Industry Canada Industrie Canada

Canada Small Business Financing Act

Assessing New Opportunities

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Executive Summary

The *Canada Small Business Financing Act* (CSBFA) came into force on April 1, 1999, replacing and updating the highly successful *Small Business Loans Act* (SBLA). The premier government small business loan program in its time, from 1961 the SBLA had provided small and medium-sized enterprises (SMEs) with access to asset-based debt financing. In 1998, the Comprehensive Review of the SBLA found it to be an efficient program, popular among its stakeholders and successful at helping to fill the financing gap faced by new and small businesses.

The CSBFA provided for a number of modifications of the SBLA, among them two pilot projects: one to assess the feasibility of extending the program to capital leasing, and the other to weigh the viability of the program for the voluntary sector.

This report offers an overview and summary of Industry Canada's initial studies and analysis, describing the issues that need to be resolved as the pilot projects are designed and implemented.

The projects would be stand-alone entities, independent of the core CSBFA, and would have their own regulations. They would run for up to five years, operating with the same key objectives as the CSBFA:

1. To make available to their target groups incremental financing — in other words, financing that would not have been granted, or would have been offered only under less favourable terms, in the absence of the program. As with the core CSBFA, the government must not find itself providing guarantees for transactions that would have occurred without it.

2. To operate on a self-financing, cost-recovery basis for the life of the financing guaranteed under the pilot project.[1]

Here, however, the similarity between the two programs ends.

Capital Leasing

As a policy process, the extension of the CSBFA to capital leasing is relatively straightforward in that it is supported by all stakeholders: the capital leasing industry, small business and lenders. Studies performed during the 1998 Comprehensive Review of the *Small Business Loans Act*, summarized below, indicated that government guarantees could be extended to capital leasing with some adjustments in parameters.

Both the leasing industry and small business support the extension of the CSBFA to capital leasing on the grounds that such an extension would complement the existing program. Estimates indicate that leasing currently

1. The current CSBFA maximum loan term is 10 years. Should loans or leases be guaranteed under the pilot projects for periods of more than five years, they would continue to be guaranteed until the loans are paid off or the final lease payments are made. For this reason, even if the pilot projects are completed, leases or loans would be judged to be cost-recovered over the course of their lives rather than only the five years of the pilot projects.

provides between 3.5 percent and 5.7 percent of total SME financing. Capital leasing firms would like CSBFA guarantees extended to their industry to help them compete with traditional lenders. In consultations, SMEs have argued that such an extension of the CSBFA would further increase the total amount of financing available to them, and would thus be welcome.

These comments, however, should not minimize the technical difficulties involved in designing an effective pilot project. Essentially, the difficulties arise because of a fundamental difference between traditional CSBFA lenders and capital leasing firms, and between loans and leases: lenders are regulated but capital leasing firms are not. The implications of lease securitization, as it relates to a CSBFA pilot project, have not been fully explored. Moreover, this diverse, dynamic industry includes a few huge, foreign-based firms operating subsidiaries in Canada (and around the world), mid-sized foreign and domestic firms, and single lease companies. Even the size of the industry is not clear, but some estimates put the number of lessors at over 550. Finally, Industry Canada needs to better understand how the leasing industry would manage due diligence with regard to government-guaranteed leases.

Industry Canada must therefore be prudent and meticulous in designing the project and resolving each of the many technical issues involved in setting its parameters. Significant care is required to create a pilot project that is run efficiently, cost-effectively and safely on behalf of Canadian taxpayers.

The Voluntary Sector

Extension of the program to the voluntary sector also presents significant challenges in terms of both substance and design.

Industry Canada is responding to Cabinet's commitment to examine federal small business programs in order to see how these might benefit the voluntary sector. The usefulness of a pilot project, however, may depend on the extent to which it is designed to recognize and deal with the essential differences between the voluntary sector and the SME community for which the loan program was originally intended.

If the pilot project remains true to the CSBFA, it will provide access to asset-based debt financing on similar terms to those that have benefited small business for four decades under the SBLA. Neither this type of lending nor these terms — crucial to the objective that the program be self-financing — appear to appeal to many voluntary sector organizations (VSOs). Among other issues, most VSOs are interested in working capital, provision of which was examined and rejected as inappropriate for the CSBFA in the course of the 1998 Comprehensive Review.

VSO executives were pleased that the government was attempting to provide them with alternative sources of income, and acknowledging their contribution to Canada's society, quality of life and economy. They were sceptical, however, of the CSBFA's practical utility.

At heart lies the fundamental distinction between a for-profit business and most non-profit or charitable organizations: a business borrows money when it expects the expenditure to increase efficiency and, hence, profits. If a VSO improved its voluntarily given services via debt-based financing, its revenue might be no higher but it would still have to repay the debt. The logic behind the business decision may not hold for many voluntary organizations. For this reason, most VSOs consulted were not convinced that the voluntary sector would benefit from an extension of the CSBFA unless it was radically modified for the sector.

Policy makers must therefore make a series of critical decisions: whether to produce a CSBFA-type pilot project that appeals to only a few VSOs; whether to radically revise the CSBFA program to target the financing needs of the majority of voluntary sector organizations; or whether to conclude that the extension of the CSBFA to VSOs is not a suitable means of benefiting the sector.

Capital Leasing Pilot Project

Overview

In response to requests from leasing companies, the 1998 Comprehensive Review of the SBLA included investigations into the viability of extending the program to include capital leasing. A number of studies (summarized below) concluded that, with technical adjustments, the SBLA could accommodate capital leasing. Small businesses consulted during the Comprehensive Review also reacted positively to the idea of extending government guarantees to capital leasing, arguing that it would increase the total amount of financing available to them. As a result, the new CSBFA provided for the design and implementation of a pilot project for capital leasing.

The capital leasing industry is dynamic and growing. In a 1999 survey, members of the Canadian Finance and Leasing Association (CFLA) showed assets of $24.8 billion, an increase of 18.6 percent over 1997.[2] According to estimates, leasing provides between 3.5 percent and 5.7 percent of total SME financing.

Extending the CSBFA to Capital Leasing

Stakeholders and studies commissioned during the 1998 Comprehensive Review of the SBLA all supported extending its successor act, the CSBFA, to include capital leasing. Initial studies determined that such an extension would be relatively straight-forward; still, the technical challenges involved in appropriately adjusting program parameters should not be underestimated.

In large part, the adjustments must compensate for the primary difference between lessors and traditional CSBFA lenders. The existing CSBFA is managed by its lenders: they make the lending and risk decisions. Most CSBFA lenders are members of the Canadian Payments Association and are carefully regulated financial institutions, either at the federal or provincial level.

On the other hand, capital leasing firms are largely unregulated (apart from the oversight of the capital markets). Some of these firms are very large, others extremely small. Industry standards exist for securitized leases, which are used by medium-sized and large leasing firms; but if leases are not securitized, they are subject to much less third-party scrutiny. In creating a program of this kind, project designers must take into account the desire to include as participating lessors the small firms, many of which do not securitize. While attractive as a criterion for determining lessor eligibility and due diligence standards, securitization would exclude smaller lessors, thereby seeming to work against program objectives. At the same time, project design must make every reasonable effort to mitigate risk. Unfortunately, membership in the CFLA would not be regarded as an alternative: most leasing firms (an estimated 450) do not belong to the 175-member CFLA, which in any event is not a governing body. As a result, Industry Canada may have to work with the industry to establish due diligence standards for government-guaranteed leases.

2. David Powell, "Leasing in Canada 1999: An Overview," *World Leasing Yearbook, 2000*.

What is known is that securitization has been heavily used by the leasing industry as a method of growth financing since the early 1990s. Securitization transfers financial assets from the owner to a Special Purpose Entity, which in turn issues publicly rated securities on the assets to investors. As asset-based lenders, leasing companies are non-deposit-taking institutions and rely on the capital markets for funding. Securitization provides access to funding from entities such as insurance and pension funds, and adds to traditional capital sources such as commercial paper, bonds and equities.

Industry Canada must therefore be prudent and meticulous in designing the project and resolving each of the many technical issues involved in setting its parameters.

To acquire the necessary information, further studies are in preparation. These include:

- a complete leasing industry profile (including non-CFLA members);
- an analysis of the securitization practices in the leasing industry; and
- a profile of the industry's accounting and pricing practices.

The various technical issues to be resolved in the design of a successful pilot project are described in detail on pages 10–13.

Pilot Project Study Summaries

***Preliminary Study on the Implications of an Extension of the* Small Business Loans Act *to Capital Leasing*, Kalymon Consulting, 1995**

This study was prepared by Basil Kalymon of Kalymon Consulting Ltd. and submitted to Industry Canada in October 1995. Its purpose was to assess available data and conduct interviews with members of the CFLA in order to determine the viability of extending the SBLA to the capital leasing market.

A capital lease is an agreement under which the owner of a piece of equipment (the lessor) gives the user (the lessee) the right to use the equipment throughout the greater part of the equipment's life in return for a specified series of payments. At the end of the lease term, ownership of the equipment generally is transferred to the lessee. The payments may be irregularly spaced but are set at a rate that does not change for the duration of the lease. Lessors generally have expertise in using the equipment they lease as well as a keen understanding of its market value.

The study's key conclusions were that, since SMEs rely heavily on leasing to finance business improvements, and since the purpose of the SBLA is to increase SME access to financing, the extension of the SBLA to capital leasing is consistent with its purpose and could be done fairly simply.

Kalymon also concluded that the impact of extension on the SBLA would be slight, and that capital lease contracts do not in principle entail a higher risk exposure than loan agreements.

Since capital leasing is unregulated, Kalymon recognized the need for strict guidelines to ensure that only reliable and reputable lessors have access to the program.

Kalymon recommended that the SBLA be extended to capital leasing and that further study be performed to determine precisely how revisions, including a fee structure to allow for full cost recovery in this portion of the program, should be made.

***Operational Issues Related to the Provision of a* Small Business Loans Act-*Type Guarantee for Leasing*, Conference Board of Canada, 1996**

Further to Kalymon's work, in December 1996 Michael Andrews and Mahmood Iqbal of the Conference Board of Canada prepared a study for Industry Canada. Its purpose was to identify the issues involved in extending the SBLA to leasing. Seventeen executives from large, established leasing firms were interviewed for the study.

The Conference Board study distinguished between *capital leases* (which finance equipment for most of its useful life and transfer ownership at the end of the lease period to the lessee) and *operating leases* (which finance equipment for less than its useful life, and at the end of which the equipment is generally returned to the lessor). These different forms of leasing entail different risks for the lessor.

Conceptually, capital leases are equivalent to term loans or conditional sales contracts, both of which are already eligible for SBLA guarantees. Operating leases are more complicated and do not translate as easily into SBLA-type guarantees. (A capital lease, like a term loan, involves credit risk only. An operating lease involves a second class of risk for the lessor: the cost and difficulty involved in re-leasing equipment or otherwise disposing of it at the end of the lease term.)

The study suggested, therefore, that the operational issues involved in extending the SBLA to capital leasing are more straight-forward than those involved in operating leasing, but that both forms could be incorporated into an expanded SBLA.

Among other key issues noted were the following:

- Industry executives expected a low volume of government-guaranteed transactions and, accordingly, were concerned about the costs of establishing registration and reporting requirements.

  The industry is structured with a handful of large participants and hundreds of specialized niche companies. The smaller companies would suffer dispropor-tionately from the costs of establishing registration and reporting procedures, particularly if the volume of guaranteed business was low.

- Leases are commonly transferred from one company to another. Further, lessors frequently fund their portfolios through asset-backed securities. The compatibility

of government guarantees with these practices would have to be examined.

- The fee paid by the lessor would have to be competitive with the guarantee fee paid for a comparable term loan.

- “Moral hazard” assurances would have to be adapted to attempt to ensure that leasing companies continued to use due credit judgment in leasing decisions.

- Some standardization of industry terminology would be necessary in developing lease contracts.

- The loss on a capital lease at any particular time would have to be defined. Doing so is more complex for operating leases, or for cases of leased equipment without a ready resale market, than for capital leases.

The Conference Board authors concluded that, while no program should ignore the concerns of the industry, none of the operational issues raised by the study were insurmountable.

***Extension of the SBLA to Capital Leases: Analysis of Lessee Attributes and Defaults*, Allan Riding, Equinox Management Consultants, 1996**

The Equinox study examined which firms use capital leases and what kind of default rates those leases tend to generate.

With the cooperation of three specialized leasing firms — Newcourt Financial Group, Commcorp Ltd. and AT&T Capital — Equinox collected data on 1368 lessee firms and examined 318 default cases in detail.

Equinox found that most of the firms leasing equipment such as computers, office/professional/printing equipment, vehicles and tractor trailers are small firms with revenues of under $5 million, and that the capital invested in these leases is typically under $250 000.

The study found that the majority of lessees are Ontario firms outside of metropolitan areas, primarily transportation companies.

The types of equipment most frequently leased are the following:

- office and professional equipment (photocopiers, fax machines, office furniture, etc.);

- tractor trailers; and

- computers and computer-related equipment.

Many of the SME lessees are very small firms — typically, self-employed owner-operators. The firms are so small that financial statement information is generally unavailable for them.

Lease financing amounts were generally found to be consistent with the terms of the SBLA, as were average terms to maturity of the leases. On the other hand, the average lease yield was 5.6 points above prime, considerably higher than the rates that banks are permitted to charge SME clients.

The default rates for contracts varied from 1.09 percent for tractor trailers to 2.72 percent for computer equipment. Loss rates for leases were found to be lower — from 0.07 percent for tractor trailers to 0.96 percent for

computers. Loss rates were lower than those that the big banks experience with SME loans. The losses are lower than default rates because leasing firms are typically able to repossess the equipment in question.

The study also found that, even though default rates were low, defaults involving computers and tractor trailers tended to occur early in the contracts. The author interpreted this as a sign that some lessors had trouble assessing financing requests.

***Report on the Focus Group Session to Develop Industry-Supported Requirements and Modalities Related to the Provision of an SBLA-Type Guarantee for Capital Leasing*, Conference Board of Canada, 1998**

In this study, presented to Industry Canada in March 1998, the Conference Board prepared and reported on a focus group session to achieve consensus on elements of an extension of the SBLA to capital leasing. The focus group found tremendous support for such a program, which the report provisionally called the Small Business Capital Leasing (SBCL) program. (It did not deal with operating leases.)

According to an earlier Conference Board study, lease financing to SMEs by specialized financing companies almost doubled between 1994 and 1996.[3] The industry is dominated by a few large, and many small, specialized finance companies — a structure that makes it extremely competitive in terms of quality of service, ease of access and quick decisions on lease applications. In contrast to the way they deal with banking relationships, businesses tend to shop around before making leasing decisions. In spite of the burgeoning market in capital leases, industry executives suggested that most lease applications not approved are rejected because of the applicants' lack of a financial track record.

Leasing is attractive to SMEs because of the fixed-rate financing (not fluctuating with the prime rate, as in the case of many loans), the flexibility of repayment schedules (particularly useful for seasonal businesses, for instance), the lessors' expertise with the equipment in question, the equipment servicing options, and the speed (credit decisions are often made within minutes).

Any SBLA-type program would have to take into account these features and preserve them; it would also have to respond to the particular concerns of lessors. The industry is funded by asset-backed securities, and leases are often securitized through third parties, many of which own or administer lease contracts on a pooled basis. Further, lease contracts require not only repayment of the lease on schedule but also adequate maintenance and insurance of the equipment in question. These issues matter because they affect the value of the equipment, which reverts to the lessor in cases of default. The definition of default under an SBCL program would have to take such issues into account.

The following key suggestions emerged from the focus group:

- To be eligible for the program, lessors would have to meet financing criteria and

3. Conference Board of Canada. *What's New in Debt Financing for Small and Medium-Sized Enterprises*. Ottawa, Ontario, 1997.

have a three-year track record in the business.

- Industry Canada would have the power to approve lessors on the basis of these criteria.

- An electronic-based registration, payment and balance tracking schedule would allow for the speed and low cost required by the industry in order to meet government reporting requirements economically.

- The maximum guarantee amount for all SBLA loans and SBCL leases with an eligible SME would remain at $250 000, including a 2 percent registration fee.

- Repayment should begin within 12 months, but flexible and irregular payment patterns should be allowed. Rather than giving a promissory note, the lessee should agree to the repayment schedule when signing the contract.

- Market rates rather than a fixed rate ceiling should be applicable to guaranteed capital leases. A maximum lease financing rate formula was suggested, based on a fixed spread over an equivalent-term Government of Canada bond rate. The fixed spread would have to exceed the 3 percent currently used by the SBLA because the real transaction cost to a leasing company is normally greater than that. Pricing is a key area of difference between lenders and lessors, making it difficult to apply traditional banking terminology to the leasing business.

- Focus group participants agreed that the SBLA guidelines for loan eligibility could be duplicated under the SBCL program.

- Research suggests that lease loss rates are somewhat lower than conventional loan loss rates. Further, the focus group believed that SBLA default remedies were directly applicable to the projected SBCL program, provided that the definition of "default" is revised (as mentioned earlier) to include failure to adequately maintain or insure the equipment in question.

Project Design Issues

The question of extending the SBLA to capital leasing was examined during the 1998 Comprehensive Review, at the strong request of leasing companies. Most stakeholders agreed that provision should be made for its inclusion.

Key considerations in the design of a capital leasing pilot project, as prescribed by Cabinet, are:

1. that financing be incremental (i.e. that it would not have been granted if the program did not exist); and

2. that the pilot project operate on a cost-recovery basis.

In a 1998 study, the Conference Board of Canada suggested that a capital leasing pilot project could be designed using existing SBLA parameters, with adjustments. For reasons already discussed, these adjustments (noted below) are of more than academic importance.

The program must be designed to be viable for lessors, lessees and the government alike. Since it will be administered by the lessors, it must take into account the diverse and unregulated structure of the leasing industry, as well as the following specific issues.

Key Capital Leasing Pilot Project Issues for Consideration

- *Incrementality*: This is the proportion of lease financing that would not have been granted in the absence of the program. A key reason to include leasing under the CSBFA umbrella is its significant contribution to the absolute amount of capital available for SME investment in Canada. Leasing firms have shown reluctance to provide financing to small businesses in existence for less than two years and seeking financing of under $100 000 — clearly a pilot project target group. At the same time, the pilot project will not be a subsidy program, and leases concluded with its guarantees must be incremental leases.

- *Cost recovery*: The pilot project should be self-financing over the life of the leases guaranteed under it. Accordingly, administration fees must provide sufficient revenues, and other parameters must be carefully managed, including the maximum interest rate, the maximum loan size, risk pricing or the possible exclusion of certain equipment categories, the financing rate, the question of a personal guarantee, and administrative issues (such as enabling the government to remove designated lessors when and if necessary).

- *Lessor eligibility*: Leasing companies are largely unregulated (except indirectly by the capital markets that fund them), and so it is important to define clearly which lessors would be eligible for the program, and to ensure that they are capable of making sound financing decisions. Policy makers must take into account a number of factors, including the wide diversity of specialized financial lessors, the relationship between leasing companies and manufacturers (to eliminate concerns about competition or tied-selling issues), the size and experience of the lessors, and the lessors' due diligence and use of securitization (bringing in the question of third parties). A critical requirement is the ability to identify potential program fraud and develop measures for eradicating it.

- *Registration and reporting requirements*: Many leasing companies are very small, with a correspondingly small business volume. It is vital to establish an efficient, low-cost registration and reporting process that does not disadvantage them and their users.

- *Fees*: At the same time, program fees should be high enough to ensure cost recovery for the pilot project. The present CSBFA registration fee is 2 percent of the amount of the loan, paid up front by the borrower. In addition, the lender is required to pay to Industry Canada an annual administration fee of 1.25 percent. To recover these fees, the lender can charge borrowers a maximum interest rate of prime plus 3 percent. Appropriate fees will be required, tailored to the unique financing features of the leases.

It should be borne in mind that loans and leases are close financing substitutes, with leases offering advantages in terms of the use of capital by the firm, among other things. However, if the program's costs make leasing a less attractive option for small businesses able to borrow instead, the other SMEs using the pilot program may tend to be poor credit risks, adversely affecting the pilot project's cost-recovery goals.

- *Maximum interest rate*: This is a critical issue, closely connected with the question of incrementality. The maximum interest rate that lenders may charge under the core CSBFA is prime plus 3 percent. This may be too low for leasing: there is some evidence that the real transaction cost to the leasing company is higher, but it remains to be determined. At the same time, since program fees are charged on top of the interest rate, the rate must remain reasonable and not reduce program accessibility (48 percent of SMEs currently perceive leases to be an overly expensive method of financing). A fundamental difference between interest on SME loans and interest on leases is that the rate for loans often floats, tied to prime, while leases are generally written as fixed-rate transactions. Further study on industry pricing practices is needed to determine an appropriate maximum interest rate.

- *Lessee eligibility*: Eligible borrowers under the CSBFA must be Canadian businesses with an annual gross revenue of $5 million or less. Analysis is needed to determine whether this definition applies equally well to capital leasing, given that the primary group not served in the lease market appears to consist of younger firms seeking under $100 000 in financing. Should only those very young, small firms be eligible for the program? This is a key issue affecting the pilot project's incrementality: bigger, older firms appear to have no difficulty in obtaining satisfactory leasing agreements, and it is critical that the pilot project not become a subsidy for leasing companies. If the pilot project is to be cost-recoverable, however, the increased risk of these very young firms needs to be factored into the equation.

- *Lease eligibility*: Clear definitions are required of the equipment or equipment types eligible for pilot project leases, as are guidelines on whether certain types should be excluded from the program altogether because of the risk they entail. Ongoing research on industry pricing practices will prove invaluable in setting these parameters.

- *Maximum lease amount*: It remains to be determined whether the maximum CSBFA loan size of $250 000 applies equally well to leasing. Most leasing within the pilot project's expected target market is below $100 000; accordingly, a lower maximum lease amount perhaps should be considered. It will also be necessary to understand precisely how the value of lease contracts is determined.

- *Payment terms*: The current CSBFA maximum of 10 years may need to be reconsidered as an appropriate repayment period for capital leasing because leased equipment may lose its value more quickly. Appropriate payment terms need to be developed; these could well vary with different classes of leased equipment.

- *Financing rate*: The CSBFA currently allows for financing of up to 90 percent of the value of the asset being purchased. On one hand, to impose a similar rate on leasing defeats the purpose of a lease (which ordinarily frees the SME from having to pay money up front). On the other hand, this financing rate has been the key to risk reduction for the government because it has imposed some responsibility on the CSBFA borrower. One solution might be to allow for a financing rate of 100 percent, and to find a creative way of using other parameters to increase lessee or lessor responsibility and reduce the government's risk.

- *Security*: The current CSBFA definition of securities and guarantees may have to be adjusted for the pilot project. The lessor ordinarily retains legal title to the asset; this becomes an issue when the leased assets are securitized to a third party, as is commonly done in industry. A solution may be to require that all leases under the pilot program be registered.

- *Personal guarantees*: The CSBFA currently permits lenders to request a personal guarantee of up to 25 percent of the value of the loan. The question is whether this amount should be increased or made mandatory if the financing rate is increased to 100 percent of the lease value.

- *Default*: The timing of default must be precisely defined to protect the value of the leased asset. Default can occur not only if a financial payment is late but also if a lessee fails to comply with a requirement of the lease, such as obtaining adequate insurance. Current CSBFA remedies for default could be directly applied to capital leases. The ongoing industry accounting and risk pricing study will help determine this parameter as well.

- *Definition of loss*: Loss needs to be redefined for capital leasing because (unlike a loan) a lease specifies not a capital amount but a series of payments due. In default, therefore, the outstanding value of the remaining lease payments constitutes the lessee's liability, after recovery of the asset. Ownership remains with the lessor but a lessee may default on lease agreements for non-monetary reasons, such as failing to maintain equipment insurance or moving the equipment out of a specified jurisdiction. Loss needs to be carefully defined to determine the amount that the lessor could claim from the government. This issue is complicated by the fact that leasing is an unregulated industry and the government has no guarantee that lessor standards are comparable to those observed by current CSBFA lenders.

- *Claim for loss*: This is a clear-cut matter of defining appropriate claim for loss procedures, but it requires clear understanding of the intricacies of lease defaults and losses.

- *Cap on claims*: Under the current program, each lender has a separate account of guaranteed loans. In each five-year period under the core CSBFA, the government will pay claims totalling 90 percent of the first $250 000 of loans in a lender's account, 50 percent on the next $250 000, and 10 percent of all remaining loans. This encourages low-volume lenders to participate in the program, while potential liability to high-volume lenders is capped at an average of about 10.6 percent.

  There may be reason to adjust this parameter for the pilot project. On the one hand, claims are likely to be lower than for loans because lessors can re-lease their equipment. In addition, leased amounts may be smaller than loans, and losses overall may be lower. On the other hand, since many lessors are small, there is greater likelihood that they would make claims in the first 90 percent, and this could have an impact on the cost recoverability of the pilot project. Once again, the industry accounting and risk pricing study will provide the data necessary to set the parameter.

- *Lease loss sharing ratio*: Since 1995 the government has taken 85 percent of the share of eligible losses for loans in default (after security has been recovered) under the core CSBFA, while lenders have been responsible for the balance. The issue is whether a similar loss sharing ratio will be adequate for the leasing pilot project.

- *Ceiling for the five-year pilot project*: An appropriate leasing ceiling (the total amount of capital leasing financing that will be guaranteed over the life of the pilot project) needs to be determined. Doing so will require quantitative analysis of the expected number and amount of leases, and of forecast default rates. Included in the analysis will be the operating assumption that leases represent no more than 5 percent, and CSBFA loans 18 percent, of SME financing.

- *Pilot project evaluation framework*: For the pilot project, a performance evaluation framework must be developed similar to that of the core CSBFA. It will provide for the periodic collection and analysis of the data required to assess the efficacy and viability of the project, including information on such aspects as SME awareness of the program, the incrementality of the financing it provides, its impact on the creation, maintenance and displacement of jobs, and the administrative performance of lessors.

Voluntary Sector Pilot Project

Overview

The government is committed to examining the viability of extending federal small business programs to the voluntary sector. To meet this commitment, the new CSBFA provides the authority for a pilot project to test the feasibility of extending the government's loan guarantee on commercial lending to the voluntary sector.

Despite considerable attention in recent years, there are still surprising gaps in data on the sector. Original research was required in a number of areas to better understand how the existing program could be adapted to this end. These studies have provided a picture of the voluntary sector and its revenues, employment and lending habits. They also provided guidance, via consultations in six cities, on how the voluntary sector would welcome and use such a program. The studies are described and summarized on pages 15–18.

The voluntary sector is a large and diffuse community, composed of some 175 000 organizations and agencies. Among its members are the behemoths of the education and health care systems: universities, colleges, school boards and hospitals. Voluntary sector organizations (VSOs) include religious institutions (congregations, parishes and synagogues) and foundations that are not themselves charities but are established to run charitable organizations (e.g. the United Way, the Kidney Foundation). From the arts community, VSOs include groups such as orchestras, theatres, ballet companies, museums and art galleries. They may also be agricultural or sports/recreational organizations, including golf and country clubs, as well as sporting associations and Royal Canadian Legions. Other VSOs include boards and chambers of commerce, community benefit organizations and multicultural groups. Some of the groups are sizeable, others tiny.

The voluntary sector is defined as the community of organizations "which are legally prohibited from distributing profits or financial surpluses to those who own or control them."[4] As a whole, the sector generates an estimated $75 billion annually — an amount that is roughly 9 percent of Canada's gross domestic product (GDP) and equivalent to the entire GDP of Alberta. The voluntary sector employs almost 1.5 million people (about 1 Canadian in 10) and benefits from the monthly service of roughly the same number of volunteers.

Consultations Summary: Extending the CSBFA to the Voluntary Sector

Consultations with experienced voluntary sector executives revealed consistent concerns about extending the CSBFA to VSOs:

- It often makes little strategic sense for a VSO to borrow money to improve services when the improvement will not increase its revenue. This is a fundamental difference between a business and many charitable and non-profit organizations.

4. Niagara Enterprise Agency. *Financing Needs of the Voluntary Sector*. Niagara-on-the-Lake, Ontario, 1999, p. 4.

- The borrowed money comes at a high cost and must be repaid by increased fundraising.

- There can be significant ethical concerns raised by fundraising to pay interest and loan fees.

- Most VSOs need operational financing more than asset-based financing, and the CSBFA does not provide for working capital. (After extensive study, the 1998 Comprehensive Review decided against including working capital under the program. See page 19 for details.)

- Most organizations lack the hard assets that would be required to secure financing.

- VSO directors, who are volunteers, either cannot or will not pledge personal assets against debt financing. The situation would be very problematic for financial institutions.

- Many VSOs have explicit restrictions on how grants and other income may be used, including a prohibition on incurring debt.

VSO executives were pleased that the government was attempting to provide them with alternative sources of income, and acknowledging their contribution to Canada's society, quality of life and economy. They were sceptical, however, of the CSBFA's practical utility.

This attitude is due to the fundamental distinction between a business and many non-profit or charitable organizations: a business borrows money when it expects the expenditure to increase efficiency and, hence, profits. If a VSO improved its voluntarily given services via debt-based financing, its revenue might be no higher but it would still have to repay the debt. The logic behind the business decision may not hold for many voluntary organizations. For this reason, most VSOs consulted were not convinced that the voluntary sector would benefit from an extension of the CSBFA unless it was radically modified for the sector.

While this is true for many VSOs, it is also true that for a segment of non-profit organizations the situation is different. Many arts and cultural organizations, for example, would be able to use asset-based debt financing to attract larger audiences.

Initial consultations have revealed that many VSOs are unlikely to find CSBFA-type asset-based debt financing useful because they are either too large or unable to support the debt load. At the same time, the pilot project may be ideal for organizations that would benefit from debt financing as a growth instrument and that (in a climate of greater lender confidence) would qualify for financing.

There are countless other issues with which Industry Canada must wrestle in designing and creating a voluntary sector pilot project. These are discussed in the following pages.

Pilot Project Study Summaries

***Financing Needs of the Voluntary Sector*, Niagara Enterprise Agency, 1999**

Industry Canada asked the Niagara Enterprise Agency (NEA) to prepare a statistical

overview of the voluntary sector, and to assess the financing needs of its subgroups and, particularly, their potential use of a CSBFA-type loan program.

The NEA defined the sector as including all organizations "which are legally prohibited from distributing profits or financial surpluses to those who own or control them." The study presented the following profile of the sector:

- The voluntary sector's annual revenues are almost $75 billion, an amount comparable to the GDP of Alberta.
- VSOs employ 1 Canadian in 10 — two thirds of them full time.
- In addition to paid staff, VSOs benefit from the services of 1.6 million volunteers per month.
- This is a growth sector: there are about 78 000 registered charities in Canada, roughly 20 000 more than in the 1980s.
- The debt-to-asset ratio varies considerably within VSO subgroups. Charitable organizations' debt-to-asset ratio is relatively low at $0.30:$1.00. Other non-profit groups have a significantly higher ratio of $0.69:$1.00. (This is roughly equivalent to the median debt ratio of retail-based SMEs, which stands at $0.73:$1.00.)

The NEA was sceptical about the extent of the need for asset-based debt financing among VSOs. It concluded that, in general, most charities — hospitals and teaching institutions, places of worship, foundations and others — require operational rather than asset-based funding. The same, it insisted, could be said of other non-profit groups: multicultural and agricultural organizations; boards and chambers of trade; arts and cultural groups; educational, recreational and social groups; professional associations; and others.

Where VSOs do require asset-based financing, the NEA asserted, their needs probably exceed the CSBFA loan limit and they have other, adequate sources of funding.

The study noted the need for further research — especially in the form of consultations with particular organizations — to more fully assess the need for asset-based financing among VSOs.

***Calgary Focus Groups*, Canada West Foundation, 1999**

In November 1999, the Canada West Foundation organized two focus groups for Industry Canada to gauge voluntary sector groups' reaction to, and need for, asset-based debt financing under the umbrella of the CSBFA.

Invited to the sessions were the executive directors of 70 VSOs or their representatives. Four groups declined to participate because they regarded loan programs as inappropriate for their organizations. Attending the first focus group were 3 groups of a scheduled 9; attending the second were 9 of a scheduled 13. The relatively low numbers reflected the ambivalence of the sector toward loan programs of any description.

The general consensus of participants was that a loan program was a potentially valuable tool for VSOs. Voluntary groups do interact with financial institutions (although generally not happily) and some use such financial services as mortgages and lines of credit.

There were, however, some concerns:

- Many VSOs are not accustomed to dealing with debt financing. The result could be low program take-up rates and organizational confusion.

- VSOs are not organized to manage debt financing. They concentrate on finding donations, and do not have the financial mechanisms or governing structure in place to repay debt on a regular basis.

- Many VSOs may require training to write business plans and manage debt financing effectively.

- VSO boards of directors will be extremely reluctant to give personal guarantees for loans. Among other factors, there is a high turnover on VSO boards, and many directors are not in a financial position to give guarantees.

- Loan repayment may be hampered by chronic revenue instability in the voluntary sector. There is frequently no steady stream of income that can be counted on for debt repayment.

In terms of program design, participants noted the following:

- Any successful asset-based debt financing program should be made available to all VSOs.

- Local chapters of large umbrella organizations should be treated as distinct entities for the purpose of loan evaluation, where appropriate. Some local chapters are tightly controlled by the parent organization; others operate as independent bodies.

***Voluntary Sector Round Table Report*, Judith Szabo Broadcast Consultants, 1999**

In November and December 1999, Industry Canada conducted consultations with 79 voluntary sector organizations in six Canadian cities. The resulting report emphasized the strong and consistent messages delivered about the extension of the CSBFA to the voluntary sector.

Participants welcomed the government's initiative as an attempt to address the financing concerns of the voluntary sector, but a significant number maintained that the CSBFA cannot be delivered in its current form to the voluntary sector for the following reasons:

- Most respondents felt that the voluntary sector has a greater need for working capital and funding for marketing than it has for asset-based financing.

- Many respondents appeared to be unfamiliar with financial concepts and indicated that "economic illiteracy" would make VSOs nervous about engaging in debt financing.

- At present, the operating rules of many VSOs are not designed to manage debt repayment.
- As currently structured, the program would benefit only large VSOs, which already face no difficulty in obtaining asset-based funding. Small VSOs with under $5 million in revenues would not qualify for loan approval because of inadequate or uncertain financial security.
- Most respondents expressed ethical and moral concerns about fundraising to repay CSBFA-type debts.
- Personal guarantees would not be acceptable to VSO board members.
- Program fees were felt to be prohibitively high.
- Participants were adamant that, while a CSBFA-type tool could be a useful alternative source of funding, the government should not replace grant funding with loans nor attempt to force VSOs to behave more like small businesses.
- Concern was expressed that the program's existing definition of revenue might force some VSOs to become profit-making enterprises in order to qualify for a loan, putting them in conflict with Canada Customs and Revenue Agency regulations.

Project Design Issues

As with the capital leasing pilot project, the VSO project is planned as a stand-alone pilot project with two fundamental attributes:

- It will provide incremental financing to the voluntary sector — in other words, financing that would be unlikely to have been granted in the absence of the CSBFA pilot project, or that might have been granted under less favourable terms than are possible under the program.
- It is intended to be self-financing over the course of the life of the loans made under it.

In designing the pilot project, it should be recalled that the CSBFA is primarily a small business program. Its VSO counterpart would be targeted at a comparable audience: VSOs that have a maximum of $5 million in revenues, and that would be able to use debt financing to increase their scale or efficiency and (along with it) their revenues. Although certainly a subset of the VSO community, this group appears to face a gap in finding sufficient debt financing. Our research has not demonstrated that the group presents a special risk to lenders, but many lenders perceive that it does. As a result, CSBFA-type lending to the group would almost certainly be incremental in nature.

It has yet to be determined how best to define the eligibility requirements for the pilot project. Moreover, lenders have yet to be consulted on each of the issues that affect their ability to lend under the program with minimal risk exposure and a prospect of reasonable returns. These issues are the guarantee rate, the interest rate

ceiling, the cap on claims, program fees, the financing rate and, of course, the question of which organizations would be eligible for the program. Further, the following particular content and design issues need to be considered in detail.

Key Voluntary Sector Pilot Project Issues for Consideration

- *Incrementality*: How much borrowing under the pilot project would be incremental for a sector that has not, for the most part, used debt financing to fund its activities? A key measurement of the success of the CSBFA program as a whole is the extent to which it fills gaps. For this reason, a core objective of the pilot project would be to ensure that it fills a gap in existing funding possibilities for the voluntary sector.

- *Cost recovery*: A key objective, this refers to ensuring that the pilot project remains self-financing for the length of the life of the loans guaranteed under it.[5] To achieve cost recovery, administration fees would have to be sufficiently high, and other parameters described below would have to be carefully managed.

- *Borrower eligibility*: A critical question is which VSOs should be eligible for the program, given their great variation in size, revenue, purpose, structure and capacity to manage and repay debt. The pilot project must be financially viable, which means that borrowers must have the wherewithal to repay loans. On the other hand, a complex definition of eligibility would create an administrative burden, and many potentially viable and incremental program borrowers might be excluded. These problems could be avoided by placing fewer restrictions on borrower eligibility.

- *Eligibility based on revenue*: Larger organizations with stronger revenue streams may appear to meet the criterion that borrowers under the project be financially viable. However, the goal of most VSOs is not to generate revenue but to provide services. As a result, judging program eligibility on the basis of revenue is problematic for the following reasons:

  - Revenue is a less accurate measure of a VSO's impact on society than of an SME's impact on the economy.

  - A revenue-based eligibility criterion could shut out the very VSOs that need the program most.

- *Loan eligibility or use of funds*: The major question is whether to broaden the use of CSBFA-guaranteed funds to include working capital or operational financing, which many VSOs indicated would be more useful to them than asset-based financing. The use of CSBFA-guaranteed funds for working capital was examined and rejected during the 1998 Comprehensive Review of the SBLA. It

5. The current CSBFA maximum loan term is 10 years. Should loans or leases be guaranteed under the pilot projects for periods of more than five years, they would continue to be guaranteed until the loans are paid off or the final lease payments are made. For this reason, even if the pilot projects are completed, leases or loans would be judged to be cost-recovered over the course of their lives rather than only the five years of the pilot projects.

was widely thought that loans for working capital presented risks too high to be managed by the CSBFA. In particular, lenders view working capital loans as much greater risks than fixed-asset financing. The reasoning was that the greater risk would translate into higher administrative costs and interest rates, and would diminish the program's ability to achieve cost recovery. Lenders appear to view VSOs as high-risk borrowers to begin with; they are unlikely to be receptive to the inclusion of working capital in a VSO pilot project.

- *Maximum loan size*: The issue is whether existing CSBFA loan limits, based on the financing needs of small business, would apply to the voluntary sector. Depending on eligibility criteria, the limit may be too low to be useful for most larger voluntary sector borrowers.

- *Percentage of asset financing*: Under the CSBFA, a borrower may fund up to 90 percent of the asset it wishes to purchase. The relevant question here is whether this parameter is appropriate for CSBFA lending to the voluntary sector.

  Financial institutions consider the voluntary sector in general to be considerably more risky than small business, but they are more likely to accept the greater risk if VSO loans cover a smaller percentage of asset prices (1998 consultations indicated that lenders would support a VSO loan program with no more than a 75 percent financing rate). In contrast, smaller VSOs would prefer the ability to fund 100 percent of asset purchases through the program.

- *Repayment terms*: Present CSBFA repayment criteria appear to be sufficiently flexible to apply equally well to VSOs. The principal requirements are that:

  - the loan be payable in instalments;
  - at least one principal instalment be payable annually; and
  - the first principal instalment be payable no later than one year from the day on which the loan is made.

- *Interest rate cap*: The CSBFA allows lenders to charge borrowers 3 percent above prime, a rate that may be prohibitively high for many VSOs. Conversely, if the interest rate cap is set too low, few if any lenders might be willing to offer it, jeopardizing the pilot project.

- *Personal guarantees*: Under the CSBFA, a lender is permitted to ask for a personal guarantee of 25 percent of the value of the loan. Consultations have indicated that VSO directors would be unable or unwilling to provide such guarantees. This will be a critical issue for lenders. Many VSOs are not able to post conventional security to begin with; without a personal guarantee, lenders' ability to secure loans is further reduced.

- *Fee payment*: Both the existing 2 percent registration fee and 1.25 percent annual administration fee may represent significant barriers to VSO use of the pilot project. To eliminate or reduce them, however, would reduce the ability of the project to remain self-financing.

- *Cap on claims*: The existing CSBFA gives each lender a separate account of guaranteed loans. In each five-year period under the CSBFA, the government pays claims of 90 percent of the first $250 000 in a lender's account, 50 percent of the next $250 000, and 10 percent of all additional loans. The "90/50/10" rule encourages low-volume lenders to participate in the program, while capping liability to high-volume lenders at an average of 10.6 percent.

  Lenders consider VSOs to be high-risk borrowers. To encourage them to participate in a VSO pilot project, the government may wish to separate the VSO cap on claims from the main program and/or adjust the risk to the financial institution, using a modified 90/50/10 rule.

- *Loan loss sharing ratio*: Since 1995, the government has taken 85 percent of the share of eligible losses for loans in default (after security has been recovered), while lenders have been responsible for the rest. Lenders perceive voluntary organizations to be higher-risk borrowers than SMEs, and will probably expect the government to increase its loan loss share as an incentive to participate in the program. Any such increase, however, would make it harder for the pilot project to achieve cost recovery.

- *Lending ceiling*: An appropriate ceiling needs to be determined for the project. Doing so will require quantitative analysis of the expected number of loans, based on the number of eligible borrowers and their use of the pilot project.