THE CURRENT MARKET

FOR

SMALL BUSINESS FINANCING

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EXECUTIVE SUMMARY

This study examines the debt financing market facing those businesses small enough to fit within the parameters of the *Small Business Loans Act*. It reviews the period since changes to the *SBLA* were effected in 1995. Its objective is to identify relevant 'gaps' in the financing market, and to assess whether the *SBLA* 'overlaps' other programs (public- or private-sector) designed to address those 'gaps'. The study arrives at its conclusions after reviewing survey data and analyses compiled and prepared both by *SBLA* 'stakeholders' and interested observers.

The SME debt financing market has experienced many recent innovations. For the most part, they partially respond to four previously identified 'gaps'. The most pervasive (and enduring) of those concerns SME need for working capital. Two 'sectors' have also received considerable attention: 'innovative' and exporting industries. A burgeoning leasing industry has offered SMEs a 'fixed assets' financing alternative.

The *SBLA* has proved its worth in responding to other pervasive 'gaps'. 'Smaller' firms (those needing term lending at the level of the *SBLA* loan average); 'younger' firms (in their first three years of operation); those in 'risky but not sexy' sectors - all would face a tighter financing market (regarding both availability and price) absent the *SBLA*. It is precisely the *SBLA*'s *non-targetted* nature that is its greatest virtue. Those small firms that do not fit a 'niche' are the mainstay of the Canadian economy. They need debt financing in order to grow. They must contend with market 'gaps' in securing that financing. The *SBLA* helps them meet their needs. Furthermore, it provides that help in a simple, non-bureaucratic fashion. Largely administered by third parties (the lenders), the *SBLA*'s other significant virtue is its flexibility.

Principally for 'cost' reasons, extremely few private sector initiatives have sought to ameliorate the financing gap with which 'smaller', 'younger', and 'mainstay sector' SMEs must deal. Most of the programmatic innovations of other federal agencies are tightly focussed - and thus do not 'overlap' the more 'sweeping' *SBLA*. Some (but not all) provincial governments have spawned programs accessible to "all sectors" - but none appears to deliver proportionately as much financing as the *SBLA* to 'smaller' or 'younger' businesses. Most utilize thoroughly different mechanisms to facilitate SME access to financing, and generally lack the *SBLA*'s essential simplicity.

To be sure, private sector lender provide more non-guaranteed credit (<$250k) than they do with the sponsorship of the *SBLA*. On its face, that could be described as 'overlap'. However, the *SBLA* neither wishes (nor can it afford) to become the sole bearer of the risk associated with SME debt financing under $250k. Accordingly, private sector efforts targetted at 'smaller' and 'younger' SMEs should be welcomed and encouraged - and in some respects, regarded as a product of stimulus provided by the *SBLA*.

The study's conclusions are straightforward. There *are* 'gaps' in the SME debt market. The *SBLA* addresses some (but not all) of them well. The preponderance of recent initiatives respond to those deficiencies which the *SBLA* is *least* suited to mitigate. Such 'overlap' as exists between *SBLA* and other lenders or guarantors is largely desirable - in the sense that the *SBLA* is designed to plug a 'gap', not to monopolize the (under $250k) SME debt financing market.

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INTRODUCTION

Since the last full renewal of the *Small Business Loans Act* (in 1995) there have been numerous developments in the financing market facing small businesses. *SBLA* 'stakeholders' (especially the CBA and the CFIB) have spawned a small literature describing the state of that market. Unsurprisingly, the various reports and surveys have sometimes yielded diametrically different conclusions - thus creating confusion for policy makers charged with recommending the form and substance of possible *SBLA* renewal legislation.

This study seeks to outline, as objectively as possible, the availability of financing to those small businesses seeking credit less than $250k (the ceiling for *SBLA*-guaranteed Business Improvement Loans). Its primary purpose is to discern both 'gaps' and 'overlap': 'gaps' in the financing market; 'overlap' (if any) between the *SBLA* (in its current provisions) and other providers of small business financing.[1] CBA, CFIB, and Conference Board studies will be analyzed in search of 'gaps'; Industry Canada's survey of lenders and public sector financing institutions is the principal source to be scrutinized in search of 'overlap'.

CHANGES SINCE 1995

The Conference Board (1997, I) asserts that "numerous changes and new initiatives have occurred in SME debt financing since 1995."[2] The most notable development (since 1994) was an increase in the relative market share (of SME business debt financing) of 'specialized finance companies' (to 15.6% from 8.9%). There were significant declines in the market shares of 'foreign banks' (to 2.8% from 5.1%), 'life insurers' (2.6% - from 3.7%), and 'Crown corporations' (to 5.2% from 6.6%), and proportionally a much smaller decline in the share held by 'Credit cooperatives' (14.6% - from 15.7%). Other sources of debt financing ('Trust and mortgage loan companies' and 'Credit cards') experienced even smaller changes (1997, 28). While still comparatively minuscule players in Canada, financial institutions engaging in the factoring of receivables are regarded by the Conference Board as representing a particularly promising innovation on the debt finance scene.

The period since the *SBLA* was last overhauled has coincided with significant growth in the Canadian economy.[3] According to the Conference Board, SME debt financing grew 20.2% between 1994 and 1996

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[1] Thompson Lightstone (1998, 25) defines a "gap" as "any factor or factors that restrict access to capital sources."

[2] The Board defines a 'SME' as "a corporation with fewer than 100 employees and a borrowing facility of less than $1 million." The maximum size of an *SBLA*-guaranteed loan, however, is only $250k. Furthermore, using the very informal '1-to-10' rule (borrowing capacity equaling 1/10th of annual sales) this definition of an SME includes companies twice as large as those eligible for the *SBLA* program (maximum annual revenues of $5 million). Similar definitions of SMEs are used by the CBA and the CFIB. Accordingly, while it is possible to use these studies in hypothesizing about the state of the financing market facing *just SBLA*-eligible SMEs, it is impossible to be precise in doing so.

[3] The economy emerged from recession in 1992, growing 0.9%. After strong increases in 1993 (2.5%) and 1994 (3.9%), growth leveled-off but remained positive in 1995 (2.2%) and 1996 (1.2%). It spiked to an estimated 3.8% in 1997.

(1997, 34) - significantly outpacing overall economic growth. While credit available from domestic banks (+ 24.7%) and Credit unions/caisses populaires (+16.5%) tracked the overall growth in the SME debt financing market, that issued by specialized finance companies grew 105.3%. This virtual doubling in the value of SME lease contracts is one product of increased penetration by Canadian Finance and Leasing Association (CFLA) members. That development, in turn, partially compensates for increased concentration in the SME financing sector brought about by consolidation in the trust and mortgage loan companies sector and by the 22% decline (over 10 years) in the number of foreign banks operating in Canada.

Real growth in the economy, in the opinion of Hendricks, Porter, et al (1988, 15), has disproportionately benefitted young firms. This conclusion conduces with that of Haines and Riding (1994, 5), who found that SMEs "are less able to cover additional financial leverage during recession" - an important consideration, given that SME cost structures "tend to reflect higher degrees of operating and financial leverage than do larger firms." Implicitly, SME demand for credit increased in the post-recession environment.[4] Better times have enhanced SME capacity to retain earnings.[5] They have also caused suppliers to more willingly extend credit to SMEs.[6]

Every bit as important to SMEs as sustained economic growth has been the sharp decline in the prime interest rate. As the table below shows, the prime has fallen *by four and one-half percent* since the second quarter of 1995. Even with recent increases, short-term rates remain more than 3 ½ percentage points *below* their early 1995 levels. Long-term rates have continued to ease, with the 10-year rate now down more than 4 percent since early 1995.

TABLE 1: CHANGE IN GDP/PRIME RATE

	'95Q2	**'95Q3**	**'95Q4**	**'96Q1**	**'96Q2**	**'96Q3**	**'96Q4**	**'97Q1**	**'97Q2**	**'97Q3**
Real GDP Growth	- 0.8%	0.6%	1.3%	0.6%	0.8%	4.1%	5.4%	4.1%	5.4%	4.1%
Prime Rate	9.25%	8.08%	7.75%	7.0%	6.5%	5.92%	4.73%	4.75%	4.75%	4.75%

The fall in short-term rates has been an important boon to small businesses.[7] On the aggregate of term loans under $250k, the CBA reports an interest rate range of prime+1%-to-prime+4%. Accordingly, SME

[4] The House of Commons Industry Committee, in its 1994 report *Taking Care of Small Business,* attributed to the CBA the argument that SME demand for credit "probably went down, since businesses did not have the cash flow or the accounts receivable to support the same credit as in good times" (17). The Committee observed, based on representations from constituents, that during the recession, small businesses "experienced increasing difficulty in obtaining finance for start-up, normal operations and expansion, while banks have been quick to close lines of credit, call in loans, or withdraw financing" (v).

[5] The Conference Board reports a significant increase in the degree to which retained earnings are identified by SMEs as a source of financing - compared to a marginal decrease in the identification of banks or other lending institutions (1997, 2). Retained earnings are described by Johnson et al as "the largest single source of financing" for "successful entrants" (1997, 36). Enhanced capacity to retain earnings also means that SMEs have been able to take fuller advantage of the tax code (see "Small business incentives need careful management," *Globe and Mail* 16March98, C7).

[6] Which, not surprisingly, has resulted in a significant increase in use of this source of financing (Conference Board 1997, 2).

[7] In their 1994 document *Growing Small Businesses*, Ministers Manley and Martin made two pertinent observations: first, that "most small businesses turn to debt financing at an early age"; second, that "banks are the main lenders, dealing with more than 80% of independent businesses in Canada" (18).

consumers who negotiated bank credit in the 1995-1997 period have obviously realized savings on interest costs (relative to what previously would have been the case). Of course, while a lower prime signifies *cost savings* for SMEs negotiating (or renegotiating) financing, it does not, by itself, necessarily signify easier *access* to credit. Smaller value loans are generally the least profitable ones offered by financial institutions - and lower interest rates potentially could serve as a *disincentive* to increased lending.[8]

The other major change since early 1995 has been to the *SBLA* itself. The application of cost recovery principles to the *SBLA* has contributed to a substantial fall-off in loans registered under the program. At $2 billion, *SBLA*-guaranteed lending in 1996-97 was off sharply from 1994-95 levels - but was not radically different from lending in either 1993-94 or 1995-96.[9] Notwithstanding the higher borrowing costs confronting *SBLA* users after April 1, 1995, more than 65,000 firms took advantage of the program in the two ensuing fiscal years.

GAPS

The *SBLA*'s existence is predicated on the view that there "are real impediments to business accessing small loans." It has become a virtual truism that smaller enterprises generally enjoy less ease of access to credit than do larger ones. Likewise, new entrants ('start-ups') and young firms have greater difficulty accessing capital than more established ones. In both cases, borrowers and lenders alike face a 'Catch-22'. Those seeking loans often would benefit enormously from the concerted application of an account managers' experience (in assessing risk and guidance in how to mitigate it). Due to the small sums being sought, however, the income stream for the lender is often insufficient to justify the expenditure of effort necessary to acquire an in-depth understanding of the subtleties of the enterprise. From a 'balance sheet' perspective, the temptation for lenders, in many cases, would be to refuse the loan. While the *SBLA* assumes the application of 'due diligence' by financial institutions, it cannot be denied that the guarantee often makes it possible for them to accept risk which they otherwise would be inclined to reject.[10]

Other 'gaps' relating to the *nature of the firm* are also conjectured.[11] Businesses in certain sectors are frequently regarded by lenders as more risky than those in other sectors. Such distinctions are further affected

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[8] In *Taking Care of Small Business*, the Commons' Industry Committee asserted that banks lose money on their smallest loans, thus limiting their appetite for such lending (v). The government itself has concluded that access to sums less than $55,000 is "acute" because, below that threshold, loans are often "deemed too small to justify the administrative costs" (Industry Canada *Presentation to the Public Accounts Committee* 2/98, 7).

[9] The 1994-95 'spike' in lending is easily accounted-for. First, by April 1, 1994, borrowers had become more familiar with the significant easing of program requirements that had taken effect one year earlier. Second, toward the end of the fiscal year, small businesses became aware of the impending tightening of the program. Both factors contributed to a surge in borrowing in 1994-95.

[10] Thus giving rise to the notion of 'incrementality' - the idea that the *SBLA* facilitates lending that otherwise would not take place. Examination of the pre-1995 *SBLA* program by Haines and Riding (among others) suggests that at least one-third of the guaranteed loans were genuinely incremental. Greater incrementality, of course, compromises cost recovery by making the overall portfolio riskier. Changes to the *SBLA*'s parameters effected in 1995, due to adverse selection, may have *enhanced* incrementality (with only more 'marginal' borrowers willing to pay the new 1.25% annual administration fee). Considering the high priority attached to incrementality by legislators - and to cost recovery by the government - while premature to judge fully the effects of the 1995 changes, it could well prove to the case that the *SBLA* is now better targetted (and more relevant) than ever before.

[11] While firms in the voluntary sector are considered by many to encounter a particularly severe financial market 'gap', this report confines its analysis to small businesses operating in the 'for-profit' sector.

by cyclical swings in the economy. Additionally, it has long been alleged that 'innovative' (often 'knowledge-based') small businesses, as well as those heavily focussed on exporting, face particular difficulty in accessing debt capital. In the former case, the 'soft' nature of the companies' assets allegedly makes it harder for lenders to assess risk. In the latter case, uncertainties associated with foreign markets (like currency fluctuations and the longer lag times traditionally associated with accounts receivable), complicate lenders' ascriptions of risk.

'Innovative' and exporting small businesses often need financing for purposes not covered by the *SBLA*. Costs associated with marketing are one such example. More generally, they - and most other small firms - are thought to suffer a 'working capital gap'. This 'gap' relates more to the nature of the *loan* than it does to the nature of the *firm.*

The *location* of the firm can, in particular economic circumstances, also constitute a 'gap'. Haines and Riding (1994, 47) found reductions in lending "have strong geographic propensities that seem to correlate with regional levels of economic prosperity." The *SBLA,* of course, seeks in part to compensate for localized recessions by pooling "risk from all regions, in all sectors of the economy, and over long periods of time."

Another 'gap' - perhaps the biggest of all - concerns the ability of small firms to obtain and build *equity* in their businesses. Studies have repeatedly concluded that the major reason for loan 'turndowns' is an inadequate debt-to-equity balance. The *SBLA'*s focus, of course, is *not* on facilitating small business access to equity investment. However, it proves frequently to be the case that would-be borrowers are rejected (for *SBLA*-guaranteed or other loans) because of the inadequacy of equity on their balance sheet. Debt capital is often a substitute for equity - but access to it can also be a function of equity. Accordingly, any examination of the state of the current market for small business financing should take at least a cursory look at what is happening on the equity front.

Other purported 'gaps' relate more to the nature of the *borrower* (than to the *firm*). Female business persons have sometimes been considered to face bigger hurdles in negotiating loans than their male counterparts. For complex legal reasons, the SBLA has not applied to on-reserve aboriginal businesses. Particularly young entrepreneurs (those just out of school) also often encounter disproportionate difficulty in accessing debt capital.

While not a 'gap' (in the same sense as in the preceding paragraphs), some analysts assert that small businesses encounter particular hurdles in dealing with lending institutions. Small firms ostensibly suffer greater account manager 'turnover' than their larger counterparts (due in part to concentration in the industry) - thus rendering their interaction with lenders less convenient, but also putting at risk their very ease of access to capital on a timely basis.

Drawing principally upon the CBA, CFIB, and Conference Board studies, this paper will now try to describe the current extent to which each of the alleged 'gaps' pertains.

A 'Smaller' Enterprises 'Gap'?

The 'book' on 'smaller' businesses is that, relative to their larger counterparts, they:

- have a higher risk profile[12], meaning that they:

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[12] Several factors account for this: earnings are frequently more volatile; proportionately higher debt loads can increase their vulnerability to changes in the economy; their management is often less experienced. Johnson, Baldwin and Hinchley's examination of '*Successful Entrants*' also found small firms to be only half as likely (as larger firms) to have a business plan, and only one-third as likely to have a written

- face higher turndown rates (which are exacerbated during downturns in the economy); and
- are asked by lenders for disproportionately greater collateral;
- rely on fewer types of financing (notably retained earnings and bank credit).[13]

This composite (of small businesses) is not new. Neither does it substantially change over time. The Small Business Working Committee had no hesitation in asserting: “There is a small business lending gap, particularly for small and micro-businesses that require loans of less than $100,000, that is not being adequately filled by institutional lenders” (1994, 18).[14] Acceptance of this ‘reality’ has given rise in many OECD countries to loan guarantee programs - “the primary objective of all (of which) is to redress a perceived flaw in the credit market” (Riding 1995, e.s.).

Hendricks et al recently challenged the ‘composite’s’ precepts, arguing that: “There is no evidence to support the hypothesis that small firms are financially more constrained than large firms” (1998, 18). To the extent, however, that ‘financial constraint’ is a contributing factor to bankruptcy, the evidence seems to be pretty overwhelming. Baldwin et al (1997, 21) note that “failure is almost entirely confined to the small-firm sector.” They find proof in the fact that 80.5% of firms have between zero and nine employees at the time of bankruptcy. While concluding that “the main reason for failure is inexperienced management,” Baldwin and his colleagues identified a “second key deficiency occur(ring) in the area of financial management.” Three problems were identified - all of which, classically, are common to smaller businesses:

- unbalanced capital structure;
- inability to manage working capital;
- undercapitalization.

The banking industry’s loan loss provisions underscore the particular vulnerability of smaller firms. The percentages of outstanding credit and numbers of customers in Table 2 very closely track the true ‘shares’ associated with each authorization level. The loan loss provisions, on the other hand, reveal much smaller-than-proportionate loss ‘shares’ for loans in excess of $1 million, and much higher-than proportionate loss ‘shares’ for loans from $250k to $999k (170% of outstandings) - especially for loans less than $250k (219% of outstandings).

TABLE 2: BANKS’ LOAN LOSS PROVISIONS (for 12 months ended October 31, 1996)

Authorization Levels	Provisions (as % of Canadian total)	Outstandings (as % of Canadian total)	No. of Customers (as % of Canadian total)
$0 - $ 249,999.	28.0	12.8	86.0
$250,000. - $ 999,000.	22.8	13.4	8.75

financial plan (1997, 34).

[13] Johnson et al also observe that “nearly three quarters of larger firms have multiple types of financing, compared to less than half of smaller firms” (10). Because smaller firms “draw their resources from fewer areas (they) have to depend more on those sources.” Hogg et al similarly conclude that smaller firms are more reliant on bank lending - and that they depend to a greater extent on retained earnings (*Tax Effects*, 3). Baldwin et al (*Strategies for Success*, 70) disparage reliance on retained earnings as inadequate to sufficiently finance market-share expansion or to produce improvements in profitability. At the same time, they favourably cite D’Ambroise’s caution that small firms’ “problems stem not so much from capital cost and capital availability as from an undue reliance on debt (27).

[14] The committee also bluntly declared that: “Not everyone who wants financing should necessarily get it” (17).

$1 million & over	50	73.8	5.6

Source: Canadian Bankers Association. 1996. *Business Credit to Small, Medium and Large Customers: Specific Provisions on the Canadian Portfolio* (seven banks). Does not add to 100% due to rounding

It must be stressed that disproportionate loan losses and exceptionally high rates of bankruptcy do not, by themselves, make the case that small businesses face a financing gap. Representatives of major banks appearing before the Commons' Industry Committee in 1995 insisted that no gap exists. Indeed, they asserted "an abundant supply of credit." The sizable difference between authorized and outstanding credit was cited as proof that "there isn't an insatiable demand out there." However, charges continue to be leveled to the effect that small businesses have less access to capital and must pay a premium for it.

In 1998, the CFIB reported that: "29 percent of business owners in 1997 said that availability of credit is among their most serious business concerns" (1).[15] According to the CFIB, evidence of "underlying lending problems" confronting small businesses is found in the fact that "fewer businesses are applying for loans." While the economy has experienced steady growth, only 61% of the 1997 respondents had applied for financing during the previous three-year period (compared to 66% in 1994 and 73% in 1987). Turndowns of *formal loan requests* have increased to 11.3% (from 9.3%) in 1987 - with the greatest increases suffered by firms employing 0-4 and 5-19 persons. The CFIB insists that closer to 30% of SMEs are "under-financed."[16]

The CFIB's 1998 report also makes the claim that the smallest businesses (those with fewer than five employees) pay an interest rate 'premium' amounting to nearly 1.5% more than the rate paid by firms with more than 100 employees. The impact of that differential is contained, however, given another CFIB finding: that "very few loans are priced higher than 2 points over the prime rate" (1998, 7).

While asserting that "bank collateral demands appear to have fallen off significantly since 1994," the CFIB study does note that firms seeking smaller loans, as well as those with the least "perceived equity" in their businesses, faced disproportionate demands for collateral.

The banking industry commissioned its own survey of small and medium-sized businesses.[17] That study takes dead aim at the allegation that a "lending problem" explains why "fewer businesses are applying for loans." The survey found that 80% of those *not* approaching financial institutions for credit cite a "lack of need" - compared to only 6% who feared being turned down.[18] The highest incidence of those *never previously seeking financing* (cumulatively one-third of respondents) does include, however, those in the smallest sales category (<$250k).

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[15] Compared to 35% in 1994 (but less than 20% in 1987).

[16] This figure is arrived-at by including loan approvals for sums less than amounts sought; demands which businesses themselves reduced (upon receiving signals that their requests might not be approved); and "non-applicants who nonetheless needed financing" - but who refrained from applying out of a conviction that they would be rejected. The Federation's 1997 *Report Card on Small Business Financing* found that while 55% of firms with more than 100 employees gave their bank "a good rating" on "willingness to lend," only 32% of firms with fewer than 5 employees shared that outlook.

[17] Conducted in each of 1996 and 1997 by Thompson Lightstone & Co. Ltd. (and referred-to throughout this report as the "CBA" study). Like the CFIB study, the CBA one includes companies much larger than those eligible for *SBLA*-guarantees - meaning that neither survey precisely describes the financing market facing Canada's smallest businesses.

[18] Thompson Lightstone's 1998 survey of Ontario small businesses (also undertaken for the CBA) ascertained that 51% of firms say they do *not need* additional financing over what they currently have (9). The earlier CBA study reported that 87% of small businesses have their loan requests approved (up from 84% in 1996 - and consistent with the CFIB's finding of 89.9%).

Differing methodologies employed by the CFIB and the CBA studies make exact comparisons difficult. For example, at 29.4%, "Availability of Financing" is *eighth* on the CFIB's October, 1997 survey of "Small Business Priorities" (the top six fell completely within the purview of government - and relate overwhelmingly to taxation; the seventh concerns the labour pool). The CBA study places "Obtaining Financing" *fourth* on the list of "Key Issues Affecting SMEs Today" (after "weak economy"; "profit/income"; and "taxes"). Both studies affirm the conclusion of earlier research to the effect that while availability of financing is a definite concern (and an important factor in the growth of small businesses), it is a 'middle ranking' rather than a 'top of mind' concern.[19] On the criterion "provides sufficient credit to meet needs," the CBA study reported only 18% of respondents as "dissatisfied" with the seven major banks.[20]

The CBA survey found that nearly two-thirds of respondents reported providing personal guarantees, assets or securities as collateral. Insufficient collateral was, however, the second-most identified criteria (by account managers) for loan turndowns - and was the "key reported difficulty" (by Ontario firms) in accessing capital. Smaller companies reported a greater incidence of demands for collateral. Those with fewer than five employees were faced with that demand 72% of the time (compared to the overall average of 65%); home-based companies (which tend to be the very smallest) were asked for collateral 77% of the time.

The two studies yield comparable conclusions concerning the smallest businesses (those with fewer than five employees). The CFIB observes that these businesses "have seen the credit shortage problem persist" (11), while the CBA study included that category of businesses in its listing of "those who may be looking for some improvements" (100).

The CBA-sponsored study observed that 78% of SMEs currently hold $200,000 or less in debt at financial institutions (38). The CFIB found that three-quarters of SMEs rely on credit financing from banks and other financial institutions (2). Considering the prominent role played by chartered banks on the Canadian lending scene, the CBA's *Business Credit Statistics* serve as useful guideposts in any effort to comprehend the debt financing market confronting small businesses over the period since the *SBLA* was last overhauled.

Those statistics confirm growth in authorized and outstanding credit *exceeding overall economic growth* at *each* lending level. The greatest growth in *authorized credit* was in the category exceeding $1 million. The greatest growth in *credit outstanding* came in the $250k-$999k category (although nearly identical growth was experienced in the $1 million+ grade). Growth in *number of customers* was highest in the 'middle level' (which still entirely fits within the most widely utilized definition of SME-borrowing). Growth in authorized and outstanding credit, as well as in number of customers, was most consistent (if also the most modest) in the 'under-$250,000. category'. Table 3 illustrates the fact that lending in the lower grade did not keep pace with that of the middle and upper grades - although only in the case of outstanding credit was there a significant decline in the category's proportionate 'share'.

TABLE 3: BANK CREDIT (all amounts - as at Second Quarter 1997[21]

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[19] Baldwin et al (*Strategies for Success*, 12) examined "factors contributing to SME growth." "Access to Capital" and "Cost of Capital" were ranked fifth and sixth.

[20] 54% were "satisfied"; 31% were "neutral" or had "no opinion" (99).

[21] The table constrasts statistics from the third quarter of 1995 [the first for which complete statistics were available for all of the (then-'Big Six') banks, with those from the second quarer of 1997 (the latest available at the time this report was being written) for the 'Big-Seven' banks.

Loan Level	Authorized Credit: C change from 1995 C 1997 share of total authorized credit C (1995 share of total authorized credit)	Outstanding Credit: C change from 1995 C 1997 share of total outstanding credit C (1995 share of total outstanding credit)	# of Customers: C change from 1995 C 1997 share of total # of customers C (1995 share of total # of customers)
< $250,000.	+ 13.4% 6.6% (7.0%)	+ 12.4% 12.4% (13.3%)	+ 14.1% 85.5% (85.6%)
$250k - $999,000.	+ 18.3% 7.2% (7.3%)	+ 23.0% 13.0% (12.9%)	+ 18.6% 9.9% (9.6%)
$1 million+	+ 21.6% 85.7% (86.2%)	+ 22.9% 74.6% (73.8%)	+ 9.0% 4.8% (4.6%)
Canadian total	+ 20.8%	+ 21.6%	+ 14.3%

Table 4 looks just at credit in the 'under-$250k category'. It shows that because the influx of customers borrowing less than $250,000 exceeded the overall growth in outstanding credit in that category, the amount of outstanding credit per borrower actually declined (although only marginally) from 1995 to 1997. Outstanding credit as a percentage of authorized credit remained virtually unchanged over the period - demonstrating that, as in 1995, there remains considerable theoretical scope for smaller borrowers to access additional credit.[22]

TABLE 4: BANK CREDIT <$250k (1995 and 1997)

	Outstanding Credit (million)	Number of Customers	Average Credit Outstanding	Authorized Credit (million)	Outstanding Credit as a % of Authorized Credit
1995 as at Q3	$19,937	566,921	$35,167	$28,371	70.27
1997 as at Q2	$22,635	647,090	$34,980	$32,177	70.35

Statistics aggregated from: CBA *Business Credit Statistics as at September 30, 1995* and CBA *Business Credit Statistics as at June 30, 1997.* Appendix One presents the same statistics by individual bank.[23]

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[22] Bankers appearing before the Commons' Industry Committee in 1995 cited this statistic as proof of the fact that there was no shortage of credit in the system.

[23] The performance of most banks individually (in the 'under $250k category') is consistent with the national average: the customer base increased significantly; outstanding credit less-so; average outstandings thus decreased (significantly in the case of National, Scotia, and TD banks; Montreal and CIBC posted marginal increases in average outstanding credit - in the latter case mostly due to a *decline* of 6.3% in the number of its customers in this category). The two most 'noteworthy' performances were by the National and Royal Banks. The National experienced virtually no gain in customers and, with a significant decrease in outstanding credit, experienced a precipitous fall in its share of total outstanding credit in this category. The Royal's performance, on the other hand, was strong across-the-board. It experienced the largest growth in customers; (by far) the largest increase in average outstanding credit; it was the only bank enjoying growth in its share of total outstanding credit (an impressive 27%); and along with the Bank of Montreal (whose increase was insignificant) and the CIBC, its outstanding credit as a

Since changes to the *SBLA* came into effect in 1995, there have been numerous initiatives and innovations in the small business lending sector. Indeed, while speculating that the *SBLA* changes would "result in a considerably diminished use of the program," bankers appearing before the Industry Committee in 1995 promised to amend their own loan programs "to ensure that small businesses do not suffer any diminished access to credit." That is exactly what they have done.

The bulk of the banks' initiatives are designed to meet small business' needs for *working capital* (and will be described below). At least two banks - CIBC and Montreal - introduced new, time-limited programs targetted at SME term credit needs.[24] The *Business Development Bank of Canada* (BDC) has spawned a 'Micro-Business Program' (in addition to its 'Term Loans') - and *Western Economic Diversification Canada* (WED) has introduced a micro-lending program in collaboration with the Vancouver City Savings Credit Union.[25] These - and other - innovations have added not insignificant sums to the small business financing market. Even more relevant (from the perspective of this analysis) is the fact that they represent lender efforts to facilitate borrowing of smaller sums (of the order normally sought by users of the *SBLA* guarantee). These initiatives are consistent with the growing banking propensity to target 'niches' in the credit marketplace.

Provincial governments have also utilized a variety of devices to promote improved access to capital on the part of smaller businesses, including direct loans, loan guarantees, and tax credits for lenders.[26] No figures are available on the amount of credit levered by the panoply of government programs seeking to enhance access to credit by the smallest category of businesses. Besides responding to a political imperative, their existence speaks to a perception on the part of governments not only that gaps exist in the marketplace, but that use of an array of tools is an appropriate public policy response.

A Young Firms 'Gap'?

'Start-Ups' and younger firms are generally considered the most vulnerable category of small businesses. Baldwin et al (1997, 21) found that 63.1% of bankrupt firms failed in the first five years of

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percentage of authorized credit grew over this period.

[24] CIBC funded a *Job Creation Loan Program* "available to any eligible small businesses that promises to create long-term sustainable employment." Loans from $15k to $100k at 1% *below* prime (for the first year) were available until the fund was depleted. BoM unveiled in March, 1997 a "$1 billion Commitment Program" ("new funds to SMEs") - offering loans of $10k-$250k at an interest rate for the first year of 4.9%. One month later, the BoM launched its *SOHO* ("small office/home office") program, offering these smallest of businesses "quick access to credit at low interest rates, without a formal business plan, and without any collateral." Wells-Fargo announced in June, 1997, its intention to offer unsecured loans up-to $100k. At the completion of 'Stage One' of its cross-border direct-mail 'lending experiment', the U.S. bank had made $50 million worth of loans ranging from $15k to $75k each.

[25] The BDC offers term finance up to $50k (for existing businesses; $25k for 'start-ups') for both fixed asset and working capital purposes. WED provides 'patient capital' (to a maximum of $15k/borrower, at a rate of prime + 4%.

[26] For example, Manitoba's *Rural Entrepreneur Assistance* program guarantees business loans (of ($10k to $100k) to full-time small and home-based businesses in rural Manitoba; New Brunswick offers loans to a maximum of $50k to start-ups (and $30k for expansions); Newfoundland provides small enterprise loans at preferred interest rates; Nova Scotia's *Community Business Loan Program* (a collaboration between N.S. EDT and the TD Bank) offers loans up to $50k ($10k for start-ups); Ontario's Ministry of Finance (via its *Small Business Investment Tax Credit for Financial Institutions*) offers a 75% credit for capital *investments* (of $50k or less in "smaller businesses"), and a 4% credit for *loans* of $50k or less to smaller businesses at interest rates less than prime. In March of 1998, pursuant to the Ontario tax credit initiative, Canada Trust Co. launched its first major foray into the <$250 SME loan market.

operation.[27] They cite the obvious - but important - fact that the management of younger firms is often inexperienced (36), and further observe that young firms are "more likely to rely heavily on a small number of sources of capital; in particular, retained earnings and personal funds" (21). Hendricks et al (1998, 18) insist that "young, incorporated firms should be the target group [of loan guarantee programs] (because) they appear to be financially more constrained than established firms."

The reasons for the 'financial constraint' confronting young firms - especially new entrants - are clear. The Canadian Council for Small Business and Entrepreneurship concluded that lenders "prefer clients with established track records" (1996, 22). The CBA study's finding that "recent start-ups" exhibit the highest incidence of *never having requested credit* from a financial institution, underscores the point that new entrepreneurs are fully aware of lenders' reluctance to extend credit to them (43).[28] At the same time, start-ups are more likely than other small businesses to *require* additional capital.[29]

Compounding this difficulty in attracting debt capital is the fact, noted by Johnson et al, that new businesses "will not yet have established either the earnings to reinvest in the company, or the earnings record that attracts outside equity" (1997, 41).[30] This 'Catch-22' explains the Canadian Chamber of Commerce's finding that 'love capital' represents "the largest single source of start-up financing" (House of Commons 1994, 60). That reality reflects the 'growth constraint' with which young enterprises must deal. As Baldwin et al found in their profile of 'Growing SMEs': "Moving to alternate sources of funds is associated with success" (1994, 70).

Recognition of the particular difficulties facing start-ups and young firms has been constant over time. Interviews of *SBLA* 'stakeholders' in 1996 yielded "widespread support for the notion that start-up firms and micro-businesses do face significant capital market gaps" (Norton, v). The view was expressed at hearings of the Industry Committee in 1995 that making the *SBLA* "more restrictive" would especially reduce start-ups' access to financing. Perhaps pursuant to that concern, lenders have increased the share of *SBLA* loans going to start-ups - to 39% in 1996-97.[31]

Clearly sensing the existence of a capital market gap, governments have taken additional steps to make credit somewhat more accessible to younger firms. ACOA's 'Seed Capital Program' makes unsecured, personal loans (to a maximum of $15k) available to start-up (or expanding) enterprises in Atlantic Canada. The

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[27] Riding, Haines and Thomas note that *SBLA* loans to "newer firms default more often" (Industry Canada *SBLA: Presentation to Public Accounts,* 35).

[28] Further confirmation of the point emerges from the finding that younger businesses report lower than average approval rates (Thompson Lightstone 1997, 82).

[29] At least in Ontario (Thompson Lightstone 1998, 99). The survey found that 65% of start-ups claim the need for more capital - and that young Ontario firms (average age: 3.7 years) would like an average of $70,300 in additional financing.

[30] The CLMPC, in their 1993 study *Access to Capital*, identified "new ventures and enterprises at an early stage of development" as "facing obstacles in securing investment capital" (9).

[31] As compared, for example, to 37% in 1992-93. Adding the shares going to firms in their first year (9.5%), second year (7.8%), and third year (6.3%), means that 62.8% of *SBLA* loans issued in 1996-97 were to firms in their third year of operation or younger (the comparable figure in 1992-93 was 56%).

BDC issued 14% of its term loans in fiscal year 1997 to start-ups.[32] Several provincial governments have also targetted programs at facilitating start-up firms' access to financing.[33]

Sectoral 'Gaps'?

The notion that small businesses might face differential access to capital depending upon the *sector* of their operations derives from the incontrovertible fact that some sectors are riskier than others. One argument raised at the Industry Committee's 1995 hearings in support of the *SBLA* was that the guarantee is important "in certain high risk sectors." Restaurants were specifically-cited on that occasion. It follows logically, therefore, that in 1996-97, businesses engaged in 'Accommodation, Food and Beverage' activities received, by far, the largest share of *SBLA* loans. Consistently, tourism businesses, part of the same sector, top the list of firms never having sought loans from a financial institution, and are disproportionately asked to provide collateral.[34]

Table 5, below, describes the differential performance of the Canadian economy over the 1995-1997 period according to sector. Reviewing sectoral differences in GDP growth and bankruptcies is one basis for an assessment of financing market responsiveness. Based on change in GDP, one might expect the greatest *growth* in outstanding credit over this period to have been registered by the following sectors: Business Services; Communications and Other Utilities; Construction; Finance & Insurance and Real Estate & Insurance; Manufacturing; Mining, Quarrying and Oil Wells; Wholesale Trade. Also according to GDP performance, *contractions* in outstanding credit might have been expected in these sectors: Agriculture & Related Services, Fishing & Trapping; Education Services; Health & Social Services; and Logging and Forestry.

On the 'bankruptcies indicator', the stellar performers from 1995-97 were the Construction, Finance & Insurance, and Real Estate & Insurance sectors. To a lesser extent, the Accommodation, Food & Beverage, Mining, Quarrying & Oil Wells, and Retail Trade sectors also exhibited some encouraging developments on the bankruptcy scene. The sectors experiencing the worst bankruptcy performance were Logging & Forestry, and Education Services.

GDP and Bankruptcies, obviously, are not the only indices of creditworthiness. However, combining the two suggests that, other factors being equal, the Construction, Finance/Real Estate & Insurance, and Mining, Quarrying and Oil Wells sectors might be expected to have enjoyed solid credit growth between 1995 and 1997, while the Education Services and Logging and Forestry sectors might have been expected to suffer credit contractions.

Table 5: GDP GROWTH/BANKRUPTCIES BY SECTOR (1995-1997)*

[32] Almost 17% of the total *value* of the BDC's term lending in fiscal 1997 went to start-ups. FY97 BDC lending to young firms was as follows: one year and less - 4% of borrowers (5% of value); 1.1 year - 2 years (3% of borrowers/2.5% of value); 2.1 - 3 years (4% of borrowers/3.7% of value).

[33] For example, Manitoba's 'Business Start Program' provides loans to a maximum of $10k to firms up-to 3 months old in any sector. New Brunswick's 'Self Start' offers loans guarantees (to a maximum of $10k for 3 years) for equity investments in "eligible new businesses." Ontario's 'Young Entrepreneurs Program' (in collaboration with the Royal Bank) makes loans up-to $7,500 to start-up entrepreneurs aged 18-29. PEI has also opted for loan guarantees - to a maximum of $25k (for 5 years) for new and expanding companies.

[34] See Thompson Lightstone (1997), pp. 43 & 62.

INDUSTRY	GROSS DOMESTIC PRODUCT (at factor cost) Change from previous year			COMMERCIAL BANKRUPTCIES Change from previous year		
	1995	**1996**	**1997**	**1995**	**1996**	**1997**
Accommodation, Food & Beverage	+ 0.9%	+ 0.5%	+ 4.6%	+ 17.7%	+ 4.7%	- 12.8%
Retail Trade	+ 0.6%	+ 0.6%	+ 5.2%	+ 4.8%	+ 5.7%	- 16.7%
Transportation & Storage	+ 1.7%	+ 0.3%	+ 4.9%	- 1.0%	+ 46.0%	+ 7.1%
Manufacturing	+ 4.9%	+ 0.9%	+ 6.2%	+ 0.7%	+ 10.8%	- 19.4%
Logging & Forestry	+ 4.1%	- 2.7%	- 4.2%	+ 24.3%	+ 38.0%	+ 36.2%
Construction	- 5.1%	+ 2.9%	+ 7.3%	+ 23.5%	- 8.4%	- 14.5%
Business Services	+ 8.7%	+ 6.8%	+ 8.6%	+ 16.4%	+ 18.0%	- 20.0%
Health & Social Services	+ 2.1%	- 0.5%	+ 0.7%	+ 5.2%	+ 11.9%	- 18.1%
Wholesale Trade	+ 2.4%	+ 3.5%	+ 10.8%	+ 12.4%	+ 11.3%	- 16.6%
Mining, Quarrying & Oil Wells	+ 4.0%	+ 3.0%	+ 3.8%	+ 104.2%	- 38.8%	+ 3.3%
Communications & Other Utilities	+ 3.2%	+ 7.3%	+ 3.4%	+ 64.9%	+ 3.9%	- 8.1%
Agriculture & Related Services, Fishing & Trapping	0	+ 3.9%	-0.5%	- 4.4%	+ 11.0%	- 24.4%
Education Services	+ 0.2%	0	- 0.6%	- 36.6%	+ 27.8%	+ 16.7%
Finance, Insurance & Real Estate	+ 0.8%	+ 2.4%	+ 2.6%	+ 6.5%	- 3.7%	- 32.6%
Other Services	+ 2.9%	+ 1.3%	+ 2.4%	+ 25.0%	+ 12.8%	+ 8.2%
All Industries	**+ 1.9%**	**+ 1.6%**	**+ 3.9%**	**+ 12.3%**	**+ 7.3%**	**- 14.3%**

* Calculated from Statistics Canada: *CANSIM Matrix 4677(GDP)* and *CANSIM Matrix 138 (Commercial Bankruptcies).*

Of those five sectors (three 'growing', two 'contracting'), the change in outstanding *bank* credit is consistent with expectations in only two cases: it did grow in Construction (by 7.0%) and in Finance/Real Estate & Insurance (by 15%). However, credit grew by *even greater amounts* in Education Services (by 19%) and Logging and Forestry (by 16%). Inexplicably, credit *contracted* in the Mining, Quarrying and Oil Wells (by 9%) sector.

Put differently (Table 6), consider three categories of *bank* credit 'growth' during this period of sustained (albeit in 1996 modest) growth in the Canadian economy: 1) where credit growth *did not keep pace* with the sector's performance; 2) where credit growth *exceeded* the sector's performance; and 3) where credit growth *significantly exceeded* the sector's performance.

Table 6: Sectoral Change in Outstanding Bank Credit, 1995-1997

Credit Growth Lagging Economic Growth (actual credit growth)	Credit Growth Exceeding Economic Growth (actual credit growth)	Credit Growth Significantly Exceeding Economic Growth (actual credit growth)

Business Services (+ 14%) Construction (+ 7%) Wholesale Trade (+ 7%) Retail Trade (+ 4%) Manufacturing (+ 3%) Mining, Quarrying & Oil Wells (- 9%)	Accommodation, Food & Beverage (+ 18%) Communications & Other Utilities (+ 17%) Finance/Real Estate & Insurance (+ 15%) Transportation & Storage (+ 10%)	Agriculture & Related Services, Fishing & Trapping (+ 16%) Education Services (+ 16%) Logging & Forestry (+ 16%) Health & Social Services (+ 11%)

One explanation for the failure of credit growth to keep pace with economic growth in several sectors is the possibility that a large proportion of businesses in those sectors had become overextended in the early 1990s - and were profiting from greater buoyancy to pay down their debts. However, in four of the six sectors in which credit growth lagged economic growth (Table 6), the rate of growth in the number of the banks' customers significantly exceeded the sector's rate of credit growth. On that basis - and taking into account each sector's GDP and bankruptcy experience, it is at least hypothetically possible that the Business Services, Construction, Retail Trade, and Wholesale Trade sectors experienced a 'credit gap' over the 1995-97 period.

Table 7, below, shows outstanding bank credit by sector (1995 and 1997) ordered on the table according to each sector's share of *SBLA* 'Business Improvement Loans' (the right-hand column). In eight sectors (Accommodation, Food & Beverage; Communications and Other Utilities; Education Services; Logging and Forestry; Manufacturing; Mining, Quarrying & Oil Wells; Retail Trade; Transportation and Storage) firms' share of BILs issued in 1996-97 significantly exceeded the sector's share of outstanding bank credit.

Comparing those eight sectors to the four in which a 'credit gap' may have existed reveals that in the case of one (Retail Trade) the *SBLA* helped address a discernible credit gap in 1996-97 (the retail trade sector is a particularly 'heavy' user of *SBLA* BILs).[35]

Beyond the SBLA, governments (especially provincial) have launched initiatives to redress what, presumably, they regard as credit market deficiencies confronting the creation or expansion of businesses in targetted sectors. Some involve collaboration with private sector lenders.[36] Many provincial programs apply equally across all sectors. Latterly, 'knowledge-based' and exporting industries have become particular beneficiaries. However, programs targetted at more 'conventional' sectors remain on the books, with agriculture/agri-food, manufacturing, and mining being the most heavily favoured sectors.

Table 7: Outstanding Bank Credit - by sector (all loans <$250k) [37]

[35] Four sectors (Accommodation, Foord & Beverage, Retail Trade, Transportation & Storage, and Manufacturing) accounted for 54.4% of BILs issued in 1996-97. By virtue of its parameters, *SBLA* BILs are heavily concentrated in those sectors necessitating a disproportionate investment in equipment and premises ('fixed assets').

[36] For example, Western Economic Diversification Canada and the Royal Bank jointly offer financing of $50k-$500k (at prime plus 3-6%) to health industry firms located in western Canada. The two also offer financing under identical terms to businesses in the 'advanced materials and advanced manufacturing technology' sectors.

[37] 1995 - six banks; 1997 - seven banks. Statistics aggregated from: CBA *Business Credit Statistics as at September 30, 1995* and CBA *Business Credit Statistics as at June 30, 1997.*

	1995 (3rd Quarter) Avg. Value	1995 (3rd Quarter) Number of Customers	1997 (2nd Quarter) Avg. Value (change from 95Q3)	1997 (2nd Quarter) Number of Customers (change from 95Q3)	Sector's share of all loans <250k By value - 1997Q2 (1995Q3)	Sector's share of SBLA BILs 1996-97 by value *
Accommodation Food & Beverage	$ 40,929	24,059	$ 42,097 (+ 2.9%)	27,663 (+ 15.0%)	5.2% (5.0%)	18.7%
Retail Trade	$ 33,695	76,721	$ 32,759 (- 2.8%)	81,721 (+ 6.5%)	11.8% (13.0%)	13.6%
Transportation & Storage	$ 42,065	22,501	$ 39,173 (- 6.9%)	26,466 (+ 17.6%)	4.6% (4.8%)	13.1%
Manufacturing	$ 33,356	39,945	$ 35,850 (+ 4.5%)	38,120 (- 4.6%)	6.0% (6.7%)	9.0%
Logging & Forestry	$ 39,164	5,676	$ 39,533 (+ 0.9%)	6,545 (+ 15.3%)	1.1% (1.1%)	4.3%
Construction	$ 28,101	47,429	$ 27,620 (- 1.7%)	51,406 (+ 8.4%)	6.3% (6.7%)	3.8%
Business Services	$ 27,552	42,452	$ 25,338 (+ 8.0%)	52,662 (+ 24.1%)	6.0% (5.9%)	2.7%
Health & Social Services	$36,453	29,679	$ 36,097 (- 1.0%)	33,216 (+ 11.9%)	5.3% (5.4%)	2.7%
Wholesale Trade	$ 35,319	21,349	$ 33,834 (- 4.2%)	23,949 (+ 12.2%)	3.6% (3.8%)	2.5%
Mining, Quarrying & Oil Wells	$ 28,224	5,464	$ 35,703 (+ 23.0%)	3,950 (- 27.7%)	0.6% (0.8%)	1.6%
Communications & Other Utilities	$ 28,911	3,753	$ 27,940 (- 3.4%)	4,538 (+ 20.9%)	0.6% (0.5%)	1.5%
Agriculture & Related Services, Fishing & Trapping	$ 41,825	96,817	$ 45,690 (+ 9.2%)	103,083 (+ 6.4%)	20.8% (20.3%)	2.6% **
Education Services	$ 28,286	2,254	$ 27,220 (- 3.8%)	2,798 (+ 24.1%)	0.3% (0.3%)	0.9%
Real Estate & Insurance	$ 50,484	20,686	$ 55,725 (+ 10.4%)	24,454 (+ 18.2%)	6.0% (5.2%)	0.6%
Finance & Insurance	$ 35,840	17,739	$ 37,701 (+ 5.2%)	17,906 (+ 1.0%)	3.0% (3.2%)	0.3%
Other Services	$ 27,746	66,851	$ 29,447 (+ 6.1%)	71,741 (+ 7.3%)	9.3% (9.3%)	21.0% ***
Unallocated ****	$ 35,240	45,854	$ 28,149 (- 20.4%)	76,872 (+ 67.7%)	9.6% (8.1%)	
TOTAL	$ 35,167	566,921	$ 34,980 (- 0.5%)	647,090 (+ 14.1%)		

* Small Business Loans Act *Annual Report on Operations for the 12-month period ended March 31, 1997* (11).
** The *SBLA* Annual Report for 1996-97 indicates that 1.4% of BILs were issued to "Industries Related to Agriculture," and 1.2% to "Fishing and Trapping Industries." The CBA's *Business Credit Statistics* combine the two categories.
*** "Other Miscellaneous Service Industries" represent 20.9% of BILs issued in 1996-97. "Government Services industries" account for 0.1%. The two figures are added here because CBA statistics make no provision for "Government Services."
**** In 1997 (but not in 1995) the CBA identified the percentage of otherwise "Unallocated" loans held by "knowledge-based industries" (KBIs). While not an exclusive list, in the second quarter of 1997 the total value of 14,501 outstanding loans to the KBI sector was $384,335,000 - for an average outstanding loan of $26,504 - or 1.7% of total outstanding loans (<$250k) by value.

An 'Innovative' Industries 'Gap'?

So-called 'innovative' industries - particularly 'knowledge-based' industries - have long been thought to suffer a financing market 'gap'. Financial institutions, accustomed to their loans being secured by 'hard' assets, were notoriously uncomfortable with the notion of lending to firms on the strength of their 'human capital'. "Innovative' firms, by nature, disproportionately expend resources on research and development (and often on marketing). They tend to spend much less on production than 'conventional' manufacturing firms. *SBLA* 'stakeholders' consulted in 1996 almost unanimously were of the view that 'knowledge-based' SMEs face a pronounced capital market gap (Norton, v).[38]

'Fast growth firms' (of which 'innovative' industries are usually considered an important sub-set), according to the 1998 Thompson Lightstone survey of Ontario SMEs, "experienced the most difficulties in trying to finance their business operations over the past three years" (100). Sixty-two percent of such firms claim that they need more capital. Already, they are indebted to the average tune of $99k and, on average, they seek an additional $166k. On the one hand, they are precisely the category of business most attractive to equity investors - and of all small businesses, they are the most aware of equity options.[39] On the other hand, the owners of these businesses are especially anxious to maintain control of their operations. It is thus critical (to them) that providers of debt capital prove responsive to their needs.

Responsiveness is precisely what Canada's banks have been trying to show. Appearing before the Commons' Industry Committee in 1995, the banking industry noted that there was no agreed definition of what constitutes a 'knowledge-based' firm. By March of 1997, sufficient agreement had been reached that the CBA was in a position to observe that approximately 2 percent of all Canadian businesses are 'knowledge-based' - and that 2.5 percent of all authorized credit is extended to companies in that sector.

The Conference Board (1997, 8) points out that several banks have started specialty units for "high-tech and knowledge-based" firms. Banks have taken the necessary steps to ensure that account managers dealing with 'innovative' firms have the requisite training to better assess the peculiar risk profile confronting these businesses. In many cases, they have also instituted lending programs targetted at firms in this sector.[40] This response is a natural (and commercially logical) one: 'knowledge-based' firms (like exporters) tend to borrow at higher dollar values - meaning that lenders' costs associated with 'due diligence' are more likely to be recouped than they are in the case of smaller loans to the majority of SMEs. So taken have the banks

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[38] They did not agree, however, on what to do. Some 'stakeholders' favoured enhancing 'knowledge-based' industry access to the *SBLA* by permitting institutions lending under the program to charge differential (meaning higher) fees or interest rates to companies with large 'soft asset' components.

[39] The 1998 Thompson Lightstone survey finds that "private investors prefer knowledge-based firms" (123).

[40] Many of which are in partnership with federal government departments (e.g., Environment or Heritage), agencies (like Western Economic Diversification, FedNor or FORD-Q), or Crown corporations (e.g., the BDC). A panoply of highly focussed (by region and specialization) lending programs targets perceived demand in the 'innovative' and 'knowledge-based' sectors. 'Information technology' and 'advanced technology' industries in almost any part of the country can access one of these programs. In 1997, the BDC issued $517 million in loans to 'knowledge-based' and exporting industries, representing 37% of their new lending (meaning loans to those sectors now represent fully 25% of the BDC's overall lending portfolio). Some of this BDC lending, it should be stressed, is to companies larger than those eligible for *SBLA* guarantees. According to the Conference Board, the BDC's 'makeover' (it was previously known as the Federal Business Development Bank) was partially motivated by the "lack of understanding by private sector financial institutions of 'knowledge-based' companies" (1997, 21).

become with the prospects of 'innovative' industries that they have also become heavily involved in the provision of venture capital to this sector.[41]

Provincial governments and their agencies have also spawned lending programs targetted at 'innovative' small businesses. B.C., Nova Scotia, Ontario and Québec employ a variety of policy instruments (including grants, loans, tax credits and venture investments) in their efforts to plug the financing gap confronting firms in this broad sector.

An 'Exporting' Industries Gap?

Like 'innovative' industries, exporting firms have long been thought to face a capital market 'gap'. 'Uncertainties' associated with foreign accounts receivable: risk of non-payment; time lags in receipt of payment; risks associated with currency conversion - all mean that exporters have a particular need for 'working' capital. *SBLA* 'stakeholders' interviewed in 1996 acknowledged this fact, but were strongly of the view that the *SBLA* should not "be turned inside-out" to rectify the deficiency.

The market, in fact, has responded vigorously to exporters' needs. The CBA reports that since 1992, the number of export letters of credit issued by the six largest banks has increased by 67% - with the dollar value of those letters increasing by 88% (1997, 10). The banks invested significantly in training account managers to finance foreign receivables. In addition to offering quick 'turn-around' on letters of credit, they are now also helping exporters manage risks by purchasing their foreign receivables ('factoring'). *Northstar* (of Richmond, B.C.) has been financing exporters' foreign receivables since December of 1994.[42]

Governments - particularly the federal government through the EDC (but also the BDC) - have acted to help address the exporters' financing 'gap'.[43] The EDC now offers four types of financing services: Export Credit Insurance; Export Financing; Bonding and Guarantee Services; and Foreign Investment Insurance (Conference Board 1995, 23).[44] In collaboration with all major banks, the EDC has assisted more than 85 'small exporters' (with working capital financing) under the *Master Accounts Receivable Program (MARG)*.[45] The BDC offers two financing programs for exporters, one of them in collaboration with the Credit Union Central of Canada.[46] At least one provincial government (Alberta) offers term loans or partial guarantees of lines of credit to SME exporters.

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[41] For example, the Bank of Montreal's 'Technology Investment Program' or the Royal Bank's equity investment focus on 'knowledge-based' and 'export-oriented' firms. Since 1983, the BDC has made 'patient investments' totaling more than $212 million in 162+ firms - 70% of which are in the high-tech sector.
[42] *Northstar* believes its services "fill a recognized gap in traditional bank and government SME financing" for export sales ranging from $100k to $3 million. Financing provided by the company is insured by the Export Development Corporation (EDC) and is secured only by the asset purchased.
[43] In 1996, the EDC supported $3.9 billion in exports by SMEs - an increase of 39% over the $2.8 billion figure in 1995 (Conference Board 1997, 23).
[44] The EDC also makes 'Domestic Credit Insurance' available to companies that insure *all* of their sales with the corporation (and who export a minimum of 15% of their total sales).
[45] Only exporters with less than $5 million in annual sales revenue are eligible.
[46] The BDC's 'Working Capital for Exporters' program offers pre-shipment financing up-to $250k; the Credit Union program extends loans typically in the $500k-or-less range.

A ‘Working’ Capital ‘Gap’?

The 1997 Thompson Lightstone study for the CBA underscores ‘working’ capital’s ‘weight’ in the panoply of SME financing requirements: “The need for working capital is the main purpose SMEs report for requesting financing from a financial institution in the past 12 months” (55). Reviews of the *SBLA* program fostered by Industry Canada have yielded “a consensus that a working capital ‘gap’ exists in small business financing and that working capital needs are growing relative to the needs for fixed-asset financing” (1998, 28). One measure of that gap might be the huge difference in the *types* of bank loans held by smaller - and larger - firms. SMEs holding outstanding bank loans of less than $250k in the second quarter of 1997 received the majority of that credit in the form of *term* loans (52.8% - against 47.2% with ‘operating’ loans). By contrast, SMEs with more than $1 million in outstanding bank credit had only 29.5% of the value of their loans in term credit - and 70.5% in the form of *operating* credit (CBA 1997, 110).

Historically, one of the reasons that SMEs reported difficulty in obtaining working capital is a lack of security to pledge against the loan. Term loans for fixed assets are often secured by the asset itself. To the extent to which additional security had to be pledged to obtain capital for land, buildings and equipment, often none is left-over to pledge against working capital loans. While working capital is explicitly *ineligible* for *SBLA* guarantees, the program’s restrictions on taking collateral have had the effect of freeing-up assets that could be used as security for working capital loans. The mere fact that a SME has a *SBLA*-guaranteed loan has, in many cases, laid the groundwork for its owner to negotiate working capital credit with the same financial institution.[47]

SBLA ‘stakeholders’ are acutely conscious of a working capital ‘gap’ facing small businesses. At the same time, they are determined that the health of the existing *SBLA* not be compromised by expanding the existing program to include working capital (Norton 1996, vi).

Small businesses complain loudly about government policies which limit their available working capital. The CFIB is especially critical of high payroll taxes - which aren’t based on profitability, but which reduce a SME’s profitability, and hence constrain its ability to retain earnings for working capital purposes. This ‘vicious cycle’ continues, with the SME forced to enter the debt market for working capital, often at a high interest rate premium (due to the fact that the owner’s collateral has already been pledged against term loans for fixed assets). The ‘drain’ represented by the fixed cost of interest payments further strains the company’s profitability. This problem will only worsen as CPP premiums skyrocket (the effects of which are only marginally offset by lower EI premiums). Presented with a choice between significantly lower payroll taxes and a government program designed to minimize the working capital ‘gap’, the vast majority of small businesses would opt for the former.

Meanwhile, the financing market has been responding to the working capital ‘gap’ with an ever-broadening array of initiatives. The banking industry has responded with three types of working capital ‘instruments’: lines of credit/overdraft protection; business credit cards; capital leasing.

The plethora of “credit lines” and “revolving loans” now offered by the major banks are all targetted at SME working capital needs. They all emphasize ease of access (in some cases automaticity - once an initial approval process is completed). All offer “competitive” rates on loans ranging from $2k to $250k (in some instances, with the option to borrow in $U.S.)

While corporate credit cards are relatively new to the Canadian market, SME owners have long used their personal (i.e., high interest rate) cards for short-term, limited working capital needs. According to the

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[47] A representative of the Royal Bank told the Commons’ Industry Committee that “the vast majority of clients with *SBLA* loans also have working capital loans with the bank” (28March95).

1997 CBA survey, almost twice as many (41% - compared to 21% using business cards) still do. Fully 71 percent of those using credit cards for business purposes pay their balance monthly, thus incurring no interest costs. One of the key advantages of *business* credit cards is that they tend to offer access to significantly higher sums (in the case of Royal's *CreditLine* up-to $35k).

Equipment loans and leases are increasingly offered by banks (in collaboration with companies like Newcourt Credit). The leases generally cover 100% of 'eligible assets' - and are marketed as a means by which SMEs can "preserve" their working capital.

The federal government has used the mechanisms at its disposal to promote SME access to working capital. In 1994, the BDC (then the FBDB) unveiled *Working Capital for Growth* - a $50 million program offering loans up-to $100k (to companies with an existing line-of-credit that have been in business for at least two years). The BDC advertises its 'Patient Capital' loans (offered on a collaborative basis, depending upon the region, with the Royal and Scotia banks, FORD-Q, and Fed-Nor), as supporting SME working capital needs.[48] The Export Development Corporation promotes its export insurance on the basis that if the SME's export receivables are insured, a bank is more likely to accept them as security when providing working capital financing.

A Leasing 'Gap'?

The Conference Board reports that the "use of lease contracts in business financing is growing rapidly" (1997, 3). The Board attributes the popularity of capital leases to both technological and market change. In their analysis, the "shift toward more specialized sources of credit is continuing." They project that "this will provide growth opportunities for (asset based) types of financing" (18).

The Canadian Finance and Leasing Association (CFLA) has well in excess of 100 members. However, according to the Conference Board, the "top five lessors account for 95% of all lease contracts" (1995, 7). These 'non-banks' claim that due to their more specialized and intimate knowledge of certain sectors, they are able to "mitigate risk that banks don't have the confidence to accept." Major banks have recently formed alliances with the largest leasing companies in order to provide alternative financing for equipment purchases (for which SMEs previously would have negotiated term loans - perhaps even loans guaranteed by the *SBLA*). While capital leases "remain the most popular type of lease in Canada," the Conference Board indicates that "growth in operating leases is expected to outpace that of capital leases over the next five years" (1997, 4).

The CFLA has long complained that the *SBLA* has negatively affected their operations [by allowing subsidized players to enter a market (fixed asset financing) that is well - and perhaps best - served by their members]. As a result, they argue, leasing firms must take on additional risk to compete with the risk banks can take under the *SBLA*. Their insistence on *SBLA*-eligibility thus has more to do with equity and fairness for *leasing firms*, and less to do with addressing financing market gaps. Their equity argument is hard to contest. At the same time, the burgeoning leasing market offers eloquent testimony to the fact that *ineligibility* for *SBLA* guarantees seems not to have acted as a drag on the activities of either leasing firms or their customers. The likelihood that the industry's growth is less likely to come in the *capital lease* business (to which the existing *SBLA* structure could be reasonably easily adapted) than on the *operating lease* side, somewhat complicates the notion of expanding the *SBLA* to include leasing.[49]

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[48] In fiscal 1997, 13% of BDC lending (under $250k) was for working capital purposes.

[49] A Conference Board study in 1996 asserted that providing a *SBLA* guarantee to *operating leases* would be unlikely to generate incremental leasing to SMEs (SBLA 1998, 34).

Regional 'Gaps'?

It is seldom asserted that *regional* gaps are the most consequential financing market deficiency confronting small businesses. Nonetheless, there is certainly evidence to suggest the existence of market discrepancies *by region.* The Office of the Superintendent of Bankruptcy told the Commons' Industry Committee that despite the many strengths of Canada's *national* banking system, it faced difficulty in being "fully responsive to local market conditions" when attempting to set policies applicable across the country (28March95; 36-4). The CLMPC (1993, 9) identified SMEs "located in disadvantaged regions or remote communities," as "facing obstacles in securing *investment* capital" - meaning, of course, that such enterprises become disproportionately dependent on *debt* capital. The 1997 CBA study found that, on average, 65% of SMEs requesting loans from a financial institution provided personal guarantees, assets or securities as collateral. Of all categories of borrowers, those based in Atlantic Canada were confronted most often with such demands (79% of the time), while demands of B.C. borrowers also exceeded the norm (75%).

Table 8: Regional Share of Canadian Bank Credit (<$250k)

	Outstanding Credit (million) 1995Q3/*1997Q2*	**Share of National Outstanding Credit <$250k 1995Q3/*1997Q2***	**Authorized Credit (million) 1995Q3/*1997Q2***	**Share of National Authorized Credit <$250k 1995Q3/*1997Q2***	**Share of *SBLA* lending 1996-97**
Atlantic	$1,666 / *$1,834*	8.4% / *8.1%*	$2,219 / *$2,454*	7.8% / *7.6%*	7.0%
Québec	$3,981 / *$4,010*	22.3% / *20.4%*	$6,339 / *$6,578*	20.0% / *17.7%*	33.1%
Ontario	$7,547 / *$8,425*	37.9% / *37.2%*	$10,602 / *$11,877*	37.4% / *36.9%*	33.4%
Prairies	$ 4,418 / *$5,230*	22.2% / *23.1%*	$5,915 / *$6,945*	20.9% / *21.6%*	16.7%
B.C./ Territories	$2,324 / *$3,138*	11.7% / *13.9%*	$3,297 / *$4,325*	11.6% / *13.4%*	9.8%

Source: CBA *Business Credit Statistics as at Sept. 30, 1995* and *as at June 30, 1997.*

Table 8 (above) describes changes in the regional shares of *bank credit* (1995-1997). It shows that the only truly significant *regional* changes in authorized and outstanding credit from 1995 to 1997 were in Québec and British Columbia. The decline in credit in the former very closely parallels growth in credit in the latter. By looking at change *within each region*, Table 9 (below) illustrates just how dramatically different the credit picture really was across the country over this period. Appendix Two portrays yet another dimension of the Canadian credit picture, showing the changes in *average* authorized and outstanding credit for each region.

Table 9: Bank Credit (<$250k) Within Each Region 1997Q2 (change from 1995Q3)

	Outstanding Credit	**Authorized Credit**	**Customers**
Atlantic	+ 9%	+ 15%	+ 8%
Québec	+ 1%	+ 4%	+ 6%
Ontario	+ 11%	+ 12%	+ 16%
Prairies	+ 18%	+ 17%	+ 13%
B.C./Territories	+ 35%	+ 31%	+ 26%

Canada	+ 12%	+ 13%	+ 14%

In every region except Québec, growth in authorized and outstanding credit exceeded the region's GDP growth over this period. The comparison between Québec and Ontario is illuminating. Québec's GDP growth lagged that of Ontario by about 0.5%/year (from 1993-1997). Yet, in the period covered by this report, outstanding bank credit <$250k grew in Ontario by *eleven times* the growth in Québec (authorized credit by *three times as much;* customers by *two-and-one-half times as many*).

It may or may not be coincidental that the beginning of the period examined in this report (the third quarter of 1995) immediately predated the October, 1995 Québec referendum. Business confidence (including that of lenders) unquestionably fell in the wake of the referendum - exactly how much is the subject of an on-going political debate. It is striking that even the National Bank (whose lending overwhelmingly is in Québec) retrenched over this period.[50] Bank loan loss provisions reflect the relative precariousness of lending in post-referendum Québec.[51]

Overall, bank credit statistics imply that the financing market adapts to Canada's regional realities. From 1995-1997, credit growth reflected strong economic growth in British Columbia and on the prairies. Credit growth in the Atlantic provinces and Ontario outpaced increases in GDP - meaning that at a 'macro' level, one could not plausibly claim that *regional* financing market 'gaps' created a drag on overall economic performance. In Québec, the facts are not as clear. Notwithstanding Industry Canada's assertion that the distribution of *SBLA*-guaranteed loans pretty accurately reflects the distribution of the Canadian population, as the final column of Table 8 (above) shows, *SBLA*-facilitated lending in Québec in 1996-97 significantly outpaced that province's share of Canada's population - thereby compensating, to a certain extent, for the overall tightening of commercial credit.

An 'Equity' Capital 'Gap'?

The fact that SMEs *may* face a debt financing 'gap' is, to a large degree, a function of the equity capital gap which they most assuredly *do* face.[52] SME inability (or reluctance) to access equity capital, perforce, compels them to seek debt financing. Even if there is no shortage of available debt capital, greater demand on that side of the 'ledger' transfers to lenders more control over terms than might otherwise be the case.

Thompson Lightstone found that only 12% of Ontario 'start-ups' use external equity (1998, 2). Their research yielded the conclusion that "many business owners exhibit a lack of awareness" of "non-traditional financing sources" - and confirmed the conclusion of others that many are disinclined to *accept* such financing in any event (1998, 5).[53]

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[50] In 1995, 92% of the National Bank's outstanding credit was extended in Québec. By 1997, it had fallen to 89%. More significantly, the National's outstanding credit in Québec actually *fell* by $300 million between 1995 and 1997. The credit cooperatives partially filled the vacuum: 60% of the movement's national lending in 1996 was in Québec (up from 57% in 1994).

[51] For the 12 month period ending October 31, 1996, the CBA reports loan losses (provisions as a percentage of outstandings) as follows: Atlantic (0.9%); *Québec* (1.5%); Ontario (1.0%); Prairies (0.3%); B.C./Territories (0.9%); Canada (0.9%).

[52] The CFIB claims that 48% of firms with fewer than five employees say they "have insufficient equity to carry-on business effectively" (1998, 2).

[53] The reasons are several. Professor Alan Riding told the Commons' Industry Committee (1994, 30) that 'angels' (found by Thompson Lightstone to be "the primary source of external capital for "small growing enterprises - 1998, 8) reject fully 97% of their investment opportunities. They do so out of a belief that

This inaccessibility (or unattractiveness) of equity capital must co-exist with another reality. Baldwin et al (1997, 9) found in their survey of failed firms that: "additional capital in the form of equity is seen to be the key to survival for both those firms with major internal problems and those that failed due to external factors." In short, when it comes to equity capital, while SMEs often can't live with it, living without it is the biggest contributor to their premature demise.

For SMEs generally, retained earnings are the "preferred" source of capital (Thompson Lightstone 1998, 27). Yet, as discussed above (see 'Working' Capital 'Gaps'), government policies (like high payroll taxes and shifting the revenue burden onto property taxes) are identified by the CFIB as a principal *impediment* to the accumulation of retained earnings. In turn, inadequate retained earnings mitigate SME access to debt financing.[54]

Canadian institutions have responded to the SME equity capital 'gap' with an array of initiatives. Major banks have created venture capital subsidiaries.[55] The Business Development Bank of Canada - uniquely and jointly - offers SMEs access to venture capital.[56] Industry Canada lists 78 different sources of venture capital for SMEs - 7 of which are operated by large Canadian banks. Notwithstanding such efforts to improve small business access to venture capital, Thompson Lightstone concluded in 1998 that "debt financing will continue to play the pivotal role for small business financing" (134).

'Borrower'- (as distinct from 'firm'-) Related 'Gaps'

"the management capabilities of those firms are inadequate to protect their capital or to commercialize the opportunity successfully." Presumably, many SMEs are sufficiently discouraged by that poor record to be disinclined to seek equity investments in the first instance - especially given the efforts and costs involved. More 'established' SMEs (those older than 3 years) may be put-off by the fact that investors "focus on early stage business opportunities" (Thompson Lightstone 1998, 122). Relatively high capital gains taxes discourage would-be investors. The rate of return which they feel compelled to demand (reported by Industry Canada to "typically" be 25-50%) is regarded by many SMEs as prohibitive - even though equity investors generally expect to wait upwards of six years before realizing any return. Perhaps most important of all is the 'loss of control' associated with acceptance of equity capital. Entrepreneurs, by their very nature, wish to be their own bosses. That paramount objective is often what caused them to pursue business opportunities in the first instance. Few investors are willing to remain completely passive - indeed, Thompson Lightstone (1998, 28) report that "the costs of evaluating and monitoring" serve to "militate against smaller venture capital investments" (which they describe as those less than $1 million in value). Baldwin et al (1994, 27) studied *growing* SMEs (in their view, the small businesses "least likely to be forced out of the equity market"). Their conclusion: heavy reliance by these companies on *internal* financing "lends weight to the argument that it [a desire to "preserve the advantages of direct control"] is a matter of choice."

[54] Haines and Riding (1994, 33) found that the "primary reason cited by banks for loan turndowns is an inadequate debt-equity balance." The CBA's 1997 survey (84) cited "insufficient equity" as the "criteria most frequently identified for turndowns (by account managers)." "Insufficient equity" was identified 57 percent of the time; insufficient collateral 47% of the time.

[55] For example, the Bank of Montreal's "Capital Corporation" maintains a "Technology Investment Program" which makes venture capital investments in "high growth, technology-based companies." The Royal Bank's venture capital subsidiary invests in knowledge-based and exporting companies.

[56] The BDC has invested more than $125 million (in more than 110 small and medium companies) since 1983. With Sofinov (a subsidiary of the Caisse de dépôt et placement), the BDC operates 'T2C2' - a "venture capital fund to provide financing for early-stage technology projects" in Québec.

On the issue of gender, the CBA study is emphatic: ". . . there is no evidence of causal effect related to: . . . gender of owner . . ." (1997, 7). However, the study then presents considerable evidence to the contrary. First, companies "owned exclusively by females" are included on a list of the types of companies exhibiting the highest propensity *never previously* to have sought financing [42% of companies owned exclusively by females never previously sought financing] (43). Consistent with this finding, the survey reports that only 37% of female entrepreneurs "rely on banks or other financial institutions for business financing" - relative to 49% of males (138). The study discerns that the "reported turndown rate . . . for businesses owned exclusively by women" is 23% - as compared to 14% for companies owned exclusively by men (139). Finally, "businesses owned exclusively by females are more likely than their male counterparts to put up personal guarantees, assets or securities as collateral (74% vs. 64%)" (8).

The CBA finding concerning loan turndowns conduces (albeit to a lesser degree) with that of the CFIB. The CFIB study asserts that "women seeking financing are refused 20% more often than men" (1995, 1). The CFIB makes an additional assertion - one not tested by Thompson Lightstone (for the CBA in 1997). Their 1995 survey concluded that "women are regularly charged a higher rate of interest than men" (1).[57]

A prospective borrower's youth can also mitigate access to financing. Due to the prospective borrowers' lack of credit rating and inexperience, financial institutions are hesitant to lend to entrepreneurs just out of school. A financing market 'gap' thus exists. Considering the greater degree of lending risk associated with the provision of credit to borrowers without a track record, this is an entirely rational 'gap'. So far, there have been very few serious attempts to address it. One such effort takes the form of the BDC's 'Young Entrepreneur Financing Program' - which offers term financing up-to $25k to start-up businesses owned by persons aged 18-34. The loan can be used to purchase assets, to buy a franchise, or for working capital purposes. Some of the provinces have launched similar programs.[58]

Aboriginal Canadians are also thought to suffer a financing market 'gap' - in recognition of which Industry Canada acknowledges that "proposals have been made to extend the *SBLA* to on-reserve lending for aboriginal business" (1998, 29). Pending further consideration of those proposals, other arms and agencies of the federal government have taken initiatives to fill the breach. More than thirty aboriginal capital firms (providing loans and financial services to aboriginal entrepreneurs) have been established under the auspices of 'Aboriginal Business Canada'. The BDC operates its own 'Growth Capital for Aboriginal Business' program, and is also involved in "strategic alliances" (with CIBC and the Royal) to support aboriginal-owned businesses.[59]

A 'Competition'/'Convenience' 'Gap'?

[57] More precisely, the CFIB found that"95% of female business owners are charged an interest rate differential of more than 0.5%. In 61% of these cases, the spread is greater than 1%" (1995, 2).
[58] Newfoundland extends loans (to a maximum of $20k) to business persons aged 19-30. Québec (through the Société d'Investissement Jeunesse) guarantees loans ranging from $10k to $150k to persons 18-35 years of age.
[59] The BDC program is available to aboriginal entrepreneurs wanting either to start or expand a business (on or off the reserve). Up-to $25k is available for start-ups (up-to $100k for existing businesses). Loans can be used to purchase (or renovate) fixed assets, for franchise fees, or for working capital; are priced-to-risk; and require security. The pilot projects with the banks offer loans up-to $500k per project with the Royal Bank (available in Alberta and in Prince George, B.C.); or to a maximum of $500k with CIBC (in Manitoba and north-western Ontario).

The existence of adequate competition in the financial services sector is vitally important to ensuring SME access to financing (and its affordability). Recent trends have not been encouraging.

The House of Commons Industry Committee (1994, 30) was sufficiently concerned about the competitive state of the financing market to advocate measures designed to promote additional competition. Recently, Finance Minister Martin proclaimed his view that "there isn't enough competition in the (banking) community," and called for more of it (*Globe and Mail* 14Feb98, B-1). The statistics bear him out.

The Conference Board (1997, 27) shows that domestic banks held 50.3% of the total SME financing market in 1996, compared to 48.5% in 1994. Whereas commercial loans accounted for 72% (of the SME financing market) in 1994, that figure had grown to 75% in 1996. Significantly, domestic banks held 72% of those outstanding commercial loans in 1996 (up from 66% in 1994). In sum, the trend in the SME financing sector is toward greater concentration.

That trend is unalleviated by developments in the trust and loan, and insurance industries[60] - notwithstanding the fact that trust, loan and life insurance companies were granted full commercial lending powers in 1992 (partially out of a hope that their participation in the SME market would engender increased access). The share of the SME business financing market held by trust and loan companies fell to 4.5% in 1996 (from 8.5% in 1994); the share held by insurance companies decreased to 2.7% in 1996 from 3.5% in 1994 (Conference Board 1997, 27).

Logically, there is a connection between diminished competition in the financial services marketplace and the diminished number of branches or outlets at which business consumers access lending services. The linkage between branch closings and account manager turnover also is an inevitable one - although that is only one of the reasons for the turnover of managers. The 1997 CBA study found that only 41% of SMEs report having had the same account manager for the past three years - compared to 47% one year earlier (9).[61] An increasing rate of turnover exacerbates the problem traditionally suffered by SMEs - to the effect that the lack of strong and enduring personal relationships with lenders combines with a lender disposition against risk (and a disinclination to invest the necessary sums in SME account management) to *worsen* the financing market 'gap' which they face.

'OVERLAP'

'Overlap' - between the *SBLA* (as currently structured) and other providers of small business financing - is as difficult to quantify as the existence (and extent) of several of the 'gaps' discussed in the pages above. Nonetheless, *where compatible statistics are available*, it is possible to draw certain inferences about the degree to which other financing options 'overlap' those offered by the *SBLA*. The caveat about statistics is vitally important. Of private sector lending institutions, only the banks produce and make available statistics that are useful for this purpose. Public sector participation in Industry Canada's 'survey of lenders' has been spotty. The BDC and FIMCLA have supplied comparable data - as has FORD-Q. By contrast, none of ACOA, Fed-Nor or WED were forthcoming (by deadline). The other statistical deficiency relates to the fact that, largely for reasons of commercial confidentiality, institutions are not prepared to supply information regarding the take-up rates on the proliferating initiatives to assist SMEs. Accordingly, while it is possible to identify these programs as potentially worthwhile responses to identified 'gaps' in the financing marketplace, it

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[60] The Conference Board reports that there were 10 fewer trust companies in 1996 than in 1994 (1997, 15). Twenty insurance companies withdrew from the market between 1994 and 1996 (16).

[61] The study also discerned that 75% of SME owners hold the view that business banking "is becoming less convenient" - compared to 71% holding that view one year earlier (1997, 8).

is not possible to determine either the extent to which they plug a 'gap' - or the degree to which they *actually* (as distinct from *theoretically*) 'overlap' with the *SBLA*.

There are at least two methods by which the existence of 'overlaps' might be ascertained. One involves looking at lenders by type, and assessing the extent to which each might be trying to target the same financing market deficiency. That will be done below. Another approach would look at each of the 'gaps' - and compare efforts to address them against the parameters of the *SBLA*. Much of that analysis is found in the discussion above. Under each heading, examples are provided of initiatives taken by banks, federal and provincial government agencies and crown corporations, as well as by other lenders, to address perceived 'gaps' in the financing market. As is instantly evident, in many cases these initiatives are designed to provide SMEs with term financing for the purchase of fixed assets - precisely the purpose of the *SBLA*.

In the cases of some of the financing programs and initiatives to address financing market deficiencies that are described above, there is absolutely *no* overlap with the *SBLA*. For example, the *SBLA* does not guarantee **working capital**. Therefore, no 'overlap' can be alleged between the *SBLA* and the lines of credit, credit cards, factoring of receivables and other steps taken in recent years to address the working capital needs of SMEs. It is often argued, however, that there is a symbiosis, of sorts, between the *SBLA* and working capital loans, since one of the effects of the guarantee is to free-up security that the borrower can then pledge against loans for operating credit. To the extent to which there is 'overlap', it is a *byproduct* of the *SBLA* - and certainly not a programmatic duplication.

Leasing activities also are not covered by the *SBLA*. It is argued above that there is no apparent financing market 'gap' insofar as leasing is concerned. The industry's share of SME debt financing almost doubled (to 15.6% from 8.9%) in the 1994-1996 period (Conference Board 1997, 28). Leasing company ineligibility for *SBLA* guarantees may be one of the reasons for the dip in demand for BILs since 1995. After all, at least in the case of capital leases, the asset secured by the SME is identical to one for which conventional term financing, guaranteed by the *SBLA*, might otherwise have been sought.

Is leasing, then, a case of 'overlap'? Could it be (counter-intuitively) argued that the *SBLA* and the activities of specialized finance companies actually do 'overlap' (despite the latter's express *ineligibility* under the *SBLA*)? It cannot - at least if the purpose of the inquiry is to identify 'duplication,' and then improve the *SBLA*'s targetting. After all, not only does the *SBLA not* guarantee leasing contracts, but in any given year, there is no real cap on the issuance of *SBLA* guarantees. Accordingly, no case could convincingly be made that financial institutions have greater freedom to issue BILs *because* much of the equipment for which term loans were previously taken, is now financed by a burgeoning leasing industry. Only if specialized finance company leases *became* eligible for the *SBLA* guarantee could it legitimately be argued that there is relevant overlap between leasing financing and the *SBLA*.

Similarly, it is *not* a purpose of the *SBLA* to infuse the market with **equity** capital. Therefore, initiatives by the chartered banks, the BDC and private venture capital corporations to improve SME access to equity investment cannot be said to 'overlap' the *SBLA*. Once again, however, there is at least a limited 'linkage' between the two. *SBLA*-guaranteed loans often bear a lower interest rate than would otherwise be the case - thus marginally improving the SME's retained earnings picture. Retained earnings, of course, constitute one of the most important sources of SME equity.

In at least two areas described above, discernible financing market 'gaps' do exist - but substantial efforts are being made to close them. '**Innovative industries**', by virtue of their 'soft assets' focus, are not major users of the *SBLA*. The specialty units created by the banks, and the plethora of targetted programs operated by the Business Development Bank, Western Economic Diversification, and numerous provincial governments, do much to address the financing 'gap' facing innovative industries, but effectively do *not* 'overlap' the *SBLA*.

Exporting industries (especially manufacturers and raw materials producers) are likely larger beneficiaries of the *SBLA* - although obviously not for their working capital needs (the financing market 'gap' which they perennially face). The measures taken by the banks, the Export Development Corporation, the BDC, private corporations like *Northstar,* as well as by provincial governments, are almost all designed to address exporters' working capital deficiencies. Accordingly, they too do *not* 'overlap' guarantees offered via the *SBLA*.

Aside from 'innovative' and exporting industries, the industries most often targetted by **sector**-specific provincial initiatives include agriculture/agri-food, manufacturing, and mining. Of those three, only manufacturing industries are large users of the *SBLA* (9.0% of the value of all BILs in 1996-97). The three sectors, in total, received only 13.2 of *SBLA* BILs that year. By contrast, three other sectors claimed fully 45% of the value of *SBLA*-guaranteed lending that year (accommodation, food and beverage; retail trade; transportation and storage). Of the three, only accommodation, food and beverage (tourism) was targetted by sectoral initiatives launched by other lenders or guarantors. Loans by banks to those three sectors constituted only 21% of all bank lending under $250k - suggesting that, once again, there is limited **sectoral** 'overlap' between the *SBLA* and otherwise available credit.

Regional gaps were identified in the preceding analysis. The most notable concerned the tightening of bank credit in Québec in the 1995-97 period. *SBLA*-guaranteed lending helped ameliorate that 'gap'. All provinces target financing initiatives at their own industries; federal agencies (ACOA, FORD-Q, Fed-Nor, WED) blanket the country, facilitating the availability of financing in each region[62] - but relatively favouring none. If only because the *SBLA* does not set-out to favour any region, however, it cannot be described as 'overlapping' any other program or initiative designed to address regional 'gaps' in the SME financing market.

In fact, the only 'gap' that the *SBLA* sets out to ameliorate is the one that faces **small firms** generally. Along the way, it particularly assists **young firms**. To be sure, other financing initiatives (launched by the public and private sectors-alike) seek to address the same financing market gaps. They are described, in capsule form, in pages 12-14 above. It is worthwhile, however, to take another look at what some of the major institutions are doing, in an effort to evaluate the extensiveness of any 'overlap' with the *SBLA* - recognizing at the outset, of course, that domestic banks, credit cooperatives, and specialized finance companies (discussed above under *Leasing*) collectively account for almost 81% of total SME debt financing. To the extent that no other individual source accounts for much more than 5% of SME debt financing (and since all, with the exception of credit cards, are *declining* sources in proportionate terms), they are not considered significant for purposes of this analysis.

The Banks

By far, the chartered banks issue more credit to SMEs than any other financing institution. As at June 30, 1997, outstanding term credit (less than $250k) issued by the 'big six' banks totalled $11.034 billion.[63] As at March 31, 1997, the balance of *SBLA*-guaranteed loans outstanding was $6.02 billion. While not clear what share of that $6 billion figure is represented by loans from the big six banks, the *SBLA* figures for 1996-97 offer some guidance. In that year, 78% of *SBLA* loans were made by chartered banks. Applying that proportion to

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[62] Except to the extent that no such agency exists for eastern or southern Ontario.

[63] Term credit is isolated because it is issued for purposes comparable to those for which *SBLA* 'Business Improvement Loans' may be secured. Because the *SBLA* explicitly does not guarantee loans for working capital, inventory, etc., the additional $9.87 billion in the banks' outstanding *operating credit* is ignored for purposes of this analysis. Term credit less than $250k is selected because that is the upper limit on *SBLA*-guaranteed loans.

the $6 billion figure implies that $4.7 billion in outstanding *SBLA* loans may be held by the banks. $4.7 billion is fully 43% of the banks' outstanding term loans (under $250k).

When attempting to assess 'overlap', the 43 percent figure is significant. First, it suggests that two-fifths of all bank *term* lending (under $250k) may be guaranteed by the *SBLA*. Of course, the reciprocal also applies: three-fifths of bank *term* lending (under $250k) is *not SBLA*-guaranteed.

The Conference Board believes that 50.3% of all SME business debt financing is provided by domestic banks (1997, 28).[64] If, in fact, half of all outstanding debt financing to the 'under $250k sector' is provided by banks then, consistent with the calculations above, it can be surmised that *SBLA*-guaranteed *bank* loans represent at least one-fifth (20%) of *all* term credit available to businesses borrowing less than $250k.[65]

What does it mean that approximately half of all term credit (<$250k) outstanding to Canadian SMEs is issued by the chartered banks, and that perhaps 40% of that credit is guaranteed by the *SBLA*? In some respects, this is a *prima facie* case of 'overlap'. *SBLA*-guaranteed lending is a very substantial subset of bank term lending. In the preceding 'gaps' analysis (especially in the section dealing with 'Small Enterprises'), new bank initiatives targetted at the '*SBLA*-equivalent' sector are described. Those, of course, merely serve to *deepen* the extent of overlap between bank term lending which is guaranteed by the *SBLA* and that which is not.

'Overlap' could imply 'duplication'. By that definition, the 78 percent of *SBLA* lending undertaken by banks in 1996-97 may all have been *redundant* - since those banks made approximately one-and one-half times the value of term loans to the same (under $250k) 'sector' *without SBLA*-guarantees as they did *with SBLA*-guarantees. Inevitably, however, some of the *SBLA*-guaranteed lending was *not* redundant, because it was *incremental* - i.e., it would not have taken place without the benefit of the guarantee (this harks back to the inconclusive discussion of 'incrementality' on page six). To the extent to which *SBLA*-guaranteed bank lending is genuinely 'incremental', it can hardly be said to 'duplicate' other term lending by the banks. For that component of lending - whatever it may be - the issue of 'overlap' seems irrelevant.

One indicator of the extent of 'incrementality' might be discerned by comparing loan size.   *SBLA* loans averaged $65,000 in 1996-97; the average outstanding bank loan (under $250k) at June 30, 1997 was only $34,980. The fact that the average *SBLA* loan is almost twice as large as the average bank loan further diminishes the contention of 'overlap'.

Loan loss statistics provide another indicator of 'incrementality'. The seven bank aggregate loan loss provision for the 12-month period ending Oct. 31, 1996, was 0.9%.[66] By contrast, the aggregate loan loss rate for authorized *SBLA* loans is 4.5%. At first blush, it appears from these loss statistics that *SBLA* loans are five-times as 'risky' as all bank lending under $250k. If so, that would suggest *SBLA* loans are highly 'incremental'. However, because the guaranteed portion of *SBLA* loans (85% since 1995) carries with it no capital

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[64] There are at least two 'problems' with this Conference Board calculation: a) 'business credit' includes operating credit (and, accordingly, is not exactly comparable to the *SBLA*); b) it includes financing up-to $1 million - or four times the *SBLA* maximum. Nonetheless, the 50.3% figure is still the best current approximation of the proportion of credit issued to *SBLA*-eligible borrowers by Canadian banks.
[65] In fact, the banks almost certainly account for *more* than 20% of all *term* credit to the 'under $250k sector', given the fact that the bulk of financing secured by using credit cards (4.4% of all SME borrowing in 1996 - itself more often than not supplied by banks) - and some of the financing provided by specialized finance companies (15.6% of the 1996 total) - takes the form of *operating* - not *term* - credit.
[66] For authorization levels less than $250k. Because the provision pertains to both term *and* operating credit, it does not correspond precisely to *SBLA* loan loss statistics.

requirements, the 0.9% bank figure is not a true representation of the 'riskiness' of bank lending under $250k.[67]

As discussed above, in many (perhaps even most) cases, borrowers with *SBLA* loans tend to secure operating credit from the same bank. Concerns about 'overlap' thus become still more irrelevant. The *SBLA* loan might introduce the customer to the bank (thereby creating the basis on which a bank's familiarity with a given customer increases its comfort level), to the point where it is willing to make non-*SBLA*-guaranteed loans. Paying down the *SBLA* loan creates an important credit history for the customer, thus establishing the basis on which other lending can take place without the benefit of a guarantee. The fact that the borrower might pay a lower interest rate on the guaranteed term loan (than would otherwise have been the case) may instrumentally affect the banks' calculation of his or her ability to bear the carrying cost of supplemental credit. In none of these instances could the *SBLA* program be described as 'duplicative' of the banks' non-guaranteed lending.

Credit Cooperatives

The Conference Board calculates that 14.6% of total SME debt financing is issued by credit cooperatives - down from 15.7% in 1994 (1997, 28). Credit unions write a comparable share (17.1%) of all *SBLA*-guaranteed loans - with fully 83% of the value of that credit being issued in Québec.[68] An estimated ninety percent of all credit cooperative debt financing is to SMEs - meaning that their lending activities, on one level, 'overlap' those of the *SBLA* to a far greater extent than is the case with the chartered banks. Credit cooperatives' 'imputed share' of total *SBLA* loans outstanding (at March 31, 1997) is approximately 6.4% of their total (1996) outstanding debt financing to SMEs. The banks' 'imputed share' is approximately 8.4% [of their total (1996) outstanding debt financing to SMEs] (Conference Board 1997, 27).[69] By that measure, credit unions are doing proportionately more non-*SBLA*-guaranteed lending to SMEs (than the banks). By some arbitrary standard, it could thus be concluded that there is greater 'duplication' (and hence 'overlap') between credit cooperatives' non-*SBLA*-related lending and the *SBLA* itself. However, the *SBLA* exists to respond to a market 'gap' - not to monopolize SME debt financing. Furthermore, the same considerations apply in the case of credit cooperatives as are described above concerning the banks (to the effect that an *SBLA* loan might facilitate additional credit from the same lender). Analyzed that way, the *SBLA* does not 'overlap' other lending. Instead, it permits lending which would otherwise not take place (i.e., that which is 'incremental'); it complements some other lending; and it stimulates still other lending.

Crown Agencies

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[67] In fact, the loss rates (banks' vs. *SBLA*) probably do not differ significantly. 78% of all *SBLA* loans in 1996-97 were issued by chartered banks. Operating loans (which are included in the banks' 0.9% loss provisions) often are riskier than term loans (which tend to be secured by the asset for which the loan was issued). Given the *SBLA* loan loss rate of 4.5%, the *actual* losses incurred by the banks have to be much greater than 0.9%. Because the guaranteed portion of an *SBLA* loan carries with it no capital requirements, lenders' capital is freed-up to finance other lending. *SBLA* lending of $2 billion in 1996-97 carried with it a government guarantee of 85% - meaning that $1.7 billion in credit required no 'provisioning' by lenders. Arguably, by virtue of not having to use available capital to provision for these *SBLA* loans, financial institutions may have felt that their balance sheets could afford additional, non-guaranteed lending. In that sense, *SBLA* loans did not to any significant extent *preclude* other bank lending.

[68] Between them, banks and credit cooperatives issued 66.5% of all SME debt financing in 1996 - and 95.1% of all *SBLA*-guaranteed loans in 1996-97.

[69] 78% of outstanding *SBLA* loans in the case of the banks; 17% in the case of credit cooperatives.

The Business Development Bank

Acting individually - as well as jointly with other banks - the BDC has spawned in recent years an array of initiatives targetted at SMEs. These are described in the above 'gaps' analysis, especially in the sections on 'Young Firms', 'Innovative Firms', and Exporting Firms. This targetting of the BDC's financing initiatives by itself ensures that there is limited overlap between its operations and the *SBLA*.[70] By every other criterion, the BDC similarly emerges as a 'non-competitor' (to the *SBLA*).

In fiscal 1997, the BDC issued 2,398 loans less than $250k in value - only 8% of the 30,765 *SBLA* loans guaranteed in 1996-97. Only 27% (by value) of the BDC's fiscal 1997 loans were for sums less than $250k - compared to 100% of *SBLA* lending. Twenty-five percent of the BDC's customers in fiscal 1997 were firms 3 years of age-or-less (compared to 63% of *SBLA* loans going to SMEs in that category). The size of the average BDC loan (under $250k) is $114k (i.e., three times that of bank lending in the under $250k category, or 175% of the size of the average *SBLA*-guaranteed loan). BDC loan losses (on the under $250k portfolio) in 1997 were 1.1% (less than one-fourth of the *SBLA*'s), suggesting that the BDC is dealing with much less risky clients than those receiving *SBLA* guarantees. In sum, there is extremely little 'overlap' between the activities of the BDC and the *SBLA*.

Farm Improvement and Marketing Cooperatives Loans Act (FIMCLA)

FIMCLA's parameters are comparable to the *SBLA*'s. In 1996-97, it facilitated almost $500 million in debt financing to farmers; 16,250 loans were taken under the Act, for an average of $30k (nearly half the size of the average *SBLA* loan). Loans are for remarkably similar purposes: 83% of FIMCLA loans in 1996-97 were for the purchase of land, buildings, equipment and implements (the *SBLA* figure was 81%).

There are also differences between the two programs. Maximum interest rates, exclusive of administrative fees, are less for FIMCLA- than for *SBLA*-loans. The *SBLA*'s restrictions on size of eligible firm do not apply in the case of FIMCLA. Loan losses of 0.1% at FIMCLA are minuscule compared to those under the *SBLA*. The 'bottom line', however, is that in 1996-97, only 1.4% of *SBLA* BILs were issued to "Industries Related to Agriculture." The *SBLA* is largely irrelevant to the farming sector - while FIMCLA is its vehicle of choice. FIMCLA complements - but does not 'overlap' (in the sense of 'duplicate') - the lending activities of the *SBLA*.

Regional Agencies

Federal regional agencies appear to be pursuing distinctly different strategies (to address financing market 'gaps'). FORD-Q has targetted start-up (or young) 'innovative industries' (principally 'high-tech'). The 98 loans made by the regional development agency for Québec in the 22 months ending Sept. 30, 1997 averaged $304k - more than four times the *SBLA* average. Interest rates on FORD-Q loans are comparable to those on *SBLA*-guaranteed loans, but loss rates are much greater (6.2% compared to the *SBLA*'s 4.5%). By virtue of these various factors, it can reasonably be said that FORD-Q financing does not 'overlap' that available under the *SBLA*.

The case is less clear cut with WED. No doubt consistent with differential development priorities across the four provinces, the federal government's western Canadian agency has been less focussed than FORD-Q. WED has clearly chosen to lever its financing resources through collaboration with private sector institutions. Multiple sectors have been 'targetted' - especially, but not exclusively, 'innovative' and exporting

[70] A limited exception (given the high proportion of *SBLA* loans going to the Accommodation, Food and Beverage sector) are two BDC initiatives targetted at tourism: the 'Tourism Industry Loan Fund' and the 'Tourism Investment Fund' (focussed on 'high-end tourism infrastructure outside major centres).

industries. WED seems to be trying to do what the *SBLA* does: facilitate the availability of financing across a very broad swath of Canada's economy and geography. It's activities to address working capital 'gaps' obviously go beyond the scope of the *SBLA*. Unfortunately, without any agency data on the 'take-up' of these various programs, it is impossible to assess the true extent to which WED's activities might 'overlap' with those of the *SBLA*.

ACOA's activities, in limited respects, are duplicative of the *SBLA'*s. ACOA offers "unsecured, interest-free repayable contributions up-to 50% of the eligible start-up, working capital and capital costs of a new establishment, modernization or expansion project." However, the agency also provides up-to 75% financing of related 'soft costs' (training, studies, marketing, productivity improvement) that are *ineligible* for *SBLA*-guarantees.

Fed-Nor's focus is somewhat akin to FORD-Q's. High-risk business proposals are targetted, especially those that have failed to secure commercial financing. Knowledge-based industries represent a particular area of concentration for Fed-Nor. In its overall conception, the Fed-Nor program complements - but does not 'overlap' - the *SBLA*.

The Provinces

Throughout the 'gaps' analysis, referencewas made to myriad initiatives by provincial governments to address financing market deficiencies confronting SMEs. There is an approximately equal division between provincial initiatives that target priority sectors, and those that seek, in *SBLA*-fashion, to ameliorate financing 'gaps' confronting the broad class of SMEs. Cumulatively, these programs 'target' almost all sectors of the economy - although no single province operates a program as extensive as the *SBLA*. Collectively, the provincial programs employ a wide array of devices to improve SME financing. Those include loan guarantees, loans at market or subsidized rates of interest, grants, and tax deductions or credits. In short, given the methods utilized to provide (or lever) financing, few of these programs are directly comparable to the *SBLA*. As such, 'overlap' tends to be limited to the fact that some provincial programs share the broad *objectives* of the *SBLA*.

CONCLUSIONS

There has been considerable dynamism in the small business financing market over recent years. "Innovative products, services and delivery channels" have been spawned. Credit growth has outpaced growth in the national economy. Small firms have benefitted from Canada's sustained economic growth - and especially from lower interest rates.

While their overall situation has certainly improved, different kinds of 'gaps' continue to plague SMEs: those relating to **size** or **age** of the firm; others pertaining to the **sector** or **region** in which they operate; still others that concern either the **form of capital** being sought or the **characteristics of the borrower**.

'**Smaller**' businesses (those of a size eligible for *SBLA*-guarantees) face enduring 'gaps' in the financing market. Some of the reasons are *systemic*. The relatively small sums they seek offer neither lenders nor investors a level of return that adequately compensates for the 'due diligence' involved. The yearning of small entrepreneurs for 'independence' reinforces venture capitalists' disinclination to invest at '*SBLA*-equivalent' levels. 'Smaller' businesses suffer greater loan losses and are more vulnerable to bankruptcy - both partially a function of their relative inexperience. Unsurprisingly, they face heavier demands for collateral.

The panoply of recent credit innovations has somewhat helped smaller businesses meet their *working* capital needs - but, in most sectors, has only minimally facilitated their access to *term* capital. The *SBLA*, by

contrast, exists precisely to addresses the term lending needs of this constituency. The size of the average *SBLA* loan ($65,000) - and the average number of employees (5.4) per firm receiving *SBLA* loans - both substantiate the argument that, absent the *SBLA*, the small firm financing market 'gap' would be compounded.

'**Start-ups**' and '**younger**' small firms face the least hospitable financing market. Their limited (or non-existent) track records class them as 'high risk'. They seek debt financing less often than other firms, in part because when they do, they encounter lower than average approval rates. There appear to have been very few efforts private- or quasi-private-sector efforts to mitigate the entrenched debt market 'gap' which the *youngest* small businesses encounter. Provincial initiatives targetted at this class of business are spotty. *SBLA*-guarantees, on the other hand, favour precisely this group (with firms three years of age or younger receiving 63% of *SBLA* loans).

Two economic **sectors** - '**innovative**' and **exporting** industries - face pronounced (but largely different) financing market 'gaps'. Unquestionably, it is to the needs of these two sectors that the market has been responding most assiduously over the past three-or-more years. In no way have the problems confronting these sectors (principally the intangibility of assets in the case of 'innovative' industries, and the abiding need of exporters for working capital) yet been overcome. It is in recognition of that reality that so many of the crown agency programs (federal and provincial) continue to target these sectors. However, the level of responsiveness by disparate lenders (or guarantors) suggests that the argument for altering the *SBLA*'s parameters in order to make it more relevant to these sectors' needs may be less pressing than in past.

Businesses in less 'sexy' sectors continue, in many cases, to deal with an imperfect financing market. At least four sectors (business services; construction; retail trade; wholesale trade) appear to have experienced credit 'gaps' in the 1995-1997 period. In the case of at least one of those sectors (retail trade), the *SBLA* may have substantially addressed the 'gap'. While numerous provincial programs are targetted at individual economic sectors, only in a few provinces are there programs designed to enhance *all firms'* access to debt financing. None of those is as comprehensive as the *SBLA*. It remains very much a 'comparative advantage' of the *SBLA* that it is 'demand driven' - and that it does not attempt to pick 'winning sectors'. In that regard, the *SBLA* is certainly unique in facilitating access across the broad swath of the economy to as much capital as it does.

By one indicator (demand for collateral), **regions** furthest from central Canada appear to suffer distinct market 'gaps'. At first blush, the *SBLA*, with its restrictions on the taking of collateral, might seem the perfect antidote to the anti-'extremities' bias in the debt financing market. However, since *SBLA* guarantees lag both Atlantic Canada's and B.C.'s shares of both bank credit and population, it clearly does not serve that function. It may, however, balance regional deficiencies in another way. The debt financing market appears to adjust naturally to regional swings in the Canadian economy. Credit available to small western Canadian SMEs definitely grew in approximate proportion to the overall economic growth experienced by that region between 1995 and 1997. In Québec, however, credit growth did not keep pace. While targetting no region, the *SBLA* does appear to have served as something of a regional 'stabilizer' since the 1995 Québec referendum.

One of the financing market 'gaps' that relates to the *form* (of capital sought) concerns '**working**' capital. It appears to be the most significant one plaguing SMEs. Statistics suggest that it disproportionately haunts small firms. It is *not* one to which the *SBLA directly* responds. It is, however, a 'gap' to which the private sector seems to be responding in a very big way. Furthermore, the federal government is using other of its levers to ameliorate this gap - namely, the BDC, EDC, and the regional development agencies.

If there is a '**leasing** financing gap', it almost assuredly is a diminishing one. Without help from the *SBLA*, the 'specialized finance company' market is burgeoning. Leasing growth is creating pronounced ancillary 'benefits'. Like *SBLA* term loans, leasing frees scarce security for other uses - thus facilitating access to working capital. It may actually enhance a small firm's eligibility for an *SBLA*-guaranteed term loan, inasmuch as the balance sheet of a company with leased assets can appear more attractive when scrutinized by

authorized *SBLA* lenders. While the 'equity' case for inclusion of capital leases within the *SBLA*'s framework is almost unassailable, there is less reason today from a market 'gap' perspective than there was even two years ago.

Market 'gaps' pertaining to *borrower characteristics* continue to pertain. The evidence is pretty irrefutable that **female** SME owners do not enjoy as accommodating a financing market as their males counterparts. Particularly **young** entrepreneurs similarly suffer poorer access to debt finance. While **aboriginal** Canadian access is sub-par, other lenders are taking limited steps to address the problem. In none of these cases does the *SBLA* deliberately set out to ameliorate the market 'gap'. However, in its heavy support of 'start-ups', the program invariably assists young entrepreneurs in overcoming the debt financing 'gap' which they face. A limited number of other incentives (offered particularly by provincial governments) similarly try to diminish the extent of the 'young' SME-owner 'gap'.

It is much easier to conclude the existence of 'gaps' than of '**overlap**' - a term which implies duplicative - perhaps even redundant - activity. On the one hand, it is pretty clear that there is no built-in, programmatic 'overlap' between the *SBLA* and those efforts by other lenders or guarantors to address working capital, leasing, equity, 'innovative' or exporting industries 'gaps'. From the borrower's (and in many cases the lender's) vantage point, once an *SBLA*-guarantee is secured, access to credit under any of those headings might become easier. For the most part, however, the *SBLA*'s parameters do not target any of those 'gaps' - and hence do not 'overlap' efforts by others to minimize them.

In other sectors (perhaps manufacturing in particular); in every region; across the entire category of 'smaller' firms; among start-ups and 'younger' enterprises; the *SBLA does* 'overlap' numerous private sector, quasi-public sector, and provincial government (and agency) initiatives designed to improve SME access to capital. How could it be otherwise? The *SBLA* is *supposed* to be a 'broad-brush' program. Unlike most of the other (comparably small) initiatives designed to improve access to financing, the *SBLA* is *not* targetted. It is *lender*-guided, meaning that of all such programs, it is probably the most responsive to market demand. Its parameters are reasonably easy for lenders and borrowers alike to comprehend, and apply to far more SMEs engaged in more different kinds of activities across the breadth of the country, than do those of any other program.

Most definitely, the *SBLA* does 'overlap' with chartered bank and credit cooperative lending. For there to be no 'overlap', *all SBLA* lending by financial institutions would have to be 'incremental'. In establishing the *SBLA*, it was never the government's objective to monopolize all 'risky' lending. If government were now to set about eliminating 'overlap', all *SBLA* loans would henceforth have to be 'incremental'. The *SBLA* program would guarantee *all* 'risky' loans; defaults would be much higher; and cost recovery would either be impossible - or would necessitate fees set at such a high level that the program, effectively, would be killed.

While hard to quantify, it is also the case that *SBLA* lending facilitates further credit, especially for working capital purposes. A lender might have been willing to make the term loan *without* the guarantee. But would it have been as willing to make the second, operating credit loan if the first had not been guaranteed? Attempting to answer that question points up much of the irrelevance of the 'overlap' notion.

'Overlap' between the *SBLA* and other federal lenders and guarantors is more limited, since virtually all of those seek to *target* their efforts. By definition, the EDC focuses on exporters. The BDC likewise assists exporters and, more particularly still, targets 'innovative' industries. BDC clients are larger, older, and less 'risky' than *SBLA* clients. Perhaps more importantly, the BDC actually *makes loans* - whereas the *SBLA* simply *guarantees* them. That radically different *modus operandi* pretty much contradicts any contention of 'overlap' between the two programs.

Of the regional agencies, the two *least* like the *SBLA* are Fed-Nor and FORD-Q - both of which are quite sectorally targetted. ACOA and WED, by contrast, come closer in their conception to the *SBLA*. Like the Québec and northern Ontario agencies, they sectorally target. However, like the *SBLA*, they also try to address the credit needs of the array of small and young firms. If policy-makers are genuinely concerned about eliminating 'overlap' between and among federal programs, they might want to direct the regional agencies to offer *only* 'targetted' financing assistance, while retaining the *SBLA*'s broader application.

The bulk of provincial government programming differs from the *SBLA* either in its sectoral targetting, or in the means utilized to provide credit to SMEs.

The foregoing analysis leads, ineluctably, to some very straightforward conclusions. There *are* 'gaps' in the small business financing market. The *SBLA* is designed to address some, but not all of them. The preponderance of non-*SBLA*-related activities and innovations (to ameliorate debt financing 'gaps') focus on those deficiencies in the market which the *SBLA* is *least* well-suited to address. Accordingly, there is surprisingly little 'overlap' (in the sense of 'duplication') between what the *SBLA* does and what other lenders or guarantors do. The greatest 'overlap' occurs exactly where it *must* (in bank and credit cooperatives term lending). If policy makers set-out to eliminate that 'overlap', they would wittingly marginalize the *SBLA* to the point of irrelevancy, and would significantly diminish SME access to debt financing.

APPENDIX ONE

Bank Credit <$250k (1995 and 1997) BY BANK

Bank	**Average Outstanding as at 1995Q3**	**Number of Customers as at 1995Q3**	**Average Outstanding as at 1997Q2 (change from 1995)**	**Number of Customers as at 1997Q2 (change from 1995)**	**Bank's share of total outstanding credit <$250k 1997 (1995)**	**Outstanding Credit as % of Authorized Credit 1997 (1995)**
Montreal	$35,653	118,643	$36,228 (+ 1.6%)	123,690 (+ 4.3%	19.8% (21.2%)	76.1 (76.0)
CIBC	$34,402	113,712	$36,138 (+ 5.1%)	106,593 (- 6.3%)	17.0% (19.6%)	70.1 (68.8)
Hong Kong			$53,513	9,194	2.2%	78.7
National	$32,685	61,191	$28,328 (- 13.3%)	61,248 (+ 0.1%)	7.7% (10.0%)	49.4 (54.2)

Royal	$30,802	144,895	$35,004 (+ 13.3%)	184,295 (+ 27.2%)	28.5% (22.4%)	72.5 (70.8)
Scotia	$43,207	63,092	$37,013 (- 14.3%)	79,755 (+ 26.4%)	13.0% (13.7%)	77.1 (79.4)
TD	$39,823	65,389	$32,339 (- 18.8%)	82,315 (+ 25.9%)	11.8% (13.1%)	67.8 (70.4)
6 banks (1995) 7 banks (1997)	$35,167	566,921	$34,980 (- 0.5%)	647,090 (+ 14.1%)		70.3 (70.3)

Statistics aggregated from: CBA *Business Credit Statistics as at September 30, 1995* and CBA *Business Credit Statistics as at June 30, 1997.*

APPENDIX TWO

Bank Credit <$250k, By Region (1995 and 1997)

	1995 (3rd Quarter) Average Authorizations	**1995 (3rd Quarter) Average Outstandings**	**1995 (3rd Quarter) Number of Customers**	**1997 (2nd Quarter) Average Authorizations (change from 1995Q3)**	**1997 (2nd Quarter) Average Outstandings (change from 1995Q3)**	**1997 (2nd Quarter) Number of Customers (change from 1995Q3)**
Atlantic	$ 46,899	$ 35,224	47,325	$ 47,881 (+ 2.1%)	$ 35,745 (+ 2.6%)	51,252 (+ 8.3%)

Québec	$ 54,948	$ 34,508	115,363	$ 53,964 (- 1.8%)	$ 32,897 (- 4.7%)	121,896 (+ 5.7%)
Ontario	$ 50,371	$ 35,851	210,480	$ 48,146 (- 4.2%)	$ 34,152 (- 4.7%)	246,689 (+ 16.8%)
Prairies	$ 46,701	$ 34,882	126,657	$ 48,650 (+ 4.2%)	$ 36,636 (+ 5.0%)	142,755 (+ 12.7%)
B.C./ Yukon/ NWT	$49,139	$ 34,623	67,095	$ 51,185 (+ 4.2%)	$ 37,137 (+ 7.3%)	84,498 (+ 27.8%)
Canada	$ 50,044	$ 35,167	566,921	$ 49,727 (- 0.6%)	$ 34,980 (- 0.5%)	647,090 (+ 14.1%)

1995 - six banks; 1997 - seven banks. Statistics aggregated from: CBA *Business Credit Statistics as at September 30, 1995* and CBA *Business Credit Statistics as at June 30, 1997.*

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