A Future for the Small Business Loans Act: Stakeholder Perspectives, 1996

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Executive Summary

MANDATE AND METHODOLOGY

With legislation to renew or amend the SBLA likely necessary sometime in 1997, this study was commissioned for the purpose of consulting 'stakeholders' on a broad range of potential options, administrative and policy. Borrowers, lenders and officials were asked for their views on the 'fundamentals' of the SBLA as it is structured today - and also for their opinions about a number of alternative structures, some styled after our competitor's small business assistance programs, and some adapted from financial assistance models serving other sectors of Canadian society.

After extensively reviewing existing literature, highly 'tailored' decks of questions were administered, in the course of forty-five interviews, to borrower and lender representatives, federal government department and agency officials (current and former), to research staff in the Canadian Parliament, and to 'observers' of the SBLA. Multiple interviews were held in many cases- for example, ten current and former Industry Canada officials were consulted, as were four from the Department of Finance.

FINDINGS AND CONCLUSIONS - 'ADMINISTRATIVE OPTIONS'

Conversion of SBLA to a Credit Insurance Crown Corporation

Aside from relief from further contingent liability (even that not being certain; a 'moral' obligation could still exist), very few pluses to credit insurance (in replacement of loan guarantees) were identified by respondents. The likelihood of a SBLA Crown Corporation receiving federal equity is limited. Required 'due diligence' would, effectively, transfer to the federal government (a la CMHC) administrative costs now being borne by the private sector. The biggest obstacle is a wide-spread lack of enthusiasm for 'pricing to risk', a fundamental characteristic of the Japanese credit insurance model.

It would appear that credit insurance could only become attractive (and thus 'salable') if a Crown Corporation, created for the purpose, were to offer significant new features (working capital; numerous other small business 'insurance needs' currently unavailable or unaffordable). Further study is definitely warranted of the possibility of folding the SBLA into a 'Business Implementation Insurance' scheme, probably best managed by a new Crown Corporation.

Separate and apart from the credit insurance concept, there is limited public sector and zero private sector support for the option of rationalizing the several Crown corporations and agencies which facilitate business access to financing.

Devolution of the SBLA to the BDC

Of the existing Crown Corporations to which the SBLA could be devolved, most viewed the BDC as the most likely candidate (except the BDC, that is - they don't want the job!). SBLA *users* oppose such a merger. One major reason for transforming the SBLA into a federally-

managed quasi-banking operation would be to re-fashion assistance to small business along the lines of the German 'Development Bank' model. For myriad reasons, however, the features of the German model are widely disparaged - particularly by officials - as inappropriate to the Canadian context.

Privatization

Most respondents believe that a capital market gap does confront at least some components of the small business sector, and that the SBLA has helped address that *need***.** Doubts are widespread either that a private sector operator could be found to run the SBLA, or that, with cost recovery, users would continue to find the SBLA affordable. There is also a widely held view that political considerations would preclude true privatization.

Opinions were solicited on quasi-privatization, along the lines of the new student loans model. Lenders protested their dislike of the idea, but could perhaps be persuaded. Government would probably have to decide to afford an annual subsidy (unattractive to officials) but, as in the case of student loans, the extent of that subsidy [as a predetermined percentage of lending - perhaps along the lines of the SBLA default rate today (i.e., 5% - half of the rate at which the contingent liability grows] would be known in advance.

It is in the context of considering privatization that the issue of government's contingent liability - and whether it can continue to *afford* to operate an SBLA, is explored. Official distaste for a growing contingent liability drives consideration of options like privatization. It also delimits the scope for SBLA expansion, inasmuch as ensuing growth in lending volume would exacerbate the liability. Privatization becomes marginally more appealing then, if seen as the only means by which new features could be added to the SBLA.

Special Operating Agency

Respondents are more perplexed when confronted with this option than they are with any other. No business case has been made for turning the SBLA into an SOA, and no plausible case is anticipated. There are numerous less cumbersome ways of introducing greater incentive for rigorous management of the SBLA program - if, in fact, that is required. SOA status has no implications for the government's liability, and lenders doubt that it would improve their relationship with the SBLA (a relationship with which they are generally quite pleased). A good case can be made for extending cost recovery to apply to administrative expenses - thereby introducing a true 'bottom line' into the program. In the event that the scope of the SBLA is significantly broadened, the SOA issue should be revisited.

Status Quo (with tinkering)

Numerous recommendations are made, including:

- that administrative flexibility be provided so as to permit processing of SBLA claims by dollar value, rather than chronologically - thus potentially saving some interest costs;

- that the Act be amended to eliminate 'automatic' lender status, and that all institutions - including potentially CFLA members - be required to apply for, and periodically seek renewal of, their status. This will create a level playing field in the event the SBLA is expanded to include capital leasing, and it will end an anomaly whereby a private sector lender, de facto, has the 'right' to obligate the Canadian taxpayer;

- Achievement of Post-payment Verification (PpV), just as soon as possible, is seen as critical to successful management of the SBLA portfolio during the upcoming 'blip' in claims, and thereafter. The Department, as a priority, must allocate the resources necessary to bring to rapid conclusion the statistical aggregation exercise on which PpV (and other efficiencies) will be based. To do otherwise is to invite serious backlogs, higher interest costs and diminishing lender confidence. As a corollary, thought should be given to streamlining the process at *the front end* - perhaps along the lines of the U.S. SBA's 'Certified' and 'Preferred' Lenders programs;

- The decision to roll the 125 basis points fee into the interest rate which lenders may charge should be revisited. The hope that it would foment greater interest rate competition has proven groundless - and rendering opaque that which should be transparent is bad public policy. Borrowers should realize that they are paying a fee in order to ensure cost recovery. That is not a message government should shirk.

FINDINGS AND CONCLUSIONS - 'POLICY FOCUS' OPTIONS

Capital Leasing

Definitionally, it is hard to continue to exclude capital leases (as distinct from operating leases) from SBLA coverage - so says almost every respondent. At the same time, almost no-one (except for the leasing industry) is asking that the SBLA be so expanded. This appears to be a *fairness* and/or a convenience issue more than an incrementality one - and yet, to the extent that differences between some leasing and traditional SBLA-guaranteed activities are becoming blurred, application of a tougher incrementality standard to leasing does not seem justifiable. Unlike working capital, for example, no respondents believe that it makes any particular sense to creating a separate SBLA-type program just for capital leasing. It is regarded as prudent, however, for the Department to satisfy itself of capital leasing's probable impact on lending volume and historic default rates - both of which significantly impact cost recovery.

'Incrementality'

Aside from considerations of expanding the SBLA to cover currently ineligible activities (working capital, for example), incrementality is widely regarded as "yesterday's issue." Cost recovery has driven many "good borrowers" out of the SBLA - and the exodus is not over. Ensuring a *balanced portfolio*, with continued 'cross subsidization' is now a far more daunting challenge than marginally increasing SBLA incrementality.

New Lenders

There is no discernible support for allowing regional agencies or Crown Corporations to issue SBLA-guaranteed loans - although there is support for further examination of the feasibility of permitting Community Futures Offices to do so.

Personal Guarantees

Borrowers don't like them - yet accept that they are not only "the way business is done", but "probably necessary" as well. Ironically, lenders tend to dismiss their importance - but only insofar as the SBLA 'status quo' is concerned. Rather than further restricting the taking of personal guarantees, the government should monitor the 'compromise' to ensure it is being adhered-to. Any decision to *prohibit* guarantees is regarded as tantamount to resolving to not expand the SBLA to include financing of either working capital or other 'soft assets'. Notwithstanding their phobia toward 'complicating' the SBLA, lenders might be amenable to some flexible formulae, viz., *no* equity contribution being required *if* more substantial personal guarantees are offered, or lower fees or premiums being applied in exchange for higher personal guarantees.

SBLA 'Fundamentals'

Borrowers, lenders and officials all agree - there should be *no changes* to the SBLA fundamentals prior to renewal legislation. There is much less consensus on what changes should be considered *in the context* of renewal. Lenders accentuate continuity, and disparage 'needless' tinkering. Borrowers also ascribe virtue to a SBLA whose parameters are generally familiar, but are more inclined to endorse calibration of the fundamentals to achieve broader policy objectives. Officials emphasize cost recovery.

Amount of Loan Guaranteed

Lenders, if spoken-to individually, are very open-minded to the notion of flexibility on the amount of equity required (currently it's an absolute 10%), in respect of which differential fees or premiums could then be applied. Obviously, the government needs to satisfy itself, to the extent possible, of the probable impact on cost recovery. If addressable, the capacity for borrowers and lenders, in collaboration, to maximally tailor the SBLA to a borrower's needs, more than compensates for the additional complexity.

Fees/Premiums

Not one respondent felt there is scope for higher fees or premiums (on net); indeed, most felt that either would send the SBLA into a "death spiral." However, as in the case of fees/premiums calibrated to varying equity contributions (or to varying amounts of personal guarantee, for that matter), there is a willingness to consider linking fees/premiums to loan size (a la the U.S. SBA), or to particular categories of lending. A higher fee on types of lending statistically found to suffer a much higher probability of default - especially if it then proved possible to *lower fees/premiums for all other borrowers* is one possibility - if *agreed* policy goals would be served and cost recovery would not be compromised. There is particular lender enthusiasm for

calibration of fees/premiums to lender performance - which, at the cost of some incrementality, would incentivize lenders to remain in the program. The Department should *very seriously consider* this possibility if it becomes particularly anxious to see the 'quality' of the portfolio improved, or if lender departure from the program, *de jure* or *de facto*, appears imminent.

Guarantee Level

There is no lender support for a reduced guarantee level - neither 'across the board' nor (especially) on 'risky' categories of lending. There is also no lender support for fees/premiums calibrated to differential guarantee levels.

Lending Ceiling

There is an *overwhelming* consensus that the lending ceiling for Period-13 should not be set *until* government knows a great deal more about the SBLA program - especially propensities to default - than it does today.

Maximum Firm Size

Respondents are generally content with the current maximum firm size ($5m in annual revenues), although a small minority would like it lowered. None want it raised. There is some openness, however, to the idea of setting different maximums by sector (as does the U.S. SBA). If, hypothetically, statistics were to show that firms of $3-5m revenues *in one*, and *only one*, sector had a much higher propensity to default than firms of that size in all other sectors, respondents agreed that it would make more sense to reduce the maximum for that sector than it would to either reduce the overall maximum, or to maintain the status quo ante. In sum, adjustments with sound statistical bases are deemed acceptable.

Maximum Loan Size

With the exception of one borrower representative, respondents generally believe that the current $250k limit is appropriate and should be maintained. There is less tolerance here for differential ceilings by sector (than in the case of maximum *firm size*), because it is felt that any reduction would likely contradict other declared policy objectives (for example, it is assumed that exporters and knowledge-based firms - two sectors almost everyone would like to see participate *more extensively* in the SBLA (if only the means could be found and cost recovery could be ensured) - tend to borrow at *higher* dollar values). There is very limited support for *increasing* the ceiling, perhaps to $300k.

Rate of Interest

Borrowers strenuously oppose any consideration of lifting the interest rate cap (which bodes poorly for pricing-to-risk, or incorporating any riskier programming - for instance, working capital - under the existing SBLA). Lenders are split between those who favour pricing-to-risk, and those who insist that higher interest doesn't compensate for higher risk and, accordingly, that

no significant incremental lending would take place within a higher cap. Indeed, since many assume that a higher cap would lead to either or both of higher interest for most borrowers or massive 'column shifting' of those loans already being made outside the program at higher interest rates, there is no reason to seriously contemplate raising (or eliminating) the cap. The corollary, however, is that 'riskier' activity would have to be covered under parallel (but complementary) programs.

Pricing-to-Risk

Consistent with the foregoing, pricing-to-risk - while conceptually attractive to some - is regarded as a practical non-starter *insofar as its application to the existing SBLA is concerned*. Lenders accentuate the administrative burden; borrowers almost totally lack faith in lenders' ability to assess risk. The EDC's MARG program, while carrying the aspirations of many exporters, is seen as too narrowly focussed to serve as a relevant model for the SBLA. There is, however, widespread recognition among all parties that parallel SBLA-type programs for 'riskier' activities would, almost certainly, have to be structured on a pricing-to-risk basis.

'Targeting'

The SBLA is not regarded as being well-targeted today (in terms of fostering jobs and growth), but there is little agreement on where and how it should alternatively be targeted - in addition to there being considerable support for what it is the program currently does. There is widespread skepticism not only about what 'targeting' choices might initially be made, but about how to keep those choices relevant over time (once an "entitlement" has been created...). One potentially workable compromise might be to target differently by region - dovetailing the SBLA with priorities already identified within those regions and being implemented by the regional agencies. That alternative does not satisfy those who are ideologically opposed to targeting, but finds some support among those who wonder how it could be practically applied.

Knowledge-based Small Businesses

Almost everyone believes that these firms face a pronounced capital market gap. Some respondents believe it is pointless, however, to speak of trying to address that gap within the SBLA: "you either create a working capital guarantee, or you don't." Others think it might be possible to meet at least some of this big-growth sector's needs by creating a second category within the SBLA, whereby for companies with large soft-asset components, a higher interest rate would be permitted and a higher premium would be required. The Standing Committee on Industry is about to embark on an examination of this sector, and it is recommended that the Committee be asked to canvass opinion about five SBLA-related options in the course of its deliberations.

Small Exporting Businesses

There is much less support for notions that the SBLA should be 'turned inside-out' in order to offer particular assistance to small exporters. In so many cases, the nature of the risk mitigating

the availability of financing is beyond the ken of lenders (or of the Industry Department) to assess. Other government agencies and programs exist to serve these needs. If one of the biggest gaps facing small exporters is financing on a pre-shipment basis, then perhaps the MARG should be amended to meet that need, or the EDC should be encouraged to foster other relevant programming. Expansion of the SBLA to include capital leasing could materially help exporters; not every government program should be attempting to meet every felt-need - to do so risks loss of any focus whatsoever.

Start-Ups

There is widespread support for the notion that start-up firms and micro businesses do face significant capital market gaps (some of which the SBLA has helped meet over the years). Even most of those attracted to targeting 'new economy' firms found themselves identifying loans of less than $100k as "the real gap" - this by way of largely endorsing the SBLA's mandate as is. There is some tolerance for adopting the UK program's stricture against lending to any one individual (up-to the maximum allowable amount) more than once - which would probably have the effect of targeting more SBLA lending at starts-ups (it might, however, compromise cost recovery). Again, at the risk of raising the overall default ratio, some respondents would be willing to contemplate a higher guarantee on smaller loans - thus provoking more lending of that sort. Some interviewees believe that including capital leasing within the scope of the SBLA would help start-ups and micro-businesses, and some also feel that a 'two-tiered' SBLA (as mooted above in the context of 'Knowledge-based firms') could assist many of the small, one-and-two-person operations that are increasingly at the base of the 'new economy'.

Working Capital

The notion of a loan guarantee program covering working capital (whether the SBLA itself, or a parallel program) is: derisively dismissed by many (especially officials); regarded by some lenders as impossibly cumbersome administratively; described by many borrowers (and some lenders) as the only truly relevant area of activity for government wishing to use its resources to facilitate small business access to capital.

There is, however, widespread consensus that: cost recovery has precluded inclusion of working capital within the SBLA as it stands; a 'Working Capital Loan Guarantee Program', if kept separate from the SBLA could, indeed, be created without threatening the integrity of the existing program; such a working capital guarantee would have to be operated on a price-to-risk basis, with higher premiums likely having to be charged in order to assure cost recovery; limitations against the taking of personal guarantees would have to be lifted for the working capital guarantee program. For every respondent, preservation of the status quo is more important than risking the 'health' of the SBLA program by expanding it to include working capital.

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1.0 Introduction

The Small Business Loans Act (SBLA) 'sunsets' in 1998, and legislation to renew or reform it will probably have to be introduced in 1997. With that reality looming, it is prudent to explore options for the SBLA, both administrative and 'policy focus', *from the perspective of stakeholders.*

The 1998 'sun setting' creates a real - but at the same time arbitrary 'window' for review. On the one hand, much has changed since 1993, when the SBLA was profoundly altered, and 1994, when the Program Review exercise largely endorsed the SBLA status quo. Skyrocketing lending volumes necessitated further alterations to the program, none more radical than the introduction, in 1995, of cost recovery. Meanwhile, both the small business sector itself, and the market in which it seeks financing, are undergoing rapid change. The volume and intensity of these changes validate the decision to review the SBLA.

On the other hand, with so much in flux, it is evident how very little is really known about the relationship between the several SBLA 'variables'. This is not a new phenomenon: in past, decisions to renew the program (and/or to adjust its 'fundamentals'), must have been taken in comparative darkness. But now, with lending volumes so much greater - and with the promise on the horizon (hopefully not a mirage!) of statistical data detailing historical propensities to default, by sector, region, size of firm, loan size, age of company, etc., it is natural to want to have in hand the fullest information and analyses possible before making changes to the SBLA.

That, then, is the context in which interviewing proceeded for this Report. It quickly became evident that borrowers, lenders and officials alike have many (sometimes mutually contradictory) views on what the SBLA's priorities should be, and how they might best be achieved. Everyone is somewhat 'in the dark', not knowing whether 'full' cost recovery is likely to be attained (or, for that matter, how absolutely important the government regards that objective as being), or what impact on the portfolio's overall 'quality' the pursuit of cost recovery is likely to have (with attendant ramifications for the default rate and, hence, for cost recovery itself). Nonetheless, the presupposition of continued cost recovery, alongside the objective of continuing to ease access to financing for small businesses), undergirded all of the consultations on which this Report is based.

The consultation process (45 interviews with 56 participants) was, emphatically, non-scientific. Given the highly particularistic outlook which many of the respondents have upon the SBLA, it made no sense to administer the same questionnaire to each. Instead, tailored decks of questions gave rise, in virtually every instance, to wide-ranging, free-flowing discussion. Because non-governmental respondents were assured of confidentiality, the Report is replete with references to "lenders", "borrowers", "industry representatives", and so on. Every attempt is made to 'quantify' the responses - and so, a reference to "lenders" can be taken to imply that a majority of lenders consulted held that particular view (unless otherwise qualified); a reference to "one borrower" suggests the absence of consensus among borrowers on a given issue, and so on. Inevitably, a process like this elicits considerable anecdotal commentary - much of which, in an effort to be as comprehensive as possible, has found its way into the Report - even if it was not

possible, in every case, to fully 'test' the opinions against those of other interviewees.

'Interviewees' are listed (by institution in the Sources section at the end of this Report. Time constraints have undoubtedly resulted in some 'stakeholders' not being consulted, but the overall list being consulted, but the overall list (which was developed in collaboration with the Industry Department) is sufficiently comprehensive to have afforded a wide range of perspectives on the SBLA.

Respondents were consulted on two sets of issues: 'administrative' options; and 'policy focus' options. Under 'administrative' options, respondents were asked their views on : a 'Credit Insurance' Crown Corporation; devolution to an existing Crown Corporation; privatization; a Special Operating Agency; and the status quo (with tinkering).

Under 'policy focus' options, respondents were asked their views on each of the SBLA's 'fundamentals' (maximum firm and loan sizes, equity and guarantee levels, fees and premiums and the rate of interest). They were also asked about 'pricing-to-risk', targeting by sector, capital leasing and working capital.

Obviously, each 'administrative' option has policy implications. In the end, it proved presentationally convenient to explore *alternative administrative structures* in the context of describing stakeholder reaction to possible structural transformations of the SBLA's modus operandi. Accordingly, it is in the 'Administrative' Options section that this Report discusses concepts like credit insurance and 'development banking', and examines potentially applicable models offered by CMHC and the student loans program.

While centred on stakeholder expressions of opinion, this study also relied upon an extensive literature review, elements of which are referred to throughout the Report. Where relevant, the experience of our key partners is highlighted (and has, in fact, formed the basis for much of the questioning).

A Report of this nature could not have been produced without the cooperation of many people. The author is grateful to the officers of the Entrepreneurship and Small Business Office, of the Small Business Loans Administration, and of the SBLA 'Re-engineering Office' for their unflagging help. Current and former public servants elsewhere in Ottawa and across the country have been similarly forthcoming, as have been the dozens of private sector representatives who made significant amounts of time available on relatively short notice. Such errors and omissions as inevitably exist are, however, the sole responsibility of the author.

2.0 ADMINISTRATIVE OPTIONS

2.1 A *New* (Credit Insurance) Crown Corporation

The Crown Corporation alternative considered in the context of this section assumes:

- creation of a *new* Crown corporation

- a conversion of the SBLA from a loan guarantee to a credit insurance program.

Transferral of the SBLA's functions to an *existing* Crown Corporation is examined in the next section, as is the idea of converting the SBLA into German-style 'Development Bank'.

The twin principal attractions to credit insurance are the extent to which the government would be relieved, at least nominally, of the SBLA's contingent liability, and the prospect that using an insurance (rather than a guarantee) system, the SBLA could be expanded to include features otherwise deemed 'unaffordable' ('pricing to risk' is also examined, in detail, in the 'Policy Focus' Options section of this report). While these goals could hypothetically be achieved via a number of alternative structures, two Crown Corporation models already exist within government - the Canada Mortgage and Housing Corporation, and the Export Development Corporation.

The EDC model may be the less relevant of the two. It has received over $800 million in shareholder (government) equity over the years ($50 million in the March, 1996, Budget), and retains earnings of approximately $200m. The Department of Finance expressed severe doubts about the prospect of an SBLA Crown Corporation receiving any capital infusion from the government.

CMHC, on the other hand, has repaid the equity originally invested by the Crown. Its insurance operations, by stature, must break-even. Whether an SBLA Crown Corp. could find its footing with the benefit of loan funding from the government is speculative, but it is probably the case that any such loans (unlike equity) would not have to appear on the government's books as expenditures.

CMHC *insures* the lender (much as the SBLA *guarantees* the lender). Mortgage insurance operates somewhat like a loan guarantee - it keeps the income stream alive. Whereas risk assessment under the SBLA is done by the lender, CMHC's insurance side employs upwards of 300 persons (counting all of the services provided to the insurance operation from within the corporation) to both assess risk and process claims (i.e., fully 15 times the SBLA's current staff, for a portfolio with an annual volume one-half to one-third that of the SBLA). It must also be borne in mind that while serving a massive sector in the economy, CMHC need only employ persons whose expertise is real estate - as compared to the far more diverse requirements that a SBLA Crown Corporation would face.

Like the SBLA, the CMHC sets fees and up-front premiums. It establishes eligibility criteria. Premiums are geographically invariant - implying, as in the case of the SBLA, some measure of regional cross-subsidy. The CMHC is very much on the cutting edge of where the SBLA is headed insofar as electronic registrations, automated transferral of funds, and post-payment verifications are concerned.

Officially, the government bears no liability for defaults on mortgages insured by the CMHC. That distinguishes the *insurance* operation from SBLA *guarantees* (on which the taxpayer cuurently faces a liability of greater than one-and-a-quarter billion dollars). However, it may be a

distinction without a difference. CMHC has had to borrow from the government in past to pay claims during severe economic downturns. Each time, it has rebounded (and has adjusted its 'fundamentals') enough to repay the government. A SBLA Crown Corporation would, presumably, do the same. However, it is difficult to imagine, in the event of catastrophic economic failure, that the government would not morally regard itself as being liable for the value of the insurance. Hence, 'failure' of an SBLA credit insurance system could, quite conceivably, oblige the government every bit as much as the loan guarantee system does today.

2.1.1. The Japanese (Credit Insurance Model)

Often assumed to be a monolith, the Japanese 'program' of assistance to small businesses, in fact, comprises myriad loan guarantee programs offered by private sector lending institutions. The government bankrolls the Re-insurer (the Credit Insurance Corporation - the CIC), which insures the Credit Guarantee Corporations, who guarantee the loans made to small businesses by private sector lenders. Recoveries are sufficiently large that the CIC is, largely, self-financing - although occasional equity infusions (from the government) are necessary.

Unlike the Canadian Government and the SBLA, the Japanese Government is not *legally* on the hook in the event of failure of the credit insurance apparatus. Accordingly, the Japanese system offers less scope for government to provide policy direction, and virtually no scope for it to take credit for assistance made available to small businesses.

No government liability, and nearly full cost recovery! Add to that the fact that lenders appear to be able to purchase guarantees from the Credit Guarantee Corporations (CGCs) for a broader range of lending than is covered under the SBLA (including, for example, loans for purposes of training employees, and loans to facilitate exporting).

Businesses pay a fee to the CGCs once their loan has been approved. There would appear to be a greater measure of flexibility available to lenders in pricing loans (as compared, for example, to the SBLA prime+3% cap) - although the fact that medium- and long-term interest rates in Japan have consistently been lower than those in Canada, itself signifies that capital has been more affordable to Japanese small businesses than to their Canadian counterparts.

2.1.2 Can it Apply Here?

One Canadian industry representative, when confronted with the "credit insurance" hypothetical, said: "how would that help". Another said: "that's no different functionally from what we have now." The regional agencies all speculated that credit insurance would increase borrower costs, and some expressed concerns that a pure credit insurance scheme could institutionalize differences by region (something the CMHC guards against by providing for "geographically invariant premiums").

Another industry spokesperson insisted that each of our competitors' models is highly contextual, and could not easily - if at all - be transposed to the Canadian scene. Indeed, the Japanese risk pools are extremely large - but then, so is SBLA lending done by each of the large banks. Those

Canadian lenders who feel their potential risk pool is large enough to enable their participation in the new student loan program should, arguably, feel similarly about a credit insurance-type SBLA. The parameters of Japan's credit insurance system are set according to what the market is seeking - and that, precisely, would be the biggest obstacle to introducing it to Canada.

The CIC *could* be a prototype for a variation suggested by the Finance Department, which was attracted to the idea of a SBLA Crown Corporation selling insurance to lenders (against 85% of losses, for which lenders might pay a 5% premium). The "passiveness" of the government's role, and its consistency with evolving patterns of "partnership" (in which the government increasingly seeks to achieve its policy objectives *through* the private sector), were deemed to be pluses of credit insurance. Requiring more study, however, is the cost effectiveness of such a system. The degree of risk would grow, and past experience is not necessarily a good indicator of future risk (against which premiums would have to be calibrated).

Representatives of SBLA *borrowers* were uniformly dubious about the benefits of credit insurance. Some endorsed a measure of pricing-to-risk within the parameters of the SBLA program *as currently structured*. While touting the importance of *access* to capital (over its price), none was willing to countenance a system which, at least conceivably, could see the price of SBLA loans go much above prime+3%. All equated credit insurance with the likelihood of higher costs to borrowers, although one non-industry analyst insisted that credit insurance does not, in itself, necessarily mean *either* higher median premiums or less lending.

Statistics are not yet available showing the impact on the credit guarantee system of the recent Japanese recession. If the system proves largely impervious to cyclical downturns, the model should attract even more Canadian attention.

Given the skepticism with which the 'borrowing public' greeted credit insurance during consultations, the government would face quite a communications challenge in opting to transform the SBLA in that fashion. The only way to do that, it appears, would be by way of the promise that credit insurance could offer coverage for activities deemed 'unaffordable' within the SBLA as currently structured - and, as importantly, that the exercise of making the SBLA conform to the inclusion of additional features, while maintaining cost recovery, would *not* completely distort the program insofar as its original objectives and current users are concerned.

As the Finance Department observed: "you would only create a Crown Corporation to do risky loans." As discussed in the 'Policy Focus' Options section, there may be no more risky category to which some would like the SBLA extended than working capital loans. If the government were to conclude that insuring working capital was a worthwhile objective that could *only* be achieved in the context of a Crown Corporation "facing a bottom line", then some detractors of credit insurance might find new merit to the proposal.

2.1.3 Business Implementation Insurance

A still more ambitious alternative (which was *not* canvassed during the course of these consultations) would be the creation of a government-run Business Implementation Insurance

scheme. The SBLA could be rolled into a Crown Corporation with functions so comparatively broad that only *via* a fully cost-recoverable credit insurance system would government be inclined to proceed. Business Implementation Insurance could cover the risks of default for which the current SBLA is designed. It could cover working capital, accounts receivable on a *pre-shipment basis* and other risks felt particularly by SME exporters, and many (perhaps most) of the risks confronting knowledge-based industries.

Beyond these (frequently studied) categories, Business Implementation Insurance could fill the discernible market gaps facing 'new economy' 'micro-enterprises' (often one-or-two person operations, increasingly run out of the home). Self-employed persons who don't qualify for unemployment insurance; those who lack (and need) income support during ill-health; and persons whose business prospects would improve immeasurably with accounts receivable loss insurance - all might find very attractive the opportunity to insure against various of these sorts of risk.

The system, almost tracking the Japanese model, could operate on a *re-insurance* basis (that is, there is no advocacy here for a wholesale incursion on the part of the government into direct selling of insurance - although the products described above tend today either to be unavailable or unaffordable, or both).

The basic objective of a Business Implementation Insurance initiative would be to render more attractive (or less forbidding) the risk climate confronting small entrepreneurs. If run as a re-insurance operation, such policies would become much less unattractive for conventional underwriters. The size of the potential market for such insurance could be significantly larger than for the SBLA - thus fostering the creation of sufficiently large risk pools to make premiums for this sort of activity affordable. Because of the fungibility of capital, those who insured against certain of these risks might find it unnecessary to purchase working capital coverage.

It must be re-emphasized: the study giving rise to this Report did not examine (and thus cannot recommend) the notion that the SBLA be folded-into a Business Implementation Insurance Crown Corporation. The digression on this issue is meant only to be illustrative of how enormously attractive credit insurance could potentially become - *if* it came to be seen as the best vehicle by which so many more of the risks (and opportunities) challenging small businesses today (than are currently covered by the SBLA) could be overcome via an initiative which, at this stage, probably only government could have the breadth of imagination to launch.

2.1.4 Rationalizing Crown Corporations

One respondent brimmed with enthusiasm at the prospect of creating mega "Loans Canada" and "Collections Canada" Crown Corporations, which would absorb the functions of (and thus render obsolete) the Business Development Bank of Canada, Canada Mortgage and Housing Corporation, the Canadian Commercial Corporation, the Export Development Corporation, the Farm Credit Corporation, the SBLA, and perhaps others. Obviously breathtaking in its scope, the idea was curtly dismissed by representatives of the institutions involved. None thought that many of the relevant skills were transferrable (for example, knowledge of foreign risk, mortgage

risk or agricultural risk does not imply ability to assess risks facing small manufacturers). It is unquestionably the case that some administrative efficiencies could be achieved - but whether government would want to create such a single colossus is doubtful. When asked, SBLA users perceived merit in tailored or targeted programming, and felt that the loss of focus and accountability which would associate with combining functions in this way would be deleterious to current consumers of the services.

2.2 'Devolution' (to an existing Crown Corporation)

In canvassing opinion about the potential desirability of merging all (or some of) the SBLA's operations and functions with *an existing Crown Corporation*, the Business Development Bank of Canada (BDC) was invariably suggested by government respondents. Treasury Board seemed especially keen that the option be examined, citing repeated business complaints about labyrinthine government programming. The Board also speculated that it would be worth seriously studying combining the claims processing units of the BDC and the SBLA to see if efficiencies could be achieved. Treasury Board disparaged the 1991 Deloitte-Touche conclusion to the effect that the claims units could be combined, but that *no* efficiencies would be realized, since *all* of the SBLA's resources for that purpose would be required by the BDC.

However, it cannot be disregarded that the BDC's *lack of interest* in absorbing any of the SBLA, as reported by Deloitte-Touche, lingers to this day. The BDC now also advances a concern about potential conflict of interest, inasmuch as it operates on a profit-making basis, and seeks "to work well with the banks" (as, for that matter, does the SBLA). The BDC felt that its relationship with the banks could be compromised if it were thrust into the role of 'arbiter' of bank claims.

The observations of two government studies surely behoove the government to seriously contemplate rationalization. *Financing the New Economy* (1994) remarked that "government programs should be reviewed regularly to address concerns about overlap and continued rationale". *Breaking Through Barriers* (also 1994) felt that a "proliferation of (federal assistance) programs has resulted in substantial overlap in program activities and duplication of administrative bureaucracies."

On their face, the BDC's and the SBLA's activities *complement* one another rather more than they overlap. The BDC is increasingly directed to the 'new economy' industries. It provides venture loans; offers a (new) working capital 'top-up' facility; *targets* 'the regions' more assiduously than does the SBLA; has a considerably smaller outstanding portfolio; and has an average loan size three times as large as the SBLA's. A decision to combine the two would be taken rather more out of a desire to avoid creating a *new* Crown Corporation than as part of a campaign to root-out duplication in government. SBLA 'users' shared the view that the two bodies are *complementary*, and should not be merged.

2.2.1 A 'Development Bank' Strategy

The other major context for considering devolving the SBLA to the BDC would be found in a government preference for having a *bank, which it owned*, acting in a somewhat more directed

(or targeted) way to assist small businesses.

2.2.2 The German Model

In the German Burgschaftsbank system, it is possible to see a hybrid, of sorts, between the Canadian (or U.K./U.S.) approaches, and the Japanese one. The 16 (lander-based) banks, initially capitalized with state funds, issue *loan guarantees* (of up to 80%). Loan guarantees can be secured for a wide range of business activities, *including capital leasing*. The Burgschaftsbanks then receive *re-insurance* (totalling 72.5%) from government (see Riding, 1995). Storey (1995) characterizes the German model as a "Development Bank Strategy" which, in his view, "implies a stronger rejection of market provision of finance for SMEs" than do market-driven loan guarantees. The basis for Storey's conclusions is the extent to which loans are made "in accordance with the objects of the Federal and Lander governments' economic policy." The OECD (1995), on the other hand, described the German system as one where the "policy is to positively nullify competitive handicaps, but not to pick winners."

As in the case of the SBLA, the Burgschaftsbanks receive fees and annual premiums in exchange for the loan guarantees which they extend. They do *not*, in turn, pay a fee for the re-insurance received from the government. Consistent with German 'corporatist' traditions, the Burgschaftsbanks bear an enormous administrative burden in exchange for re-insurance (one such bank, KfW, describes the structures as follows: "The Board of Supervisory Directors and the specialist committees set-up by it are responsible for harmonizing the manifold interests of the Federal Government, the Lander governments, the various economic sectors, and the credit institutions that have to be taken into consideration in the performance of KfW's functions". The Chairman is the Federal Minister of Finance; the Deputy is the Federal Minister of Economics. The Committee consists of several other Federal Ministers, members appointed by the Upper House, representatives of commercial banks, of industry, local authorities, agriculture, crafts, trade, the housing industry and the trade unions). Elaborate committees like these scrutinize each loan guarantee application. Accordingly, take-up of guarantees (proportionate to the SBLA for the example), is low - and, understandably, the default rate would also appear to be lower than Canada's.

Notably, provisions of the German banking law do *not* apply to the Burgschaftsbanks. "Supervisory functions" are delegated to the Federal Minister of Finance (who, as is indicated above, is also Chairman). As in the case of Canada, governments are 'on-the-hook' ("legally *and* morally") in the case of defaults. Governments' contingent liability, in fact, would appear to be considerably higher than is the case in Canada.

2.2.3 Implications of Embracing the German Model

The reason for looking at the German experience in the context of a review of the merits of devolving the SBLA to an existing Crown Corporation (particularly, to the BDC) is that the BDC is the closest Canadian equivalent to the Burgschaftsbanks. They received initial capitalization from public funds, and finance their operations substantially through retained earnings and borrowings on domestic and international markets. In the March, 1996, Budget, the BDC

received an additional infusion of $50m, permitting $350m in lending to "knowledge-based, exporting and growth businesses that find it difficult to obtain loans from commercial institutions." In short, the BDC 'targets', according to public policy priorities, in somewhat the same way as the Burgschaftsbanks.

If Canadian authorities wished to embrace the German model, it would be necessary either to create new state-funded banks, or to turn the SBLA over to the BDC. A considerable additional infusion of equity would be required (approximately $3.9b in SBLA loans were registered in fiscal 1994-95 alone; BDC's *total* loan and guarantee portfolio was valued at $3.2b at the end of March, 1995 - and its capitalization from the federal government now stands at $353m). As in the case of capitalization of a *new* Crown Corporation, it can reasonably be assumed that the Department of Finance would oppose any significant 'on the books' infusions of equity. The Government could opt to re-insure BDC guarantees - but in order to be willing to do so, due diligence, now supplied by SBLA lenders would, presumably, have to be undertaken by the BDC itself - at substantial incremental cost!

While the BDC would like to be able to *issue* SBLA loans, there's no evidence that it would enthusiastically opt to become the Canadian equivalent to the Burgschaftsbanks system. Of course, the virtue of owning your own bank (as the Canadian people do in the case of the BDC) is that, within the law, you can have it do what you want. Should the government prefer a far more hands-on, interventionist approach to selecting SBLA loan recipients, the BDC is probably the most logical vehicle to serve that purpose.

Treasury Board identified three criteria against which either the creation of a new SBLA Crown Corporation or devolution of the SBLA to an existing Crown Corporation might be considered:
- will it reduce or eliminate the government's contingent liability?
- will substantial administrative savings be realized?
- will it provide significantly greater stimulus to the small business sector?

The criteria were not meant to be exclusive. Devolution to the BDC would appear likely, however, to 'fail' all three: as in the case of the German system, the government's liability would remain; administrative costs borne by the government would *increase* - probably very substantially; the amount of stimulus would almost precisely track the amount of equity invested by the government - but, as in the German case, take-up would probably be reduced, given the higher proportion of applications that would be 'weeded-out' in the first instance.

2.3 Privatization

Treasury Board has observed that the option of privatizing the SBLA has never been seriously considered. Further, the Board suggests that such consideration should be *periodically* undertaken, consistent with the government's declared intention to rid itself of functions in which it no longer has to be involved.

The 1995 Budget declared that "privatizing/commercializing operations which government no longer needs to run represents good management and common sense." An important issue, then,

is whether or not the government *needs* to run the SBLA. Another major consideration is whether it can continue to *afford* to run the SBLA.

Subsets of the *need* issue include:

- why is government currently operating an SBLA? Do the capital market *gaps* perceived at the time of the program's inception in 1961, still exist to an extent warranting government involvement? Are the public policy objectives underpinning the continued existence of an SBLA achievable in a privatized format?

- is there an alternate operator, who would manage the program as economically *and* foster at least as much lending, at no significantly greater cost to the borrower (which itself presupposes that all current SBLA lending is both good and necessary, and that the existing rate structure is the optimum one - surely debatable propositions)?

Subsets of the *afford* issue include:

- should the taxpayer continue to bear the contingent liability which grows with every SBLA loan (the introduction of 'cost recovery' notwithstanding)?

- if there is a will to broaden the SBLA's mandate and coverage (e.g., to include either or both of capital leasing or working capital), can that be done within the parameters of the existing program?

Before proceeding, it should be stipulated that what is being talked about here is privatization of *the entirety* of the SBLA program (which some lenders regard as tantamount to abolition of the SBLA). There appears to be no particular impetus behind privatization of only the *administration* of the SBLA. As one stakeholder observed: "why bother. It costs government $1-1.5m per year on $3b in lending" (that *has been* the cost - it will soon increase, albeit marginally, due to the anticipated higher volume of claims following from the lending 'spike' in 1993-95).

Deloitte-Touche (1991) studied the notion of privatizing just the SBLA *administration*. Their conclusions (which remain applicable today):

- there would still be a requirement to maintain a core administrative function with the Department (including the policy development and interpretation, and liaison with other departments during the periodic reviews of the SBLA);

- the *claims* function could, in theory, be privatized to bankruptcy trustees. However, the latter showed little interest - and identified a potential conflict of interest, inasmuch as they represent SBLA lenders in auditing and other relationships;

- the *collections* function could, theoretically, be privatized to collections agencies - however, the SBLA experience since 1985 (when collections agencies ceased to be used)

is that it is significantly cheaper to do the job in-house.

- “delivery of the program through the Small Business Administration Branch within ITC continues to be the least expensive and most viable delivery vehicle available.”

2.3.1 *Need*: Does the SBLA Fill a Market Gap?

The literature tends to assert that SMEs, particularly knowledge-based and exporting companies, do indeed face a capital market gap. It is far from unanimous in claiming that the SBLA fills those gaps.

Haines and Riding (1994) cite a study by Peterson and Shulman claiming that Canadian SMEs rely on banks for credit to a greater degree than small firms in most other developed countries. Of course, that Canadian SMEs disproportionately seek financing from banks does not, in itself, substantiate that they are unable to obtain financing.

MacIntosh (1994) concludes “that there do not appear to be serious ‘capital gaps’ in the market for SME debt capital”. MacIntosh believes that such gaps as might exist arise on the equity side. Baldwin et al (1994) assert that there is “capital *rationing* problem”, and that the major difficulty is *not* the capital structure.

Recent studies prepared for (or by) government have, however, been unequivocal in stating the existence of a gap. *Breaking Through Barriers* (1994) identified a “small business lending gap, particularly for small and micro-businesses that require loans of less than $100k, that is not being adequately filled by institutional lenders.” *Financing the New Economy* (1994) cited OECD conclusions to the effect that “SMEs are ... suffering most from ... market failure in providing adequate financing for R&D ... and this problem has required government intervention to bridge the gap.”

Comments gleaned from interviews overwhelmingly asserted the existence of gap, viz.: “the small business market is highly imperfect - largely due to the organization and bureaucratic nature of financing institutions. Small companies don’t get the attention that large ones do”; “there’s been a substantial failure on the banks’ part to reach out to new economy industries”; “part of the market gap is the Canadian geography and weather”; “the capital market differs substantially by region - and that is major competitive disadvantage for Canada.”

One official passionately deplored the extent to which lenders, especially those outside large centres, had downgraded the value of security (particularly real estate) during the recession - thus cutting-off lines of credit, even for companies for whom nothing else had changed. The point was that *absent* the SBLA guarantee, small business bankruptcies would have been much more numerous.

Some interviewees, however, asserted that the only *real* ‘gap’ concerns access to working capital - something the SBLA doesn’t currently cover. Holders of this view tended to argue that virtually any ‘worthwhile’ application for financing for a *capital asset* can be met in the

marketplace *without* an SBLA, and that if the SBLA is not going to be adapted to include working capital, it might just as well be abolished.

The regional agencies, however, all believe that the gap is being usefully addressed by the SBLA. None would want to see the SBLA privatized (or abolished), and all believe that lending to small businesses would significantly decline absent the program. The biggest supporters of the SBLA, unsurprisingly, are to be found outside of southern Ontario (which one industry representative characterized as "the only place where banks properly serve small business.") To the extent to which regions experience differential loan losses, privatization could eliminate or reduce cross-subsidization inherent to the current program.

Bureaucratic opinion was not consistently supportive of the view that the SBLA usefully fills a gap. On one hand, the Finance Department acknowledged that the "SBLA may have created a niche", and wondered "if it wasn't there, what would happen?" On the other, an Industry Department official described the massive 1993-95 uptake in SBLA lending as tantamount to "collusion between government and the banks to restrain competition," and advocated the SBLA's abolition, with a focus on eliminating barriers to lending by non-deposit-taking institutions, domestic and foreign. Entirely understandably, those whose jobs relate most directly to the SBLA were among those most convinced that the SBLA fills a critical gap which, otherwise, would remain unaddressed.

Unquestionably, the government has acted and spoken as if it perceives a gap, and believes that the SBLA fills it. In the 1995 Budget, the Government declared that it was "determined that small business will have access to financing." *Building a More Innovative Economy* (Industry Canada, 1994) stated that "The government is committed to retaining the SBLA as an essential vehicle for ensuring that small businesses have access to loan financing."

All commentators emphatically believed that the SBLA serves one important political (if not necessarily public policy) purpose extremely well - it allows decision-makers to demonstrate the importance they attach to small business. None felt that government would seriously contemplate any dramatic measure - such as privatization - unless it could be quantified, 'up-front', what the incremental benefits to small businesses would be. Since the prevailing view was one of doubt that "you'd get something better than you have now", the consensus view was that privatization would never be seriously considered.

2.3.2 *Need*: Does an Alternate Operator Exist?

The Government seems to doubt it - or at least that's implicit in ESBO Director General Sagar's comments to the Industry Committee (Oct. 19, 1995): "if you could find an insurance company that was willing to run it as inexpensively and with such a low margin that the lenders would participate, then you could certainly consider privatization. But the reality is that the government has some significant advantages as an impartial participant in financial markets in running this program ... No private sector operator would be willing to run the program at zero margin to support small business."

Administrative costs for 1996-97 could run at 2-3% of fee revenues. Additionally, a privatized operation would have to realize a profit. Conceivably, administration costs plus profit could amount to as much as 15% of revenues (perhaps necessitating adjustments to program parameters, assuming that *full* cost recovery on *future lending* would be an absolute requirement of a privatized operation.)

The assumption of full cost recovery is itself questionable. While the 125 basis points fee imposed as of April 1, 1995, was ostensibly selected to achieve full cost recovery, inasmuch as defaults have historically largely taken place in years three-through-five of a loan (and are highly affected by prevailing economic conditions), it will only become evident towards the end of the decade whether or not cost recovery has been achieved. Lenders are skeptical; some bureaucrats think that the undeclared objective was to return losses on the program to the $20-$30m annual figure that predated the spiking to the approximately $100m in 1994; user representatives tend to dismiss the importance of full cost recovery (a "controlled, stable" loss level seemed to be the priority for these groups). Accordingly, the government should come to grips, prior to give any serious consideration to privatization, with whether absolute cost recovery is its goal - or whether it is prepared to continue to somewhat subsidize the SBLA. If there is to be no subsidy whatsoever, then privatization necessitates freedom for the operator to routinely amend the program's fundamentals in order to eliminate the possibility of losses.

Therein lies an issue potentially much greater than 'margins'. Full cost recovery could be achieved in different ways. Premiums could be raised, although lenders and borrowers both insist that there would be virtually no market-place tolerance for higher premiums - and some lenders accentuate the extent to which higher premiums would accelerate the onset of a SBLA "death spiral". In any event, as premiums have increased the 'quality' of the overall portfolio is thought to have declined ('less risky' borrowers pursuing non-SBLA alternatives, thereby increasing the portfolio's default rate on those loans that are made). A higher default rate only worsens the cost recovery balance. The guarantee level could be further reduced, although lender enthusiasm would diminish, and some loans now made would be refused. The percentage of the loan 'guaranteeable' could be further reduced, but borrowers would thus be forced to ante-up a higher proportion of equity, meaning less money for working capital and other purposes. Rules could be tightened to reduce lending in categories thought to have a higher propensity to default (e.g., leasehold improvements), albeit with an attendant increase in would-be borrowers' frustration.

In sum, privatization *with full cost recovery*, would quite probably yield less lending (itself not necessarily a negative outcome, if the government's objective is to eliminate or reduce some of the more risky lending currently taking place under the program). Since that is exactly the suspicion (within the 'borrowing community') that would attend privatization, the government would have to be willing to acknowledge the likelihood, up front.

Privatization *without* full cost recovery is far from unheard-of within government. However, an unwillingness to declare a long-term funding commitment at the outset would undermine both the prospect of any financial institution being inclined to bid for the program, and would engender skepticism among borrowers as to the extent of the government's commitment to the

program.

There are other issues. One industry representative asked: "to whom (would the SBLA be privatized) - the Canadian financing system is already too highly concentrated." Another thought that borrowers would be extremely displeased if a bank were to take over responsibility for guaranteeing small business loans. Lenders speculated that privatization would simply be a device whereby government "pushed onto them" responsibility for making programmatic choices otherwise found politically unpalatable. One of the regional agencies speculated that privatization would simply mean pushing higher costs onto borrowers.

Ironically, the market is currently observing a proliferation of private lender programs. Whether for 'less risky' fixed asset financing [where the bank and the borrower can 'split the difference' (the doubling of the registration fee and imposition of the 125 basis points annual fee having made this possible)], or via programs targeted at knowledge-based or exporting industries, almost all of those who perceived a 'capital market gap' for small businesses felt that the situation was improving (at least as measured by declining volumes of complaints).

Some, including the federal officials, believe that the SBLA's *mandate* is becoming increasingly *privatized*, because in the course of niche market 'targeting' by financial institutions, the nucleus of SBLA's 'better borrowers' is being appropriated, leaving the SBLA with an 'unaffordable' (in risk terms) residue.

A fully representative cross-section of 'interviewees' speculated that the biggest 'casualty' of a "purely market driven" SBLA alternative would be lending outside of southern Ontario. Those sharing this concern felt the government would have to stipulate minimum lending 'requirements' by region (and perhaps to start-ups and given sectors as well).

2.3.3 The Student Loans 'Model'

A recent example of 'privatization' *without full cost recovery* is the transformation of the Canada Student Loans Program (through which the government *guaranteed* loans) to a vehicle through which lenders make loans according to strict government criteria, in exchange for which they are compensated with a risk premium.

Obviously, there are very few similarities between student loans and the SBLA. Generically, students would probably compare only with the riskiest recipients of SBLA loans. There are five times as many student- (as SBLA-) loans annually - yet the total dollar value of student loans issued in 1994-95 was about one-third of the value of the SBLA loans. While 'purchasing' different things with their loans, the two sets of borrowers take approximately the same time periods to repay their loans.

Some differences between student loans and the SBLA needn't be considerations in any decision to convert the SBLA from a guarantee to payment of a risk premium. Universities act as 'selectors' of students, largely based on the extent to which their previous grades predict their ultimate success (and from the loans program's perspective, their ability to repay!). Lenders

largely perform the same function today within the context of the SBLA. Student loans are made on a 'need' basis - but then, so are SBLA loans. No businessperson is taking on the obligation to pay premiums plus annual interest on a loan he or she doesn't need.

Under the student loans program, the government has estimated interest subsidy and interest relief expenditures, for 1996-97, of almost $240m. Such costs would not pertain in a privatized SBLA (businesses are expected to have an income stream from day one of the loan; students not until months after graduation). The 5% risk premium to be paid by the government to lenders (to cost $16m in 1996-97) will grow, should current levels of student borrowing be sustained, to something in the order of $65 million towards the end of the decade. Vast administrative savings are anticipated. Accordingly, once fully implemented, the new program will probably cost only one-third of the old one.

The new program effectively reduces the default rate to 5% from 20-25%. That 5% uncannily tracks the SBLA's historic default rate. One key difference, is that the government is committed to continue laying out 5% of the total value of student loans made. The SBLA, on the other hand, has set its sights on cost recovery.

Theoretically, the government could convert its SBLA guarantee into an annual risk premium to be paid to lenders *if* the re-tailored SBLA program failed to yield full cost recovery. As suggested above, however, such 're-tailoring' would almost certainly result in either-or-both-of fewer loans being made or loans generally costing more. It would behoove the government to acknowledge that effect.

One potentially serious additional effect would be to collapse the pool of lenders. Not all chartered banks issue the new student loans. More and more credit unions are deciding that the risk pool is too small for them to continue to participate. Accordingly, it may come to pass that only very large institutions remain willing to offer a program on which they claim to expect only to break even, but which they regard as an exercise in long-term marketing. Transposed to the SBLA that could severely mitigate access in rural communities, and deprive the program of some of the 'due diligence' which, arguably, it is easier for community-based lenders to provide.

There is also the possibility that major lenders, upon conclusion of their five-year participation contracts with the government, will opt-out of the student loans program, thereby further reducing the delivery pool. The government's political leverage, however, is probably sufficient to ensure that a sufficient number of lenders take-up a program which the taxpayer is committed to subsidize in perpetuity. That leverage would be somewhat diminished in the case of a 'privatized' SBLA (along the student loans lines) operating on the basis of full cost recovery.

The very big plus (to the government) however, would be eventual relief of its SBLA contingent liability. The Student Loans Program's contingent liability for 1995-96 was projected to be $4.23 billion. It is forecast to decline to $3.68 billion in 1996-97, and will continue to fall, ultimately to zero.

Also possible is that different types of lenders could be increasingly drawn into SBLA lending

pursuant to ‘privatization a la student loans’. Non-deposit taking lenders, who aren’t interested in carrying the loans on their books, might find a student loans-type SBLA highly enticing. The consistently biggest U.S. SBA lender is The Money Store, a non-deposit taking lender which funds itself exclusively through securitisation of its loan portfolio. The Money Store issues only three types of loans: home equity; SBA; and government-guaranteed student loans.

Under the SBA’s ‘Secondary Market Program’, lenders are able to sell the guaranteed portion of SBA-guaranteed loans to investors and thereby improve their liquidity and increase their yield on the *unguaranteed* portions of SBA loans as well. The ability for SBLA lenders to securitise loans made under the program could be the best means of utilizing the government guarantee for what it was intended to do - increase the volume of capital available to small businesses. It is an option which warrants further study prior to renewal legislation being introduced.

2.3.4 *Afford*: Contingent Liability

The SBLA’s contingent liability at December 31, 1995, was $1.264b. That literal figure, however, is misleading. It represents the absolute maximum which the taxpayers would have to bear in the worst-possible-case default scenario. Because the government bears its liability until the time at which the SBLA-guaranteed loan has been fully repaid, the $1.264b figure includes the government’s liability on loans, that for example, have already been 95% repaid. It is also calculated at the (approximately) 10% rate which describes the government’s maximum liability - virtually twice the program’s historic default rate.

The 125 basis points premium (on annual outstanding balances) introduced April 1, 1995, seeks to achieve cost recovery on SBLA-guaranteed loans made *after* that date. As noted above, it is premature to know with confidence whether the premium is sufficient to attain that objective. Variables somewhat beyond the government’s control will be determinative. Neither has it been made clear if full and complete cost recovery was, in fact, the government’s goal - or whether containing and stabilizing the deficit was the principal driving impetus behind the move to cost recovery.

What is clear is that a residual liability exists on loans made before April 1, 1995 (about which no-one is recommending that anything should be done). Equally clear is that more that $2b in SBLA-guaranteed loans were made in the 1995-96 fiscal year (to which the 125 basis points fee will apply - although no fees have yet actually been collected, and none will be remitted before June, 1996).

Pending attainment of greater statistical certainty about the propensity to default (by region, sector, size of loan, etc.), speculation over whether or not cost recovery is on track is just conjectural. Lamenting the delays in gathering and aggregating that data, one lender “failed to see how the government could embrace a contingent liability that large when it knows so little about the propensity to default.” However, interview respondents overwhelmingly doubted that cost recovery is likely to be achieved. Consistent with theories of adverse selection and moral hazard, it is exceedingly likely that the nature (the ‘quality’) of the SBLA portfolio has significantly - perhaps dramatically - changed (see section on *incrementality*). Higher premiums

and fees have driven many 'better risk' customers to look elsewhere (surely one of the reasons why lending in 1995-96 will be approximately half that of 1994-95), and have caused lenders to recognize that there is profit to be made in accommodating them. Accordingly, the default rate (on post-April 1, 1995) loans is expected to increase beyond the traditional SBLA average (of 5-5.5%). Where it settles will determine how close to cost recovery the program is coming, and only then will government be able to judge whether its liability is 'affordable'.

The 'problem' almost certainly compounds should a decision be taken to expand the SBLA's parameters to target 'new economy' industries; to include capital leasing; or, most particularly, to embrace working capital (all are examined in greater detail below). One analyst of the prospect said: "working capital is *not* an administrative issue - it's an issue of what the contingent liability might be." Virtually all respondents believed that losses on SBLA-guaranteed working capital loans would be twice the current rate - at least. Add to those higher losses the fact that, *everything else being unchanged*, overall lending would significantly increase (to the point that the $12b ceiling for the current period would almost certainly be insufficient to supply demand in the next period), and the government's contingent liability could balloon.

This last point is perhaps the most important one in the debate over contingent liability. Under the Act, the government's liability is, for all intents and purposes, limited to 10% of total lending. The default rate is traditionally 5%. Accordingly, it is *lending volume* (combined with riskiness) that affects the government's contingent liability. The level of guarantee (unless set at a level certain to attract too great a proportion of highly risky loans) is somewhat less important. As one lender commented: "when considering possible expansion of the program, it's for the government to decide how much of the potential loss - between its current 5% and the maximum of 10% - it's prepared to absorb."

Any transformation of the SBLA (privatization; credit insurance Crown Corporation; transferral to another government body or agency) should at least in part be informed by an awareness of what weight the government attaches to being relieved of its contingent liability. "Getting it off the books" appears to be the principal concern for some officials. Any scheme which continues to offer loan guarantees maintains that liability. Alternative structures could *literally* lift the liability from the books, but might well imply a continuing *moral* obligation on the government's part.

2.3.5 Other Considerations

A privatized operation might be less willing to share data with government and Parliament - not in itself grounds to opt for the status quo, but a factor to be taken into account, especially by those who project that the current data collection exercise, once fully operational, will yield important insights into the functioning of a key sector of the economy.

Since in at least in one model, it is *lenders* who would come together to create a body which would 'absorb' the SBLA, it can reasonably be assumed that lenders would be able to trust their creation, and that 'curtains' could be 'installed' between individual lenders and the 'collective' (the latter being responsible for setting premiums, guarantee levels, etc.). This consideration is

important to the extent that the borrowing community would want to be reassured that no individual financial institution would either exert disproportionate influence over the privatized scheme, or would enjoy unique access to information.

A final consideration has to do with what our international competitors are doing. This is not simply an issue of ensuring a level playing field for Canadian exporters (or Canadian producers of 'tradables' who face competition from foreign firms assisted by their governments), but it also concerns the role of government, where possible, to help strengthen the overall economy - on the basis both that Canada thus becomes more competitive internationally and that certain firms, assisted in the process, might ultimately become exporters of Canadian goods and services. That issue recurs throughout this Report. Suffice it to say here that *none* of our major competitors has fully 'privatized' its small business guarantee or credit programs - at least not to the extent of fully relieving itself of the obligation of subsidizing, infusing equity capital into the delivery mechanism, or bearing some measure of liability in the event of defaults.

2.3.6 'Abolition'

As mentioned above, for some respondents, 'privatization' was indistinguishable from abolition. Invariably, the question then arose: "if abolished, could the same objectives be achieved through suasion?" The reference, obviously, is to the "benchmarking" exercise, presided-over by the CBA, by which data on bank lending, including to small businesses, is now presented quarterly to Parliament (serving as a 'benchmark' against which lender performance can be judged).

For the most part, lenders were insistent that a considerable proportion of their current SBLA-guaranteed lending is truly 'incremental'; that most such lending would *not* take place in the absence of an SBLA (in some form or other); and that they "can't be cajoled into doing what is bad for the bottom line." In short, they dismissed the relevance of the 'benchmarking' data to any effort to secure given lending outcomes.

Borrowers expressed *no* confidence (absent an SBLA), that lenders could be 'persuaded' (by use of the benchmarking data) to maintain lending to small businesses at anything near current levels - this despite the fact that the preponderance of lending to small businesses in Canada today is *not* SBLA-guaranteed.

It also became evident during consultations that despite Parliamentarians' liking for SBLA-type programs (and perhaps consistent with the anti-bank posture which they almost professionally strike), they would probably share borrowers' lack of faith that lenders would continue to loan at current levels if the SBLA were formally abolished.

2.4 A "Special Operating Agency"

Ballooning SBLA-guaranteed lending since April of 1993 will, pursuant to SBLA experience, lead to significant increases in claims starting in 1996. Concern about the capacity of the current administrative structure to efficiently process those claims, as well as apprehension over the potential additional administrative costs involved, has revived interest in a "Special Operating

Agency" (SOA).

Deloitte-Touche (1991) assessed the SOA-alternative against standard criteria utilized by Treasury Board to evaluate the applicability of SOA status to program delivery arms of government. Their conclusion was that the SBLA was too small to become a SOA.

Treasury Board confirms that all of the 1991 criteria remain applicable today - in addition to others. Treasury Board insists, however, that size, in itself, does not have particular weight - and affirms that the government is genuinely interested in "alternative delivery mechanisms" (their preferred generic term is "special agency status"). And so with the door evidently open, the issue is - should the SBLA walk through?

2.4.1 Cash Management

Arguments for an SOA tend to focus on cash management. Clearly, with lending since 1993 six-to-seven times greater than during any previous three-year period; with registration fees having doubled; and with the advent of the new 125 basis points annual fee the SBLA is responsible for vastly greater remittances to the Consolidated Revenue Fund (CRF) than was previously the case (more than $70m in 1994-95, *prior* to imposition of the 125 basis points fee - representing almost half of Industry of Canada's total fee revenue). Similarly, the inevitable increase in claims will result in significantly greater draw-downs. Are there advantages to the taxpayer; to lenders; or to borrowers, of the SBLA managing that cash flow internally?

Advocates of a SOA complain that, under the current structure, there is no financial incentive to achieve administrative reforms. All revenues collected flow to the CRF. Cost recovery does not apply to SBLA *administration*; the 20-odd staff managing the operational side of the program are funded from Industry Canada's 'A-base'. Even the Claims Processing Fee, which the Minister had proposed in 1995 (and subsequently abandoned in the face of Parliamentary opposition) might have remitted directly to the CRF. Ostensibly, "inability to recover costs" yields lack of concern about costs.

This argument is ill-formed. Without regard to merits of a claims processing fee, Industry Canada's legal counsel is quite convinced, pursuant to Sect. 18-21 of the Department of Industry Act, that such a fee could be imposed. Treasury Board cites two alternatives whereby Industry Canada could retain such fees as the Minister decided to impose: vote-netting (thought less appropriate); and negotiation, under the auspices of the existing Treasury Board-Industry Canada Memo of Understanding, of an arrangement whereby Industry's appropriation could simply be increased by whatever fee revenue is credited to the CRF. While problems could arise (revenue is not entirely predictable, and the appropriations processes might not be able to precisely track revenues), solutions short of an SOA could certainly be found. Similarly, Treasury Board believes 'bookkeeping' ways could be found to deal with the high up-front costs of new information technology, if it were to prove possible (and desirable) to electronically link the SBLA Administration to all lenders.

Claims Processing Fee-or-no, there should be no lack of incentive for Industry Canada to

continuously seek SBLA administrative efficiencies. It is currently projected that approximately six additional staff (i.e., a 30% increase over current levels) will be required to deal, over the next two-to-three years, with the 'spike' in claims which follows from the 1993-95 lending surge. On its face, that projection appears modest - but if accurate, is a reflection of the efficiencies which have been introduced (and are forthcoming) in claims processing and verification methodology. Given the live prospect that new staffing requirements could be even greater (the worst-case alternative being huge delays in claims processing, corollary increases in interest costs, decreasing lender satisfaction with the program, and movement away from cost recovery), the Department should be *very* concerned about maximizing administrative efficiencies. A SOA embodies no inherently better incentive to achieve managerial and process efficiencies than does the status quo.

Accountability and transparency are different issues. The case has been made that "within a SOA, a 'bottom line' must be met." Segregating the true 'bottom line' of course, is never easy. As just one of the 'assistance to business' tools managed by Industry Canada, the logic for keeping policy functions separate from operational ones remains unassailable. For that reason, an indigenous policy capacity would not logically be located in a SBLA SOA (and there is every reason to assume that the government would want to offer policy direction to a SOA). But the cost to the taxpayer of retaining policy-making capability elsewhere within the Department would remain. How would such costs be accounted-for as part of an effort to render the SBLA more transparent?

Notwithstanding such difficulties, a compelling case can be made that 'true' cost recovery should be made to apply to the operating costs (to the taxpayer) of running the SBLA. That case becomes strengthened in the event of policy initiatives which significantly expand the scope of the current program (thus necessitating, *on an on-going basis*, a much larger administrative staff). A decision could easily be taken to both identify and publicize those costs, and to recover them via subsequent changes to the 'fundamentals' of the SBLA. Such a decision would promote transparency and effectively, would create a 'bottom line' within the current administrative structure, thus giving the Department whatever additional incentive it may require to rigorously manage the SBLA program.

2.4.2 Contingent Liability

A SOA, as such, has no impact on the taxpayer's ultimate liability for the share of SBLA loans guaranteed by the government. While Treasury Board, as a general rule, is less-than-enamoured with Revolving Funds, both it and the Finance Department would likely embrace the notion of a SBLA Revolving Fund (with or without SOA status), as long as the *Industry Department* accepted responsibility for all future liabilities which the loan guarantee program incurs for the taxpayer. Finance would probably go further: credit the SBLA Revolving Fund with all revenues received since April 1, 1993 - and debit the Department with all of the contingent liability incurred since that date.

In short, a Revolving Fund is certain to be *unattractive* to the Department - and neither it nor a SOA wipe the contingent liability off the government's books. To achieve that outcome (at least

nominally), it would be necessary to create a Crown Corporation. Privatization would relieve the government of future liability, but almost certainly not of residual liability - and, in any event, could perhaps only be accomplished if the government were willing to continue to subsidize the newly privatized program on an annual basis.

2.4.3 Relationship to Beneficiaries/Clients

The SBLA's 'clients', it is said, are the lenders. Its 'beneficiaries' are the borrowers. By virtue of its "Agency" relationship, however (considerable authority and much administration delegated to lenders), the SBLA Administration is extremely lean relative to other SOAs in government. The government's *Passport Office* is labour intensive. The 'beneficiaries' of the services provided by the *Tourism Office* interact directly with the service providers. Merely amassing fees (and remitting them to the CRF) does not, at first blush, establish any kind of equivalency between the SBLA and the service-oriented government organizations currently being according SOA status.

Furthermore, there is no pressure from the clients to alter the SBLA's status. Lenders "doubt how a SOA would improve the relationship." In fact, the banks - who generally seem to be quite pleased with current claims processing times (albeit not necessarily with some of the paper burden demands which they face) - expressed opposition to "any alternative cash management procedures that risked lengthening the amount of time involved in receiving payment on claims."

2.4.4 Structural Rationale Doesn't Exist

The Minister of Industry *can* create a SOA - provided it has a distinct character, cost-recovery, an approved business plan and Treasury Board approval. However, the business case has simply not been made - and absent such a case, there is no rationale for embarking on the kind of bureaucratic restructuring that attends the creation of a SOA.

Until such time as decisions are taken which would significantly expand the scope of the current program, there is no compelling argument for creating a SOA. It is *not* sufficient that an extraordinary 'blip' looms in the immediate future (insofar as claims processing is concerned). There is no reason to create a different bureaucratic structure simply to address short-term requirements. If policy decisions having to do with the size of the program effectively transpose the short-term onto the medium-term horizon, then the issue of a SOA could be revisited.

2.5 Status Quo (with tinkering)

Various 'tinkering' alternatives are also reviewed in the 'Policy Focus' Options section that follows. This final portion of the section on 'Administrative Options' considers administrative changes that could be made to the SBLA structure and operations, all within the context of a loan guarantee program which continues to be housed at the Industry Department.

2.5.1 Claims Processing

While the Financial Administration Act requires 'due diligence', the SBLA Administration should be mandated to employ greater discretion in the processing of claims. Currently, they are dealt with in chronological order (of receipt, either in the first instance, or after supplementary documentation is solicited and received). No distinction is made between claims for $100,000, and those for $5,000 - notwithstanding the fact that $1 million was paid by the government during 1994-95 in interest on unprocessed claims. Movement to 'post payment verification' may, of itself, address this concern. If not, it involves being 'penny wise and pound foolish' to treat each claim equally, regardless of its size - and procedural amendments should be instituted to allow differentiation by value.

2.5.2 Data Collection

Respondents unanimously endorsed the efforts currently underway to significantly improve the quality of available data; expressed concern about delays in its aggregation (it is now expected only to begin being available in September, 1996, and to 'dribble out' over the ensuring six months); and strongly encouraged that every effort be made to accelerate the process.

Given that the loan ceiling for period-12 could be breached prior to March 31, 1998, there is some consideration being given to collapsing the effective requirement for back-to-back passage of legislation into a single exercise, whereby period-12 is brought to a close, and period-13, with a new loans ceiling, is embarked upon. That superficially makes perfect sense *providing* the data accumulation effort has reached fruition beforehand, and government and partners have had the opportunity to study the results. Lenders and borrowers alike emphasized that it is imperative for everyone to fully understand the portfolio risk nature (what kind of customer is defaulting, on what kind - or size - of loan ...) *before* attempting to adjust the fundamentals for the next period.

One of the best ways of ensuring that a continued priority is placed by the department on allocating the resources necessary to gather and process that data might be to entrench a requirement, in regulations, for an annual actuarial assessment of the portfolio's risk. As managers of a program which has amassed a $1.264b liability in the name of the taxpayer, the department should want to be just as certain as it can possibly be of the ramifications of 'policy tinkering' before proceeding.

2.5.3 Eligible Lenders

Statistics already available show that some lenders consistently perform worse than others (in terms of claims submitted for defaulted loans). It would serve as an additional discipline on lenders if the Minister had the authority to remove a lender's designation. For that matter, the automaticity (of designated lender status) conferred on the members of the Canadian Payments Association should be jettisoned. All would-be lenders should be obliged to apply for designation, perhaps once per lending period. Consideration should be given, consistent with the spirit of cost recovery, to levying a fee that accurately reflects the costs to the Department of reviewing such applications.

Among the issues here is whether any private sector lender should, by right of being a member of any particular association (like the Canadian Payments Association or, potentially, the Canadian Finance and Leasing Association) enjoy an effective entitlement to oblige the Canadian taxpayer. In the particular event that the SBLA is expanded to include capital leasing, the Department should want *all* would-be designated lenders to have to jump equally high hurdles and, in so doing, the stage will have been set for refusal of some applications, perhaps from deposit-taking institutions as well as from others. Performance over time is one criterion that should be heavily ranked.

2.5.4 Post-Payment Verification

Everyone - officials and lenders alike - acknowledges that the *key* to achieving sufficient administrative efficiencies to be able to process the looming 'hump' of claims (to say nothing of the plateau thereafter, which will be at a much higher level than that for which the current allocation of administrative resources was originally made), involves being able to move to a system of *post-payment verification* of claims. The importance of the early acquisition of full and reliable data, and of moving rapidly to implement post-payment verification cannot be emphasized enough. To delay is to guarantee higher interest charges, the probably need for the Department to hire (inexperienced) staff on a emergency basis (at inflated cost) to process accumulating claims according to current procedures, and to sour the all-important relationship between the SBLA Administration and lenders.

Lenders, it should be said, are really quite pleased with the nature of that relationship today. They find the restructured SBLA Administration to be highly responsive, and they are generally satisfied with the rate at which claims are processed. They are apprehensive, however, that there may be unadvertised delays in moving to post-payment verification, and that claims could pile-up as a result. They - and others - also hope that as great a measure of stability as is possible be introduced into the SBLA Administration (the Division has borne its proportionate share of departmental downsizing, without evident regard to the increased workload volumes that are looming), and believe that such stability will contribute to boosting all-important morale.

The 'flip-side' of post-payment verification could be consideration of introducing aspects of U.S. Small Business Administration procedures *at the front* (or registration) *end* of the process. Under the SBA's 7(a) program "the most active and expert lenders qualify for streamlined lending" practices. "Lenders are delegated partial or full authority to approve loans, which results in faster SBA processing." *Certified* lenders are given a 3-day turnaround (and account for nearly 1/3 of all SBA loan guarantees). *Preferred* lenders "are chosen from among the SBA's best lenders and enjoy *full* delegation of lending authority in exchange for a lower rate of guarantee." Preferred loans account for more than 10% of total SBA lending. Authorities under these two designations must be renewed at least every two years.

The 'better' SBLA lenders (those with default rates consistently - and in some cases significantly - lower than the SBLA average of 5%) would welcome some measure of delegated authority, *especially* if combined with a reduced premium (a possibility which warrants a closer look at the point at which it becomes more evident whether cost recovery is being achieved, and with the

benefit of superior data in hand allowing somewhat more accurate projections of the impact on cost recovery of alterations to the program's fundamentals.) The 'better lenders' essentially argue that if 'inferior' lenders are going to continue to use the program almost as a loss-leader (to improve their market share), thus saddling the taxpayers with a disproportionate burden, then they (the 'better' lenders) should enjoy some consideration which would allow them to maintain market share while remaining prudent in their lending practices. One mitigating concern: the 'incrementality' level might fall!

Another reason for fully examining this suggestion is that 'better lenders', increasingly, are shifting less risky customers to their own guarantee programs, on which they and the borrower are 'splitting the difference' (not necessarily equally), rather than remitting a 2% up-front registration fee to the government, combined with a 125 basis points annual fee. While the government should not necessarily be concerned at this development (fostering such private sector initiatives and promoting cheaper access to capital should generally be applauded), it does risk significantly compromising the overall quality of the SBLA portfolio. To the extent to which 100% incrementality has never been a declared government SBLA goal, it may be worth promoting better lenders (and borrowers) remaining in the program - and the U.S. model might provide one means.

2.5.5 Regulatory Review

The SBLA Administration has not yet contributed to the Department's review of regulations currently underway. That process should be seized upon as an opportunity to thoroughly review the SBL Act regulations, to see if they are up-to-date and relevant. As pertains to most government programs, there has been an accretion of regulations over time, and some of the SBLA regulations may no longer describe the best way of operating.

The Department should have no illusions, in proceeding, that this offers an opportunity, in relative terms, to diminish Parliament's authority and increase the Minister's. Unquestionably, there is a dilemma here. Parliamentarians claim to recognize the importance of the SBLA, as a 'business service', being equipped to respond quickly to changes in the economy (responses which might be delayed by the need to seek Parliamentary approval of particular program changes). On the other hand, they view the SBLA more 'possessively' than they do any other program administered by the Industry Department. The obvious reason: they hear weekly from many small business persons, whereas they hear only rarely from most of the consumers of other Industry programs. They will not happily relinquish *any* authority they currently have over the program (for which they believe they would be held fully accountable anyway), and so, if regulatory changes are to be proposed to that effect, the Department must develop - and sell - a very compelling case. Otherwise, the outcome will be the status quo, but with heightened suspicion on the part of Parliamentarians towards the Department and its Minister.

The corollary, of course - assuming it wishes to maintain (or even expand) the SBLA - is that the government could expect no more fervent group of supporters than it finds in Parliament.

2.5.6 Transparency

The decision, prior to April 1, 1995, to raise the SBLA interest rate caps to prime (for the mortgage rate) + 3% was, ostensibly, taken with the view that in accommodating the 125 points basis fee within the cap, somehow more interest rate competition might take place on SBLA loans. Anecdotal evidence suggests that this hasn't happened.

Such significant SBLA interest rate competition as there has been took place in 1993-94, and to a lesser extent in 1994-95. Borrowers insist - and lenders more-or-less confess - that most SBLA loans made since April 1, 1995, have been at (or very near) the cap.

And so, incorporating the annual fee into the interest cap may not have had its desired effect. What it has most certainly achieved, complain lenders, is that many borrowers assume it is the lenders who pocket that 1.25% fee (the phenomenon is likely to become more pronounced once fees start being collected and remitted). Lenders appeal for greater transparency (surely a laudable public policy objective), with government making more effort to inform borrowers that the fee is being levied to achieve cost recovery, and not to line lenders' pockets.

One suggestion from a non-lender was that the *registration* fee be increased, and the *annual fee* be *abandoned* - so as to reinforce that at issue is a *fee to government* rather than an annual interest payment to lenders.

3.0 'POLICY FOCUS' OPTIONS

3.1 Capital Leasing

Industry Canada is fostering other studies which exclusively focus on the potential costs and benefits of expanding the scope of the SBLA to include capital leasing, as well as the process by which that could be made to happen. For that reason, capital leasing will be dealt with only cursorily here – concentrating on just a few of the key issues and arguments, and on stakeholder responses to them.

Minister Manley set the tone at the Industry Committee (Nov. 21, 1995), when he said: "I'm very sympathetic to the notion that we find a way to extend the intent of the SBLA to leasing arrangements if we can do it in a fashion that both maintains the cost recovery mode and is effective in helping small businesses." ESBO Director General Sagar had dealt with the definitional issue just a month earlier (Oct. 19, 1995) at the same Committee, when he said: "leasing is another form of fixed asset financing, and should be looked at."

3.1.1 Does Leasing Fit?

Carolyn Conner (1995) confronted the definitional question. She concluded that asset-based financing "is the financing of equipment and related assets pursuant to a *secured loan, lease or conditional sales contract*." She described a "finance or capital lease – also known as a 'full payment' lease" as a "long-term instrument generally matching the life of the asset." Based on

these definitions, it is very hard to distinguish a *capital lease* (i.e. *not* an *operating lease*) from the kind of financing the SBLA guarantees today – and the leasing industry insists that for accounting and tax purposes, there is no real difference.

To the extent, then, that a strict actuarial definition of *capital leasing* could be entrenched in legislation, it is exceedingly difficult to continue to make the case *against* including leasing within the scope of the SBLA, at least insofar as arguments about what type of business activity it pertains to are concerned.

3.1.2 At What Cost?

Cost recovery is another question, and given the importance attached to it by the Minister, the Department must satisfy itself that the cost recovery objective would not be adversely affected by extension of loan guarantees to cover capital leasing.

The leasing industry claims that its default rate runs 20-30 basis points *lower* than what the banks suffer on term lending. Clearly, there should be at least as much scrutiny of the propensity to default on capital leases as there is of the default rate endured by current SBLA lenders, *before* the program is expanded to include leasing.

The bigger issue would seem to be what impact on the overall lending *ceiling* the government would be willing to let inclusion of leasing make. As has been discussed elsewhere in this Report, the biggest single variable today affecting government's contingent liability on SBLA lending is *volume*. To include leasing within the program at a ceiling *not* selected to reflect the extent (and potential) for leasing in the economy is to address the *equity* issue (which so bothers the leasing industry), by way of *substituting* lease guarantees for current financing. In that scenario, there could be next-to-no lending incrementality.

So, at base, the government has to decide *how much* lending – under a revised SBLA program – it is willing to risk absorbing liability for. It could well be – and perhaps should be – that the government will only be willing to answer that question once the evidence about how effectively cost recovery is working starts to come in (around 1998-99).

An alternative (if awkward) way to proceed – especially if expert study supplies evidence that inclusion of leasing would *compromise* prospects for cost recovery – would be to create a *separate* guarantee program for capital leasing, with a fee calibrated to 'ensure' full cost recovery. In that way, users of the SBLA for the types of loans conventionally guaranteed would not find themselves cross-subsidizing an influx of 'lease loans'. A *separate* leasing guarantee program would also satisfy those primarily worried about further 'dilution' of the SBLA.

A separate program could, either in addition-to or instead-of a different *premium*, offer a different *level of guarantee*. As one respondent observed: "they don't need the same guarantee – there's a fixed asset to seize" (as distinct, for example, from a leasehold improvement). While certainly possible, care would have to be taken *not to* introduce new biases into the SBLA, whereby a lender financing the purchase of a piece of equipment received a different guarantee

(thus perhaps paying a different rate of interest) than the lender financing a capital lease on precisely the same sort of equipment. If one of the reasons for considering including capital leasing within the SBLA is to eliminate the aspect of "selecting against" leasing that attends the program today, then one would not want to build biases into co-existing guarantee programs. For that reason – and because the nature of the asset being financed appears to be essentially the same – one combined program rather than two separate ones would appear to make more sense.

3.1.3 Incrementality

How much *new* lending an SBLA revised to accommodate capital leasing would cover is an issue which preoccupies officials - but perhaps unnecessarily. Unquestionably, addition of leasing would be 'incremental' in the same way that increasing eligible company size and loan size, as well as expansion of the program to cover some sectors previously ineligible, fostered 'incremental' SBLA lending from 1993-onwards. However, the concern about leasing seems to be whether a capital market gap exists whereby small businesses are incapable of securing lease financing. On its face, there's little evidence of a yawning gap, and quite a bit of evidence of a narrowing one. The leasing business is "going gang-busters". Lender and industry interviewees *overwhelmingly* said that they had *never* been asked "why does the SBLA not cover leasing." In short, the only people for whom this seems to be an issue are those already in the leasing business.

However, is that fact sufficient to 'keep leasing out'? No administrative procedures or rules are in place to ascertain whether lending under the SBLA program as it stands today is *incremental* (in the sense that it *would not happen* without the benefit of the guarantee), let alone to prohibit it. Until clearing such hurdles becomes the sine qua non for lending under the SBLA as currently structured, it seems arbitrary - indeed, discriminatory - to exclusively hold the leasing industry to that standard. Of course, leasing companies should be expected, as a condition of participation in the program, to relax their lending criteria to the same extent as other SBLA lenders (thus assuring some measure of incrementality).

'Incrementality', however, can be measured in different ways. Many (but my no means all) interviewees were dubious about the manageability of including *working capital* within the parameters of the SBLA. There was some limited support, however, for the idea that due to the fungibility of capital, expansion of the SBLA to include *capital leasing* would, *at the margins*, increase the amount of *working capital* available to small businesses.

The same argument was made by some who favour greater efforts to *target* the SBLA to 'new economy' (often higher growth) industries (and, implicitly, *away from* many of the kinds of businesses currently using the program). Leasing was seen as likely to become more and more important as the cost of technology increases. Inclusion of leasing within the SBLA was thought to have particular relevance to exporters: often, to meet a one-off export opportunity, a company may need equipment that doesn't (yet) feature in its medium-term plans. Leasing provides the solution!

3.1.4 Who Would Lend?

The CFLA has officially asked that its members become designated SBLA lenders, in the same way that members of the Canadian Payments Association automatically become sanctioned SBLA lenders. As is recommended in the *Status Quo (with tinkering)* section of this Report, the notion that any lender should *automatically* enjoy the right to encumber the Canadian taxpayer is anachronistic. Stringent criteria should be laid-out for would-be lenders to meet. The CFLA recognizes that some - perhaps even most - of its members might not pass the test, and seems undisturbed about the prospect of two tiers of CFLA membership. They ask only that other BLA lenders be required to meet similar standards - surely a sensible and prudent request.

3.1.5 Other Considerations

Some have wondered whether leasing companies could accommodate themselves to the SBLA's existing 'fundamentals', most notably the interest rate cap. The CFLA claims that financing on the average capital lease is now available for the equivalent of prime + 3%-to-prime + 4% (allowing that the industry "doesn't work off-of prime"), and that achieving the prime + 3% cap would *not* be a problem. The guarantee would, in and of itself, make lower interest charges possible - although someone currently financing a prime + 4% loan, given the need to remit 1.25% annually to the government (to say nothing of the 2% up-front registration fee) would have to be content, in exchange for the guarantee, with only 13/4% interest thereafter. Presumably, the same phenomenon currently being experienced by 'better' would-have-been SBLA borrowers (whereby lenders are creating their own, less costly guarantee programs, and making them available at savings-over-SBLA), would come to pass insofar as SBLA-guaranteed lease financing is concerned.

A recurring issue (raised by officials) concerns the difficulty involved in evaluating the worth of the repossessed good. While surely never easy, it may suffice to say that this, after all, is what leasing companies do for a living - rather more than your average SBLA lender of standing today. It seems a strange concern in the context of SBLA guarantees of leasehold improvements, which everyone involved acknowledges default at a higher rate than most other loans, and which are known to be worth *next to nothing* upon default.

Some change might have to be contemplated to current rules which effectively permit SBLA loans to be amortized over periods longer than the term of the loan - and longer, often by far, than the depreciable life of leased equipment. Accordingly, amortization periods for SBLA-guaranteed capital leases might have to be limited to the period of the loan itself.

Finally, Industry Canada's legal counsel is firmly of the view that substantial changes would be required to the existing SBL Act - or, alternatively, that separate and distinct legislation (A 'Small Business Leasing Act') might be the best way to go. Neither alternative should constitute a major problem. The need to go to Parliament looms (that is what precipitated this Report). Providing no one is considering altering the parameters of the SBLA program *before* legislation governing the next lending period is passed, then the necessary changes - whether in the form of an expansion of the SBLA or a stand-alone lease financing guarantee program - should be quite

achievable. There is no discernible opposition in Parliament to the notion of bringing leasing under the wing of the SBLA - on the contrary, there is palpable enthusiasm for the prospect.

3.2 ‘Incrementality’

While a minority of stakeholders remain ‘ideological’ on the ‘incrementality issue’ (viz., “there’s no excuse for government to be guaranteeing loans that would otherwise be made without the guarantee”), the weight of stakeholder opinion is overwhelmingly pragmatic, and is inclined to the view that efforts to ensure significantly greater incrementality (than is currently offered by the program) are likely to be counterproductive.

Lenders were generally unable (disinclined?) to estimate how much SBLA lending that they currently engage-in would take place even if the program were abolished. Predictions ran the gamut from zero to 50% - implying that up-to-half of today’s SBLA lending is truly ‘incremental’. On average, lenders said that the maximum default rate they ‘tolerate’, on non-SBLA guaranteed loans to small businesses, is 2%. Obviously, the 5%+ SBLA default rate implies some considerable measure of incrementality.

Consideration could be given to introducing to the SBLA the test applied under the ‘Working Capital Guarantee Program’ offered by the U.S. EXIMBANK. The guarantee may cover working capital loans “if the lender certifies that the loans *would not be made without EXIMBANK’s guarantee.”*

To some extent, incrementality may have been ‘yesterday’s issue’. The introduction on April 1, 1995, of the 125 basis points annual fee has, according to *all* lenders, had a *pronounced* impact on their lending - in fact, there is a real danger that the impact has been *too great*. Lenders rejected the term “a market for lemons” (sometimes applied to the British SBLA-equivalent after premiums were raised to relatively high levels), but most expect that the default rate on post-April 1, 1995 loans will certainly increase relative to the historic SBLA average. While lenders insist that the haven’t “consciously entertained higher risk loans”, they nonetheless expect that the effect of pushing *out* of the SBLA ‘borrowers on the cusp’ (who have increasingly concluded that they now have better priced options) has been to increase the riskiness of the remaining portfolio.

Within the cost recovery parameter there isn’t much that can be done to increase incrementality. A riskier portfolio is one on which the rate of the default will be greater. Cost recovery necessitates fees being set in order to cover the cost of defaults. Higher fees attract *riskier* applications, both absolutely (lenders may ‘move up the risk curve’ because a borrower is willing to pay more to receive a loan), and relatively (‘better risks’ look for less costly alternatives). *Every single lender* said that there is *absolutely no tolerance* for higher fees - and argued that the effects would be counterproductive from the taxpayer’s perspective. Government should recognize and accept that reality, and cease ‘beating up’ on lenders about non-incremental lending, at least for as long as cost recovery remains the sine qua non of the program.

Increasing incrementality without significantly greater risk would be most observers’ idea of

‘win/win’. Increasing the maximum loan (and eligible firm) sizes in 1993, combined with making the SBLA applicable to categories previously excluded, may or may not have increased the riskiness of the overall portfolio. It did literally result in lending incremental to what the SBLA program had previously covered, but no-one knows how much of that lending was taking place anyway.

The CFLA has an interesting proposal - that a ceiling be placed on individual lenders, and that a given lender’s eligibility to write SBLA loans within that ceiling should be tied to the amount of non-SBLA lending the institution does to small businesses. That could lead to better loans being shifted-off the SBLA, and riskier ones added. As always, there would be definitional and counting problems. The extent to which it would compromise cost recovery is anyone’s guess - and therein lies the rub.

It would appear that the only ‘answer’ is to take a risk on risk. Evidence of the default rate on working capital loans (for which, by definition, there is no collateral - except personal guarantees) implies it would be a very bad risk to promote incrementality by expanding the SBLA to include working capital - but it may be a risk government is prepared to take to ensure the continued relevance of the SBLA program (albeit that cost recovery might have to be abandoned as a goal). Greater targeting of the program on sectors not currently participating at high rates (e.g., ‘knowledge-based’ industries, and small exporters) might yield genuine incrementality at ‘bearable’ risk levels (see section on targeting) - simply because there’s less evidence that ‘new economy’ industries default at as high a rate as borrowers of working capital. On the other hand, distinguishing the needs of ‘new economy’ industries from working capital loans may be pointless.

On balance, pursuit of significantly higher levels of incrementality is probably chimerical. Tomorrow’s challenge, unless cost recovery is abandoned, is far more likely to associate with ensuring a balanced portfolio, in which there continues to be implicit ‘cross subsidization’.

3.3 New Lenders

There are essentially three issues that could be considered under this heading: a) whether members of the ‘leasing community’ should be accorded ‘SBLA lender’ status; b) whether the program should be completely restructured so that institutions whose purpose is *not* to carry loans on their balance sheets would become interested in participating (perhaps via a model that lent itself to securitisation of loan portfolios), and: c) whether publicly-funded bodies should be permitted to write SBLA-guaranteed loans. (a) is dealt with above, in the section on Capital Leasing. (b) is touched upon at the end of the highlighted section on Student Loans. The entire matter of the *process* by which would-be lenders gain status is accorded a sub-section in the *Administrative Options (Status Quo)* portion of this Report. Accordingly, this section will exclusively focus on © - whether publicly-funded institutions should be able to issue SBLA loans.

Theoretically, some measure of ‘competition’ could be introduced into SBLA lending if public institutions - for example the Business Development Bank (which would very much like to enjoy

the privilege) could write SBLA loans. Purists might argue "who better than public agencies to obligate the taxpayers." Clearly, however, the vast majority of SBLA lending will continue to take place in the private sector, whether a change is made or not. Existing lender opinion, however, was predominantly hostile to the idea: "wasn't the real purpose behind the SBLA to facilitate private sector lending to small businesses...?"

One business body and two regional agencies strongly recommend that serious consideration be given to allowing Community Futures Offices (CFOs) to write SBLA loans. While this idea did not sit well with every respondent, the merits were seen as two-fold: because CFOs are community-based non-profit corporations, with volunteer boards, they tend to know their clients extremely well. Their natural market would tend to be smaller SBLA loans, which larger lenders might be delighted to be rid of. If the SBLA were expanded to include working capital, ironically it might be small outlets like CFOs that would be best positioned to provide the kind of due diligence necessary to monitor the loans.

The second line of argument in CFOs' favour tended to be that SBLA status might be a means of weaning them from public funding. All could perhaps be given the choice - the more confident of them might relinquish funding for the right to issue SBLA-guaranteed loans. While they often currently charge prime + 4-5%, the fact of the guarantee could allow them to accommodate themselves to the SBLA cap of prime + 3%.

There is obviously a danger in trying to serve too many public policy purposes via one government program. The SBLA is about promoting access to capital, not about putting government-supported lenders on their feet. However, there can also be excessive concern about precedent. Sincere investigation of the possible effects of letting CFOs write SBLA loans does not require prior decision to 'open the floodgates' to the BDC, the CCC, the regional agencies or any other, much larger, federally-funded body. A threshold could be set which, in the event, would exclude larger bodies while including CFOs. First, of course, the CFOs would have to be asked if they are interested.

3.4 Personal Guarantees

Growing Small Business, the companion to the February, 1994, Budget, noted: "The issue of personal guarantees requires resolution. Many small businesses favour eliminating them. The banking community disagrees - although one bank has indicated that it will ask for guarantees only in exceptional circumstances. The government will resolve this issue with the financial institutions."

Profile has been given to the issue of personal guarantees no doubt because of the *Red Book* commitment: "In order to increase access to capital, a Liberal Government will ensure that no personal guarantees are required for loans under the SBLA." And so, a compromise was negotiated which, essentially, limited the value of the personal guarantee that could be taken, and provided for its release after a portion of the loan had been repaid.

Stakeholders representing borrowers and lenders alike feel the compromise was "hard won and

seems to be working." That's a far cry, however, from suggesting that everyone is happy.

Storey (1995) is just one of a long line of economists who insist that by prohibiting - or even restricting - personal guarantees, the market is doubly distorted: demand for loan financing increases, and the supply decreases. The SBLA parameters already limit another major mechanism by which the market would normally be heavily influenced - price. But then, as more than one interviewee opined, "the SBLA is itself a distortion of the market" (this by way of a pitch to refrain from too much additional interventionism). However, if (as so many respondents declared) "the issue is *access* to capital", then government should hesitate before taking further initiatives concerning personal guarantees whose effect could be to *restrict access* to capital.

It is worth nothing that those of our competitors who assist small business through *loan guarantee programs*, generally permit the taking of personal guarantees by lenders. In the case of the U.S. SBA, personal guarantees are normally *required*.

Lenders have largely acquiesced in the new status quo - even though they tend to believe it is counterproductive insofar as the SBLA's declared purposes are concerned. Why then is this an issue?

Parliamentarians (especially some Senators) expressed concerns about the taking of personal guarantees at the time at which C-99 was under consideration in 1995. That may drive officials to try to fully implement the *Red Book* promise.

One non-lender, non-borrower declared that eliminating the personal guarantee probably "wouldn't affect the banks that much," and speculated that "there may be some other ways to achieve satisfaction on the 'moral commitment' issue. One borrower representative insisted that lenders "take them because they can." Lenders did not challenge either of those points - but emphasized that far more of the government's money is at risk than theirs, and that the government should want to think twice before acting in a fashion likely to increase taxpayer losses.

Most interviewees ascribe salience to the argument that the taking of a personal guarantee extracts a 'moral commitment' from the borrower to not be imprudent with taxpayer-guaranteed loan proceeds. Others emphasized equity: "if the lender and the taxpayer are being asked to take a risk, then why shouldn't the borrower." Another counselled pragmatism: "no borrower likes them, but everyone accepts that personal guarantees are the way of doing business. They would rather have more access than less."

One outlier in the debate is the nascent *Small Business Development Association of America*, which is contemplating launching a Canadian counterpart. The SBDAA accentuates the moral hazard argument (if the business starts to go sour, someone who has given personal guarantees will take desperate measures to protect his or her own assets), and has determined that it will *not* take such guarantees.

Given contrary opinions on the taking of personal guarantees and the fact that a compromise was

negotiated and is in place, the dynamic could be assumed to favour the new status quo. Instead of further tightening-them-up the government could scrutinize implementation of the compromise involved limiting the taking of personal guarantees to 25% of the total loan value - but that lenders, in instances where there is more than one partner, are asking *each* borrower for a personal guarantee.

By far, a bigger concern will arise should policy makers decide to expand the scope of the SBLA - or, for that matter, should a preference emerge for gearing or calibrating the SBLA's fundamentals to provide lenders with additional flexibility, or out of a desire that SBLA lending should more accurately be 'priced to risk".

While generally skeptical about including working capital within the purview of the SBLA, *all lenders* insist that it could *only* be done if *more extensive* personal guarantees (than are provided-for in the compromise) could be taken. Because working capital loans, as well as those that might be taken by knowledge-based industries invariably involve little (or no) collateral, ideological insistence on 'purifying' the SBLA system of personal guarantees will likely foreclose *any* prospect of SBLA expansion along these lines.

Options do exist. A two-tiered system could be structured, whereby if the *borrower* chose to offer a higher personal guarantee, he or she might enjoy a higher loan/equity ratio (currently 90/10; previously - until Dec. 31, 1995, 100/0; potentially lower than 90/10). Another alternative might be to permit the *borrower* to enjoy lower premiums or fees in exchange for a greater personal guarantee. One down side: complexity and confusion is thereby introduced into a system which everyone - borrowers and lenders alike - acknowledges should best be kept as simple and straightforward as possible if take-up is to continue to be widespread.

3.5 SBLA 'Fundamentals'

All respondents agreed that while it is important to *occasionally* alter the SBLA's fundamentals, *no changes* should be made to any of them before renewal legislation is passed - and then, ideally, only with complete statistical information in hand concerning cost recovery and propensities to default, as well as thorough analyses about the probable impact on the program of both major and minor changes which are under consideration. Borrowers and lenders alike place a greater premium on continuity - on making the program work *as is* - than they do on achieving any particular change to either the program's fundamentals or its scope. An overriding regional concern is that every attempt must be made to fully analyse, in advance, the impact by region of any changes to SBLA 'fundamentals'.

3.5.1 Amount of Loan Guaranteed

As of January 1, 1996, the SBLA-guarantee can only be applied to 90% of the value of the loan being sought (down from 100% previously), thus necessitating a minimum up-front contribution by borrowers of 10% equity (towards the project/purpose for which the loan is being sought). [The U.S. SBA guarantee applies to only 75% of the value of the loan]. Lenders regard the Jan. 1, 1996, change as being of acute interest to customers, and project it will have a far more

pronounced impact on demand than the concurrent reduction in the level of guarantee.

Lenders (whom virtually all officials and some borrowers emphatically assert *must concur* in any changes if they are to have a positive - as distinct from chilling - effect on the program), were open-minded about the idea of differential equity requirements. For example, they tended to feel that if (for reasons of cost recovery) the government becomes concerned about the higher propensity of any particular sector to default, then the best response (short of entirely deleting the category or sector from eligibility), would be to require significantly higher up-front equity contributions for loans in those categories or sectors (this preference partly derives from cynicism about the chances of government ever actually deleting anyone currently eligible). This case was especially advanced by those who believe that altering the *guarantee level* would cause loans to completely dry-up (see below), and who are of the view that there is absolutely *no tolerance* in the system for *higher fees or premiums*. Some lenders, it must be said, oppose anything other than universally applicable rules, for fear of introducing sufficient complexity to kill lender interest in participating.

Of course, 'playing with' equity levels needn't be engaged-in simply so as to 'penalize' (or reduce losses on) particular categories of loan. Those lenders attracted to pricing-according-to-risk felt it would be administratively feasible to calibrate fees or premiums to equity (on the principle that the higher the equity contribution, the less risk of default, and the lower premium or fee that should, therefore, be levied) - although the preference was for a limited number (perhaps three) thresholds. CMHC already employs a similar system in regard to the setting of their fee. It was precisely this CMHC model which M.P. Andy Mitchell has encouraged upon the government.

One approach, suggested by a lender, would have the current 2% registration fee apply to loans where the borrower advances 10% of equity (the status quo); charge 1.5% for an equity contribution of 20% and 1% for equity of 30%. Clearly, officials would have to satisfy themselves, to the extent possible, that the ensuing reduced overall fee revenue would still be sufficient to yield cost recovery. If that concern is addressable, the result would be an SBLA more modulated to borrower needs, as distinct from sustenance of the "one size fits all" model.

One down side of the system which encouraged at least some borrowers to contribute a higher percentage of equity is that less money would be available to those businesses for working capital purposes. However, businesses, in collaboration with their financial advisers, are presumably capable of making those decisions, and if some (perhaps more traditional firms for whom purchasing needed fixed assets is the primary objective) would make that choice, then perhaps they should be given the opportunity to do so.

3.5.2 Fees/Premiums

Effective April 1, 1995, a new fee (set at 125 basis points, to be calculated on outstanding balances) was put in place. An up-front registration fee has been set at 2% since 1993. The probable effects of the 125 basis points fee have been discussed at various points throughout the Report - suffice it to say here that lending has measurably declined since its introduction.

The opinion is overwhelmingly held, among borrowers and lenders alike, that there is no additional scope within the SBLA system for *higher* fees or premiums - at least not on net. A broad-based increase of either or both, it is held, would drive better borrowers out, thereby stimulating upward risk and default spirals that would eventually kill the program. Fear was particularly pronounced of replicating the U.K. experience (whereby with high fees, the few relatively good risks subsidized the many poor ones). There is, however, considerable openness to several potential variations to the existing fee and premium structure.

Differential fees according to levels of equity participation on the part of the borrower, is one option discussed immediately above. Another would follow the U.S. model (designed to encourage relatively smaller loans), and calibrate the fee to loan size [under the U.S. SBA 7(a) program, the one-time registration fee on loans up-to $80k is 2%; it's 3% on the next rung to $250k; 3.5% to $500k and 3.875% above that amount). A proportionate adaptation to Canada might have fees on loans up-to $30k at 1%, 1.5% on loans up-to $80k; 2% up-to $165k; and 2.5% up-to $250k. There would be even greater cause for that kind of differentiation if data were to substantiate, for example, a greater propensity to default on higher dollar value loans. On the other hand, data may argue for a 'reverse' fee structure (lower fees on larger loans) - although public policy objective might mitigate that kind of change.

Yet another alternative would calibrate premiums or fees to lender performance. The principle underlying the concept is that by creating incentives, the government could improve the quality of both registrations and claims, and probably alter the overall make-up of the SBLA portfolio itself. Some individual lender's SBLA-guaranteed portfolios default at a rate much lower than the SBLA average; some at a higher rate. If fees or premiums were, for example, calibrated to a five-year running average of an individual lender's SBLA performance, "good" lenders (those with the lowest default rates) would face a choice - they could achieve higher profits on the SBLA loans they make, or they could pass the 'saving' on to customers, in the process probably enhancing their market share. Conversely, "bad" lenders would either risk losing market share, or would have to "eat" the premium/fee differential. Lenders would inevitably advertise the differential premiums (just as they did in 1993-95 when they competed more aggressively on price), and those who received SBLA-guaranteed loans would, almost certainly, enjoy some saving relative to what they pay today.

One very significant advantage to a premium or fee tracking bank performance is the extent to which it might motivate "better" lenders to remain in the SBLA program. A very real concern (especially since April 1, 1995) has been that "good" lenders will opt-out (formally, or defacto) of the program; will create their own equivalent programs, using their sizeable risk pools to 'guarantee themselves'; and pass some of the difference between what they will charge and the premiums/fees which the borrower would have had to face under the SBLA, along to the borrower. Superficially, that outcome appears attractive - providing the government is planning to get out of the SBLA business. If, on the other hand, perhaps after concluding that many of the riskier loans previously made with the benefit of the SBLA would no longer be made, the government felt it had no choice but the continue to offer an SBLA guarantee, the portfolio it would find itself guaranteeing, in this scenario, would suffer a considerably higher default rate than today's portfolio - necessitating higher government subsidies. The issue boils down, in

some respects, to the government's relative preference for incrementality or balance in the portfolio.

Lenders conceded, however, that one potential outcome of a fee/premium-to-performance structure would be at least a slight diminution in the volume of 'riskier' SBLA-lending (lenders would not want to see their low default rates compromised). For that reason, a fee/premium-to-performance structure should probably only be opted-for *either* because of genuine alarm at the prospect of "better" lenders imminently dropping-out of the program, *or* because a deliberate decision has been taken (for cost recovery reasons) that the portfolio's quality must be improved and the other alternative means of achieving that end (a lower guarantee level; rendering given sectors or types of loans ineligible for guarantees, among others) have been, for whatever reasons, deemed unsatisfactory.

Yet another variation of the above would be to institute a claims processing fee (one had been considered in 1995, but was abandoned) *only* on lenders whose default rates were consistently greater than the SBLA average. In addition to its 'incentive value', the proceeds would contribute, however marginally, either to achieving cost recovery on the portfolio or to defraying some of the SBL Administration's operating costs.

Two final suggestions of methods by which the current universally applicable fee/premium structure could be departed from were:

a) a differential fee according to *size of firm* (as distinct from size of loan), if data were to show that firms of a particular size (for example, revenues less than $250k, or greater than $3m - but less than $5m) were consistently to default at a significantly higher rate than the SBLA 5% average. Other considerations might trump the idea of a higher premium for firms with revenues in the lowest category, but give way in the case of a higher fee on larger loans; and

b) an additional premium on loans in given *sectors or categories* consistently found to have a higher propensity to default. There was, in fact, considerable support among lenders and borrowers alike for at least studying this idea further (in terms of its possible ramifications on cost recovery and on the sectors likely to be affected).

All respondents on this issue emphasized the importance of having reliable data permitting actuarially-based conclusions. Of course, the existence of data would not necessarily persuade the affected sectors. It is easy, for example, to imagine a concerted lobbying effort by the Canadian Restaurants Association (if data were to substantiate that leasehold improvements consistently defaulted at a higher rate than other SBLA-guaranteed-lending and, in accordance with that data, the Minister endorsed a supplemental premium for leasehold improvements). In the event Parliamentarians would have to be impressed with the argument that all other small business SBLA-users are currently carrying a heavier load so as to subsidize leasehold improvements. That case would be strengthened if in addition to higher fees for particular sectors, it proved possible to *lower* the overall fee or premium for remaining users.

It should be emphasized that not all lenders endorse any system changes involving the introduction of differential fees or premiums. Opponents of change ascribe greater weight to simplicity (fearing that branch lending would dry-up if greater complexity is introduced into the

program) than they do to any of the potential benefits which could flow from changes designed to lead to an incentive-based system.

3.5.3 Guarantee Level

Of the various SBLA 'fundamentals', the guarantee level is definitely the least important to the borrower, but remains of considerable importance to the lenders. Riding (1995) defined as the central task of the guarantor: "setting the level of guarantee sufficiently high that lenders have an economic incentive to deliver the program, yet not so high that lenders lose the incentive to discriminate on the basis of borrower quality. Similarly, it is not in the interest of the guarantor to set the level so high that banks fail to carry out adequate due diligence and monitoring."

So much importance is attached by lenders to the guarantee level that respondents made it clear that a Riding's (1995) 'optimum' guarantee of 50%, *virtually no loans* would be made under the SBLA. Most lenders clearly regard the current 85% guarantee level as being "about right." Some acknowledged that the less risky borrowers don't require an 85% guarantee, but protested that setting different levels of guarantee according to risk would be too administratively cumbersome for them.

One specific option posed to respondents was that should SBLA statistical data prove a consistently higher propensity to default for one or more sectors or types of SBLA-guaranteed loans, a lower level of guarantee (perhaps 50%) could be set for that category (or those categories). While there was obvious agreement on the need for actuarially reliable data to substantiate such propensities, the Period 12 *Risk Analysis* already identifies the retail and accommodation, food and beverage sectors as being the weakest performers. Lenders generally said that the loans wouldn't be made; one offered that leasehold improvements (an oft-cited example of a category prone to default at a much higher rate than other SBLA-guaranteed loans) constitute precisely the kind of activity which should receive the benefit of some kind of government support. Borrowers tended to support the status quo, as did the regional agencies.

A variation canvassed with stakeholders proposed a fee calibrated to different levels of guarantee (the idea had been advanced by Andy Mitchell, M.P., in correspondence to Minister Manley). While the idea of a *different fee* calculated according to the actuarial risk of default found some favour, no respondent was attracted to the option of differential fees according to level of guarantee.

3.5.4 Lending Ceiling (Periods 12/13)

The matter of timing - when it is that the current period (12) should be brought to a close, and the next one begun - is referred-to elsewhere in this Report. It bears emphasis, however, that whatever the complications in going *twice* to Parliament (i.e. once to *raise* the ceiling for Period-12 - in the event it is reached before April 1, 1998 - and a second time, not too long thereafter, to secure approval for a ceiling for Period-13), it would be worse to try to do the two at once (by commencing the next period 'early') *if full and complete data* about the program are *not yet available.* The ceiling should not be set until officials know more about the risks inherent to the

program than they do today. Inasmuch as renewal legislation is, invariably, *the* chosen vehicle for 'adjusting' the 'fundamentals', it would be imprudent in the extreme to determine adjustments to any of the variables without greater comprehension of their respective impacts on the default rate - and hence on cost recovery. Lack of knowledge of whether the 125 basis points fee is genuinely yielding cost recovery would be another sound reason to delay - perhaps even to the point of *extending* the current period for one or two years (or limiting Period-13 to only 1 or 2 years), with 'variables' left at their current levels or rates pending fuller data.

One change to the ceiling which could usefully be considered at the next legislative opportunity is to make it a 'net' figure (i.e. for Period-12, there could be $12 billion in net lending from that period outstanding at any time - thus factoring-in repayments), rather than maintaining a system in which a repaid loan of x value has no bearing on the making of a subsequent loan at that same value (if the ceiling has been 'hit').

3.5.5 Maximum Firm Size

The maximum size for SBLA-eligible firms increased in 1993 to $5m (in gross annual revenues). For only the smallest minority of respondents is optimum firm size any longer an issue - and even those who opposed the increase at the time and continue to do so today, don't make too much of a point about it now.

The regional agencies, in particular, all feel that $5m "makes sense", and that the previous $2.5m limit was "too small". Industry representatives, generally, do not regard $5m in revenues as a "large firm". Every interviewee acknowledged that increasing the eligible maximum assisted so-called 'new economy' industries (exporters and knowledge-based companies, among others), and that it would be *counterproductive* to reduce it.

One alternative that might be worth looking-at once a full statistical array is available is to establish differing firm size maximums by sector, much as the U.S. SBA does. If, for example it was found that construction firms with $3-5m in revenues had a much higher propensity to default than the overall portfolio, and that firms of that size in other sectors had default rates comparable to the norm, there should be no programmatic imperative (aside from the complexity it introduces), why a decision to *reduce* the eligible firm size for construction firms would have to apply across-the-board.

3.5.6 Maximum Loan Size

Opinions about the appropriateness of the current maximum loan size ($250k) were slightly more tentative than about maximum firm size. No respondents pressed *strongly* for a further increase - although at least one of the regional agencies would favour a 20% increase. Because the regional agencies have, for the most part, adjusted their own assistance programming to reflect the increase in the SBLA maximum, all would oppose a *reduction* in loan size.

The small minority of interviewees who favour returning to a maximum of $100-125k express concern that larger loans are increasing the risk that the $12b lending ceiling for period 12 will be

reached *prior* to March 31, 1998. That concern has some foundation - the ceiling looks as if it could be met in 1997. Changes (to other 'fundamentals') introduced April 1, 1995, and January 1, 1996, appear, however, to have slowed lending volume short of cutting-back on maximum loan size. As in the case of eligible firm size, anecdotal evidence suggests that 'new economy' industries are disproportionately receiving larger SBLA-guaranteed loans. Accordingly, reducing the maximum size would run counter to what appears to be a growing government priority to assist small firms with high growth potential. As it stands, the $250k limit is only *one-third* of the amount that can be guaranteed under the U.S. SBA's 7(a) program.

Lenders (who universally insist that the costs they incur in making - and monitoring - smaller SBLA loans exceed the benefits they receive), would be most *unenthusiastic* about a cut to the maximum.

One highly particular observation emerged from discussions on loan size. There is some doubt that lenders are fully honouring the *spirit* of the law - whereby "the maximum amount of business improvement loans a borrower may have outstanding *in aggregate*" is $250k. The concern is that lenders have engaged (deliberately or inadvertently) in 'loan splitting' - a phenomenon by which, for example, a single individual wanting to buy two trucks is 'encouraged' to form two numbered companies (both of which are controlled by the same shareholder), with *each of the two companies* being granted an SBLA loan (and the combined loans exceeding the maximum). The suggestion being made is that the SBL Administration track registration documents more aggressively (looking for evidence of 'loan splitting'), and that any instances in which it is discovered be pursued with lenders. It is assumed that overt policing of this phenomenon will itself solve the problem - but changes to either the legislation or regulations should be considered, as necessary.

3.5.7 Rate of Interest

Those lenders attracted to 'pricing-to-risk', favour raising or eliminating the interest rate cap. They argue that most loans would continue to be made within the parameters of the existing cap (and that some borrowers would even enjoy lower rates); that only the most risky loans would be priced at a higher rate; and that, even then, there wouldn't be too much lending at higher rates "because price cannot compensate for risk." (One lender insisted, however, that "higher risk is not necessarily the same thing as unacceptable risk", and pointed out that lenders could accommodate themselves to a higher interest rate ceiling "although it would necessitate fundamental changes to bank risk assessment standards and lending policies"). Lenders generally argued, however, that there would be some measure of lending incremental to the SBLA program as it stands today.

Borrowers (and even some lenders) preferred the status quo. The anticipated competition on interest rates (when the cap increased in 1995 to 3%) has, in the view of borrowers, largely failed to materialize. Borrowers are quite convinced that raising or eliminating the cap would be tantamount to inviting lenders to upwardly price *all* of their SBLA loans. It was widely assumed that virtually all lending at interest rates in excess of prime + 3% would be 'column shifted'. It was suggested that Parliamentarians would have a hard time stomaching any upward change to

the interest rate cap.

The above notwithstanding, Minister Manley did imply (at the Industry Committee, Nov. 21, 1995) a willingness to adjust the interest rate. That openness could suggest a recognition that the existence of the cap does, in fact, contribute to 'quantity rationing' in Canada (MacIntosh (1994) observed that U.S. lenders tended to discriminate more by price, whereas Canadian lenders discriminated by withholding credit). The Minister's openness to adjusting interest rates could also speak to a recognition, on his part, that obduracy on the cap would largely (but not completely) foreclose useful discussion of the whole 'pricing-to-risk' concept (more below).

Even those who are completely allergic to a higher (or eliminated) cap, might usefully accord a modicum of attention to the U.S. model. Under SBA's 7(a), the maximum interest rate *declines* as loans get larger (recognizing that banks are less resistant to making the larger loans anyway - and, therefore, don't need to be as 'handsomely' compensated). The maximum rate, for example on loans under $25k, is prime + 4 3/4%; prime + 3 3/4% on loans of $25-$50k. That kind of nuanced approach would be highly congruent with a policy objective of fostering more micro-lending under the SBLA (lenders would be willing to make more such loans, because they would be better compensated).

3.6 Price-to-Risk

Government, over the past couple of years, has increasingly declared its conceptual openness to pricing-by-risk. *Financing the New Economy* (1994) counselled that "the government should not react unfavourably to higher pricing for riskier transactions." The same report declared that government supplied-or-facilitated financing "should not carry a pricing subsidy. It should be priced to reflect risk and be as close as possible to market prices." *Small Business: A Progress Report* (1995) described various committees as having asserted that "more efficient ways should be developed to evaluate and administer small business loan applications, with more flexible risk-rating procedure and pricing techniques."

3.6.1 The 'MARG' Model

The Export Development Corporation's new Master Accounts Receivable Guarantee Program (MARG), designed to cover a 'niche gap' (accounts receivable from non-NAFTA purchasers), is one of the government's first forays into assisting small businesses with their financing needs using a pricing-to-risk model.

The minutia of the MARG are not relevant to this Report. What does matter is its 'three tier' pricing system, which devolves to lenders, using their own risk rating systems (which are not identical), responsibility for establishing the annual premium (which is remitted to the EDC for purposes of covering defaults - which are not expected to exceed 1%). 'Least likely' transactions are assessed at 0.5% premium; 'medium risks' a 1% premium; and 'higher risks' a 1.5% premium. There is *no* interest rate cap; the EDC is confident that competition in the market will keep interest rates affordable. The bulk of the program's administration is devolved to the lenders; claims will be rapidly paid and scrutinized on a post-payment verification basis; an

annual review will be conducted with each lender, which could result in premiums being raised (or lowered) for particular lenders (or categories, as defined by the lenders), based on their performance.

The MARG is extremely new, and take-up is almost non-existent. Small exporters remain extremely hopeful about the MARG's prospects, while lenders are dubious. They are especially skeptical that the MARG's fundamentals, as currently designed, could be applied to a much more broadly subscribed program like the SBLA, concluding that the three levels don't offer enough basis for differentiation. They envisage "spending a long time arguing with clients over the validity of their risk assessments." However, they do acknowledge that it would be possible (although it is not currently required on the registration forms) for them to provide the SBLA - as they do the EDC - with their internal risk ratings.

3.6.2 Pricing-to-Risk: Is it Practical?

The motivation behind the MARG was the creation of incremental financing - and its cost was not a principal concern. In that vein, the pricing-to-risk model might be worth emulating in a *working capital* guarantee program *parallel* to the SBLA, or in a comparably structured guarantee program designed to fill the gap facing the knowledge-based sector. As one major lender commented "old economy companies (that constitute the bulk of SBLA users) are non-growth and very traditional. They don't see themselves in a risky category - and they wouldn't tolerate interest above prime + 3%." Lenders, generally, sought to contest the assumption underlying 'pricing-to-risk' - that the market would probably bear a significant level of risk-based pricing - and emphasized their concerns about the huge administrative burdens which they believe would flow from that change.

Some lenders thought it would be impossible ever to reach agreement on common standards (maybe not an overarching problem; if the businessperson is willing to shop around, he or she could potentially realize some savings). Another described pricing-to-risk as a "bureaucratic nightmare that would drive smaller lenders out of the program" (while admittedly an outcome which could have unfortunate ramifications, the SBLA isn't about *lenders*, per se).
In sum, respondents generally regarded pricing-to-risk as conceptually attractive but probably too administratively daunting *if applied to the existing SBLA program*. There was much greater enthusiasm for the approach if applied either to a parallel program or to segmented components of the SBLA.

Even then, there would be reservations. *Growing Small Business* (1994) asserted that "borrowers often perceive banks as using formula-based, inflexible risk assessment models." As Riding (1995) pointed out, there is some evidence of credit rationing due to lenders' *inability* to assess risk. For any pricing-to-risk based system to have credibility with borrowers, actuarially reliable data would have to exist attesting to risk-over-time - and it is the kind of data that Parliament would, no doubt, want to monitor quite assiduously.

Lenders raised other considerations. With some systems work, they believe that price-to-risk could be instituted, but they felt it would be excessively complicated for risk to be adjusted (and

the premium likewise) *over the term of the loan*. Quite understandably, lenders felt that pricing-to-risk would require an up-front declaration by government in favour of a balanced portfolio (i.e., some diminution of pressure for ever-greater 'incrementality'). Unless SBLA (or equivalent) loans were to be issued under the model *only to the riskiest of borrowers* (with an attendantly higher default rate), then government would have to be openly tolerant of the many *low-risk* loans made under such a system (in the interests of ensuring a balanced portfolio).

Queasiness about pricing-to-risk extends to government. At least one regional agency was extremely concerned that the concept, if embraced, could institutionalize regionally-differentiated pricing for small business loans.

The particular criticisms and concerns raised over pricing-to-risk engender a conclusion that, at least insofar as the *current* SBLA function and portfolio is concerned, pricing-to-risk appears too radical to be acceptable. Combine concerns over its implementation with considerable reluctance to contemplate an increase (or elimination) of the current interest rate cap (the capacity to price at rates higher than prime + 3% probably being integral to any successful application of pricing-to-risk), and there are even more reasons to doubt its viability. Pricing-to-risk, as suggested above, could be very seriously considered in conjunction with either new loan guarantee programs targeted at 'new economy' sectors, or with the creation of the distinct components of the SBLA so-targeted. To totally dismiss the concept is probably to rule-out loan guarantees for working capital or for 'new economy' firms.

3.7 'Targeting'

Many interviews stated preferences for a better 'targeted' SBLA program. Their argument, essentially, was that if an SBLA were created today, it would be structured so as to contribute to the government's "jobs and growth" agenda. Indeed, the OECD (1995, Overview of SME Financing...) recommended that: "particular focus should be directed toward SMEs with high growth potential and good managerial ability, versus those with low growth potential, in order to support an ensure future employment growth." Arguably, new equipment (almost 74% of SBLA loans in 1993-94 financed equipment purchases) is not necessarily the optimum path to promote job creation. Hence suggestions that SBLA "focus" or "target" knowledge-based, high-tech/R&D industries that, for some, promise more rapid economic growth. Others advocate reinforcing the successes of our export sector, by adapting the SBLA to better suit its needs. Some supporters of such targeting felt it could be done regionally, without trying to superimpose priorities upon vastly different parts of the country. Others thought that gearing the SBLA toward start-ups, whatever the sector of their operation, would be both more consistent with the historic objectives of the program and would make the greatest contribution to filling a market gap. While few volunteered it as their first choice, most worked themselves towards endorsing the status quo - without targeting - usually for highly practical reasons.

Unsurprisingly, lenders were most skeptical of the whole notion of targeting - principally due to the administrative complexity which targeting would, almost certainly, introduce to the SBLA. Some opposition was expressed to the whole notion of *dirigisme* of that sort ("the data don't exist"; "who would decide"; "aren't we trying to persuade Moscow that it didn't work"...)

3.7.1 Definitional Problems

Assuming policy makers were able to get past the philosophical debate over "whether or not government should be in the business of 'picking winners'", huge definitional problems would remain. How do you determine *which* firms need targeting - and once the choice is made, how do you ensure that it remains relevant? One (skeptical) interviewee said, "in order to justify creating a *new entitlement*, you need to argue that the targeted sector disproportionately benefits the economy. And once entitlements are created, they tend to be static - even as the circumstances which gave rise to their selection in the first place change."

In every case, leaders emphasized definitional problems - and expressed a preference for "letting the market decide." Some felt that the only way to target high-tech companies, for example, (short of guaranteeing working capital), would be to eliminate the prime + 3% interest rate cap - claiming that for high-tech growth industries, price was far less important than having access to capital, something that the SBLA could help routinize. Given borrowers' phobia towards raising the cap (a fear that the price of *all* SBLA lending will jump), the definitional issue really does become paramount. The only concrete suggestion was for two-tiered SBLA interest rates, with the higher tier applying *only* to companies seeking financing for "large soft-asset components (like software, research or management)". Two-tiered interest rates might be acceptable to lenders, inasmuch as the higher rate for 'soft asset' financing would compensate lenders for the significantly greater costs they face in providing due diligence. While lenders do not generally regard higher interest rates as adequate compensation for higher risk ('if the loan is likely to default, prime plus 10% isn't enough to make it affordable for us), they would unquestionably be more attracted to two-tiered interest rates than they would be to two-tiered premiums (if it's the government that receives the higher premiums). However, given the greater risk which lenders and the taxpayer alike would be certain to bear, it would only be realistic to attach a higher premium to the higher interest rate. It would soon become evident whether a market exists for this kind of financing, given that the *cheapest* such loan including a higher premium, would likely be priced at prime + 6%. If no market materializes, the 'new economy tier' could be eliminated without impact on the SBLA's nucleus.

3.7.2 Knowledge-Based Small Businesses

Virtually all stakeholders agree that, by virtue of its statutory concentration on fixed-asset financing, the SBLA has not been terribly applicable to the principal needs of 'new economy' knowledge-based industries. Those needs are generally regarded as being truly different from those faced by more traditional firms. Storey (1995) described "The 'Special Case' of New Technology-Based Firms". The Government of Australia (1995) found that "in lending, banks rely heavily on security and are not expert in assessing the potential cash flows of non-traditional, highly innovative SMEs." Beyond acknowledging the differences, however, many feel it would be counter-productive to try to adapt the SBLA (viz., "you either have the SBLA cover working capital, or you forget about it.") Many of these people point to an improving marketplace for knowledge-based firms seeking financing, with more and more lenders creating focussed programs of their own (either on their own or, as in the case of a recently announced Royal Bank-BDC program being tested in southern Ontario, in collaboration with other arms of government).

The Government's new science policy, issued on March 12, 1996, did not focus on the *financing* needs of knowledge-based industries. Nonetheless, the declaration to the effect that "the federal government must respond to the challenges of the knowledge-based economy by becoming a more effective partner in the innovative system", presumably reflects a government priority to assist the sector where possible. A deeper examination of how government-guaranteed financing could be rendered more attuned to knowledge-based industry needs, would be consistent with other declared policy priorities.

The Standing Committee on Industry is set to embark on an examination of 'new economy' industries, apparently based on a view that "there's been a substantial failure on the banks' part to reach out." The Committee could be encouraged to probe for more specific reaction (from lenders and borrowers alike) to several SBLA-related options for targeting knowledge-based industries:

a) a two-tiered structure, whereby lenders would be permitted to charge a higher interest rate - and higher premiums - on SBLA-guaranteed loans covering "soft assets" (changes would be needed to the SBL Act, and some considerable study would be required of the probable default rate, and its likely impact on cost recovery);

b) a soft-asset financing guarantee program *completely separate and apart* from the existing SBLA (really just a variation of (a), structured that way so as to not an any way risk the integrity of the existing program);

c) expanding the SBLA (or creating an SBLA-equivalent) to guarantee loans for *working capital*;

d) converting the SBLA into a 'Credit Insurance Crown Corporation', which would ensure, on a price-to-risk basis, the kind of financing sought by knowledge-based companies (as well as many other types of coverage not currently available to small businesses at affordable prices);

e) making no changes to the SBLA - but instead examining how other government programs could be adapted to meet the particular needs of knowledge-based companies;

f) making no change to government programs, but exhorting lenders to do more, and promising to monitor - and publicize - their activities in that regard.

3.7.3 Small Exporting Businesses

Small exporters face problems akin to those confronting knowledge-based firms. Many of the burdens they must bear are, in effect, working capital costs. For example, they invariably have to carry full costs through the (often lengthy) transportation period. Increasingly, even small firms are having to compete on payment terms (delaying payment for 60, 90 - even 180 days after delivery) in order to win export contracts. Service exports are growing far more rapidly than merchandise exports - and a fixed-asset loan guarantee program is of minimal relevance to

service industries. Also, just as lenders have trouble in assessing the risks of lending to firms with only (or disproportionately) 'soft assets', they are generally incapable of assessing 'buyer risk' (when the buyer might be across an ocean).

In the traditional view, a loan guarantee program targeted at small firms will *not* have a large impact on export industries. According to a 'longitudinal view', however, it could allow small 'potentially-exporting firms' to achieve the necessary 'first level of growth'. The point is that if Canada fails to encourage such firms while other countries are, we pay a price in competitiveness. It bears emphasis, however, that *none* of our competitors' small business financing programs are *targeted* at small exporters (or, for that matter, at knowledge-based industries either), and none are industry specific. The U.S. SBA 7(a) program *permits* the guaranteeing of export loans (providing they are secured, and with an additional fee).

A large proportion of respondents felt that government programs other than the SBLA are best suited to assist the peculiar problems faced by small exporters. The new EDC MARG program could, for example, be broadened to guarantee receivables on a *pre-shipment* basis. Perhaps the EDC (whose speciality is knowledge about *buyer risk* - not something either the Industry Department of Canadian lenders are expected to know much about) should be encouraged to structure other programs to meet identified market gaps. In the U.S., the EXIMBANK administers a 'Working Capital Guarantee Program' targeted at exporters (although not exclusively at small exporters). Notably, it is for the EXIMBANK to determine that the exporter is creditworthy - thus necessitating costly due diligence that perhaps compares to the high administrative overhead faced by CCC's PPP program.

Expansion of the SBLA to include working capital would, obviously, go a long way toward addressing exporters' needs. So might the conversion of the SBLA into a Credit Insurance Crown Corporation. Indeed, in that scenario, several of the risks confronting exporters could potentially be insured on a price-to-risk basis. Short of those alternatives, however, there is neither much call nor much evident scope to massage the SBLA into a program especially suitable for exporters.

3.7.4 Start-Ups

More than for knowledge-based or exporting firms, there was unflagging support among interviewees for continued (and perhaps even enhanced) targeting at the SBLA to start-up (or at least very young) small businesses. The Small Business Working Committee (1994) had identified a particular credit gap among small and micro businesses that require less than $100k. Many respondents highlighted the difficulties which micro businesses suffer in securing financing. One regional agency went so far as to comment that while "the banks hate micro-lending, perhaps under the SBLA they should be required to do more of it. That is their social obligation."

One 'new economy' focus of those emphasizing the importance of micro-lending concerns the emergence of small consulting and other out-of-the-home businesses, often employing only the principal and perhaps one other person. Some forecasters anticipate rapid employment growth in

this ‘sector’ (not necessarily as great as in the knowledge-based sector generally, but still very significant). Concurring, some interviewees lamented that the SBLA today is not ideally structured to assist in the development of this kind of activity. The expansion of the SBLA to cover capital leasing (or the creation of a parallel program for the purpose) might offer some relief but, realistically, it is probably only the creation of a much more encompassing ‘Business Implementation Insurance’ scheme (as outlined in the section titled a *New (Credit Insurance) Crown Corporation*) that could be expected to significantly help ‘new economy micro-businesses’ with their true needs.

Start-ups routinely receive between 35% and 40% of all SBLA loans (36% in 1994-95). Add to that the 20% of firms one-two-or-three years old that enjoy SBLA guarantees, and it becomes clear that new or fledgling firms consistently receive more than half of SBLA lending (by number of loans guaranteed). As ESBO DG Sagar told the Industry Committee (Oct. 19, 1995) “the bias in the SBLA is toward younger firms. But we would never want to limit the program only to those younger firms.” ‘Ranking’ Reform M.P. Schmidt responded: “I wouldn’t either - not at all.”

The U.S. SBA 7(a) program does set-out to offer particular encouragement to smaller borrowers. Loans of under $100k are guaranteed at a higher rate than those over $100k - and lenders are allowed to charge higher interest on smaller loans (recognizing that lender distaste for smaller loans - given their disproportionate administrative costs - is so great that only with such an incentive will many small loans take place).

Two ‘targeting’ options, both features of the U.K. loan guarantee program, were somewhat embraced by Riding (1995), and are relevant to this discussion. The U.K. program ‘favours’ new firms by making benefits to established firms less attractive. Additionally, the U.K. program stipulates that an individual can access a loan guarantee up-to the maximum *only once*.

Aside from a small minority of respondents who would target the SBLA *exclusively* on start-ups, it became apparent in the course of interviewing that emphasis on start-ups was most frequently advanced as a *caution* against the SBLA losing sight of its original mandate. Obviously, there are start-up knowledge-based and exporting firms, just as there are start-up restaurants. A majority of stakeholders, however, while superficially drawn to the notion of greater targeting on ‘new economy’ industries, found themselves coming around to an emphasis on “loans of under $100k”. It became evident that however pronounced the ‘new gaps’ are, most of those intimately familiar with the SBLA believe that its basic mandate remains fully valid.

The Government of Australia’s 1995 publication *Financing Growth* might also illuminate some Canadian realities. That study found that “only approximately 10% of Australian SMEs aspire to significant growth, and only 20-30% *of those* are willing to take external equity.” If Canadian SME characteristics are even remotely comparable, then the beneficiaries of an SLBA targeted at high-growth firms would prove to be a very small minority of companies indeed, with the vast majority of previously eligible businesses going without guarantees (all of this presupposes that *targeting* inherently means the introduction of requirements - either statutorily or by regulation - or the establishment of quotas or voluntary thresholds or some other devices designed to ensure

that a higher proportion of SBLA-guaranteed lending goes to *targeted* sectors - with the corollary being that not only proportionately fewer - but probably absolutely fewer - guarantees are available to non-targeted sectors. In the alternative, of course, the SBLA lending ceilings could be significantly raised, with the desired effect being *proportionately less lending* to traditional sectors, but with those sectors enjoying absolutely at least as *much* guaranteed lending as they do today).

3.7.5 Targeting by Region

One possibility which emerged part way through stakeholder consultations was that *if* the SBLA were to be targeted, such targeting need not be nation-wide, but could be regionally differentiated. Two of the Regional Agencies keenly embraced the notion, arguing that efforts to reach agreement nationally on which sectors should be targeted would probably be doomed to failure - and that, in any event, priorities-by-region have already largely emerged, and could be dovetailed nicely with a targeted SBLA. At least one lender enthusiastically agreed. Clearly, it's a big country, with often highly regionally-differentiated small business sectors. It might make a great deal of sense, if the SBLA is going to move from a 'one-size-fits-all' approach to a targeted one, to move more in the direction of "different loan guarantee programs by region." One potential risk: elimination of elements of cross-subsidization inherent to the existing program. It is worth bearing in mind that while none of our international competitors has targeted by sector, some have introduced lower fees for depressed regions, thus entrenching cross-subsidization.

3.7.6 Other Considerations

One consideration mitigating target is the overwhelming desire, shared (and emphasized) by virtually all stakeholders, for maximum SBLA simplicity and continuity. Many lender outlets write only a few SBLA-guaranteed loans per year, and the introduction of complex new rules, it is asserted, might cause many branches to simply 'withdraw from the business' (a concern somewhat belied by the fact that the 1993 changes, collectively, were more profound than any previously made to the SBLA program, with ensuing lending levels eclipsing those of any previous years). Nonetheless, given the lengths to which even borrowers went to make the point, it should be borne very much in mind that targeting, almost certainly, would complicate the rules and increase prospects for confusion and misunderstanding.

Finally, there is the issue of 'statistics'. Within months, it is hoped that SBLA-'partners' will have a much clearer sense of existing propensities to default (under the program as currently structured). Hypothetically, decisions could ensure to 'de-select' currently-eligible sectors; to alter maximum loan size rules, or whatever (although there is considerable lender skepticism that political leaders would ever 'discriminate' in this way). Such changes would be tantamount to 'targeting', albeit perhaps of a more negatively-motivated sort. At base, no 'positively-motivated' targeting decisions should be firmly taken until decision-makers enjoy a firmer understanding of the risk characteristics of the SBLA as it is currently structured.

3.8 Working Capital

On no issue tested with stakeholders was opposition more vehemently expressed or support more tentatively advanced than for the idea of expanding the SBLA to cover working capital. Most officials were derisively dismissive, citing the fact that "this was studied to death in 1993", with the conclusion at that time (that working capital should not be included within the SBLA) deemed still appropriate.

Industry Canada itself asserts that one principle undergirding the 1993 changes was: "to maintain the program as a fixed asset financing vehicle but at the same time seeking program changes which would help businesses maintain their working capital." That assertion implicitly recognizes two facts: the fungibility of capital, and the existence of a 'working capital gap' facing small businesses.

Opposition to including working capital within the realm of the SBLA has traditionally centred on risk (by definition, higher than for fixed-asset financing, where the assets serve as collateral), and on the high administrative costs of providing 'due diligence' on working capital loans. For the latter reason, it has conventionally been assumed that "it is those whose capital is at risk who should monitor working capital loans." By logical extension, since the taxpayer's money would be put at risk, the government could only comfortably expand the SBLA to include working capital if it were prepared to significantly increase the bureaucratic resources allocated to the SBLA program. Even with cost recovery (which, of course, does *not* currently apply to the administrative costs of operating the SBLA program), the extent to which, downsizing has now gripped government almost ensures that finding the necessary bureaucratic resources could not be rationalized.

And yet, the working capital 'gap' is recognized by almost all respondents as being just as large today as it was in 1993. In fact, as the proportion of GDP represented by knowledge-based, service-providing and exporting industries continues to increase, it is almost universally recognized that working capital needs are growing relative to fixed-asset financing needs, and are likely to continue to do so.

Attempts are certainly being made elsewhere in government to narrow the gap. The BDC's "Working for Growth" program has now issued hundreds of working capital 'top-up' loans. Some regional agency programming does cover working capital needs (at admittedly high administrative cost to the agencies). The "Master Accounts Receivable Guarantee" program recently launched (but not yet taken-up to any significant extent) by the EDC covers certain export-related working capital needs of exporters. The CCC's Progress Payment Program helps meet working capital needs for specialized exporters - again at extremely high administrative cost. B.C. Trade and Quebec's SDI both cover working capital for exporters. In short, a case could be made (and was by some respondents) that it would be duplicative and confusing for the SBLA to embrace working capital (especially if targeted on exporters) and that, in any event, not every government program should strive to meet every need - for fear of losing coherence (and sight of its original objectives) along the way.

The flip side of the argument is that government programs, to continue to survive, have to be relevant - and if the biggest gap facing small businesses is working capital (with only a minuscule proportion of that gap being fulfilled by existing government programs), then it defies logic for the government's principal program targeted at helping small businesses access financing to expressly exclude that gaping need.

For some, it is sufficient that because the loan guarantee program of our American competitors guarantees working capital, so should Canada's. Working capital is indeed eligible under SBA program 7(a) (the major U.S. small business loan guarantee program), with maximum maturities for working capital loans set at seven years. Of course, as Riding (1995) points out, long-run default rates under the SBA program are estimated to range from 16.4% to 23.5% - fully three-to-four times greater than those under the Canadian SBLA. Of course, the U.S. SBA is not required to operate on a cost-recovery basis - which makes it possible to include more risky categories of guarantee without having to adjust fees to levels that would, effectively, kill the program. Those fundamentally different characteristics should be reflected upon in every instance where the SBA 'model' is cited in this Report.

In the section on 'Privatization' above, the 'capital gap' issue is dealt with and, via the presentation of anecdotal evidence, it is essentially concluded that the gap which the SBLA has traditionally found itself filling - smaller companies, perhaps particularly those outside of southern Ontario, requiring financing for capital assets - both remains today and is usefully addressed by the SBLA. In short, diminishing comparative relevance, given the capital needs of the 'new economy' does not negate the SBLA's utility. The working capital issue should not be seen in 'adapt or die' terms.

3.8.1 Alternatives

Alternatives to full SBLA embrasure of working capital were proposed and canvassed during consultations. SBLA-guarantee of working capital loans *only* for *established* companies (with liberalization of strictures against the taking of personal guarantees) was discussed, and was generally thought superior to unrestricted inclusion of working capital within the SBLA. Even contained in this way, however, respondents were convinced that the default rate would be driven above the current 5%, necessitating a decision on government's part as to how much additional liability it was willing to bear. Lenders were unanimous in their view that the current limitations on the taking of personal guarantees would have to be lifted (for working capital loans), or *no* such loans would be made, even with the benefit of a government guarantee.

Representatives of borrowers were loath to endorse the inclusion of working capital *within the current cost recovery parameters of the SBLA*. The issue here was *not* the additional *administrative* costs that associate with monitoring working capital loans. Rather, there was an overriding concern that the 'fundamentals' of the current program (fees and premiums; guarantee level; interest rate cap) would have to be adjusted *for all loans* made under the program so that cost recovery could be achieved once working capital loans were included. In short, current 'beneficiaries' of the program seem to rank preservation of the SBLA's 'fundamentals' (as they stand today) ahead of program expansion to include working capital.

One option advanced by a lender was to restrict SBLA-guarantees to working capital loans valued at no more than 10% of the fixed-asset loan extended by the lender and guaranteed by the SBLA. Other lenders pointed out, however, that this is the kind of feature increasingly being made available in the marketplace *absent* the benefit of an SBLA guarantee (one bank has introduced an overdraft protection program for those with term loans and without other lines of credit. The overdraft 'line' is set at a maximum of 10% of the value of the term loan, up-to $10k. This is *not* a guaranteed program. Personal guarantees are taken. It is priced at prime + 5%, and the take-up rate is said to be impressive). It would not address an almost overriding concern among officials about 'incrementality' ("how could you ensure that the banks wouldn't simply 'column-shift' the working capital lines of credit they currently extend to the SBLA?"). Most importantly, it would do little to fill the existing gap. If a small high-tech firm needs $25k in working capital, it is not likely to want (or be able) to take out a $225k fixed-asset loan in order to be able to enjoy an SBLA-guarantee of the working capital portion.

One observation came up several times: the move on Jan. 1, 1996, to reduce 'guaranteeable'-portion of the capital being sought (to 90% from 100%) had the corollary effect of increasing by 10% the equity which a borrower must put forward - thus reducing funds (for security) available to the borrower for working capital purposes. While all respondents understood the reasons for which this change was made, it was felt that *further reductions* would be inconsistent with a declared government interest in fostering the availability of working capital.

The consensus view among those not completely hostile to government guarantees of working capital loans was that a guarantee program separate and distinct from the SBLA should be created for the purpose. Such a program, it was felt, should be structured so as to achieve full cost recovery. There should be *no cross-subsidization* between loans guaranteed under that program and the current SBLA. The parameters could be entirely different: pricing according to risk; a higher (or no) interest rate cap; fees and premiums calibrated to achieve cost recovery; different rules for personal guarantees. In this fashion, the risk of 'adulterating' the current SBLA would be eliminated, and it would be evident, presumably in reasonably short order, whether the 'working capital market gap' is, in fact, addressable via a government guarantee program run on a cost recovery basis. If take-up was insignificant, government could either eliminate the program (leaving the original SBLA intact), or confront the issue of whether a public subsidy was necessary, appropriate and affordable. The 'Working Capital Loan Guarantee' could take the form either of a self-standing program, as discussed above in the section on a 'New (Credit Insurance) Crown Corporation', or be folded into a more ambitious effort on government's part to meet numerous of the gaps not currently covered by the SBLA.

4.0 FUTURE RESEARCH

This Report is replete with proposals both for alternative administrative structures and for different policy emphases for the SBLA. While forthcoming with opinions, interviewees perpetually underscored the extent to which their preferences exist in a statistical vacuum. By far, then, the greatest need for 'future research' relates to statistical analyses (usually on probable impacts on the default rate and on cost recovery) of many of the options canvassed with (often suggested by) respondents. Some of the data will be available as a result of the statistical

exercise currently underway; some might be available in the form of 'best estimates' from lenders; and some may not exist at all.

Specifically, the following have been identified as requiring additional information (after having been embraced – as hypotheticals – by significant numbers of respondents):

- the effects on cost recovery and incrementality of reducing fees or premiums on those loans guaranteed by "better" lenders (or raising them on "poorer" lenders);
- the probable effects on lending volume of expanding the SBLA to include capital leasing;
- the impact on cost recovery of calibrating fees or premiums to differentiate levels of equity 'participation' by the borrower;
- the impact on cost recovery of borrowers being able to substitute larger personal guarantees for any equity participation whatsoever;
- the impacts of lower fees or premiums in exchange for higher personal guarantees;
- the effects of calibrating fees or premiums to: loan size; firm size; or category/type of loan (i.e., differential fees/premiums according to actuarial risk of default);
- the impacts of setting different maximum firm sizes by sector (according to actuarial risk of default);
- the impact on incrementality, the default rate and cost recovery of a two-tiered structure whereby a higher maximum interest rate could be charged (with higher fees being levied) on loans taken for 'soft asset' (software, research or management) purposes;
- the propensity to default of the second (and subsequent) SBLA loans relative to the first (taken by any one individual) - with an eye to testing the probable effects of a U.K.-type 'one-time only' structure;
- the effects on cost recovery of a higher guarantee (perhaps 95% – or even 100%) on *smaller* loans (as a means of encouraging more lending to micro businesses);
- the probable effects on the default rate of working capital loans being extendible under the SBLA *only* to established companies (with a provision for taking higher personal guarantees).

Additionally, it is proposed that further analysis (statistical and otherwise) be embarked upon of:

- the cost effectiveness of the SBLA re-insuring lenders (against 85% of losses, for example, for which a 5% premium would be paid to the SBLA);
- the possibility of launching a 'Business Implementation Insurance' scheme – which would include assessing demand (for what range of services), risk to the taxpayer, and the potentiality of such services being offered in the private sector independent of a government initiative;
- the extent to which incremental lending might result from promoting the securitisation of SBLA-guaranteed loans;
- lender ability to deliver 'targeting' on a regional basis;
- whether Community Futures Offices would be interested in trading their public subsidy for the opportunity to issue SBLA-guaranteed loans.

Finally, it is recommended that the House of Commons' Standing Committee on Industry, in the

course of their upcoming focus on knowledge-based industries, be asked to probe for specific borrower and lender reaction to several SBLA-related options for targeting knowledge-based firms:

- a two-tiered structure;
- a soft-asset financing guarantee program completely separate and apart from the SBLA;
- expanding the SBLA (or creating a SBLA-equivalent program) to guarantee working capital loans;
- converting the SBLA into a Credit Insurance Crown Corporation (which could provide guarantees for soft-asset-based financing, or for working capital, on a price-to-risk basis);
- making no changes to the SBLA, but instead modifying the programs of other government agencies and departments to better meet the needs of the knowledge-based sector;
- of making no changes, but tightly monitoring lender activity – and publicizing the results.

5.0 Sources

5.1 Interviews – Private Sector

Bank of Montreal (2 representatives)
Bank of Nova Scotia
Canadian Bankers' Association (2 representatives)
Canadian Chamber of Commerce
Canadian Exporters' Association
Canadian Federation of Independent Business (3 representatives)
Canadian Finance & Leasing Association (3 representatives)
Canadian Manufacturers' Association
Canadian Organization of Small Businesses, Inc.
Credit Union Central of Canada (2 representatives)
Newcourt Credit Group (3 representatives)
Professor Allan Riding, School of Business, Carleton University
Royal Bank of Canada (2 representatives)
Small Business Development Association of Canada
Toronto-Dominion Bank (2 representatives)

5.2 Interviews – Public Sector

Atlantic Canada Opportunities Agency
Business Development Bank of Canada
Canada Mortgage & Housing Corporation
Department of Finance (4 officials)
Export Development Corporation of Canada (2 officials)
Federal Office of Regional Development (Quebec) (2 officials)
House of Commons, Canada (research staff to House Standing Committees on
Foreign Affairs and Industry)
Human Resources Development Canada (2 officials)
Industry Canada (10 current and former officials)
Treasury Board Secretariat
Western Economic Diversification

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