap relates to the fact that Canada is lagging behind the U.S. in terms of the appetite of investors for investing in IPOs, so that companies can expand their equity base and allow venture capital to exit ownership. In 1999, the per capita dollar value of IPOs done by Canadian enterprises in Canada was only about half the level raised by American enterprises in the U.S.[22] If the Canadian venture capital industry is to be successful, it will be essential for venture capitalists to be able to see their investments mature and reach public markets, in time frames and conditions comparable to those prevailing in the U.S.

If Canada is to foster a culture of innovation, entrepreneurs' and financial providers' attitudes towards risks must change. Given the pull of American capital markets on Canadian businesses, it is vital for the Canadian equity financing market to quickly adjust to meet the needs of new economy companies. If it does not, Canadian entrepreneurs will take their ideas elsewhere to be financed and developed by others.

21 The Honourable Paul Martin, speech, the Toronto Board of Trade (September 14, 2000).

22 *Ibid.*

Subordinated Financing

While the BDC's involvement in the subordinated financing market continues to be strong, it appears that other private sector providers may be decreasing their level of activity, as evidenced by the decline in the number of transactions in the first nine months of 2000.[23] The challenge in developing this market is for providers to find the right balance between risk, price and profitability. Indeed, the high risks inherent in subordinated financing are mainly due to the combined debt and equity components unique to this type of financing product, and the fact that it is needed mostly by small, high-growth firms. In fact, statistics have shown that approximately 44 percent of firms using subordinated financing have fewer than 25 employees, and another 31 percent have between 25 and 50 employees.[24]

It is expected that the Bank will continue its strong presence in this unique marketplace, given its yet untapped potential. This market has not yet matured and it will take time before it reaches the level of competition that exists in the U.S.

Perspectives on Access to Consulting Services for SMEs

On the business consulting front, intermediaries such as accountants in the Angus Reid Group study and suppliers of financing in the SECOR study know the value professional consulting services can bring to SMEs, and they promote more use of these services. However, they recognize that these services are not affordable to the vast majority of SMEs. According to the accountants interviewed, it is usually enterprises with $1 million or more in revenues that would use professional consulting services. SMEs for their part do not value consulting services the same way. In the Angus Reid Group study they acknowledged that they are unable to pay for these services but also professed to know how to manage their businesses themselves, except for technical tasks such as Web site development and accounting. Indeed, some survey results suggest that many SMEs are reluctant to use consultants and that consultants are not among the preferred sources of business information. KBIs and exporters differed from other SMEs in this respect as they showed an interest in using consulting services. They value the knowledge that consultants can bring to a business, and seek assistance from a wide spectrum such as human resources, marketing, exporting and financing consultants.

A recent study by the Ordre des administrateurs agréés du Québec showed that about 75 percent of larger SMEs in Quebec (with 10–200 employees) purchase consulting services every year.[25] Furthermore, these SMEs are interested in obtaining consulting services in engineering and production, systems, human resources, marketing and sales, quality, R&D, finance, training and coaching, general management, strategic planning and exports.

23 Based on Q3 1999 and Q3 2000 comparative data compiled by M. Macdonald & Associates Limited (see *Quasi-Equity Market Activity, First 9 Months, 2000*), which found a 16 percent decrease in the number of transactions.

24 Based on data compiled by M. Macdonald & Associates Limited (*Analysis of Quasi-Equity Market Activity 1999*).

25 Ordre des administrateurs agréés du Québec, *Les besoins et attentes en service conseils de la PME au Québec* (February 2000).

The total number of consulting firms serving SMEs in Canada is at least 20 000, of which 95 percent are estimated to be independent consultants.[26] These small firms represent an estimated 14 percent of total employment in the industry. Mid-sized firms provide some SME consulting but their services tend to be centred on accounting or information technology. The biggest consulting firms — that is, the "big five" accounting firms and a few others — have tended to move away from the SME market to focus on larger clients, as most of their revenues originate from projects valued at more than $100 000.[27] Universities and other educational and public institutions also provide SME consulting services of a more general nature. The main issues around accessibility of SMEs to consulting services are discussed below.

While it is demonstrated that the survival of any business is highly dependent upon the quality of its management, most small business owners do not have access to the resources or knowledge to determine whether their management practices need to be refined to be more in line with evolving industry practices. In fact, the ability of management to determine that a specific need exists and that it can only be met by seeking outside expertise can be a core survival issue for many small businesses.

Whenever a need has been identified, SMEs are faced with the task of selecting an outside consultant. Given the fragmented nature of the consulting market for SMEs, this is an important challenge for small business owners, who may not know how to find sources of expertise at a reasonable cost. The choice of the right consultant is often the key success factor in consulting mandates.

While the costs of entry into the consulting services industry are not significant, the costs of maintaining skill levels and product offerings in line with SME demands can be extremely high and even prohibitive for many small consulting firms. These realities explain why some of the smaller players are interested in joining associations or networks that allow them to pool resources to offer quality services.

The emergence of information technologies has created new opportunities for the delivery of consulting services, including those offered to SMEs. Such technologies are ideal for the delivery of affordable solutions to businesses such as business plan templates, various information sites of interest to SMEs and even self-diagnostic tools. However, these technologies cannot replace the personal contact that is often the basic element for building trust between the consultant and the entrepreneur. This human contact is often key to the higher value-added consulting solutions offered to fast-growing businesses.

As the Canadian economy becomes increasingly dependent upon the emergence of new SMEs, it is essential for these businesses to be able to benchmark their management practices and technologies to ensure that they remain competitive with industry peers and are able to grow their businesses.

The following section will provide a succinct overview of the way BDC consulting and financing services will support the growth of Canadian SMEs over the next 10 years.

26 Industry Canada, *Management Consulting*, Sector Competitiveness Framework Series, 1997 and *Canada — Management Consulting Services — ISA980601,* U.S. Department of State (1998), p. 9.

27 *Ibid.*

Part III

BDC Outlook

BDC Outlook

The BDC's continuing role in the financial services industry is defined by the ongoing presence of SME financing gaps and the fact that suppliers of SME financing have not increased the accessibility of financing for riskier, fast-growing Canadian SMEs. The BDC's role complements that of private sector sources by meeting the financing needs of this type of SME. Moreover, to contribute to the government's objective of making Canadians more innovative and competitive in the knowledge-based economy, the Bank must continue to ensure that Canadian SMEs are active in defining the future Canadian economy. Given that new technologies and the globalization of markets are creating an increasingly competitive environment for SMEs, it will be more important than ever that this critical segment of the economy be equipped with the tools to continue to play a leading role in Canada's innovative economy.

Given the recommendation to maintain the BDC's mandate, it is appropriate to look at how the BDC should fulfil this mandate over the next 10 years. The following outlook is based on the premise that the BDC's role as a contributor to the development of economic capacity in Canada has not yet reached its full potential and impact, particularly in light of the evolution of the market. The following section thus provides a perspective on broad strategies that the BDC will be pursuing to meet the requirements of its mandate and to reach its full potential. These strategies are based on the assessment of today's environment; there is no doubt that ongoing adjustments will be necessary to ensure that the Bank adequately supports the evolving needs of the SMEs it is mandated to serve.

Over the next 10 years the BDC will focus its resources on implementing two overarching strategies:

- ensuring that BDC services contribute to the success of Canadian SMEs whose financing needs cannot be satisfied by private sector providers; and
- ensuring that the BDC delivers on its mandate while balancing its public policy role with that of operating in a commercially responsible manner.

The following elements deliver on both strategies.

Contributing to the Success of SMEs

As demonstrated in Part II of this report, there are many SMEs in Canada whose financing needs are not being satisfied by private sector providers. To properly deliver on its mandate, the BDC will have to adjust its service offerings to the evolving needs of targeted SMEs, including the young, fast-growing high technology firms whose risk and credit profiles fall outside the scope of most private sector institutions. The BDC must do this while still serving the needs of its traditional clientele. The Bank's relevance will be determined by its ability to adapt to changes in the marketplace and to create value for its customers and its shareholder.

The BDC as a Provider of Complementary Financial Services

a) The BDC's Role in Debt Financing

The analysis of the debt financing market in Canada has revealed important trends that are changing the nature of this market and of its gaps. The shift from term lending to demand lending, the introduction of credit scoring, and the integration of sophisticated risk management tools and aggressive return on equity targets will all affect the availability and accessibility of debt financing in Canada. Until these trends result in increased access to financing for SMEs, it is likely that the BDC will need to maintain strong growth in its portfolio to meet the increasing debt financing demand that is anticipated. Despite having outpaced economic activity in the last five years, demand for BDC term loans — the product that the private market is less interested in — continues to increase. These conditions reinforce the need for the BDC to fill the SME financing gaps. The growth of the lending portfolio will complement the activities of private sector institutions, as BDC's relationship with these institutions is expected to further deepen over time.

As private financial institutions continue to address conventional lower-risk demands and as more SMEs innovate and adopt new technologies, the BDC's complementary role will be reinforced through partnerships and strategic alliances. In this vein, the BDC will work towards maintaining an excellent working relationship with all of its partners, including Canada's chartered banks and credit unions. The BDC will also work closely with other members of the Industry Portfolio to better address the needs of Canadian SMEs. Finally, the BDC will maintain frequent contacts with other Crown financial institutions to ensure complementarity of service offerings, while identifying opportunities to cooperatively improve operational efficiencies.

This interpretation of the complementary role will need to be aligned on an ongoing basis with the changes occurring in the operating environment of the Bank.

Increase Reach

To deliver properly on its mandate, the BDC will work over the next 10 years to increase its reach among those Canadian SMEs that are affected by imperfections in the marketplace. The BDC will achieve this through advertising campaigns, strategic partnerships, use of Web technologies, and optimization of its existing infrastructure and strategies. The Bank will also focus on strengthening its activities in regions where it is now relatively under-represented, especially Southern Ontario and the Western regions, to ensure that it fulfils its mandate nationally.

Continue to Address the Needs of Developing Markets

To better address the needs of its targeted clients, the Bank will continue to dedicate specific resources to support Aboriginal and youth entrepreneurs. In this respect, the BDC intends to continue to partner with other organizations to ensure that it invests its resources in a strategic manner, thus producing maximum benefits for these targeted groups. This will mean taking a holistic approach to the development needs of these markets, and ensuring an adequate combination of financing, consulting, mentoring and community involvement.

Support to Aboriginal Entrepreneurs

In line with major economic development recommendations of the *Royal Commission Report on Aboriginal Peoples* and the Speech from the Throne, the BDC's Aboriginal Banking Unit will focus on improving access to BDC services and to business education for young Aboriginal people. More specifically, this strategy will focus on areas such as:

- human resources;
- increased business support services;
- increased access to capital; and
- creation of an Aboriginal business development tool.

Support to Youth

While the Bank will continue to use its Young Entrepreneur Financing Program as a core strategy, it will also enhance its recently launched Entrepreneurship Centres. These centres, which are established in BDC branch offices across the country, have dedicated resources to serve smaller businesses, especially growing KBIs. Through these centres small businesses and micro-businesses, including start-ups, can access the Bank's regular term loans; the Micro-Business program, which has a mentoring component; BDC Global Lines of Credit; the Young Entrepreneur Financing Program; and Innovation Loans.

b) The BDC's Role in Subordinated Financing

As recent surveys show, the subordinated financing segment of the Canadian financial services industry remains underdeveloped. In fact, the large market share occupied by the BDC in this market clearly demonstrates that the Bank is more or less "creating" the market for small transactions. The structural shifts toward a service economy as well as the increasing importance of intangible assets in the creation of value are important factors that are expected to increase the demand for this type of non-traditional financing in the future. Another important factor will be the transfer of ownership that will likely take place with the progressive retirement of baby boomers. These factors reinforce the importance of developing this segment of the market for the growth of Canada's knowledge-based economy. It is thus essential for the BDC to continue to assert its presence and to attract other players to this market, thus ensuring that the evolving financial needs of Canadian SMEs are met.

c) The BDC's Role in Venture Capital

The experience that the BDC has gained in venture capital since 1976 has allowed it to achieve a reputation of excellence in the marketplace. This experience and reputation can now be leveraged to allow it to continue to be a path breaker in the industry.

In this respect, BDC Venture Capital intends to work towards being recognized as an investment leader in Canada in early-stage, high technology companies. In addition, it will work to innovate its service offering so as to be a path breaker for other venture capitalists in the country, and to help increase the financial support and degree of sophistication of the Canadian venture capital industry.

Since BDC Venture Capital is relatively small, it will continue to ensure optimal leverage from its activities by partnering with other organizations. For instance, the BDC will co-invest with other venture capitalists to create new specialized venture capital funds, just as it did with seed capital funds across Canada. These partnerships will not only make more venture capital available for various technology sectors, but will also mobilize industry expertise to assist investee companies. BDC Venture Capital will also undertake a number of initiatives, including investing in a fund of fund, with a view to drawing institutional investors (especially pension funds) into the venture capital industry. Finally, the BDC will look at different alternatives to support greater commercialization of university research in Canada.

d) The BDC's Role in the Consulting Market

Demand by SMEs for consulting services is directly related to SME's market challenges and issues. Management of businesses has become increasingly complex, given globalization and technological innovations in today's knowledge-based economies, and this trend will pose a particular threat to those small businesses with limited financial and human resources. It is thus expected that the market for SME consulting will increase rapidly in the near future.

The fact that the BDC provides both consulting and financing solutions is a very special attribute. This unique feature allows the Bank to develop integrated business solutions that may in many cases make the difference between an entrepreneurial success and a failure. Another important feature is that the target markets for both types of solutions are identical: early-stage, knowledge-based, high technology export and growth-oriented businesses.

The presence of the BDC Consulting Group ensures that Canadian SMEs have access to consulting solutions specifically designed to meet their needs and delivered by a national network of private consultants that caters to the needs of this specialized clientele. This not only allows Canadian SMEs to have access to a constantly updated suite of consulting solutions at reasonable cost, but also allows private consultants to become part of the BDC network, accessing the knowledge embedded in BDC consulting solutions.

Strong Customer Focus

Customer focus will remain at the core of BDC operations. Since the BDC is a niche player in the SME market, its future success will continue to depend on its ability to have a value proposition that fulfils the needs of its clients. The BDC will also develop the capability to understand how customer experience is determined and how best to adjust and continue to provide personalized services whereby the client feels the Bank and its staff understand each company's uniqueness.

To build on its customer satisfaction performance, the BDC will regularly monitor customer satisfaction and survey customer needs. Past surveys have confirmed the importance to the BDC of understanding and addressing the needs of each and every one of its clients. The BDC will therefore maintain its core competencies to adapt its service offerings to the individual needs of its clients in a flexible and customized fashion. This will be made possible by ensuring that BDC employees spend as much time as possible with their customers. The Bank will also favour decentralized over centralized decision making to ensure maximum consideration of the individual situations of clients. The Bank will strive to ensure that its employees are perceived as trusted business advisors who understand their clients' preoccupations and challenges.

The Bank will also revise its service offerings to offer the customized and innovative solutions that its SME clients need. As a provider of financing and consulting solutions, the BDC is well positioned to help SMEs innovate or adopt innovations of others that will allow them to be more competitive. To pursue this objective, the Bank will use its network of account managers and consulting managers to remind SMEs of the importance of investing in their future competitiveness. It will build upon solutions such as the Innovation Loan and Productivity Plus Loan to support innovative SMEs.

Recognizing that, more than any other phenomenon, e-business is redefining the way business is conducted, the BDC has made it a priority to develop an e-business strategy. The Bank will use a multi-dimensional approach to support SMEs in their adoption of e-business. The proposed solution will include awareness sessions, on-line self-diagnostic tools, specific consulting solutions for incorporating e-business and financial solutions to support the implementation of e-business strategies.

Balancing Public Policy Mandate with Commercial Responsibility

To ensure that the BDC delivers on its mandate while balancing its public policy role with the need to operate in a commercially responsible manner, the Bank will focus its activities on the following fronts.

Human Resources

The BDC recognizes that its employees are the heart and soul of the organization and are the key drivers of customer satisfaction. That is why its Employer of Choice philosophy has become a central component of its human resources management framework. This strategy is based on the principle that committed employees deliver good quality service, which will inevitably translate into positive financial results and the success of the organization. Most major Canadian financial institutions recognize this, and the BDC competes in the same market as they do for talent. The Bank will monitor the satisfaction of its employees to ensure that it reaches this objective.

Another strategic priority for the Bank will be to continue to attract and retain the right talent. The BDC will refine its hiring profiles to ensure that it employs people who can generate high customer satisfaction levels and who have strong customer service skills and capabilities. The BDC will also monitor its compensation policies to align them with industry norms and to be able to maintain a reasonable level of employee retention. It will also work to enhance the leadership skills of its staff.

The BDC will refine its professional development programs so that employees can improve customer satisfaction. There will be an emphasis on ensuring employees clearly understand the challenges facing SMEs and thus can better analyse their needs.

Focus and Operational Excellence

The Bank aims to be more efficient and effective in its operations and to apply proven business principles that have led to its success in serving Canadian SMEs. To ensure the commercial viability of the institution, the BDC will strive to achieve a financial performance that allows it to generate a return at least equal to the long-term cost of shareholder funds. This objective is key to delivering on its public policy mandate, while generating sufficient earnings to sustain future growth. As such, the following aspects of the Bank's operations will be particularly emphasized over the next 5 to 10 years.

Integrated Management of Risks

Since receiving its mandate in 1995, the BDC has expanded its financing into situations that are riskier and more costly to administer, yet it has not compromised its return on equity. However, it should be borne in mind that economic conditions have been very favourable during this expansion. As the Bank responds to SME financing demands over the next 5 to 10 years, it will continue to refine its credit system to accommodate new demands and changes in the SME environment. Furthermore, recognizing that it has a riskier portfolio that could be more seriously affected during economic downturns, the Bank will ensure that its reserves for losses are fully adequate to cover write-offs through all economic cycles.

Managing individual credit risk is important for the Bank, but so too is monitoring and managing other risks through various mechanisms. For example, the Bank has implemented a comprehensive liability risk management system that adheres to guidelines issued by the Minister of Finance. To respond to observations of the special examination completed in 1999, the Bank is further developing and refining its integrated risk management systems. The Bank will monitor collectively all the important risks it faces, including credit risks; treasury operations risks; operational risks related to human resources, reputation and information systems; and market risks such as interest rates and liquidity. This system will provide the Bank with a structured, disciplined approach that supports the alignment of strategy, processes, people, technology and knowledge within the Bank and helps the Bank evaluate and manage uncertainties inherent in its business.

The risk management system will monitor trends in the BDC's total financing portfolio in addition to monitoring individual financings. With this system in place, the Bank will be able to proactively manage its portfolio as a whole to reduce volatility and ensure greater consistency in lending and loan administration across the Bank.

Risk management is an evolving field. As such, the BDC plays a leadership role in forums sponsored by the Risk Management Association, an organization with a membership of more than 3000 North American financial institutions. Through these forums the Bank shares its experiences and know-how and keeps abreast of the latest risk management issues and methods.

Integration of Web Technologies Into Core Processes and Delivery

The BDC will take a multistep approach to further integrating Web technologies into its operations. The approach will include:

- implementing employee training programs to ensure that employees are proficient in the use of the tools and knowledgeable about the topic in their dealings with SMEs;
- enhancing customer service to provide clients with access to the Bank's services on-line at their convenience, including access to account information and mechanisms for modifying loans;
- making its loan delivery network fully compatible with recently introduced Web technologies, which will include improving the reach and accessibility of the Bank's services;
- launching on the Web in 2002 a more automated loan prequalification and fulfilment form, which may be the first step in revolutionizing the process for obtaining commercial financing in Canada; and
- using e-business to continue to enhance the Bank's presence and reach in remote areas.

In most cases, potential and existing BDC clients will have the option of pursuing their dealings through the Bank's e-business channels or dealing directly with staff at a BDC office. For the BDC itself, e-business will improve customer service and operating efficiencies by streamlining internal workflow, reducing processing time and providing on-line loan processing.

Appendix I

Copies of the the Minister's 1997, 1998 and 1999 Letters to the BDC

Minister of Industry   Ministre de l'Industrie

Ottawa, Canada K1A 0H5

The Honourable   L'honorable
John Manley P.C., M.P. c.p., député

NOV - 5 1997

Mr. Patrick J. Lavelle
Chairman of the Board
Business Development Bank of Canada
150 King Street West, Suite 1101
P.O. Box 31
Toronto, Ontario
M5H 1J9

Dear Mr. Lavelle:

Pat

I am writing further to a number of requests from board members for a written version of my remarks at the Business Development Bank of Canada's (BDC) Board of Directors dinner held on Tuesday, September 16, 1997, in Ottawa. I was very pleased to have had this opportunity to discuss how the Bank can play an important role in improving the climate for jobs and growth in Canada. This is particularly timely as the government is embarking on its second mandate, and the Canadian economy is restructuring to meet the opportunities and challenges of the global, knowledge-based economy of the 21st century.

At the outset, let me reiterate that I believe the Bank is making a lot of progress. Two years ago, the government set out a strategic vision in new legislation for the Bank. The board, working with management, turned that strategic vision into a Corporate Action Plan. The Bank's management and staff have made great strides in implementing the corporate plan, and hence in meeting the challenges of that vision. I want to congratulate, and thank, board members, Bank management and staff for their commitment and hard work.

Looking ahead, I think we can all agree that bringing permanent, long-term change in any organization takes time and effort, and this is particularly challenging in financial services given the accelerated rate of change

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Canada

which is taking place globally in this sector. We must work hard at not just becoming another bank. The challenge now is to intensify our support for knowledge-based companies. In setting your 1996 Corporate Plan, you indicated that, by 1998, 38 per cent of your lending would go to exporters and knowledge-based companies, and you did this at a time when few were even focused on the strategic importance of knowledge-based industries. The Bank has made excellent progress towards this target, but I believe now is the time to become even more ambitious. Our future competitiveness as a country depends on the success of knowledge-based businesses in sectors where Canada can be a global leader, such as bio-technology and bio-pharmaceutical, aerospace, information technology and high-tech manufacturing exporters.

As we look ahead, the Bank needs to not only maintain but to strengthen its national presence. As your products and expertise develop an increasingly positive reputation in the marketplace, the Bank will need to manage the growth of the Bank's portfolio to ensure a strong presence across the country. This is particularly important in Ontario, where there is no regional development agency.

Achieving this objective will require, in part, building on the framework of strategic alliances and partnerships that the Bank has begun developing over the last two years. The goal is to lever more activity and expertise to meet the needs of particular sectors, especially to better serve knowledge-based companies. Your alliances with the private sector banks to better serve knowledge-based companies are very encouraging, as is the partnership with the Canadian Tourism Commission. Similarly, the development of funds to help commercialize university research and innovation is an important development. As you build on these initiatives, you will need to ensure that federal visibility is maintained in these relationships and that concrete results are being achieved through effective benchmarking. Your motto says you are "a different kind of bank," and the Bank must be seen to continually live up to this challenging expectation.

One way the BDC can be "a different kind of bank" is through more aggressive and innovative development of its venture capital operations. Venture capital can be a key contributor to the success of our strategic vision for the future, and the Bank should consider ways to increase its venture capital activities, including through alliances, where gaps in the market continue to exist. Our objective should be a significant increase in investments in knowledge-based companies, particularly in sectors such as those mentioned earlier. The Venture Capital Division should become more aggressive in seeking such investments on a pan-Canadian basis.

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Another distinguishing characteristic of the Bank should be how it serves businesses with special needs. The Young Entrepreneur financing program has demonstrated your commitment to youth. It would be worthwhile to explore ways to complement that effort by finding innovative ways to help young people gain work experience in the Bank itself, and elsewhere by committing additional resources from the Bank's earnings to this important national priority. You have made some progress in aboriginal lending, but the recent Royal Commission report throws out challenges which the BDC will need to examine and work with the Industry Portfolio to meet. The BDC should build closer relations with the other Crown financial institutions, in particular the Farm Credit Corporation, with the clear goal of providing seamless, cost- effective delivery of service to the customer, without regard to organizational considerations.

Marketing and outreach activities by the Bank have seen a dramatic improvement over two years. I am a strong supporter of your innovative marketing approaches. In this context, I appreciate your support for the first phase of the small- and medium-sized enterprises (SME) info-fairs. As these will now become a permanent feature of our outreach as a government, I look to the Bank for continuing support for them.

This is a challenge I have set for all my departments and agencies, I want the Industry Portfolio to be at the leading edge of putting government online. As a key part of a Portfolio, which spearheads the development of the information highway, the Bank should be at the leading edge in meeting the challenge of electronic banking by developing innovative ways of servicing its small business clients.

In closing, I want to thank you again for your contribution to the remarkable transformation of the Bank over the last two years. As I indicated at the BDC board dinner, I believe we can and must build aggressively on our successes. I am looking forward to your 1998 Corporate Plan, which will chart a path to achieving these new strategic objectives. At our meeting next year, I anticipate the opportunity for an update on your new corporate plan, and your progress in implementing it.

Yours very truly,

John Manley

English version of the signed French letter dated August 4, 1998.

Michel Vennat
Stikeman, Elliot
1155 boulevard René-Lévesque
Montreal, Quebec
H3B 3V2

Dear Sir:

Since you are beginning your mandate as Chairman of the Board of the Business Development Bank of Canada (BDBC), I felt it might be useful to pass along a few thoughts on the direction that the Bank will be taking in the years to come. I conveyed these thoughts to the Bank's Board of Directors last September; since then, my views have remained basically the same.

As you know, barely three years ago the government established a strategic vision as part of the new legislation regulating the Bank's activities. The Board of Directors, in cooperation with management, transformed this strategic vision into an Action Plan. The Bank's management and employees have made great strides in implementing this plan and tackling the challenges posed by this vision. This progress, along with the approaches set out in the 1998-1999 Business Plan, constitute a solid foundation for the future of the Bank.

I am particularly impressed by the Bank's potential in terms of serving businesses with special needs. The Bank has targeted knowledge-based and exporting firms in particular, and the progress that has been made to date in these areas is impressive: BDBC has created innovative financial products and succeeded in meeting

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businesses' needs. The Financial Program for Young Entrepreneurs, for example, shows that the Bank intends to help young people. The Bank has also made progress in the area of loans to Aboriginal businesses, but the report published recently by the Royal Commission describes the challenges that BDBC will need to examine and try to meet in cooperation with the Industry portfolio. BDBC should establish closer ties with the other finance-oriented Crown corporations, in particular the Farm Credit Corporation, with a view to providing clients with integrated, cost-effective services.

I also asked all the departments and agencies under my direction to take on another challenge: I want the Industry portfolio to be in the vanguard of direct public services delivery. As a key component of a portfolio that is overseeing the development of the information highway, the Bank should play a leadership role in delivering electronic banking services by developing innovative means of serving its clients in the small business sector.

In addition, I expect the Bank to take advantage of the strategic partnerships and alliances that have been established over the past two years. The objective is to marshal your resources and increase your know-how in order to meet the needs of specific sectors (e.g. providing knowledge-based businesses with better services). In this regard, the alliances concluded with private-sector banks are very promising, as is the partnership with the Canadian Tourism Commission. Similarly, the creation of funds to help market the results of university research and innovation is an important development. As you attempt to take advantage of these initiatives, you must make sure to maintain the federal government's visibility and to obtain concrete results; to that end, an effective comparative analysis could prove useful.

Over the past two years, the Bank's marketing and resource marshalling activities have come a long way. I am very keen on innovative marketing approaches and, as such, was pleased with how the Bank supported the first two phases of the info-fairs for small and medium-sized businesses (SMEs). Since these fairs will become a permanent aspect of our public actions as a government, I hope that the Bank continues to support these activities.

In the future, the Bank must not only maintain but strengthen its presence at the national level. As its products and know-how garner an increasingly enviable reputation on the market, the Bank will need to manage its growth so as to ensure a strong, visible presence all across the country. This is especially important in southern Ontario, which lacks a regional development agency, and in regions which could be affected by the proposed mergers.

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As you are perhaps aware, the government has placed BDBC within the vast Industry portfolio, which includes Industry Canada and 12 other agencies. We feel that bringing together organizations that cooperate so closely should help produce more efficient and consistent approaches to supporting Canadian companies. The Bank has played an important role in this process, and I believe it should consider more extensive cooperation opportunities.

We live in a world where Canadian and international financial markets are in a constant state of flux. It is my hope, therefore, that the Board of Directors will inform me regularly of its views on how the Bank can best fulfil its role as a public institution, continue to add value to Canada's economy and meet the needs of small businesses.

To that end, and as the senior deputy minister responsible for policy in the portfolio, Kevin Lynch and his replacement, Shirley Serafini, play key roles on the Board of Directors, in addition to apprising me of the issues facing the Bank. I also appreciate and benefit from the participation of the Director General of the Entrepreneurship and Small Business Office in Board meetings. I know they are all delighted at the prospect of working closely with you and supporting the Board's work.

In closing, I would like to thank you once again for agreeing to chair the Board of Directors of the Bank. Kevin Lynch and I look forward to meeting with you early in the fall to discuss your impressions of the Bank and its future in what is shaping up to be an interesting and stimulating period in the history of Canada's financial community.

Yours truly,

John Manley

English version of the signed French letter dated August 29, 1999.

Mr. Michel Vennat
Chairman of the Board
Business Development Bank of Canada
5 Place Ville Marie, Suite 400
Montréal, Quebec
H3B 5E7

Dear Mr. Vennat:

I am writing to elaborate further on my vision for the Business Development Bank (BDC), which I outlined at our meeting in Ottawa on March 9, 1999. I was very pleased to have had another opportunity to discuss the achievements of the Bank since its mandate change, and to look toward the future. This is particularly timely as we contemplate and evaluate changes in the financial services sector as it adjusts to meet the challenges of the 21st century.

The Board has one primary role: to implement the BDC's current mandate. In today's climate of rapid change in the financial services market, I am also looking to the Board to develop recommendations for changes to the mandate to meet small businesses' evolving needs. The examination of possible future changes to the Bank's mandate is a long-term strategic activity, distinct from the immediate challenges of implementing the current mandate in the most effective way possible. In a history that spans over half a century, the BDC has succeeded because it has evolved to meet changing needs of both the marketplace and public policy.

Implementing the Current Mandate

The Bank's current mandate responds to important public policy priorities, and makes it a critical partner in the Industry Portfolio. In this regard, last year, portfolio partners were able to make direct contact with more than 36,000 small business owners who attended Info-Fairs and Small Business Week events sponsored, to a significant extent, by the BDC. These events provide small businesses with an opportunity to discuss issues and obtain information on a full range of products and services available to entrepreneurs.

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The Bank complements the services offered by private sector financial institutions and works in partnership with them to fill the gaps left in the financial markets. In the knowledge-based economy, four particular gaps have been identified: risk; size; knowledge; and, flexibility. By filling these gaps, the BDC helps develop small businesses so that they will grow and, eventually, be eligible for more traditional sources of financing.

A major factor in the Bank's success has been the services offered to develop business skills among entrepreneurs. The Bank's account managers and business consultants provide customized service to ensure that the individual needs of entrepreneurs are met at every stage of their business development.

The BDC has also pioneered many of the practices that will become commonplace as other financial institutions learn to respond to the needs of small businesses. Some of these innovations, such as its on-line service, BDC Connex, have been quickly taken up by other financial institutions. The Bank can be proud that it was the first Canadian bank to offer on-line access to its complete range of financial services, including loans and lines of credit. I am confident that other financial institutions will follow the Bank's lead in offering a range of innovative products and demonstrating that there is money to be made in lending to small business.

Since Parliamentary appropriations were phased out two years ago, the Bank must generate a rate of return on equity at least equal to long term costs of funds, as well as generate profits for the future growth of its lending and investing activities. Over the past year, the Bank moved effectively to implement its Corporate Plan and performance exceeded objectives in such critical areas as: value of loans authorized; loans to knowledge-based industries (KBIs) and exporters (though the majority of the lending has been to exporters); net income; and return on shareholder's equity.

KBIs remain a rapidly-growing, strategically important, sector of Canada's economy, but they pose special challenges for the financial sector. The government continues strongly to support the BDC's target of 50 percent of new authorizations going to KBIs and exporters, though the results show that most of the growth in this category has been on the exporter side. It is important that the Bank remain focussed on lending to KBIs. This will mean continuing its role as a path-breaker for the financial services industry in the development of products and strategies to improve access to financing for this key sector. In doing so, I would like to see the Bank report on its achievements in meeting distinct targets for KBIs, specifying a KBI target within the 50 percent overall target.

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In short, the BDC has enjoyed marked success in responding to its mandate. I would like to see it address several challenges over the immediate term, and urge you, as a Board, to help oversee their development:

- continue to close the four gaps – until the other financial institutions follow your leadership, the task remains incomplete;
- build on your experience in lending to KBI's and exporters, but within this category increase the emphasis on KBIs;
- build on the leadership in electronic banking services;
- build new strategic partnerships and alliances with private sector banks;
- continue building a strong, visible presence across the country;
- coordinate activities with the rest of the Portfolio; and,
- leverage with outside partners to create more access to funds for SMEs.

Advising on Changes to Mandate

The BDC was given a mandate to pioneer new products and services while earning a return. It is a very ambitious mandate, and it has come a long way in meeting it, but challenges remain. It must build on the existing framework of strategic alliances and partnerships. It must help guide the way for the private sector to follow the example of innovation that the BDC has set in its current mandate. In this current climate of change in the financial marketplace, the government is looking to the Board for suggestions on the future role of the Bank, keeping in mind the need to balance the commercial goals of the Bank with its public policy role.

In 1997, the government commissioned the Task Force on the Future of the Canadian Financial Services Sector. The Mackay Report highlights issues that government will need to address and calls for a better understanding of the forces affecting SMEs.

The Report calls for improved competition through such recommendations as new entrants to the financial services industry, and more access to micro-credit. Improved competition along the lines outlined in the Report could lead other financial institutions to follow the BDC's example. The government is looking at the options available, and will consider what role the Bank might play as a gap filler in the emerging financial services market. I would value your recommendations in this area.

As well, the Bank will be preparing for the legislative review of its mandate, scheduled to begin in July 2000. The review will provide an opportunity to examine potential changes to that mandate, in line with the Mackay recommendations and the evolution of the financial services industry. At that

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time, we will want to consider how the BDC could best complement services offered elsewhere. I would like to stress, however, that the Bank should, until decisions on future direction are made, continue to develop its five-year corporate plans based on its current mandate.

The BDC, as one of the four unique federal financial Crown corporations, has thrived for half a century because it has a public policy goal to fill gaps. The BDC's only business is small business. As the needs of small business change, the mandate changes. But a public policy purpose remains.

I encourage the Bank to be innovative and resourceful, and wish you every success in the coming months as you direct its activities from your position on the Board. I look forward to hearing about your progress in meeting these goals.

As I have indicated previously, I have recommended that Treasury Board approve the first year of the five-year BDC Corporate Plan (2000-2004), subject to the Bank operating within internally-generated funds and the $50 million injection announced in the Budget on February 16, 1999. In this regard, I enclose, for your information, a copy of a letter I recently received from the Minister of Finance concerning the capital of the Bank and the implementation of the Corporate Plan over the coming fiscal year.

Yours very truly,

John Manley

Enclosure

c.c. Members of the BDC Board of Directors

Appendix II

BDC Definition of Knowledge-Based Industries

Standard Industrial Classification (SIC) Code and Description

Tier I Indicators

0239	Other Services Incidental to Agriculture n.e.c.
3211	Aircraft and Aircraft Parts Industry
3341	Record Player, Radio and Television Receiver Industry
3351	Telecommunication Equipment Industry
3352	Electronic Parts and Components Industry
3359	Other Communication and Electronic Equipment Industry
3361	Electronic Computing and Peripheral Equipment Industry
3362	Electronic Office, Store and Business Machine Industry
3369	Other Office, Store and Business Machine Industries
3381	Communications and Energy Wire and Cable Industry
3741	Pharmaceutical and Medicine Industry
3911	Indicating, Recording and Controlling Instruments Industry
3912	Other Instruments and Related Products Industry
4814	Cable Television Industry
4821	Telecommunication Carriers Industry
4839	Other Telecommunications Industries
7721	Computer Services
7759	Other Scientific and Technical Services
9611	Motion Picture and Video Production
9619	Other Motion Picture, Audio and Video Services

Tier II Indicators

0231	Agricultural Management and Consulting Services
3111	Agricultural Implement Industry
3121	Commercial Refrigeration and Air-Conditioning Equipment Industry
3191	Compressor, Pump and Industrial Fan Industry
3192	Construction and Mining Machinery and Materials Handling Equipment Industry
3193	Sawmill and Woodworking Machinery Industry
3194	Turbine and Mechanical Power Transmission Equipment Industry

3199	Other Machinery and Equipment Industries n.e.c.
3371	Electrical Transformer Industry
3372	Electrical Switchgear and Protective Equipment Industry
3379	Other Electrical Industrial Equipment Industries
3611	Refined Petroleum Products Industry (Except Lubricating Oil and Grease)
3612	Lubricating Oil and Grease Industry
3699	Other Petroleum and Coal Products Industries
3711	Industrial Inorganic Chemical Industries n.e.c.
3712	Industrial Organic Chemical Industries n.e.c.
3721	Chemical Fertilizer and Fertilizer Materials Industry
3722	Mixed Fertilizer Industry
3729	Other Agricultural Chemical Industries
3731	Plastic and Synthetic Resin Industry
3791	Printing Ink Industry
3792	Adhesives Industry
3799	Other Chemical Products Industries n.e.c.
3913	Clock and Watch Industry
3914	Ophthalmic Goods Industry
4611	Natural Gas Pipeline Transport Industry
4612	Crude Oil Pipeline Transport Industry
4619	Other Pipeline Transport Industries
4911	Electric Power Systems Industry
7751	Offices of Architects
7752	Offices of Engineers

Appendix III

SME Financing Studies

Conference Board of Canada: *A Changing Demand for SME Debt Financing?*[1]

The Conference Board of Canada recently published a study titled *A Changing Demand for SME Debt Financing?* This is an update of two previous studies and provides an overview of the recent data on SME financing. This study will eventually be replaced by the work done by Industry Canada and Statistics Canada under the Financing Data Initiative, which will look at supply of and demand for SME financing in Canada.

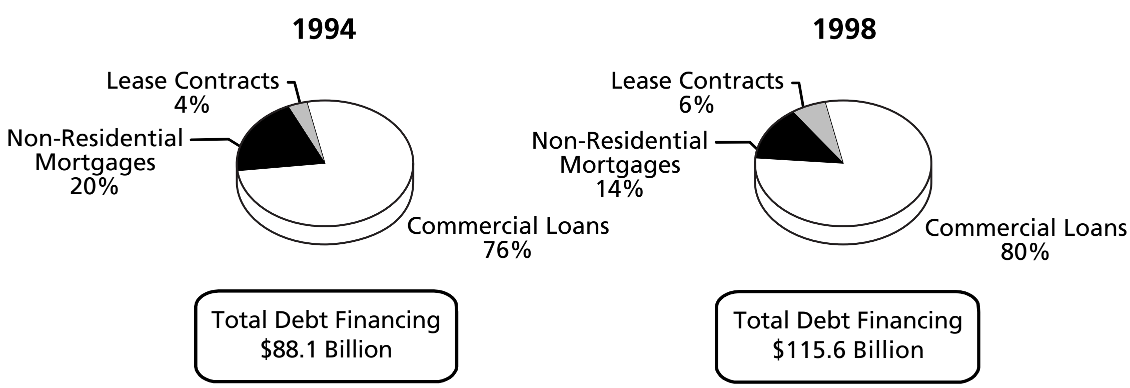
Overall, the Conference Board research showed that amounts outstanding in the SME debt financing market continue to grow, from $88.1 billion in 1994 to $115.6 billion at the end of 1998. This would indicate that the total SME loan market, with its 7-percent compounded annual growth rate, has grown faster than the market for chartered bank loans. Moreover, non-bank suppliers are accounting for a larger share of this market. Indeed, while there was growth overall during the period, the 1996–98 growth rate was slower than the 1994–96 growth rate.

A comparison of 1997 and 1998 data reveals that demand for some traditional debt instruments, such as commercial loans, is decelerating. The share of lease contracts in the market has increased from 4 percent in 1994 to only 6 percent in 1998. The Conference Board suggests that the lack of growth in demand during the period is due to sustained economic growth that has allowed companies to build at a steady pace and develop more balanced capital structures. With better financial strength, SMEs are showing more moderate credit usage.[2]

Figure A-1 illustrates the Conference Board's findings by type of debt financing product.

Figure A-1: Total SME Business Debt Financing, by Type of Product

1994 and 1998



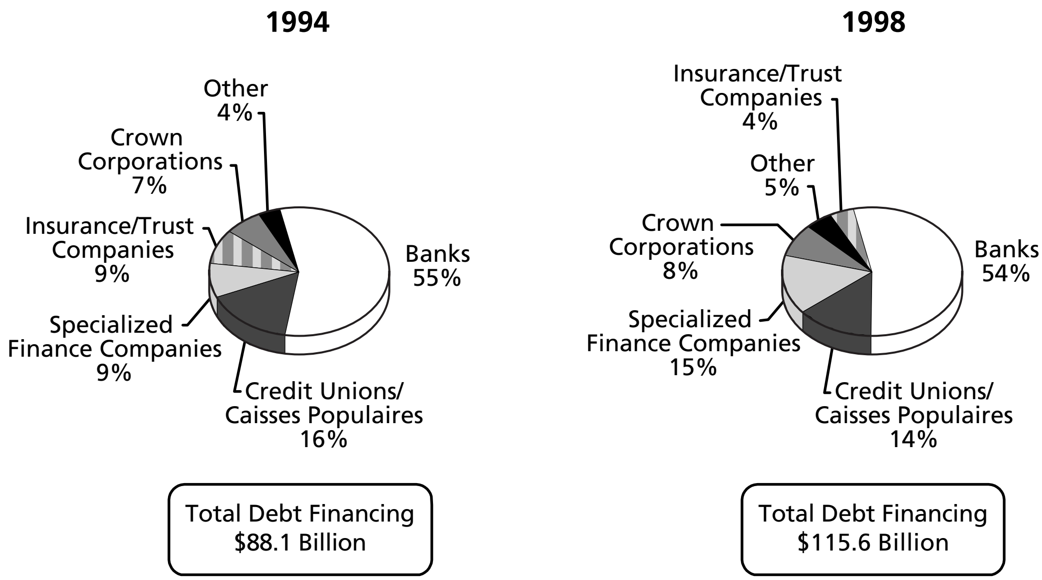
1 Conference Board of Canada, *A Changing Demand for SME Debt Financing?* (January 2001).

2 *Ibid.*, p. 28.

The trend becomes more pronounced upon examination of the SME debt providers. As shown in Figure A-2, the share of financing provided by banks continues to decline slowly. SMEs are choosing several alternatives to banks for their financing, particularly specialized finance companies, Crown corporations and other sources such as credit cards. In fact, specialized finance companies (e.g. leasing companies) and other companies (e.g. credit card companies) increased their share of the SME credit market from 13 percent in 1994 to 20 percent by 1998. Specialized finance companies alone increased their share of SME credit from 9 percent to 15 percent in the period. With continued spending on machinery and equipment, it is likely that this trend will continue.

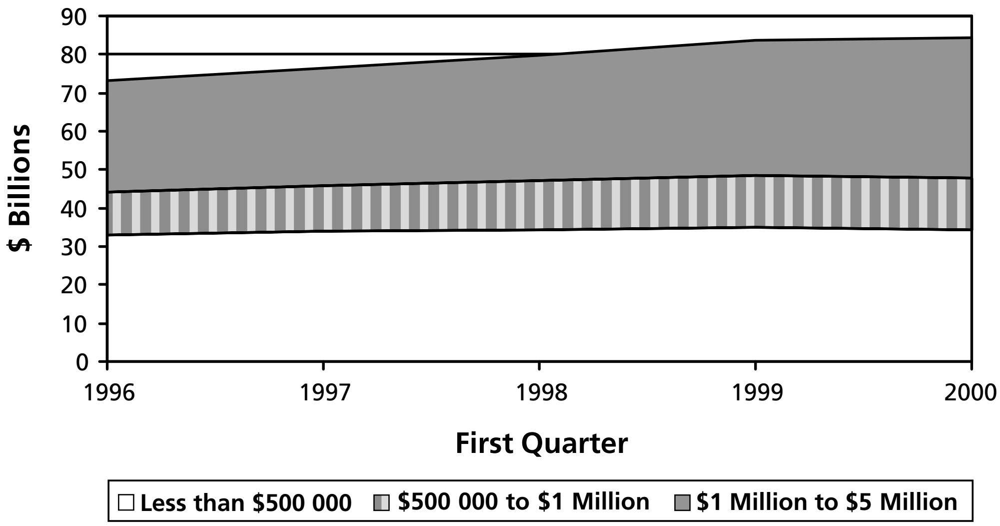
Figure A-2: Total SME Business Debt Financing, by Type of Institution

1994 and 1998



Upon closer examination of chartered bank activity, it appears that loans over $1 million have grown at a faster rate than loans for amounts under $1 million (the common definition of an SME loan used by the chartered banks). This is illustrated in Figure A-3. As indicated in both the Angus Reid and SECOR studies, presented later, this could be the result of more small business loans, especially those for small amounts, being treated and disbursed as personal loans by chartered banks, combined with a reduced demand for financing by SMEs given the positive economic environment.

Figure A-3: Business Credit Statistics:
Outstanding Loans Authorized for $5 Million or Less
Seven-Bank Aggregate (Big Six Plus HSBC Bank Canada)



Source: Canadian Bankers Association.

MacKay Task Force:
Report of the Task Force[3]

The Task Force on the Future of the Canadian Financial Services Sector, chaired by Harold MacKay, published its findings and recommendations in 1998. As part of its work, the task force looked into the state of SME financing in Canada. Overall, it found that Canadian SMEs have limited access to capital markets and that their level of financial sophistication is low compared to other business segments.

Responding to SME concerns, the task force conducted a special study of interest rates and loan fees. In comparing interest rates charged to SMEs in Canada and in the U.S., the task force concluded that Canadian SMEs are getting a good deal on price. However, it found that the range of interest rates is much narrower in Canada, as most SME loans are priced between prime and prime plus 3 percent, with an average of prime plus 1.75 percent. In the U.S., the range is much broader and loans can be priced anywhere from prime to prime plus 8 percent, with an average of prime plus 3.25 percent. The task force believed that the narrower range in Canada may indicate that Canadian banks are not adequately pricing for risk, which may have implications for SME access to financing.

3 The complete version of the report is available at **http://finservtaskforce.fin.gc.ca**

In terms of choice, the task force noted that SMEs in Canada have fewer choices than their U.S. counterparts. There are more community banks and credit unions in the U.S. and more alternatives to bank financing, such as leasing and credit card companies. Moreover, the non-bank, specialized finance companies are much more developed in the U.S. These institutions price for risk, and the range of rates charged is wider than in Canada.

The task force recognized the "plethora of new SME initiatives" promoted by Canadian banks and aimed at addressing concerns about SME accessibility to financing. Examples are programs specifically aimed at KBIs and exporters, and partnerships with Crown corporations to increase the supply of credit. On balance, though, the task force noted, the banks' efforts have been oriented more toward special initiatives than towards fundamental changes in skills, approach and attitudes.

In looking ahead, the task force felt that technological change should benefit the SME segment and result in higher service levels and more accessibility to credit. Technology has enabled new entrants to start offering services in Canada. Technology will also enable SMEs to compare pricing and service offerings between institutions more quickly and easily.

Based on its observations, the MacKay Task Force made some SME-specific suggestions and recommendations. It recommended that:

- the government undertake a substantial program of information collection and analysis on the financing needs of SMEs;
- deposit-taking institutions, particularly banks, find new and creative ways to address the problem in small business lending created by the frequent turnover of business account managers;
- banks continue to decentralize decision making in respect of credit-granting authority and collection practices, a task that would include making a meaningful delegation to the local level;
- Canadian financial institutions be prepared to make credit available to higher-risk borrowers with more innovative financing packages and appropriate pricing;
- financial institutions pursue their recent KBI initiatives, with a focus on seed and venture capital, thus ensuring a vigorous rate of investment in innovative KBI firms; and
- the House of Commons Standing Committee on Industry hold annual hearings on the state of KBI financing.

In looking at the state of SME financing, the task force made several references to the BDC in its report:

- "With respect to SME finance in particular, we recognize the strong role that the Business Development Bank of Canada (BDC) is playing, particularly in innovative quasi-equity financing instruments. The BDC is filling an important niche and developing constructive partnerships with private-sector lenders" (p. 153).

- " . . . we believe that banks should be able to appropriately price for risk and additional cost, and should be encouraged to do so . . . financial institutions in the United States . . . offer customers a wider variety of terms and prices. Indeed in Canada, the BDC extends credit to willing borrowers at higher rates than prime plus 3 percent, and Wells Fargo is offering loans at rates that extend to prime plus 8 percent" (p. 154).
- "The Business Development Bank provides targeted financing and has increased its emphasis on KBI firms since its mandate was revised in 1995. BDC has been an innovator in developing new risk-sharing instruments" (p. 157).

Angus Reid Group: *Financing Services to Canadian Small and Medium-Sized Enterprises*[4]

In June 2000, the Angus Reid Group conducted an assessment of financing needs and issues of Canadian SMEs for this review. The principal objective was to evaluate the evolution of access to financing in the last five years for different SME segments — KBIs and exporters; young, Aboriginal and women entrepreneurs; and micro-loan borrowers. The study also sought to evaluate the need for consulting services and to understand the importance of e-commerce to SMEs.

The study employed a combination of qualitative research techniques. There were 12 meetings for focus groups of SME owner-managers, 22 paired interviews with accountants and 14 in-depth interviews with Aboriginal business owners. The focus group meetings were held in Vancouver, Winnipeg, Toronto, Ottawa, Montréal and Saint John. The Winnipeg and Saint John participants were selected so as to include entrepreneurs from rural areas. BDC clients were screened out of all focus groups and interviews. Before the in-depth focus group discussions were held, approximately 100 SME owners completed a brief questionnaire to facilitate the collection of spontaneous attitudes and opinions. The results of this study are based principally on the views of SME owner-managers who participated in the focus groups. As such they are directional in nature rather than statistically based.

Access to Financing in the Last Five Years

Most of the study participants perceived that, in general, SME access to financing has either stayed the same or become more difficult over the last five years. Not only did most participants feel that access to financing has not become any easier for their own business, but they also perceived the situation to be the same for businesses in their industry sector and for SMEs in general.

This overall impression was confirmed by results from the questionnaires administered prior to the focus group discussions. Thirty-six percent of respondents indicated that it is somewhat or much more difficult

4 The complete version of the study is available at http://www.bdc.ca

to obtain financing for their business today compared to five years ago, and 20 percent felt that there has been no change. When asked about SMEs' access in general, 39 percent felt that it was somewhat or much more difficult to obtain financing today, compared to five years ago, and 38 percent felt that there has been no change. Participants did not on the whole feel that loan conditions or processes had been made easier for SMEs at financial institutions, and only 14 percent agreed that in general financial institutions are interested in lending to SMEs.

Those participants who indicated that it is easier to access financing today than it was five years ago believe that the positive change is related primarily to an improvement in the financial health of their own businesses, to an improvement in the economy or to both factors.

According to participants, access to financing appears to vary by stage in the business lifecycle. Start-up enterprises have difficulty obtaining a business loan unless personal guarantees, co-signatures or fixed asset collateral are pledged. Access becomes somewhat easier for businesses in the growth stage that have an established track record, although obtaining a loan remains a function of performance, fixed asset collateral and personal guarantees. And these businesses do not expect much support when intangibles have to be financed, unless hard assets are pledged as guarantees.

Participants agreed that it is easy for SMEs at the mature business stage to obtain financing. Financial institutions are seen to be more tolerant and more responsive to the needs of this group.

Participants confirmed that they have had to find alternatives to chartered banks to fund start-up or company growth. The alternatives mentioned most often were credit unions, caisses populaires, and trust and leasing companies. For KBIs and young entrepreneurs, venture capital was mentioned as one of the few financing options because of the nature of their business and the size and nature of future projects. Vendor financing was often mentioned as an alternative source in the manufacturing sector. For start-ups, personal money, family support and angel (informal investor) support were mentioned.

Participants felt that growing competition in the banking industry, mainly from the United States (where it is perceived that access to financing does not pose any problem), can be positive for Canadian SMEs. It was felt that Wells Fargo, MBNA America Bank, Citibank and others had all made inroads in the Canadian market. However, no participant had yet taken the steps to obtain financing from across the border.

Faced with difficulties in accessing financing, some participants mentioned giving up and using personal funds, while others referred to using tricks to get around the system, such as regularly borrowing small amounts for shorter periods on a project-to-project basis.

Participants did not feel that accessibility to SME financing had improved over the last five years and they did not expect any better conditions in the future. Some voiced concern about where banks are placing their priorities. Bank mergers were mentioned, as participants expect that large borrowers will be the ones to benefit from the concentration of money in a limited number of financial institutions. Perceived high profit targets for individual account managers and lending institutions in general were also seen as leading financial institutions to limit risk taking. With banks clearly focusing on international lending, it is believed that there will be less interest in domestic markets.

In addition to these general observations on the state of SME financing in Canada, the following perspectives were discussed.

KBIs and Exporters

KBI focus groups offered comments that reflected their technological orientation, while the comments of exporter groups reflected their business longevity. Established or mature manufacturers and wholesalers, because of their track record, size and growth, did not experience problems accessing bank financing. They stated that loyalty to one institution and long-lasting relationships are two factors that facilitate access to financing. However, even among this group there are perceived limits to obtaining financing. If a financing application is declined by one bank, chances are that all banks will decline it. Also, financing rapid growth was considered problematic. Rapid growth, it was felt, is financed basically through retained earnings, private and personal investments, third-party sellers (distributors), clients, and vendors, manufacturers or suppliers.

On the other hand, participants involved in the new economy, or KBIs, felt they needed new lending criteria to meet their needs. Their expertise is not quantifiable, their production is intangible and their equipment becomes obsolete rapidly. They felt that these were all factors that traditional lenders cannot accommodate, and that instead they have to find hard assets to support their credit applications. These participants felt that their evolution is too rapid for bankers, that the institutions do not have the human resources trained to understand their industry, and that they have limited access to financing for e-commerce ventures, R&D and innovation. They perceive that U.S. financial institutions are more inclined to deal with enterprises in the new economy. For these participants, there are limited financing alternatives — venture capital and private capital — but they hope that banks will set up special units to deal with KBIs.

Young Entrepreneurs

Young entrepreneurs felt that they usually have nothing to substantiate their credit applications except their ideas and projects, while banks need collateral. Youth-owned businesses also lack a track record on which they could be judged, and often require a co-signature, especially at the start-up stage. This group felt that government support — subsidies, grants and tax credits — has become necessary for young entrepreneurs to launch their businesses, and even then it is difficult to get money. To quote: “The SBLA (*Small Business Loans Act* [now the *Canada Small Business Financing Act* (CSBFA)]) is about the only way to get a loan — and even for the percentage not guaranteed, they ask for collateral.” For some young entrepreneurs, accessing bank financing is too much trouble. Instead they finance their businesses through personal credit cards. For this group and for micro-enterprises there seems to be a significant void in the market between financing sourced through personal means ($15 000 to $20 000) and what venture capitalists can offer ($1 million and up).

Aboriginal Entrepreneurs

For the Aboriginal entrepreneurs who were interviewed, access to financing mirrors that of other SMEs. Young Aboriginal entrepreneurs face the same problems as other young entrepreneurs, mainly related to the absence of a track record. In addition, Aboriginal entrepreneurs face a problem related to using hard assets on reserves as security: they cannot be seized in the event of a default and, as a result, are not acceptable to lenders. Some also felt that they faced "social stereotyping" problems. Aboriginal businesses do have access to targeted government loans and grants. However, these programs are designed for one-time projects rather than ongoing business financing. Many interviewees cited the use of personal sources as alternatives. Like SMEs in general, the more mature Aboriginal businesses found financing comparatively easy to obtain. These businesses have built up relationships with their banks and have earned the banks' trust in return for having developed a stable and profitable business. Familiarity and experience with banks' lending criteria were also mentioned as key to obtaining financing.

Rural Entrepreneurs

Focus group participants from rural areas voiced concerns regarding accessibility. Participants from rural Manitoba mentioned that access to financing is much more difficult than it was five years ago simply because services have been moved elsewhere and account directors do not know the company, the region or the industry. To quote: "Branches have been closed down; knowledgeable people have been moved; officers in centralized branches do not know the clientele in rural areas." A similar situation was cited in the Saint John focus group regarding services that have been centralized in Halifax. As well, in some urban centres, financial services seem to be moving towards larger cities often outside the province — Toronto for the West and Halifax for the East. In Ottawa the centralization to Toronto was mentioned.

Women Entrepreneurs

Women entrepreneurs in the focus groups felt that access to financing, especially during the start-up phase, was made possible because of targeted government programs. Over and above the usual problems that SMEs face in accessing financing, the personal financial situation of women entrepreneurs can be weaker, and often they are asked to bring a cosignatory. A situation was mentioned where a commercial loan application with personal guarantees was declined but the same amount for the same project was obtainable as a personal loan. (It should be pointed out that neither the 1997 nor the 1998 survey of SME lending by chartered banks, conducted by Thompson Lightstone for the Canadian Bankers Association, revealed discrimination by gender when banks decide on commercial loans. This conclusion is based on rigorous statistical analyses of loan applications.[5]) Leasing has been an option for some women when a bank has turned down a loan application.

5 Thompson Lightstone & Company Limited, *Small and Medium-Sized Businesses in Canada: Their Perspective of Financial Institutions and Access to Financing*, and *Small and Medium-Sized Businesses in Canada: An Ongoing Perspective of their Needs, Expectations and Satisfaction with Financial Institutions* (1998).

Micro-Enterprises

Owners of micro-enterprises participating in the focus groups felt that the size of their business is an obvious restrictive factor. Their perception is that financial institutions prefer larger loans because of processing costs, and more established businesses because they can offer more collateral and are less risky. They felt that since their business credit demands are small, they are directed to the use of credit lines, credit cards, overdrafts, personal loans and the like — products they feel are not adequate and are more expensive. Compared to five years ago, these participants felt that access to financing was more difficult because the supply of funds is limited and there are a lot more start-up companies and micro-enterprises. They do not see any brighter prospects for the future. They feel they must build up their asset base, both business and personal, to obtain a loan.

Accountants

Accountants were selected to participate in this study since they are well positioned to evaluate the evolution of SME access to financing. According to those who were interviewed, SME lending conditions are no easier today than they were five years ago. They felt that enterprises must still respect debt/equity ratios, which have not changed, and that banks still ask for general security agreements or personal guarantees. They recognize that longevity is a facilitating factor in accessing financing and so is the CSBFA. In some instances, the accountants felt that the situation has worsened, as there are new barriers to borrowing. Higher application fees, the need for a good business plan and presentation, and the required paperwork are adding to the costs of borrowing.

Financing Gaps

Thus, from the point of view of SMEs, there are financing gaps in the market. There continues to be a **size gap**, whereby financing requirements are not large and many focus group participants feel they do not represent enough potential to attract financial institutions' interest. There also continues to be a **risk gap**, whereby financial institutions are not willing to price to risk. Financing for a company's growth is often rejected because its financial ratios either do not match those firmly pre-established by the lenders or the collateral requirements are too steep. There continues to be a **knowledge gap** supported by the perception that financial institutions do not understand knowledge-based businesses and the new economy. Many of these businesses do not even attempt to obtain bank financing, relying instead on other sources such as venture capital. Finally, there continues to be a **flexibility gap**, whereby financial institutions do not provide flexible terms and conditions on their loans. Moreover, for the most part SMEs do not feel empowered to even request terms other than those dictated by their financial institution.

Entrepreneurs feel frustrated by the mechanical approach characterized by forms, formula lending and credit-scoring methods now in use at financial institutions.

Notwithstanding their views about the current state of their access to financing, many focus group participants felt optimistic about obtaining business financing in the future. However, their optimism was based on the belief that their businesses and the economy will increase in strength, not on the perception that lending institutions will make access to financing and lending conditions any easier.

The Angus Reid study also included reference to the use of consulting services and e-commerce practices by SMEs. These subjects were included because they are relevant to BDC's service offerings.

Consulting Services

According to participant comments, consulting services are sought in limited quantity by SMEs. Barriers to use include small budgets, owners' entrepreneurial spirit (they know how to run their businesses) and their focus on operating their businesses. Entrepreneurs in KBI and exporting businesses show a greater interest in using consulting services, and assistance is sought from a wide spectrum of fields: human resources, marketing, exporting and financing. These entrepreneurs value the knowledge that consultants bring to a business.

Consulting services are little used by micro-enterprises and young entrepreneurs. These services are judged too expensive, and entrepreneurs feel they can do most of the work except for specific, technical tasks such as Web site development and accounting. Women entrepreneurs are more inclined to use consulting services in diverse areas such as information technology, human resources and marketing.

Accountants interviewed indicated that only about 10 percent of their clients use consulting services, and these are usually enterprises with sales of $1 million or more.

When asked whether traditional financial institutions should offer consulting services, most participants were skeptical, even if an arm's-length group separate from the lending group would offer those services. Their skepticism related to the need for independence between financing and consulting and potential conflicts of interest. They felt that information would be shared with their account manager, thus potentially creating barriers to financing. Accountants, on the other hand, would recommend the use of such services, and often do refer their clients to the BDC and other government-supported agencies and services.

E-Commerce

Even those participants not currently involved in e-commerce understand that they will eventually have to invest in e-commerce. Manufacturers, exporters, wholesalers, professionals and those who require a presence at the consumer level are the most interested. A few projects are already in progress in participants' businesses, although they appear to be limited in scope and investment — in the $3000 to $50 000 range.

E-commerce projects are typically financed with internal working capital, personal funds and government subsidies. Financial institutions are not even considered a financing source, as they are perceived as not lending for these projects. Clearly a void exists in the market for e-commerce financing.

SECOR: *Recent Developments in SME Debt Financing: The Supply Side*[6]

To obtain the perspective of suppliers of SME financing for this review, SECOR conducted a survey. It covered essentially the same themes as the Angus Reid study: the overall view of respondents on SME financing in Canada today, the way sources of supply have shifted over the last five years, new instruments and delivery channels introduced over the last five years, and the likely trends for SME financing over the next five years.

SECOR conducted the survey through face-to-face or telephone interviews with senior personnel of 13 representative organizations. Three were from major chartered banks, three from insurance companies, two from credit unions and two from leasing companies. The other three were from small business organizations or were knowledgeable observers. In addition to surveying these respondents, SECOR tapped secondary sources of SME financing data to complete the study.

SME Growth

According to respondents, the number of SMEs grown cyclically with the economy. Only one respondent cited a possible structural factor accounting for the faster rate of SME growth — the trend towards large firm outsourcing of non-core functions. This trend has resulted in the formation of new SMEs to supply business or other professional services. However, the consensus of suppliers was that growth in the number of SMEs has tracked economic growth, not outpaced it.

Credit statistics suggest that the SME loan market grew faster — at a 7-percent compounded annual growth rate — than the overall economy during the 1994–1998 period. This may suggest that demand has been increasing more quickly in the SME sector or that SMEs are getting access to debt financing more easily than they did in the early 1990s. However, respondents, with the exception of specialized finance companies, did not believe that they were doing significantly more lending to this market than in previous periods.

Growth of Suppliers

Most respondents believed that growth of the SME financing market in the last four years has been driven by economic growth and the sustained upturn, rather than by entry of new suppliers of financial

6 The complete version of the study is available at **http://www.bdc.ca**

services. The most significant trend has been the growth in market share of specialized finance companies such as GE Capital and CIT/Newcourt. Those companies moved from a 9-percent share in 1994 to a 15-percent share in 1998. Membership in the finance and leasing industry association has almost tripled since 1993.

More foreign (American) finance companies are coming into the Canadian market. Companies such as Heller, Finova and Congress were cited as aggressive suppliers of term lending and specialized asset-based financing. The success of these suppliers may be due to the increasing sophistication of SME borrowers who are turning more frequently to long-term equipment financing packages and solutions from finance companies or from vendors. The financing companies themselves have been innovative in their ability to offload risk while maintaining their margins. The domestic banks have re-entered the leasing market alone or in alliance (as in the case of the Bank of Montreal) with suppliers such as CIT/Newcourt, although this is not a major part of their business.

Wells Fargo, which led the way three years ago by entering the Canadian SME loan market electronically, has not met with much success, possibly owing to lack of demand. Other foreign suppliers have not copied Wells Fargo's example.

Credit unions have not yet become significant suppliers of SME financial services on a national level, although they are making sizable investments in centralized back office services, which will permit them to compete more aggressively with the chartered banks in specific regions such as B.C. and Saskatchewan. Their strength is variable across the country, being greatest in Quebec and in the West, and less in Ontario.

The regional picture varies greatly and the leading SME financing organizations do tend to be regional players. Chartered banks dominate in the Atlantic region and in Ontario, while local institutions dominate in the other provinces: credit unions in B.C. and the Prairies, Alberta Treasury branches in Alberta and Les Caisses Desjardins in Quebec (p. 11).

Access to Capital

Most respondents believed that there is sufficient debt capital available to SMEs across the country. There do not appear to be significant regional variations, particularly given the increased use of more uniform credit-scoring models and systems. One respondent noted that, in fact, the demand for debt capital is not as strong as the demand for other services and "solutions." Many SME customers are not interested in obtaining a conventional term loan, although this is still the product most widely purchased by bank SME customers. As noted previously, many SME customers are turning to specialized finance companies or vendors for long-term financing needs, and to personal financial products for some of their short-term operating needs.

The user perspective on capital availability differs from the supplier perspective. According to industry observers, many SMEs state that since the mid-1990s, it has not been as easy to get access to debt financing as it was before the recession. The suppliers note that risk scoring and risk management have become more sophisticated, which has increased consistency of access across the country but has also raised the access floor and deterred potential applicants. Significant numbers of SMEs resort to alternative methods of financing, including vendor financing and personal credit, to either supplement or substitute for commercial loans.

Bank Versus Non-Bank Suppliers

Domestic chartered banks continue to dominate the SME loans market, with a 62-percent share. Specialized finance companies have about 85 percent of the SME leasing market. Second-tier suppliers such as credit unions and Crown corporations have a significantly smaller share of the loan market. Insurance companies, which have traditionally been in the commercial mortgage market, are retiring from this market and in general are not players in SME financing. Among the chartered banks, the Royal Bank of Canada leads with roughly a quarter of the market.

One respondent noted increasing competition from credit card suppliers who market directly to personal customers. MBNA America Bank and others have entered the market with lines of credit attached to cards, and SME owners are using these to finance their business. This is a growing trend.

Market Gaps

Supplier respondents generally agreed that SMEs at the start-up stage still have difficulty getting access to debt financing. This view is echoed in the Thompson Lightstone survey of SMEs. While the standardization of credit scoring has eliminated some of the risk variability, there is still less information on the potential borrower at the earliest stage and less collateral for the loan. The high fixed cost of the initial valuation means that suppliers are correspondingly more conservative in their assessment.

The Thompson Lightstone survey also states that small KBIs have the hardest time obtaining financing. Lending institutions have responded by setting up distinct business units to serve this market but have not necessarily catered to the needs of smaller KBIs.

Both chartered bank and non-bank respondents suggested that rural or non-major urban centres would be increasingly served by non-banks or through direct channels, particularly as bank branches are rationalized. Smaller players such as the credit unions, small leasing companies and insurance companies clearly have an opportunity to gain more SME market share in these regions (particularly in the Atlantic region and the West).

Chartered bank respondents suggested that pricing to risk was not a commercially viable way for them to increase availability of capital to higher-risk SMEs. On average, prime plus 3 percent remains their upper limit. (This corresponds to the limit on government-guaranteed CSBFA loans.) Few suppliers are willing to take on more risk, even at a higher price. The costs of managing the risk and the probability of default outweigh the margins to be made.

There was general agreement among respondents that in the next economic downturn suppliers will tighten up on SME loans again, and that they are keeping a sharp eye on their portfolio exposures.

According to some respondents, an important gap remains in SME education and support services in terms of needs assessment and business plan preparation — a gap that could be better filled by government and industry associations. Suppliers find these services very costly to provide, but in their absence, many SME customers are having their financing requests turned down.

A few respondents noted that the federal government was appropriately filling in market gaps through the BDC. Also, suppliers would welcome the federal government expanding its use of CSBFA guarantees in order to continue meeting SME demands for credit.

Diversification of Financial Products

A number of chartered bank respondents suggested that they were streamlining and simplifying rather than expanding their SME product range. This trend is related to the perceived risk and cost associated with the SME loan portfolio. The bank respondents noted that SME business loans are not a high margin product, and that banks in general tend to offer a suite of products, rather than just term financing. Rather than adding more business products, they want to cross-link their small business products with personal financial products such as lines of credit and credit cards. Business credit cards, with associated lines of credit, have become common and are a very attractive product for chartered banks to pursue.

Credit unions are trying to diversify their product offerings to SMEs, particularly in the area of banking services, where they have been limited by their decentralized structure. In B.C. and Saskatchewan, efforts are being made to create centralized back office services, permitting member unions to offer more products such as payroll services, credit cards, wire transfers and leasing. They are also purchasing off-the-shelf products from outside manufacturers and offering them to their members.

Changes in Distribution Channels

Respondents suggested that there had been only incremental changes made to their distribution channels over the last four years. Chartered banks, for the most part, have been closing branches, mostly in rural areas, or selling them to credit unions, particularly in the West. Even so, the respondents believe that SME customers' access has actually improved for two main reasons:

- SME customers are being treated as retail rather than business customers; and
- direct or self-serve channels such as telephone banking, ABMs and, increasingly, the Web, have made up for the reduced number of branches.

The implication of the first trend is that the banks are managing their SME customer relationship differently. Rather than being handled by account managers in business centres, SME customers are being treated as retail customers who have access to any branch for their account. Their customer data are being linked to the personal financial service customer database, which allows bank employees to better assess the full value of each SME relationship. Furthermore, retail customer managers tend to be less mobile than business account managers, allowing for the development of more sustained customer relationships and addressing a principal grievance of many SME customers about account manager turnover. Finally, centralized risk assessment and scoring has promoted more uniform treatment of SME customers across branches, permitting decentralized and more accessible service.

The second trend, the expansion of direct channels, is still evolving. Most supplier respondents noted that they expect the Web in particular to have a major positive impact on SME access. Most banks are now offering on-line business loans and are working to make more products available.

Although credit unions have traditionally perceived their hands-on community presence and physical network to be their competitive advantage against the larger banks, some of them, such as VanCity Credit Union, are actively developing on-line services as well. VanCity offers VanCity Direct Net to its members through the Web, as well as access to Citizens Bank, the on-line personal financial services bank for customers across Canada (except in Quebec).

The Royal Bank of Canada has gone further than other banks in becoming a supplier to PrimeStreet.com, an on-line SME loan auction site out of the U.S. CIBC has chosen to work with other SME suppliers through a portal dedicated to SME needs (bizSmart.com). Scotiabank has set up a service allowing SMEs to launch transactional Internet sites at greatly reduced costs. And the Bank of Montreal is working with Canada Post on e-business solutions for SMEs.

Future SME Market Evolution

As noted in the previous section, the single most important structural trend to affect SME financing in the future will be the development of Web-based markets. Chartered banks are investing resources in various Web options, and credit unions are following suit. SME customers are likely to become much more active on the Web as options increase.

Respondents noted other trends:

- credit scoring and risk management will continue to evolve and support risk reduction for suppliers;
- risk offloading through securitization, as well as unbundling of financial product manufacturing from distribution, will promote greater product accessibility;
- SME customers will be dealt with more and more on a relationship basis rather than viewed as product purchasers; and
- reform of federal financial sector regulations will support the development of credit unions as second-tier suppliers on a national scale, although it will take credit unions some years to develop the appropriate risk handling and relationship management skills necessary to serve the SME loans market, as well as the required product range to compete with the banks.

CFIB:
Banking on Entrepreneurship[7]

In March 2001, the CFIB released its latest survey results of members and their assessment of financial institutions.[8] More than 10 000 members of the CFIB responded to the survey. Overall, satisfaction levels with respect to financial institutions are up. However, the survey findings indicate that there is a significant small business financing gap, particularly for young high performers (defined as businesses under 10 years old with revenue growth over 20 percent for 3 years).

The CFIB report calls attention to the fact that activity for loans under $200 000 has remained stable since 1988, while loans over $200 000 have increased substantially. Furthermore, the survey results reveal that fewer SMEs are applying for financing, despite a strong economy. Only 60 percent of survey respondents indicated that they had applied for a term loan, a line of credit or an increase in a line of credit in the last three years. Of those that had applied for financing, 66 percent were young firms (in business for 10 years or less). Only half of the firms under five employees had applied for financing over the last three years.

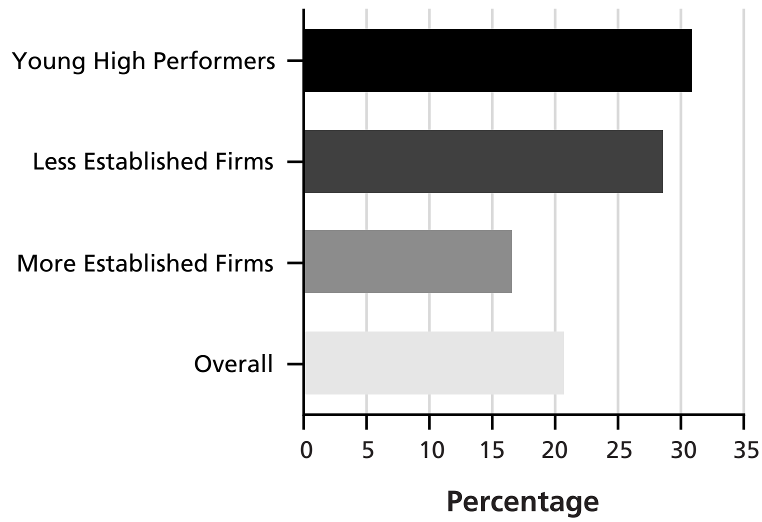
The CFIB report states that this trend does not appear to be related to business cycles, since the number of businesses seeking financing began to decrease during the recession of the early 1990s and continued to fall during the good economic times of the latter 1990s. The CFIB offers the following commentary with respect to the decrease in the number of small businesses applying for financing: " . . . the continuance of this trend throughout a period of strong economic growth raises serious concerns. It is particularly troublesome since it is more pronounced among the smallest firms where only one in two applied for financing in the past three years."

As shown in Figure A-4, extracted from the report, one in five SMEs is unable to obtain the necessary level of financing. Of the "underfinanced" group (i.e. those respondents who indicated that they had had their credit financing applications rejected by their bank, were unable to obtain the amount of financing they required or were so discouraged that they did not even bother to apply for financing), 31 percent are young high performers.

7 The complete version of the survey is available at **http://www.cfib.ca/research/reports/banks2001.pdf**

8 Canadian Federation of Independent Business, *Banking on Entrepreneurship* (March 2001).

Figure A-4: Percentage of SMEs That Are Underfinanced



Note: "Young high performers" are respondents in business for 10 years or less who grew their gross sales revenue by more than 20 percent during the past three years.

The CFIB says that these findings are quite troubling not only for the small business sector but for the whole economy as well. In this context, the report states:

> *...the fact that the issue of access to financing is more severe among the smallest and youngest firms indicates that the job-creation ability for the vast majority (Statistics Canada data indicates that 78.4 percent of all businesses in 1997 employed fewer than five people) of businesses has yet to be fully unleashed.*[9]

Moreover, it is when a business is in its early stages that a financial loan often makes the difference between surviving and having to close down.[10]

The CFIB survey also found that high account manager turnover contributes to loan rejection. Here again, the results indicated that younger, smaller businesses are more likely to have loan applications rejected. Loan rejection is "less likely" when the business uses a lot of banking services. While not stated in the report, this finding underscores the fact that banks are compartmentalizing their small business customers by streamlining their financial product offerings.

9 *Ibid.*, p. 10.

10 Canadian Federation of Independent Business, news release (March 14, 2001).