Canada Small Business Financing Act

Comprehensive Review Report

1999–2004

This publication provides a review of the operations of the Canada Small Business Financing Program from April 1, 1999, to March 31, 2004.

This publication is also available electronically on the World Wide Web at the following address:
strategis.gc.ca/sbresearch/csbfa

This publication is available upon request in multiple formats.
Contact the Information Distribution Centre at the numbers listed below.

For additional copies of this publication, please contact:

Information Distribution Centre
Communications and Marketing Branch
Industry Canada
Room 268D, West Tower
235 Queen Street
Ottawa ON K1A 0H5

Tel.: (613) 947-7466
Fax: (613) 954-6436
E-mail: **publications@ic.gc.ca**

Cat. No. Iu188-1/2004
ISBN 0-662-68873-2
54271B

PRINTED IN CANADA
IMPRIMÉ AU CANADA

Contents

1. Preface 2

2. Executive Summary 2

3. Small Business Financing Challenges 3

3.1 Small Business and the Financial Marketplace 3
3.2 Financing Challenges 4
3.3 Role of Government 5

4. Overview of the *Canada Small Business Financing Act* 5

4.1 Program History 5
4.2 Program Objectives 6
4.3 Program Parameters 7

5. Performance Review 7

5.1 Approach 7
5.2 Program Activity 7
5.3 Incrementality vs. Cost Recovery 9
5.4 Program Administration 10

6. Conclusions and Future Directions 11

Appendix A: *Canada Small Business Financing Act* Research for the Comprehensive Review 12

Appendix B: Key Canada Small Business Financing Program Parameters 13

Appendix C: Canada Small Business Financing Program Activity Review 14

Appendix D: *Canada Small Business Financing Act* Background on Cost Recovery 16

1. Preface

Under the provisions of the *Canada Small Business Financing Act* (CSBFA) of 1999, the Minister of Industry must table a comprehensive review of the Act every five years. This is the first such report. It reviews the provisions and operations of the Canada Small Business Financing (CSBF) Program from April 1, 1999 to March 31, 2004.

2. Executive Summary

Small businesses are the growth engine of the Canadian economy. To realize their full potential, they need a favourable environment in which to grow and prosper. Governments, the private sector and other institutions need to collaborate on small business needs and priorities, including the critical area of access to financing.

The *Canada Small Business Financing Act* (CSBFA) was created in 1999 as the successor to the *Small Business Loans Act* (SBLA), which had helped small businesses obtain debt financing since 1961. The Canada Small Business Financing (CSBF) Program represents a strategic partnership between the federal government and lending institutions to extend the supply of credit to small businesses. It has been described as a fundamentally efficient, effective and simple mechanism for meeting small business financing needs.[1]

The overall purpose of the current review is to examine how successful the CSBF Program has been during its first five years of operation in facilitating small businesses' access to financing. Specifically, the review determines the degree to which the program has achieved:

1) Incrementality, that is, extending financing that would otherwise have been unavailable to small businesses, or available only under less attractive conditions; and
2) Cost recovery, that is, the ability of the program's revenues to offset its associated cost of claims.

A number of background studies were undertaken in support of the review including an independent program evaluation conducted under the direction of a public–private sector committee in accordance with the program's Results-based Management and Accountability Framework.[2] Reports from this research are listed in Appendix A, and a summary review of them is available at the following website: **www.strategis.gc.ca/sbresearch/csbfa**.

Key findings from the review are as follows.

Program Rationale

- There is an ongoing need for facilitated access to asset-based debt financing for small businesses.
- There is no viable alternative to the CSBF Program, and minimal overlap between it and other government programs supporting access to financing by small businesses.
- The CSBF Program is consistent with government-wide and departmental priorities.

Program Activity and Benefits

- During its first five-year period, the CSBF Program supported nearly $5.4 billion in lending through about 66 000 loans.
- Program usage declined from about $1.35 billion through 18 000 loans in 1999–2000 to about $1 billion through 11 000 loans in 2003–04.
- Loans made under the CSBF Program were highly incremental:
    - 50 percent of CSBF loans went to new or start-up firms; and
    - 75 to 80 percent of the loans were financially incremental (i.e. they would not have been made or would have been made for a lesser amount than sought by the borrower).

1. *Access to Financing for Small Business: Meeting the Changing Needs*, Industry Canada publication prepared in conjunction with the 1998 Parliamentary Review of the *Small Business Loans Act*, 1998.
2. *Evaluation of the Canada Small Business Financing Program, Final Report*, BearingPoint, 2004.

- Loans delivered major economic benefits:[3]
  - Job creation (around 110 000 incremental jobs);
  - Higher sales growth for CSBF borrowers than for other firms (43 percent higher over the four-year study period);
  - Higher business survival rates than for other firms (10–20 percent higher);
  - Increased net GST remittances as compared to other firms (over 20 percent higher); and
  - Higher operating profits as compared to other firms ($13 500 more than other firms over the four-year study period).
- These benefits have been realized throughout Canada, with approximately one-third of CSBF borrowers residing in rural areas.

Cost Recovery

- The net cost to government of CSBF loans made during the reporting period is estimated at about $114 million on a net present value basis over the maximum ten-year life of the loans.
- Compared to the last four years of the Small Business Loans (SBL) Program, the average net cost to government (as a percentage of total lending) has narrowed from 2.6 percent to 2.1 percent.
- In a strict accounting sense, the CSBF Program is expected to recover 71 percent of costs, compared to 66 percent under the last four years of the SBL Program.
- It seems unlikely that full cost recovery could be achieved without unduly compromising the program objective of facilitating financing to small businesses that would not likely obtain it otherwise.

Program Administration

- While financial institutions recognize the need for the CSBF Program, they consider the administration of CSBF loans to be burdensome as program regulations are not always consistent with their evolving and increasingly automated lending practices.
- Administrative modernization of the CSBF Program must be undertaken — with due consideration given to accountability to Parliament and the needs of lenders and borrowers.

Looking ahead, it is clear that small businesses will continue to make a vital contribution to economic growth and face challenges in accessing the financing they need to do so. This review confirms the importance, efficiency and effectiveness of the CSBF Program in helping address these challenges. It concludes with questions for future consultations by Industry Canada on how the program could be improved and made even more successful.

3. Small Business Financing Challenges

3.1 Small Business and the Financial Marketplace

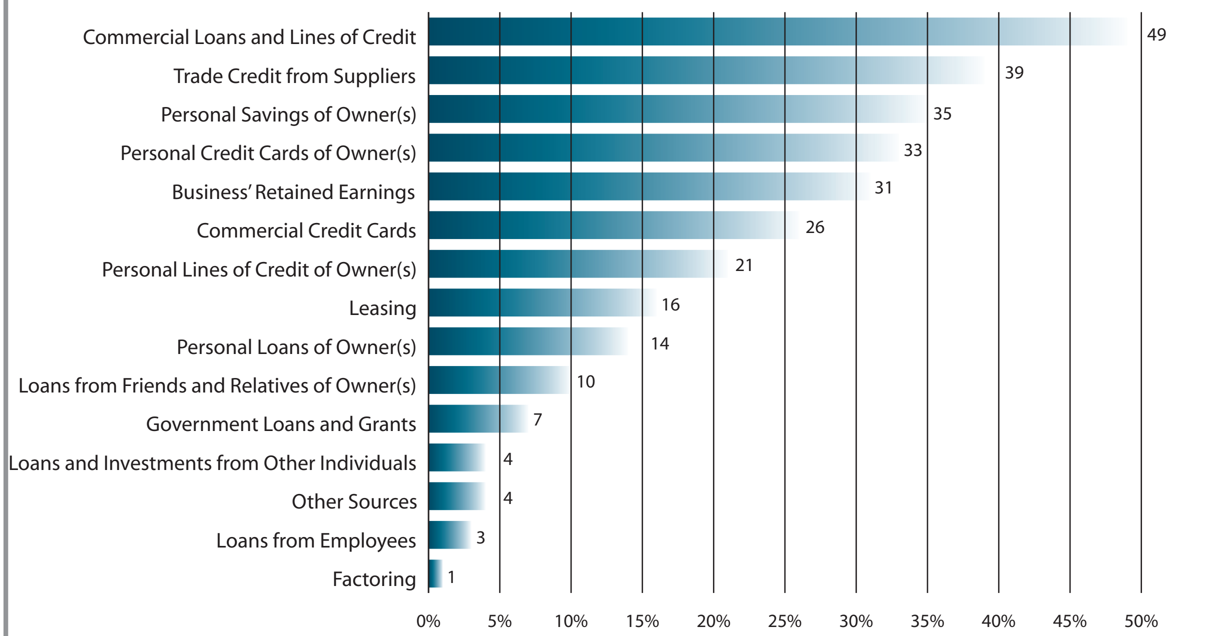
Small businesses represent the growth engine of the Canadian economy. There are more than 1 million employer establishments in Canada, 98 percent of which have fewer than 100 employees, 74 percent have fewer than 10, and 57 percent have only one to four employees.

On average in 2003, just over 5 million paid employees, representing 49 percent of the private sector labour force, worked for small enterprises. These enterprises accounted for 56 percent of all job creation between the start of 2000 and the third quarter of 2003 and they are expected to continue to drive the economy forward in the years ahead.

More than 140 000 businesses enter the Canadian marketplace in any year, and they must have access to capital to become established and grow. Their capital starts with personal savings and investment by family and friends and can come to include loans, lines of credit, retained earnings and other sources of financing. Figure 1 (see next page) reveals the types of financial instruments used by

3. *Longitudinal Economic Impact Study of the Canada Small Business Financing (CSBF) Program*, Statistics Canada, 2005.

Figure 1: Types of Financial Instruments in Use by SMEs in 2000*



* Includes any source used, regardless of whether it was authorized or obtained in a previous year.
Source: Statistics Canada, Survey on Financing of Small and Medium-sized Enterprises, 2000.

small and medium-sized enterprises (SMEs) in 2000 on total borrowings of $70 billion.[4]

The vast majority of small businesses meet their financing needs through market transactions without any government involvement. Most turn to debt financing at an early stage of development. Banks are the major lenders, accounting for about 45 percent of small business financing in Canada in 2001. Trust companies, credit unions, caisse populaires and other institutions play a smaller but important role, especially for businesses seeking smaller amounts of credit.

Financial institutions have strived to improve their service to small businesses. Many have developed product offerings specifically tailored to meet small business financing needs (e.g. commercial credit cards). They have also taken action to speed up credit decisions through the application of information technology. So-called credit scoring permits institutional lenders to reduce transaction costs of high-volume, low-value loans, expanding the number of small business clients that can be profitably extended credit.

3.2 Financing Challenges

Certain types of businesses represent greater risk to lenders and investors than others. They include start-ups with little or no credit history, and firms with few tangible assets to secure a loan. Moreover, enterprises engaged in developing new products and services can encounter lenders or investors with comparatively little knowledge of the business and corresponding perceptions of high risk. These factors and others help to explain why only 29 percent of start-up businesses in 2000 were financed through a commercial loan or line of credit from a financial institution, compared to 49 percent for established enterprises.[5]

Size of firm is also a major determinant of a business' financing profile — both start-ups and established smaller firms make more use of "informal" financing, including loans from friends and family, than do other businesses. The larger, more established a firm is, the more likely it is to successfully obtain commercial loans, mortgages, lines of credit and other "formal" types of financing.

4. This figure shows lending to all businesses that received credit of less than $250 000.
5. *SME Financing in Canada, 2002*, Industry Canada, 2003.

Obtaining relatively small sums of money for small business financing can be difficult. Notwithstanding credit scoring, some small loans often still do not justify overhead costs. Moreover, a report from a survey in 2003 by the Canadian Federation of Independent Business emphasized that relationships between loan managers and their clients had a strong influence on loan application success rates — the higher the turnover rate of account managers at a financial institution, the higher the loan rejection rate.[6]

3.3 Role of Government

Like governments in many other countries, including all of Canada's major trading partners, the government has long recognized the importance of small businesses to economic growth and well-being and that access to financing can be a critical issue for small businesses, particularly during their early years. Therefore, the government has sought to help small businesses and entrepreneurs through a variety of financing programs.

This effort includes loan programs offered by some of the regional development agencies, federally supported community futures and other local economic development organizations, and the Business Development Bank of Canada (BDC). The BDC's mandate as a complementary provider of financial services to small business was reconfirmed by Parliament in 2001, as part of a report on the BDC's operations between 1995 and 2000. This report concluded that there are many small businesses in Canada whose financing needs are not being satisfied by private sector providers and that there remains a public policy rationale for government to help fill marketplace gaps, including through the BDC.[7]

Essentially the same considerations led Parliament to adopt the CSBFA in 1999 as a successor to the SBLA, which had helped small businesses obtain debt financing since 1961. The CSBF Program is unique in that it is available to small businesses throughout the country through more than 15 000 points of service operated by private sector financial institutions. At the time of enactment, the CSBFA was considered to be highly relevant to the needs of small businesses and, overall, an efficient, effective and simple mechanism to facilitate debt financing for emerging and established small businesses.[8] It has been subsequently confirmed that there are no attractive alternatives to a small business financing program along the lines of the CSBF Program and that there is minimal overlap between it and other federal initiatives to support access to financing by small businesses.[9]

4. Overview of the *Canada Small Business Financing Act*

The *Canada Small Business Financing Act* is an act "to increase the availability of financing for the establishment, expansion, modernization and improvement of small businesses." It received royal assent on December 10, 1998, and came into effect for loans made after March 31, 1999.

4.1 Program History

Together with the SBL Program, following the first five years of the CSBF Program, Canada has nearly 45 years of experience with facilitating debt financing for small businesses through an innovative public-private partnership. The program has helped establish and grow some half-million Canadian businesses that have received cumulative private sector financing worth some $30 billion.

Small businesses seeking a loan under the program have always needed to apply directly to any approved or designated financial institution, such as a chartered bank, trust company, caisse populaire or credit union. Lending institutions evaluate the creditworthiness of an applicant, with the same diligence applied to any other loan application.

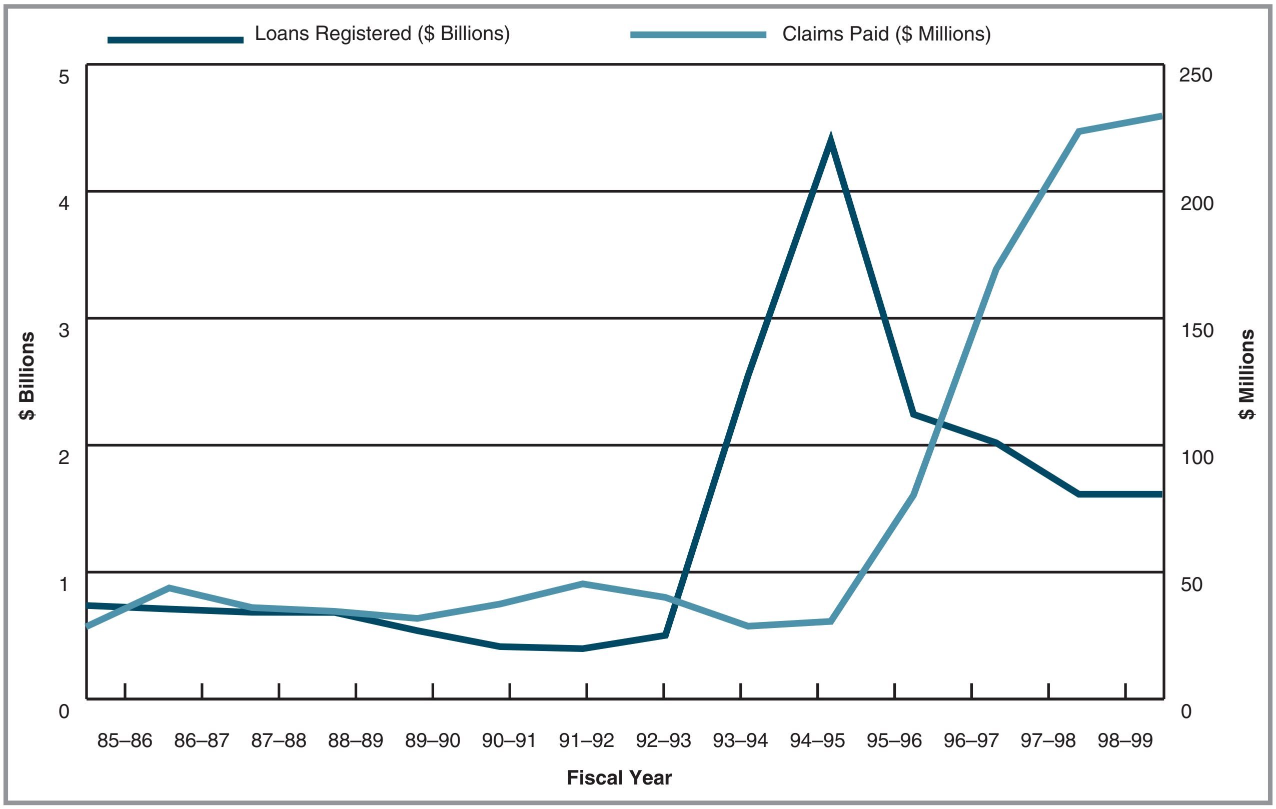
6. *Banking on Competition*, Canadian Federation of Independent Business, 2003.

7. *Supporting Small Business Innovation: Review of the Business Development Bank of Canada*, 2001.

8. *Access to Financing for Small Business: Meeting the Changing Needs*, Industry Canada publication prepared in conjunction with the 1998 Parliamentary Review of the *Small Business Loans Act*, 1998.

9. *Evaluation of the Canada Small Business Financing Program*, BearingPoint, 2004.

Figure 2: Changes in SBL Program Lending and Claims From 1985–86 to 1998–99



If the lending institution agrees to extend credit, the lender can choose to register the loan with Industry Canada, which is responsible for accepting the registration from the lender provided it meets the eligibility requirements under the Act. Where registered loans go into default and claims for a loan loss have been made, the government absorbs part of the loss (currently 85 percent, after recoveries on security).

The program has evolved over time in response to changing conditions in the marketplace and the evolving needs of small businesses. For example, the maximum loan size started at $25 000, reached $100 000 by 1980, and was increased to $250 000 in 1993, where it stands today. Fees and charges to borrowers and lending institutions using the program have also varied over time.

In response to the recession of the early 1990s, the program parameters were significantly broadened. For example, the government's loss-sharing ratio was raised from 85 to 90 percent. The result was significant growth in program activity between 1993–94 and 1994–95.

Lending increased from a norm of about $500 million annually to a peak of $4.4 billion in 1994–95, at which time some of the changes were reversed in an effort to begin moving the program toward cost recovery. This episode was a costly one for government as the total value of claims rose to peak at $230 million in 1998–99. Figure 2 displays the relationship between program changes and growth and claims up to the end of 1998–99, when the SBLA was repealed.

4.2 Program Objectives

The objective of the CSBFA is to increase the availability of financing for small businesses. This is known as *incrementality*, which occurs when loans made under the program would not have been made at all, or would have been made under less favourable terms, in the absence of the program.

The mid-1990s experience with sharply higher lending and claims for loan losses led to the establishment of the other program objective of *cost recovery*.[10] This occurs when revenues in the form of fees paid on the loans in a given year are equal to or greater than the total claims paid

10. Cost recovery does not include Industry Canada's operating costs (approximately $3 million per year) associated with administering the program.

for losses on those loans over their term, up to a maximum of 10 years.

4.3 Program Parameters

The major program parameters under which the CSBF Program operates today are identical to those in effect at the time the SBLA was repealed. The parameters are interrelated, which is to say that modifying one can impact on others. In addition, changing the parameters can involve trade-offs between the degree to which the above-mentioned policy objectives of incrementality and cost recovery will be achieved.

The current key program parameters are listed in Appendix B. It should be noted that the Act is applicable only to small businesses carried out for "gain or profit." This definition of small business excludes non-profit entities and, as such, may exclude some enterprises in the social economy that are run like businesses but manage their operations and redirect surpluses in pursuit of social and community goals. As current government policy incorporates the social economy for a wide range of programs currently offered to small business, the needs of this sector in relation to the CSBFA are under study.

5. Performance Review

5.1 Approach

A number of research studies and ongoing internal analyses were carried out by or for Industry Canada to inform the review of the CSBF Program. They can be grouped into the following categories:

- *Program evaluation*: An independent program evaluation, under the direction of a public-private sector committee, was carried out, based on a Results-based Management and Accountability Framework (RMAF) that Treasury Board recommends be used for assessing major policies, programs and initiatives. The RMAF identified key questions for the evaluation, including the program rationale, incrementality, cost recovery, employment, and program efficiency and effectiveness.
- *Economic impact and benefit*: Studies were undertaken on program incrementality, including best practices in methodologies for estimates under the program. Employment impacts were examined, and a longitudinal economic impact study of CSBF borrowers was undertaken.
- *Cost recovery*: Borrowing, defaults and claims experiences of SBL and CSBF borrowers were compared. Cost recovery forecasts based on various statistical models were carried out and subsequently updated with the latest information.
- *Stakeholder discussions and surveys*: Meetings were held with representatives from financial institutions to discuss working experience with the program and possible improvements. Awareness and satisfaction surveys were conducted of both lenders and borrowers, and lenders were also surveyed regarding their use of CSBF loans.

Reports from this research are listed in Appendix A, and a summary review of them is available on the World Wide Web at the following address: **www.strategis.gc.ca/sbresearch/csbfa**

5.2 Program Activity

Between 1999–00 and 2003–04, the CSBF Program supported nearly $5.4 billion in loans to about 66 000 small businesses. The average loan size was $82 000.

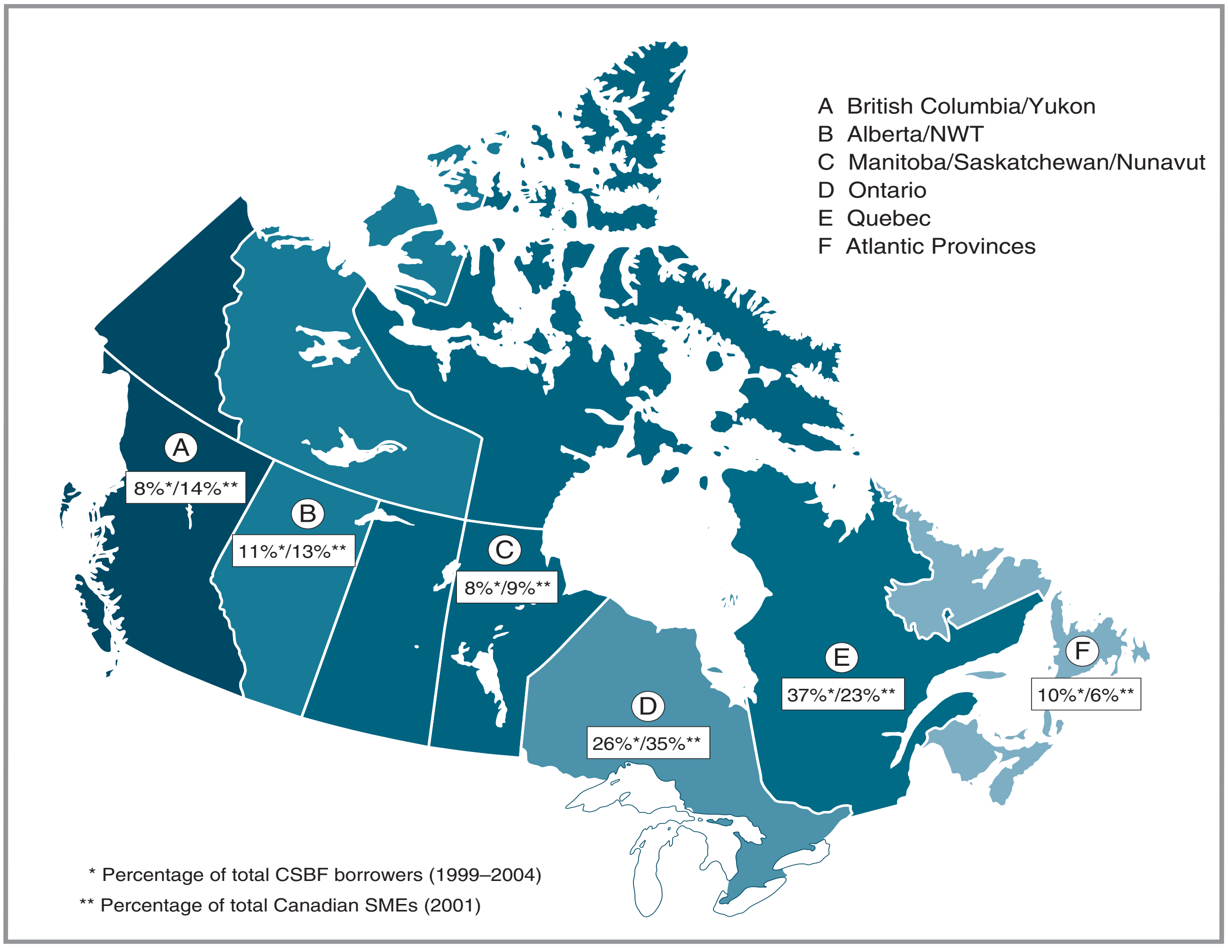
Annual lending volumes declined by 26 percent over this period, from about $1.35 billion in 1999–00 to about $1 billion in 2003–04. The number of loans decreased proportionately more, from 18 000 to 11 000, or by 39 percent. Consequently, the average annual loan size increased, from $76 000 in 1999–00 to $90 000 in 2003–04.[11]

Reasons for the decline in lending volumes include a decrease in the demand for debt financing over the five years,[12] increased use of flexible commercial lines of credit and credit cards by small businesses, an increase in the relative importance

11. The average loan size in 2003–04 was approximately $85 000 in 1999–00 dollars. Therefore, some of the increase in average loan size is also attributable to inflation.

12. *Small and Medium-sized Enterprise Financing in Canada*, 2003, Industry Canada, 2005.

Figure 3: Percentage Distribution of CSBF Borrowers (1999–2004) vs. Canadian SME Population by Region (2001)



of service sector and research and development (R&D)-intensive firms using sources of financing other than asset-based debt, and administrative burden on lenders and borrowers using the program.

Start-up firms younger than one-year old accounted for 50 percent of the five-year total number of CSBF loans, and 57 percent of their value. This compares with 40 percent and 46 percent, respectively, during the last four years of the SBL Program. In view of the greater difficulties experienced by start-ups in obtaining financing discussed earlier in Section 3 (because they often lack both the collateral and experience to make them credit-worthy), this result speaks well for incrementality under the CSBF Program.

The program facilitated financing of small businesses in all provinces and territories. Figure 3 compares the population of CSBF borrowers (1999–2004) to the overall population of SMEs (in 2001). It shows that in some regions the share of borrowers roughly approximated the share of SMEs located in that region (e.g. Manitoba, Saskatchewan and Nunavut). Elsewhere the borrowers' exceeded the region's share of SMEs and vice versa (e.g. Ontario and Quebec). Approximately one-third of CSBF borrowers were located in rural areas.[13]

The CSBF program is demand-driven and does not target any particular region or sector. As such, these regional variations in program use reflect the choices made by lenders and borrowers.

CSBF loans have helped support the purchase of equipment (58 percent of the five-year total value of credit), real property renovations (23 percent) and leasehold improvements (19 percent). While they have also helped to free up financing for working capital, such financing is not directly

13. *Longitudinal Economic Impact Study of the Canada Small Business Financing (CSBF) Program*, Statistics Canada, 2005.

supported under the CSBF Program (i.e. working capital financing is not an eligible class of loan). At the time the CSBFA was adopted, most stakeholders felt that extending program eligibility to working capital could jeopardize the attainment of cost recovery.[14] Experience with the CSBF Program suggests this concern may be unwarranted since equipment loans accounted for 71 percent of the value of claims, which is considerably more than their share of the total value of loans (58 percent) would suggest. On the other hand, the percentage value of claims from loans for leasehold improvements, which like working capital, offer little security for realization against claims, was roughly commensurate with the share of the total value of lending for this loan category — 20 percent versus 19 percent.

Other Economic Benefits

The program has resulted in substantial job creation and preservation. CSBF loans have created approximately two jobs per loan[15] for an estimated 110 000 net jobs created during the period. Additional indirect (supplier-related) and induced (re-spending-related) employment impacts are unknown, as are job displacement impacts.

A Statistics Canada economic impact study compared CSBF borrowers with similar firms that were not CSBF clients. It confirms positive results for program users and the Canadian economy. The study demonstrated that across industries, regions, and businesses of varying size, CSBF borrowers showed more employment growth than other firms.

In addition, CSBF borrowers:

- had higher sales growth than other firms (43 percent higher than other firms over the four year study period);
- had increased net GST remittances as compared to other firms (over 20 percent higher);
- had higher operating profits as compared to other firms ($13 500 more than other firms over the four-year study period); and
- had 10–20 percent higher survival rates than other firms.[16]

A more detailed overview of program activity during the first five years of the CSBF Program, including charts and graphs, is provided in Appendix C.

5.3 Incrementality vs. Cost Recovery

The essential challenge facing the CSBF Program has been and remains ensuring appropriate support for access to financing by small, often young businesses that would not likely obtain it otherwise, while at the same time achieving cost recovery.

In a 1997 report on the SBL Program, the Auditor General of Canada commented that the dual objectives of increasing the availability of loans at reasonable rates and recovering all costs need careful analysis. It was suggested that the extent to which these two objectives are simultaneously achievable be thoroughly studied, and that it was uncertain whether full cost recovery would be achieved under existing program parameters.[17]

The Auditor General's report helped inform Parliament's deliberations in the development of the CSBFA. While authority for pilot projects was provided for capital leasing and extension of the program to the voluntary sector,[18] program parameters remained unchanged. The contingent liability of the Crown to CSBF lenders was capped according to a declining-share formula based on the value of loans that each lender registers under the program. Measures concerning due diligence and compliance with CSBF administrative rules were strengthened to reduce portfolio risks and costs.

14. *Access to Financing for Small Business: Meeting the Changing Needs*, Industry Canada, 1998.

15. Industry Canada estimate based on the *Longitudinal Economic Impact Study of the Canada Small Business Financing (CSBF) Program*, Statistics Canada, 2005, and the study entitled *Incrementality of CSBF Program Lending*, Equinox Management Consultants, 2004.

16. *Longitudinal Economic Impact Study of the Canada Small Business Financing (CSBF) Program*, Statistics Canada, 2005.

17. In a 2002 Status Report, the Auditor General reiterated concern about whether the cost recovery objective would be achieved. It was considered imperative for Industry Canada to develop a better model to forecast the financial performance of the CSBF Program.

18. A pilot project for capital leasing was introduced and lies beyond the scope of this review. Consultations with the voluntary sector ascertained that debt financing supported through the CSBFA was not appropriate for the financing needs of this sector.

Incrementality

Within these parameters, the CSBF Program has achieved a high level of incrementality. Survey research demonstrates that 50 percent of CSBF loans have been made in circumstances in which the borrower would not qualify for any other loan at all.[19] In addition, about 27 percent of CSBF loans have allowed small businesses to obtain a larger loan than would otherwise have been approved, and 62 percent of loans were in other respects more advantageous to borrowers relative to conventional financing available in the marketplace. In this case, for example, the loan was provided with more favourable terms or facilitated a desirable working relationship between a firm and a lending institution. Of firms surveyed as part of this research, 55 percent reported that the CSBF loan had helped them start up, 35 percent reported that they were able to operate more efficiently, and 30 percent indicated that the CSBF loan had helped them expand.

Overall, between 75 and 80 percent of CSBF loans would not have been made or would have been made for smaller amounts or on less advantageous terms, if the program had not been available.

Cost Recovery

Benefits from the CSBF Program have been realized against a backdrop of improved cost recovery. As structured at present, however, the program is expected to fall short of full cost recovery.

In particular, cost recovery forecasts carried out for Industry Canada suggest lending over the first five years of the program could translate into a loss of $114 million on a net present value (NPV) basis. These forecasts seek to predict the value of claims from loan losses over ten years following the year in which loans are made, net of revenues from registration and administration fees paid by lenders and borrowers to the Crown.

Relative to the last four years of the SBL Program, the level of cost recovery has increased. For loans made between 1995–99, it is forecast that NPV costs will total $207 million on lending of $7.85 billion, for a net cost to government of 2.6 percent (as a percentage of total lending). Over the first five years of the CSBF Program, the expected NPV cost is $114 million on lending of $5.4 billion, for a net cost of 2.1 percent (as a percentage of total lending). Appendix D provides a more detailed comparison of cost recovery under both programs.

5.4 Program Administration

In light of the decline in loans during the initial years of the CSBF Program, a number of studies and discussions with lenders were undertaken to determine the causes of this decline. They cited program design and administrative burden as contributing factors. Lenders felt that some program requirements, such as those to gather and keep invoices for each loan, or rules that prohibit service fees, were inconsistent with their evolving and increasingly automated lending practices and the competitive environment in which they operate. Lenders also expressed frustration because claims for losses (especially under the old SBL Program) could be rejected for minor errors or technicalities.

Program modernization measures suggested by lenders include reduced regulatory burden, greater use of information technology, improving revenue potential, greater program flexibility in reviewing claims, and improved communications.

Modernization of the CSBF Program must be undertaken to ensure the partnership with lending institutions continues to provide needed access to financing for small business. While some initial measures have already been undertaken, such as regular meetings with major lenders, further regulatory changes should give due consideration to the need to maintain accountability to Parliament, as well as the needs of lenders and borrowers.

19. *Incrementality of CSBF Program Lending, Volume 3*, Findings From Survey Data, Equinox Management Consultants Limited, 2004.

6. Conclusions and Future Directions

The comprehensive review has demonstrated the program remains a successful, efficient mechanism for facilitating asset-based debt financing to small businesses. The program has moved toward greater, but not full cost recovery while supporting billions of dollars in new financing for small businesses, helping them to drive the Canadian economy forward.

It has been questioned whether the program could be fully cost-recovered while maintaining any "reasonable" degree of loan incrementality. At the same time, it has been suggested that there is greater scope for cost recovery.[20] The fundamental issue remains, however, as to whether program modifications in this direction would discourage program usage to such a degree that foregone economic benefits would exceed cost savings to government.

Industry Canada will undertake consultations with the small business community, representatives from financial institutions and other stakeholders on this matter with a view toward identifying how the CSBF Program could be improved and made even more successful. The issues that have been identified for these consultations are as follows:

- Are current program parameters optimal in view of the needs of small businesses for access to financing and evolving market conditions?
- Should the government seek to realize greater cost recovery from the program and, if so, how?
- Should the program be expanded to include new types of financing for small businesses? In particular, should working capital be eligible for financing under the program?
- In view of the importance of social economy enterprises to the communities they serve, how might the program be adapted to their particular financing needs?

As stated previously, program modernization to lessen administrative burden on lenders that use the program must be undertaken in any event. The scope and timing of the necessary changes will be pursued along with recommended changes that emerge from the consultations noted above.

20. *Evaluation of the Canada Small Business Financing Program*, BearingPoint, 2004.

Appendix A: *Canada Small Business Financing Act* Research for the Comprehensive Review

Program Evaluation

Evaluation of the Canada Small Business Program, Final Report, BearingPoint, November 2004.

Economic Impact and Benefit

Longitudinal Economic Impact Study of the Canada Small Business Financing (CSBF) Program, Statistics Canada, January 2005.

Incrementality of CSBF Program Lending, Volume 1: Insights From SME FDI Data, Equinox Management Consultants Ltd., December 2003.

Incrementality of CSBF Program Lending, Volume 2: Findings From Aligned Interviews, Equinox Management Consultants Ltd., February 2004.

Incrementality of CSBF Program Lending, Volume 3: Findings From Survey Data, Equinox Management Consultants Ltd., March 2004.

Methodological Review of Loan Incrementality Studies, The Conference Board of Canada, May 2003.

Canada Small Business Financing Act Employment Impact Study, Compas Inc., March 2002.

A Literature Review on Best Practices of Job Studies, Ted R. Heidrick, John W. Kramers, and Rosa Spadavecchia, March 2001.

Cost Recovery

Forecasting Expenses Related to SBLA and CSBFA Debt Financing Loans, Dr. Allan Riding, January 2005.

Forecasting Expenses Related to SBLA and CSBFA Lending, Equinox Management Consultants Ltd., July 2003.

SBLA and CSBFA Claims and Costs Experience, Equinox Management Consultants Ltd., March 2003.

Stakeholder Discussions and Surveys

Small Business Loans Administration Discussions with Financial Institutions, Heron & Company, June 2004.

Lender Awareness and Satisfaction Survey, Circum Network Inc., June 2004.

CSBFA On-Site Examination: Report on Findings, Industry Canada (Small Business Loans Administration), August 2003.

Canada Small Business Financing Act (CSBFA) Loans Decline Study, Compas Inc., January 2002.

Lending a Hand: The Role of the Canada Small Business Financing Act in Fostering Entrepreneurial Success, Nicole Baer Communications, December 2001.

Canada Small Business Financing Act Awareness Study, Compas Inc., April 2001.

Appendix B: Key Canada Small Business Financing Program Parameters

Borrower eligibility:

To ensure the program is targeted at small businesses, only firms with annual sales of $5 million or less are eligible to use the program.[21]

Loss-sharing ratio:

The government shares in eligible losses after realizations on security. Its share of eligible losses for loans in default is 85 percent. Lenders are responsible for the remaining 15 percent.

Cap on claims:

Each lender has a separate account of registered loans. The Government of Canada's obligation to an individual lender is to pay eligible claims (i.e. 85 percent of the eligible losses) on defaulted loans in its account, up to a maximum of the aggregate of 90 percent of the first $250 000 in loans registered, 50 percent of the next $250 000 and 10 percent of all loans in excess of $500 000.

Assets financed:

Loans are restricted to financing: (1) purchase of leasehold improvements, equipment, software and real property or immovables; (2) improvement to equipment and real property; and (3) program registration fees.

Percentage of asset cost financed:

The maximum amount of financing available is 90 percent of the cost of the assets.

Fees:

A one-time, up-front fee of 2 percent of the amount financed is paid at the time of registration. This fee can be included in the CSBF loan. In addition, the lender is charged an annual fee of 1.25 percent on outstanding loan amounts. Lenders may pass this fee on to borrowers only as part of the interest rate charged on loans.

Maximum interest rate:

The maximum floating rate is the lender's prime rate plus 3 percent (including the 1.25 percent annual fee). The maximum fixed rate is the lender's residential mortgage rate plus 3 percent (including the 1.25 percent annual fee).

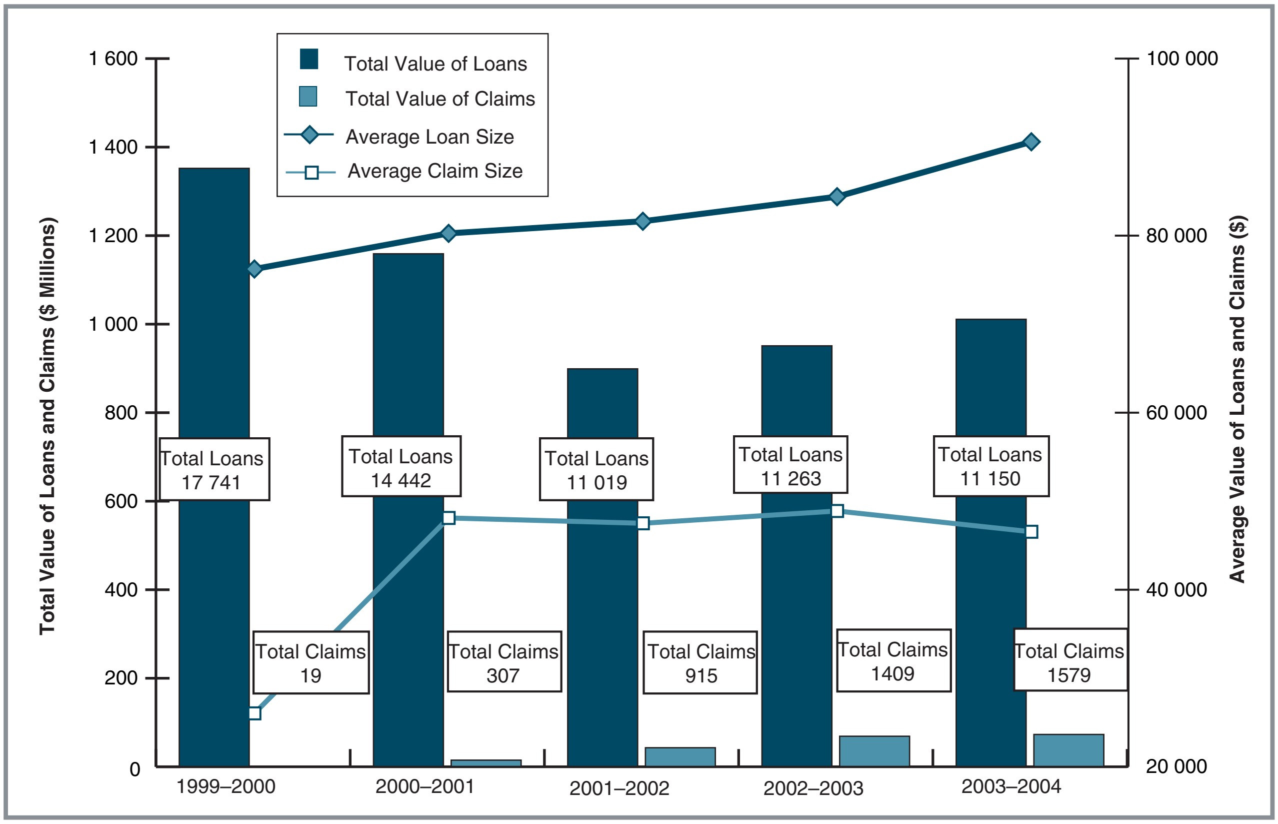
Maximum financing amount:

A borrower cannot have more than $250 000 in total loans outstanding under both the SBL and CSBF programs.

21. Businesses involved in farming and businesses having as their principal objective the furtherance of a charitable or religious purpose are excluded from the program.

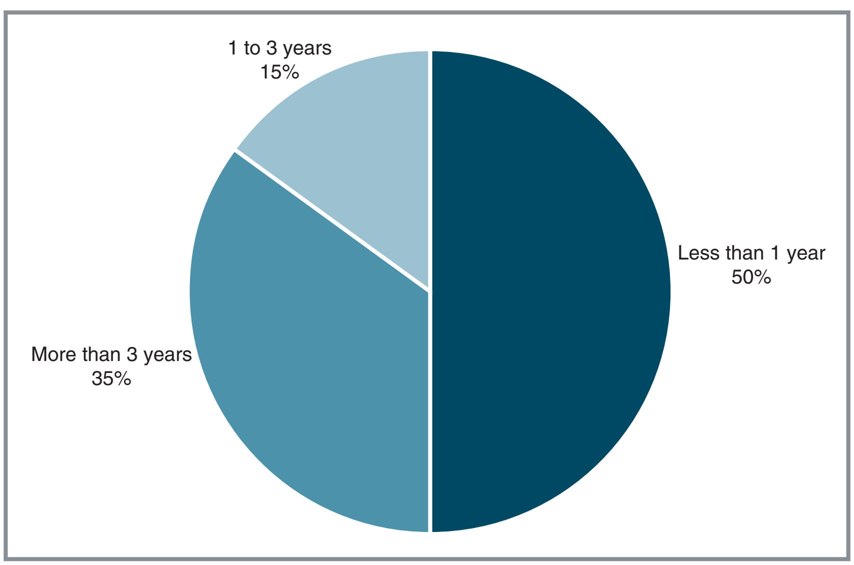
Appendix C: Canada Small Business Financing Program Activity Review

Figure C-1: Number and Value of CSBF Loans and Claims, 1999–2004



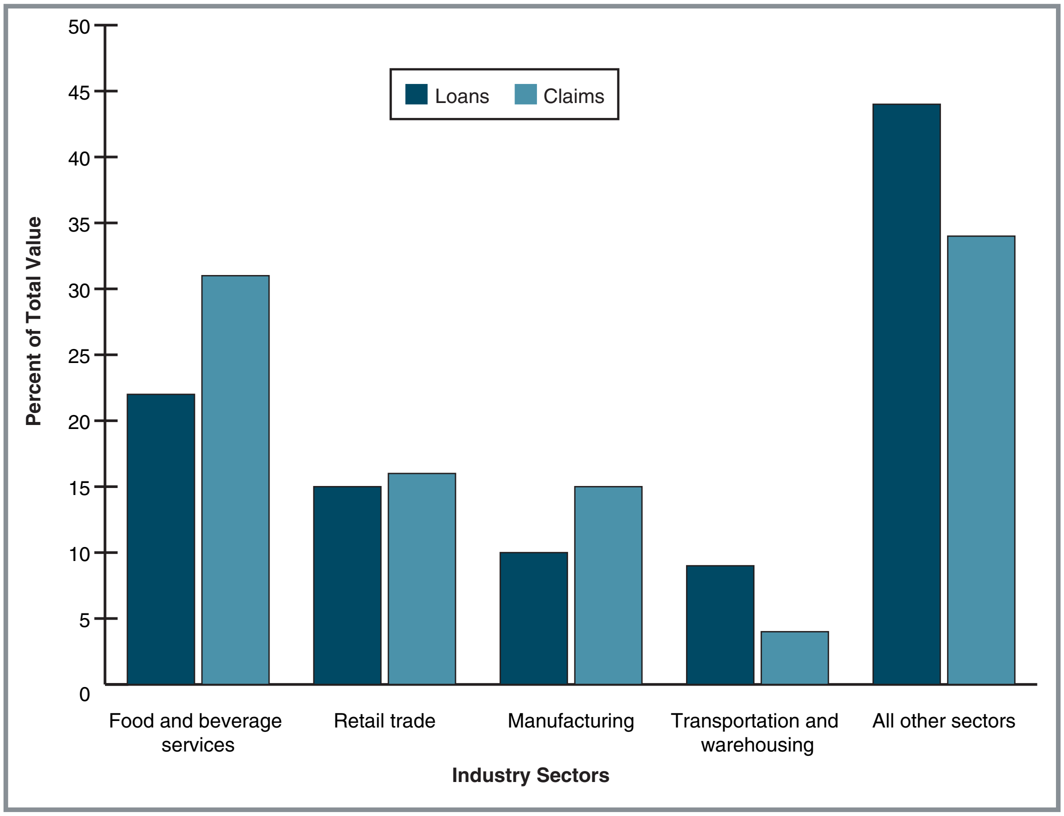
CSBF Program lending has stabilized at approximately 11 000 loans and $1 billion in lending annually after dropping 26 percent.

Figure C-2: Percentage of CSBF Loans by Age of Borrower Firm, 1999–2004



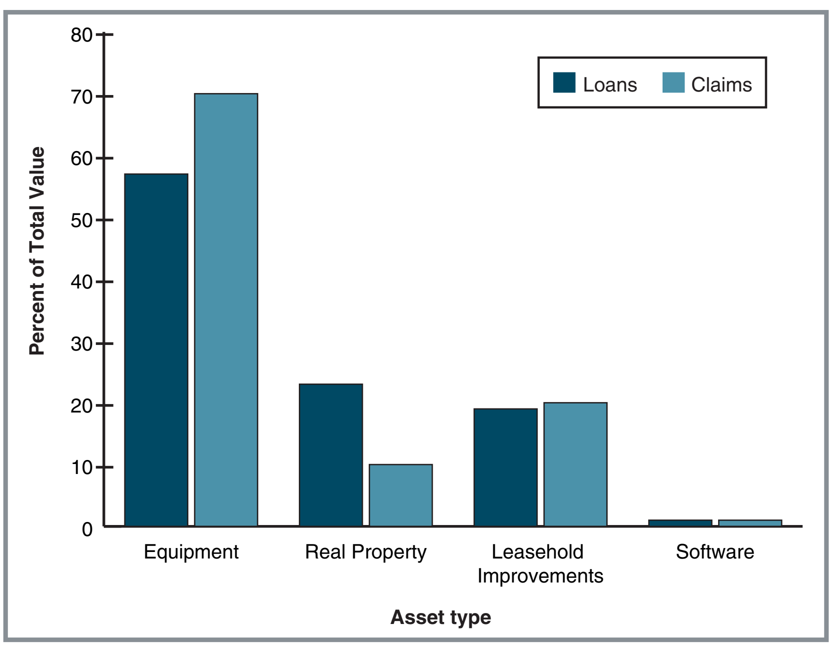
50 percent of CSBF loans were to start-ups and businesses less than one year old.

Figure C-3: Percent of Total Value of CSBF Loans and Claims by Industry Sector, 1999–2004



Four industry sectors accounted for 56 percent of the value of loans and 66 percent of the value of claims.

Figure C-4: Percent of Total Value of CSBF Loans and Claims by Asset Type, 1999–2004



Over the review period, equipment loans, which account for 70 percent of claims, declined, as a portion of the value of the portfolio, from 62 percent to 54 percent.

Appendix D: *Canada Small Business Financing Act* Background on Cost Recovery

In 1995, the SBL Program was given a cost recovery mandate. The importance of carefully monitoring the financial performance of the loans portfolio and regularly updating the program's cost recovery model was reinforced by the Auditor General in 1997 and 2002.

Methodology

Forecasting program revenues and costs is a complex task. First, sufficient data on loan risk and lender behaviour takes nearly four years to accumulate from the time of a parameter change. This is essential to a forecasting model. Second, the cost recovery model must cover the entire life of all loans made in a given year, which can be as much as ten years. Third, there is a significant lag time between the receipt of revenues and the payment of claims. Finally, lenders can take as long as three years after default to submit a claim for loss, so the period can be extended as much as 13 years. As a result, revenues and claims need to be forecast long into the future, making estimates of cost recovery difficult and subject to variance according to economic conditions and other factors. For this reason, Industry Canada updates its forecast and forecasting models on a regular basis to ensure they reflect the most recent experience.

Using a multivariate analysis of the claims received in a given month combined with statistical and econometric-based forecasting models, Industry Canada is able to project future claims[22] against the forecast revenues to arrive at the cost recovery forecast for the program.

Findings

Table D-1 illustrates the current cost recovery forecast for CSBF loans made during the period 1999–2004 and for SBL loans made during the period 1995–99. It provides a summary of the revenue and expense streams associated with each of the annual cohorts. These gross forecasts are outlined in Table D-1.

In aggregate, for the CSBF Program (see Table D-1 below):

- Revenues (registration and administration fees) for the five years of loans are expected to reach approximately $303 million.
- Expenses (claims) are expected to be approximately $463 million for a net cost of $160 million.
- Revenues are expected to offset expenses by 65.5 percent. This is over 5 percent higher than the expected percentage cost recovery for SBL loans made from 1995–1999.

Table D-1: Cost Recovery Forecast Summary: 1995–2004 SBL and CSBF Programs

($ Millions)		Revenues and Expenses				% Cost Recovery[1]	Net Cost / Loans (%)
Cohort	Loans	Reg Fees	Admin Fees	Claims	Net Cost		
1995–96	2243.2	44.4	82.7	-229.3	-102.2	55.4	-4.6
1996–97	2018.9	40.0	72.6	-184.2	-71.6	61.1	-3.5
1997–98	1977.3	39.2	67.4	-163.8	-57.3	65.0	-2.9
1998–99	1613.7	32.0	54.3	-141.8	-55.6	60.8	-3.4
SBL (1995–99)	**7853.1**	**155.5**	**277.0**	**-719.2**	**-286.7**	**60.1**	**-3.7**
1999–2000	1352.3	26.8	49.0	-112.6	-36.8	67.3	-2.7
2000–01	1159.0	22.9	43.4	-96.0	-29.6	69.2	-2.6
2001–02	899.4	17.8	33.3	-77.5	-26.4	66.0	-2.9
2002–03	959.9	19.0	34.7	-86.5	-32.8	62.0	-3.4
2003–04	1017.5	20.1	36.3	-90.8	-34.3	62.2	-3.4
CSBF (1999–2004)	**5388.2**	**106.7**	**196.8**	**-463.3**	**-159.9**	**65.5**	**-3.0**

[1] % Cost recovery: revenues (registration and administration fees) divided by expenses (claims).

22. *Forecasting expenses related to SBLA and CSBFA debt financing loans*, Dr. Allan Riding, Equinox Management Consultants Ltd., January 2005.

- From an overall loans portfolio perspective, the net cost to government is expected to average approximately 3 percent of the total loans made, which is an improvement over the average of 3.7 percent for loans made under the 1995–1999 SBL period.

Table D-2 provides the same summary of the revenues and expense streams associated with each of the 1995–2004 annual cohorts. This table takes into consideration the three- to five-year lag between when the revenues are received and when the expenses are paid (i.e. presented on a net present value [NPV] basis).

In aggregate, on an NPV basis:

- Revenues (registration and administration fees) for the five years of CSBF loans are expected to reach approximately $274 million.
- Expenses (claims) are expected to be approximately $388 million for a net cost of $114 million over the term of the loans.
- On a percentage basis, revenues are expected to offset expenses by over 70.6 percent. This is 5 percent higher than the expected percentage cost recovery for SBL loans for the 1995–1999 period.
- From an overall loans portfolio perspective, the net cost to government is expected to average 2.1 percent of loans made, which is also an improvement over the average of 2.6 percent expected for SBL loans made during 1995–1999.

Conclusion

A comparison of the results for the last years of the SBL Program and the review period for the CSBF Program demonstrates that the program changes Parliament made in 1998 have worked to improve the program's cost recovery experience. Industry Canada will continue to update its forecasts and refine its forecasting models on the basis of the latest available data, to ensure appropriate monitoring of this program objective.

Table D-2: Cost Recovery Forecast Summary: 1995–2004 SBL and CSBF Programs (NPV[1] Basis)

($ Millions)		NPV Revenues and Expenses				% Cost Recovery[2]	Net Cost / Loans (%)
Cohort	Loans	Reg Fees	Admin Fees	Claims	Net Cost		
1995–96	2243.2	43.1	72.2	-191.3	-76.0	60.3	-3.4
1996–97	2018.9	38.8	63.7	-154.0	-51.5	66.5	-2.6
1997–98	1977.3	38.0	59.2	-136.4	-39.2	71.3	-2.0
1998–99	1613.7	31.0	47.7	-119.1	-40.4	66.1	-2.5
SBL (1995–99)	**7853.1**	**150.9**	**242.8**	**-600.8**	**-207.1**	**65.5**	**-2.6**
1999–2000	1352.3	26.1	42.2	-94.8	-26.5	72.1	-2.0
2000–01	1159.0	22.4	37.6	-80.4	-20.5	74.5	-1.8
2001–02	899.4	17.4	28.8	-64.3	-18.1	71.8	-2.0
2002–03	959.9	18.5	29.9	-72.3	-23.8	67.0	-2.5
2003–04	1017.5	19.6	31.4	-76.2	-25.3	66.9	-2.5
CSBF (1999–2004)	**5388.2**	**103.9**	**169.9**	**-388.0**	**-114.2**	**70.6**	**-2.1**

[1] Net present value (discount rate = 5%)

[2] % Cost recovery: NPV revenues (registration and administration fees) divided by NPV expenses (claims).