An Assessment of the Effectiveness of the Small Business Loans Act (SBLA) in Light of Financial Sector Developments

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Introduction

Since 1961, the Government of Canada has supported small business in Canada via a strategic partnership with financial institutions. This strategic partnership exists in the form of the *Small Business Loans Act* (SBLA), which allows financial institutions and the government to "share the risks inherent in extending credit."[1] In its 37 years, the SBLA has facilitated the financing, creation and/or improvement of more than 500,000 businesses. During this time, financial institutions have been able to provide small and medium-sized enterprises (SMEs) with more than $20 billion in financing. This has resulted in significant job creation and promoted Canada's economic growth.

The Canadian financial sector is changing. Financial institutions reported record profits in 1997, but regulatory change is promoting increased competition and consolidation within the industry.[2] Consolidation, coupled with the trend towards electronic delivery of financial services, has a direct effect on Canadian SMEs. Consolidation among providers of SBLA loans will reduce the number of sources of these loans for small businesses. If the SBLA is to continue fulfilling its objective effectively in the changing financial environment, new methods of delivery (i.e., electronic distribution methods, new loan providers, etc.) should be considered.

At the same time, there are a number of new initiatives in financing for SMEs, which are being provided by both the government and financial institutions. These new initiatives are increasing SMEs' access to loans in general, raising the question of whether these initiatives duplicate the efforts of the SBLA. This does not appear to be the case. In fact, the markets served by the SBLA (small, young firms) are not the primary targets of these new sources of financing. While new financing initiatives are certainly very helpful to small business, they do not negate the usefulness of the SBLA.

Like any business, SMEs require financing both to start up and to improve or expand as they become successful and grow. And small business needs for debt financing are

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[1] Industry Canada, *Small Business Loans Act: A Presentation to the House of Commons Standing Committee on Public Accounts*, February 1998.

[2] Chris Roth and Hugh Williams, *The Canadian Financial Services Industry: The Year in Review, 1997 Edition* (Ottawa: The Conference Board of Canada, 1997).

increasing. In fact, "growth in the SME debt financing market…outpaced that of the total business market, increasing 20 per cent between 1994 and 1996."[3] This growth has been attributed to increased post-recession SME demand for credit, improved SME capacity to retain earnings, increased willingness of lenders to extend credit to SMEs, and a reduction in the prime rate.[4] However, access to financing remains a major concern for small business owners,[5] who argue that they do not have sufficient access to capital and that banks discriminate against them. In their view, this discrimination exists in the form of higher collateral requirements and higher costs of capital imposed by the banks.[6] However, recent changes to the SBLA, along with new financing initiatives from both the public and private sectors, are improving the availability of financing for SMEs.

An Assessment of the Usefulness of the SBLA

The objective of the SBLA is clear: "to increase the availability of loans for the establishment, expansion, modernization and improvement of small business enterprises."[7] The SBLA was created in recognition of the above-mentioned difficulties SMEs have experienced in obtaining debt financing and in recognition of the "important role small business plays in economic output and job creation."[8] SMEs provide 50 per cent of private sector employment and 43 per cent of private sector economic output.[9] Because of the importance of SMEs to the economy, the federal government believes that it should support them, and one of the ways it does so is via the SBLA.

The SBLA is by far the broadest method of financing used by governments to support new, small and growing SMEs. It has increased the availability of certain types of loans for SMEs and thus has been successful at achieving its objectives. The SBLA has

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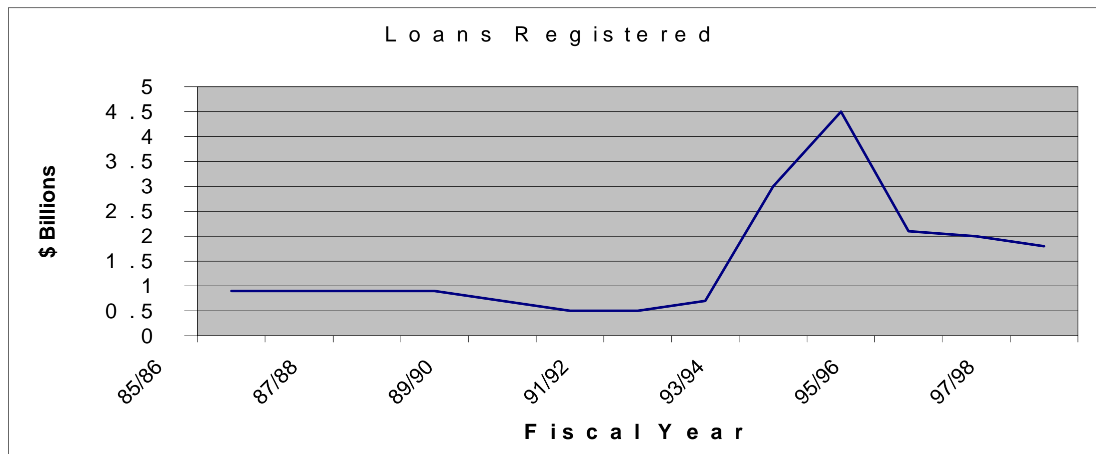
[3] Catherine Moser and Pierre Vanasse, *What's New in Debt Financing for Small and Medium-sized Enterprises?* (Ottawa: The Conference Board of Canada, 1997)..
[4] Roy B. Norton, *The Current Market for Small Business Financing*, Draft, April 1998, pp. 4–5.
[5] Canadian Federation of Independent Business, *Credit Where Credit is Due: Results of CFIB Survey on Credit Conditions in the Small and Medium-sized Business Sector*, January 1998.
[6] Moser and Vanasse, *What's New in Debt Financing for Small and Medium-Sized Enterprises?*
[7] Industry Canada, *Small Business Loans Act: A Presentation to the House of Commons Standing Committee on Public Accounts*, February 1998, p. 5.
[8] Ibid.

facilitated the financing of more than 500,000 SMEs since its inception. It has helped financial institutions provide more than $20 billion of financing to SMEs. Since claims against the guarantee totalled only $669 million as at March 31, 1997, this means that more than $19 billion went towards supporting and improving Canada's SMEs.[10] More than half of this amount has been disbursed since 1990, and two-thirds of the loans have been repaid. This is an indication of the level of success enjoyed by those whose financing was supported by the SBLA. It also suggests that the objective of the SBLA—to encourage financial institutions to lend to SMEs—has been achieved.

The Effect of the Economic Cycle on SME Financing

Significant changes to the SBLA program were made in 1993 and again in 1995. Prior to 1993, the program was relatively stable; therefore, it is difficult to note any change in SBLA financing related to economic cycles between 1961 and 1993. Changes in 1993 significantly increased loan registration and claims under the SBLA loan guarantee program (see Chart 1). In response, the government initiated a number of new changes in 1995, which helped reduce the lending spike that had occurred largely as a result of the 1993 changes.

SBLA Loans Registered, 1985-1998



Source: Industry Canada

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[9] Industry Canada, *Small Business Loans Act: Annual Report on Operations for the 12-month period ended March 31, 1997*, p. 1.
[10] Ibid., Table 3.

The most recent economic cycle took place from approximately 1990 to the present. Because there were significant changes to the program in the middle of this cycle, it is not possible to determine quantitatively whether there are trends in SBLA financing tied to the economic cycle.

Any analysis of the impact of the economic cycle on SBLA financing must therefore be speculative. It is likely that Canada is currently at the peak of its economic cycle and that an economic downturn can be expected within the next five years. It is possible that at the peak of an economic cycle, small business owners simply have more money to invest and therefore need to borrow less; if true, this would diminish demand for SBLA loan guarantees. However, entrepreneurs might also be more willing to take the risk of launching or expanding a small business during a period of economic prosperity, which might increase demand for loans and therefore for guarantees on these new loans.

Conversely, during an economic downturn, demand for SBLA loan guarantees might decline, because businesses would feel less confident of their ability to service the debt once it was granted. However, it is also possible that financial institutions would feel less willing to absorb the risk of small business loans themselves and would therefore push more loans through the SBLA.[11] To determine specifically what effect the economic cycle has on SME financing, more data on the use of the SBLA throughout several economic cycles are necessary.

It is possible to identify more quantitatively, though, the impact that a stronger economy has had on the provision of debt financing to SMEs. During the last five years, the Canadian economy has been relatively strong, and both SMEs and providers of financial services have benefited. The current economic environment is conducive to SME lending because:

1. Financial institutions are more profitable, so tend to be less risk averse.
2. SMEs are more profitable, so more of them qualify for loans more easily.

[11] These postulations are supported by findings of Haines, Riding, the Canadian Bankers Association and The Conference Board of Canada, as reported in Roy B. Norton, *The Current Market for Small Business Financing*, Draft, April 1998, p. 5.

3. There is general interest in the industry in showing support for the SME market because of the increasingly apparent and significant contribution small businesses make to the economic well-being of Canada.

Banks Are More Profitable, So Less Risk Averse

The Conference Board yearly publication that reports on the financial services industry in Canada captures 1997 activity in the sector with its title: *Financial Services in Canada: Record Profits and Fundamental Change.*[12] The report concludes that the industry is attaining record profits and is likely to continue to do so in the short term, certainly for the 1997–98 fiscal year.

Financial institutions are offering a number of new financing initiatives targeted at SMEs and, in the process, are granting additional loans for small businesses. Part of the reason for the increased willingness of the financial services sector to lend has to be the favourable economic cycle. Loan losses are down. The economy is doing well. Inflation is low. Profits are up. Under such conditions, it is definitely easier to loosen up lending criteria and allow for increased lending. To their credit, the financial services industry has been reinvesting its favourable results and has been especially supportive of SMEs.

Would these initiatives of financial institutions exist if Canada found itself in the middle of a recession? While it is difficult to speculate, the experience of the financial services industry during previous economic downturns suggests that in response to increased risk (caused by a recession, for example) there is a decrease in the supply of financing. How much of a contraction and where the lending ceases to be available have been subjects of much debate and are well beyond the scope of this report. Suffice it to say that during recessions, institutions look for ways to reduce their exposure to loan losses. This will affect both large and small businesses, both new and established firms.

[12] Hugh Williams, *Financial Services in Canada: Record Profits and Fundamental Change* (Ottawa: The Conference Board of Canada, 1997)..

SMEs Are More Profitable, So Qualify More Easily For Loans

At the same time, SME customers of financial institutions are changing. It has been well documented that SMEs are more risky than larger, more established firms. In one study, Baldwin et al. (1997) found that over 63 per cent of firms that failed did so during the first five years of operation.[13] The main reason for this, according to the study, is inexperienced management, and a second key deficiency is in the area of financial management. In fact, even "successful entrants" often lack a business plan and a financial plan—and these are arguably key managerial tools used by successful firms.[14] Partly as a result of this, studies have found that "young and unincorporated firms appear to be financially more constrained than established firms."[15] These studies have confirmed that SMEs tend to rely more on fewer sources of financing than larger, more established firms. As a result, retained earnings and personal funds—and traditional lending—tend to be more important for such firms.

Perhaps as a result of this, small firms have tended to benefit more from real growth in the economy. In fact, the studies suggest that they have benefited more from good economic times than have other firms. This is because, while better economic performance brings with it the requirement for additional financing for growth, for example, it also brings with it the ability to service the additional financing. Thus, better economic times and the current low interest rate environment have changed SMEs by enabling them to grow much more rapidly than during recession, when cash flows are constrained. A better economy has also made it easier for SMEs to meet the financing requirements of financial institutions.

General Interest in Showing Support for the SME Market

The recent proliferation of targeted financing initiatives may well be the result of institutional loan strategies or risk management strategies dedicated to increasing market shares in the SME segment of the market. In managing their loan portfolios,

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[13] John Baldwin, et al., *Failing Concerns: Business Bankruptcy in Canada*, Statistics Canada, 1997, p. 21.

[14] Joanne Johnson, et al., *Successful Entrants: Creating the Capacity for Survival and Growth,* Report 61-524-XPE (Ottawa: Statistics Canada, 1997)..

financial institutions appear to have determined, for example, that they need to further diversify their product offerings to capture a share of the SME market. In doing so, these institutions favour SME borrowers with good track records and positive prospects for the future. Thus, certain SMEs become choice targets of financial institutions and have no difficulty in obtaining financing. Such firms would be qualified businesses and individuals from a variety of sectors and would even include (at this stage of the economic cycle) high-tech firms, knowledge-based industries, and other sectors that may have traditionally been thought of as "under-served."

It is interesting that, even in the current business environment, the SBLA continues to be used extensively by both SMEs and loan providers. It is used despite the good economic times, despite the apparent enthusiasm of banks for supporting SMEs outside of the SBLA, and despite the significantly increased fees introduced in 1995. This, over everything else, confirms the usefulness of the SBLA guarantee and suggests that other factors, over and above the general availability of financing, are contributing to its success.

In the end, the availability of financing for SMEs has as much to do with the overall lending strategy of the organization within the current economic environment as it does with the risk and returns from the SME loan portfolio. Such strategies, in effect, create a supply and demand effect for SME lending that has been described in various forms in the documentation reviewed for this study. At one time or another within an economic cycle, some areas of the economy or subsets of the lending portfolio will be deemed unfavourable or unduly risky for the institution. At such times, even an otherwise viable SME (but particularly the more risky SMEs, such as start-up firms) will be likely to face an insurmountable challenge in obtaining the financing it needs to grow and survive past the stage of the economic cycle. Even within the context of the SBLA, gaps arise, either when SMEs demand loans that they do not fully qualify for or when the institutions no longer want to take on the risk of an additional SME loan. In such cases,

[15] Kenneth Heidricks, et al., *Are Canadian Entrepreneurs Financially Constrained?* Industry Canada, 1998.

the SBLA guarantee may become the only difference between qualifying for a loan or being turned down.

The Effect of Financial Sector and Other Government Initiatives in SME Financing on the SBLA

The financial sector has been particularly innovative over the past 10 years. Much of this innovation directly affects Canada's SMEs. Although banks continue to enjoy a little more than 50 per cent of the SME financing market, increased competition from other providers of financing has meant that SMEs now enjoy a much wider range of financing choices. This choice comes not only from innovations among the major providers of banking services (e.g., banks, credit co-operatives and trust companies) but also from other sectors (e.g., insurance, sales finance and leasing, and credit cards).

The Conference Board study *What's New in Debt Financing for Small and Medium-Sized Enterprises*? confirmed that growth in SME lending outpaced that of the total debt financing market between 1994 and 1996.[16] More importantly, many of the non-traditional sources of financing, such as specialized finance and leasing, were shown to be actually growing the fastest. The study also suggested that, despite consolidation in the financial sector, there were in fact many suppliers of debt financing for SMEs. These developments have largely been positive for the industry. In fact, this type of environment is conducive to an expansion of available financing and particularly for small business lending.

Each year, the Canadian Bankers Association describes the initiatives specifically targeted at SMEs in its annual report, as well as in yearly surveys of SME customers (such as the Thompson and Lightstone studies).[17] They list a growing number of initiatives every year, with the funds associated with each initiative tending similarly to grow each year. This shows clearly that the banking sector is providing financing to a

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[16] Moser and Vanasse, *What's New in Debt Financing for Small and Medium-sized Enterprises?* p. 34.
[17] For example, see Thompson Lightstone & Company Limited, *Small and Medium Sized Businesses In Canada: Their Perspective of Financial Institutions and Access to Financing,* Toronto, April 24, 1996.

large number of SMEs. Furthermore, a growing number of SMEs are qualifying for loans under new risk requirements of financial institutions.

The various government initiatives in the area of small business financing have played a significant role. The SBLA itself has made a significant contribution by providing a guarantee for certain types of loans made to SMEs by financial institutions. The Business Development Bank of Canada (BDC), Export Development Corporation (EDC) and Farm Credit Corporation provide complementary financing for SMEs. Their initiatives are somewhat smaller, with around $4 billion in direct loans outstanding in each case. The BDC, in particular, has been actively creating new financing products and services for SMEs, many of which are being made available through partnerships with other government agencies and private sector financial institutions.[18]

There are advantages and disadvantages to government agencies directly offering small business financing initiatives. One disadvantage is that, while the only costs associated with the provision of SBLA loan guarantees are administration and claims, government agencies that offer direct loans have these costs as well as staffing and overhead costs associated with their branches. In some respects, the fact that these government agencies have branch offices enables them to offer ancillary programs in support of SMEs (such as the training for entrepreneurs that is offered by BDC). However, the fact remains that setting up such agencies may have been relatively more costly than setting up the SBLA. Another disadvantage of providing SME financing directly through government agencies is that, instead of being able to obtain access to financing at their regular financial institution, as is the case with the SBLA, customers must deal with yet another financial institution in yet another location.

An undeniable benefit of the SBLA is that it succeeds in supporting considerable SME-related financing without its own delivery infrastructure. Instead, loans are provided through regular financial institutions and then partly guaranteed by the SBLA. The risk that remains with the institutions ensures that they conduct due diligence testing on the

[18] A key component of BDC's new mandate is to actively complement the operations of the private sector, which has also introduced a number of new services to meet the needs of SMEs.

loan applications before they are approved. Thus, the SBLA is able to provide financing through more than 8,300 bank branches, 2,340 credit unions and the branches of those trust companies (primarily Canada Trust, which has 422 branches) eligible to offer SBLA loans throughout Canada. Through this cost-effective mechanism, the SBLA has facilitated the granting of financing to more than 177,000 SMEs since 1994 alone.[19]

New initiatives in SME financing do not appear to render the SBLA less useful. These initiatives do not address the basic problems faced by many SMEs, as the SBLA does. Even in good economic times, many SMEs fail to meet the basic requirements of lending, such as financial track record—and even the special initiatives have those basic requirements. It is these firms that will benefit the most from the SBLA. In fact, the SBLA may well allow some SMEs, which would otherwise fail, to survive and grow by obtaining SBLA-guaranteed loans from institutions that, because of the increased risk exposure resulting from an economic downturn, would not otherwise support them.

Degree of Alignment Between Current Financing Gaps and the SBLA

There are a number of "gaps" in financing for SMEs—factors that make it more difficult for small businesses to obtain financing by making them more risky. These include size of the firm, age of the firm, nature of business/industry, and nature of the loan requested.[20] The SBLA helps to fill many of these gaps by encouraging financial institutions to grant loans to SMEs they consider more risky, thereby achieving its objective of improving small business' access to financing.

The SBLA appears to serve many of the gaps that have been identified. Loans that end up being guaranteed under the SBLA have often been granted to young SMEs, to those with no financial track record, and to those from industries considered more risky than others. The data shown in Norton and in Riding support this finding.[21]

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[19] Industry Canada, *Small Business Loans Act: Annual Report on Operations for the 12-month period ended March 31, 1997*, Table 1.
[20] Roy B. Norton, *The Current Market for Small Business Financing*, Draft, April 1998.
[21] Ibid., and Alan Riding, *SBLA: Estimation of Cost–Benefit Scenarios—Phase I, Base Case Analysis*, Draft, March 1998.

Smaller businesses are considered to have a higher risk profile than their larger counterparts and therefore face higher turndown rates or must provide greater collateral when applying for loans.[22] The Canadian Federation of Independent Business claims that the smallest businesses pay interest rate premiums 1.5 per cent higher than those imposed on firms with more than 100 employees.[23] The SBLA's annual report shows, however, that the firms it has lent to over the last decade have had an average of five employees at the time the loans were made, indicating that the SBLA helps fill the financing gap for smaller businesses. Furthermore, because fees associated with the SBLA are uniform, smaller firms are not subject to higher fees than larger firms obtaining these loan guarantees. Thus, the SLBA again improves smaller firms' access to financing.

"'Start-Ups' and younger firms are generally considered the most vulnerable category of small businesses."[24] They often have more difficulty than established firms in obtaining funding because of management inexperience, lack of funding, and a lack of track record with a financial institution. The SBLA has helped to address this gap—39 per cent of SBLA loans in 1996–97 were made to start-ups.[25]

Certain industries and sectors are considered by the financial sector to be more risky than others. By virtue of its guarantee, the SBLA improves high-risk sector businesses' access to loans and encourages financial institutions to lend to such firms when they are otherwise qualified borrowers. For example, businesses in the accommodation, food and beverage services industries received substantially the highest proportion (18.7 per cent) of SBLA business improvement loans in 1996–97.[26] There are, however, some sectors less served by the SBLA. "By virtue of its parameters, SBLA business improvement loans, or BILs, are heavily concentrated in those sectors necessitating a disproportionate investment in equipment and premises ('fixed assets')."[27] In that vein,

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[22] Norton, *The Current Market for Small Business Financing*, pp. 7–8
[23] Ibid., p. 9.
[24] Ibid., p.13.
[25] Industry Canada, *Small Business Loans Act: Annual Report on Operations for the 12-month period ended March 31, 1997*, p. 9.
[26] Ibid., p. 11.
[27] Norton, *The Current Market for Small Business Financing*, p. 18.

there is some concern that knowledge-based enterprises face a significant financing gap that the SBLA does little to address. "The concentration of the SBLA on fixed-asset financing makes the program particularly unsuitable for financing knowledge-based businesses, which typically lack fixed assets and have a greater need for working capital."[28] Addressing such sectoral gaps would have significant implications for the SBLA, which will be discussed in more detail below.

Some gaps still exist pertaining to the nature of loans demanded—specifically, capital leasing and working capital financing. Although new partnerships being formed for capital leasing are improving small business access to capital leases, a gap in this type of financing remains. The provision of this type of financing has not been addressed by the SBLA to date.

Another gap that remains for SMEs is access to working capital. However, it may not be prudent to serve the working capital needs of SMEs by means of a guarantee. To guarantee a working capital loan would remove the small business' incentive to actively and prudently manage working capital. Norton also suggests that, by restricting the security on its loans (i.e., not taking full collateral on SBLA loans), the SBLA leaves more of the SMEs assets available as collateral for use in obtaining regular working capital loans from financial institutions.[29] In fact, Norton asserts that "a SBLA guarantee, in many cases, laid the groundwork for its owner to negotiate working capital credit with the same financial institution."

If the SBLA were to attempt to eliminate all gaps, the program would be more costly than it currently is, it would be more risky, so less able to recover costs, and it would duplicate a number of other government initiatives directed at SMEs. Gaps will remain as long as there are demands that cannot be met through traditional financing channels. *However, the SBLA does appear to address a number of significant gaps in SME financing, thereby satisfying its stated objective.*

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[28] Industry Canada, *Small Business Loans Act: A Presentation to the House of Commons Standing Committee on Public Accounts*, February 1998, p. 28.

Role of Government in SME Financing

Small and medium-sized enterprises in Canada are important drivers of economic growth. "In 1996–97, firms with fewer than 50 employees created 81 per cent of the new jobs in Canada—up from 70 per cent the year before."[30] Almost all SMEs in Canada have fewer than 50 employees, yet they provide 50 per cent of private sector employment and 43 per cent of private sector economic output.[31] This represents a significant contribution to Canada's economy on the part of SMEs.

As discussed earlier, the objective of the SBLA is to assist the SME sector by improving its access to financing. Since its inception, the program has facilitated 500,000 small businesses in obtaining $20 billion in start-up or improvement loans. The SBLA "provides a service essential to those small businesses for which debt financing would otherwise be inaccessible."[32] This has helped the economy measurably—in 1996–97 alone, it is estimated that 73,000 jobs were created as a direct result of business improvement loans made under the SBLA.[33]

Economic growth is at the heart of the government's role in facilitating SME financing. As long as SMEs contribute meaningfully to economic growth and the SBLA continues to contribute to the growth and success of SMEs, the SBLA has a role to play in furthering Canada's economic health. Therefore, as long as this remains an objective of the government and it can do so without taking undue risk, the government appears to have a role to play in promoting SME debt financing.

The Incrementality of the SBLA

One of the most basic questions related to the SBLA is whether loans made under the government guarantee would have been made in the absence of such a guarantee. This

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[29] Norton, *The Current Market for Small Business Financing*, p. 20.
[30] Industry Canada, *Small Business Loans Act: A Presentation to the House of Commons Standing Committee on Public Accounts*, February 1998, p. 5.
[31] Industry Canada, *Small Business Loans Act: Annual Report on Operations for the 12-month period ended March 31, 1997*, p. 1.
[32] Industry Canada, *Small Business Loans Act (SBLA) Program, Detailed Assessment Cri*teria, pt. 1(ii)..
[33] Industry Canada, *Small Business Loans Act: Annual Report on Operations for the 12-month period ended March 31, 1997*, p. 1.

question is both complex and simple and, in light of industry developments, is at the centre of this assessment of the SBLA.

The question of incrementality is complex, because determining whether a loan is incremental would involve reproducing, on an analytical basis, the sometimes subjective thought processes of loan officers who accept or reject individual loan applications. Would loans granted under the SBLA have been rejected outside of the SBLA? Have loans been received by applicants that would have been rejected without the SBLA's contribution to their success?

To answer these basic questions about incrementality, financial institutions' assessment of creditworthiness of SMEs would need to be analyzed relative to:

- the loan portfolios of the participating institutions,
- the risk–return profile of the loan, and
- the loan-granting procedures and policies of the institution at the time the loan was made.

An effective analysis of the incrementality would examine in detail the processes by which financial institutions make their loan-granting decisions. Similarly, the analysis would have to assess the borrower's creditworthiness and potential success upon having received an SBLA loan.

This type of analysis would not only be complex, but several broad assumptions would have to be made, and the conclusions drawn from the analysis would be sensitive to any errors and/or omissions in those assumptions. In reviewing the documentation assembled for this review, we were able to find only one such recent study of the incrementality of the SBLA. This study, entitled *Impact of SBLA Lending: An Evaluation of the Economic Impact of the SBLA Program,* by Alan Riding, went some way towards the goal of measuring incrementality.[34] It reviewed data drawn from registration forms and included interviews with recipients of SBLA lending. In the process, it estimated that approximately 54 per cent of SBLA loans granted are incremental. More importantly,

[34] Alan Riding, *Impact of SBLA Lending: An Evaluation of the Economic Impact of the SBLA Program,* Equinox Management Consultants Ltd., Industry Canada, December 13, 1996.

the study estimated that only 14 per cent of all of the loans reviewed could not be associated with at least one of the types of incrementality that were identified.[35] Thus, it can be argued on an empirical basis that at least 54 per cent, and probably 86 per cent, of all SBLA loans are in fact incremental. This figure is up considerably from a 1993 study by Haines and Riding, which suggested that only 60 to 70 per cent of SBLA loans were incremental. These studies are the only available quantitative estimates of incrementality to date.

From our perspective, the more recent study is incomplete in that it captures only half of the story. To really get a sense of the incrementality of the SBLA, one would also have to review loan documentation and interview the loan officers responsible for the decisions to guarantee the loans through the SBLA. The last time this was done was for the 1993 study. [36] At that time, the SBLA was substantially different than it is now, and even the 1993 study did not go as far as described above. The ideal analysis would provide a better, more balanced estimate of the incrementality of the loans granted under the SBLA, because it would canvass the perspectives of both lenders and borrowers on specific loans as they are made. After all, the decision on whether or not the loan should be an SBLA loan does not rest only with the borrowers. Both lenders and borrowers decide whether it is appropriate to register the loan under the SBLA.

With this in mind, the Conference Board set out to analyze, albeit on a more qualitative basis, the question of incrementality relative to the current SBLA offering. The analysis is based on the assumption that if the loan could be granted without the SBLA, then it would not be registered with the SBLA, particularly if there were costs associated with that registration. This analysis seeks to explore the cost/benefit of an SBLA guarantee from the borrower's and the lender's points of view. This is intended to determine whether either party would ever find it advantageous to register an SBLA loan when there are no apparent incremental benefits from doing so.

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[35] Ibid., p. 25.
[36] See George Haines Jr. and Alan Riding, *Recent Experience with the SBLA: Economic Impacts, Incrementality and Risk Profile* (Ottawa: Carleton University, August 17, 1994)..

The underlying hypothesis is simple: since SBLA loans are more expensive for borrowers to service and less cost-effective for financial institutions to issue and approve than non-SBLA loans, both parties are less inclined to use them unless necessary. If true, then the loans being registered under the SBLA are likely to be relatively incremental. In other words, if SBLA loans are registered despite the inconvenience and cost of doing so, then the SBLA must serve some higher purpose that makes the additional costs worthwhile.

On an empirical basis, lending to SMEs is growing more rapidly than SBLA lending in general. An analysis of the change in SME lending by financial institutions conducted by the Conference Board estimated that lending to small business had grown by 20 per cent between 1994 and 1996.[37] This compared to overall lending growth of only 6.6 per cent over the same period. Growth among providers was relatively uneven, with specialized finance companies' product offerings growing the fastest and loans by foreign banks and trust companies declining considerably, thanks to significant consolidation in those sectors (see Table 1).[38]

Table 1. Growth in SME Debt Financing, 1994–96 (per cent)

Financing source	Non-res. mortgages	Commercial loans	Lease contracts	Total
Domestic banks	-2.7	27.7	29.6	24.7
Foreign banks	-29.6	-30.4	-37.6	-30.5
Life insurers	-9.9		-25.7	-10.0
Trust & mortgage loan cos.	-39.0	-26.9	-24.0	-37.2
Credit unions/caisses populaires	8.1	23.2		16.5
Specialized finance cos.	56.6	98.2	126.5	105.3

[37] Moser, and Vanasse, *What's New in Debt Financing for Small and Medium-sized Enterprises?* Appendix 1.

[38] See also Roth and Williams, *The Canadian Financial Services Industry: The Year in Review, 1997 Edition*, and Moser and Vanasse, *What's New in Debt Financing for Small and Medium-sized Enterprises?*

Crown corporations		0.3		0.3
Credit cards		28.6		28.6
Total	-11.8	26.3	97.8	20.2

Source: The Conference Board of Canada.

By contrast, the 1993 changes to the SBLA brought significant benefits to both lenders and borrowers and led to a lending spike in 1994–95. This spike was partially reversed by additional changes implemented in 1994–95, which resulted in a 50 per cent decline in SBLA lending during the subsequent year.

In absolute terms, the portfolio of SBLA loans outstanding grew from 3.9 billion in 1994 to more than 4.3 billion in 1996, or by about 10 per cent.[39] As this was a period of significant change for the SBLA (see Exhibit 1), we cannot conclude from this alone whether the SBLA lending was in fact incremental lending or whether the lending spike was a result of a wholesale shifting of loans to the SBLA.

Exhibit 1 – CHANGES TO SBLA

1993 changes to SBLA
- Eligible firm size grows from $2 million sales to $5 million sales.
- Government share of the loss goes from 85% to 90%.
- Maximum loan size grows from $100,000 to $250,000.
- Eligible share of financing goes from 90% of the asset to 100% of the asset

1995 changes to SBLA
- Government share of the loss goes back to 85%.
- Eligible financing goes back to 90%.
- 1.25% yearly administration fee is charged to borrowers.

The following sections will demonstrate that the nature of the changes that were implemented in 1993 (and the subsequent changes in 1995) have substantially changed the economics of SBLA lending for both borrowers and lenders. Clearly, the *behaviour* of the SBLA loan portfolio during this period of change, from the perspectives of both borrowers and lenders, shows that the conditions under which SBLA loans are granted

[39] See Table C7, *Bank of Canada Review*, Winter 1997–98, Ottawa, 1998, p. s-29.

can have a direct impact on the volume of loans granted under the program and therefore on the incrementality of the program.

But what are the economics of offering or taking on an SBLA loan? One way to arrive at a conclusion is to create a model situation that compares the cost/benefit of an SBLA loan in financial terms to a hypothetical non-SBLA loan. Haines and Riding reviewed the loan portfolios of several financial institutions in 1993 and found that only about 20 per cent of loans to SMEs had taken place at prime plus 2 or above.[40] Because the interest cost is a function of the risk related to the loan, it follows that more risky loans will bear a higher rate of interest than less risky loans. Therefore, the section reviews a hypothetical term loan example in which lenders and borrowers are given a choice between a loan at prime plus 3 and an SBLA loan at current maximum rates, both before the 1995 changes and after. In each case, the impact of lowering interest rates on the economics of SBLA lending is reviewed, an assessment of the desirability of the loan is made, and in the end, the types of incremental risks that are currently being financed through the SBLA are reviewed. Ultimately, our analysis supports all of the findings of the Alan Riding studies that SBLA loans (post-1995) are incremental.[41]

The Economics of SBLA Lending Between 1993 and 1995

To lenders, the SBLA changes announced effective April 1, 1993, must have seemed like a relative bargain. Although facing a cap on the SBLA loan interest rate of prime plus 1.75, the risk of an SBLA loan for the institution was to be effectively reduced from 100 per cent to 10 per cent. There were reporting requirements, but these tended to be descriptive in nature. The decision on whether or not to register the loan would therefore consist of comparing the cost/benefit of the SBLA loan with that of a non-SBLA loan. Table 2 describes the situation in 1993.

For the institution, is it more profitable to issue the loan as a non-SBLA loan, receiving interest payments of prime plus 3 per cent and retaining all risk of default, or to

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41 *A presentation to the House of Commons Standing Committee on Public Accounts,* Industry Canada , February 1998, Part 2, pp. 10–17.

Table 2 The Economics of the SBLA, 1993-95

Cost	*1993-1995 SBLA*	*Non SBLA*	*Cost Difference*
Prime	6.5%	6.5%	Same
Interest margin	1.75%	3%	1.25% higher
Institutional risk	Very low (10%)	Full (100%)	Higher
Set-up fee (year 1)	2.0%	N/A	2% less
Yearly admin fee	N/A	N/A	N/A
Total cost	10.25% (year 1)	9.5%	0.75% lower
	8.25% (other years)	9.5%	1.25% higher
			(unless renegotiated)
Desirability of financing	Very high	Average	
	No down payment	Requires down payment	
	100% financing	Not 100% financing	
	Low risk	Relatively risky (lender)	

Source: The Conference Board of Canada

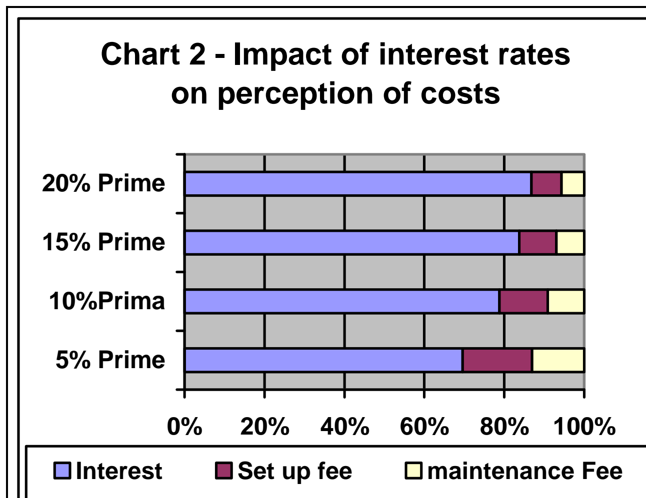
guarantee the loan under the SBLA at interest (under pre-1995 requirements) of prime plus 1.75 per cent while retaining only 10 per cent of the risk? In our example, it is unclear whether the additional 1.25 per cent of margin fully offsets the additional risk. We suspect it does not, as Riding (1994) has found that there are few loans granted at prime plus 3 in any case. However, the calculation back in 1993 must have caused a number of loan officers to take notice and consider the SBLA as a cost-effective way to reduce risk levels: witness the impact on SBLA lending levels.[42]

At the same time, many borrowers would have argued for turning their loan into an SBLA loan. Although these borrowers would have to bear a registration fee of 2 per cent of the total cost of the loan, they would face a financing cost of only prime plus 3.75 per cent in the first year, and this would be competitive with the prime plus 3 example cited earlier. In fact, with the prime itself hovering around 10 per cent in 1993, the fee would represent only about 20 per cent of the financing rate for the first year (see Chart 2). This

[42] *A presentation to the House of Commons Standing Committee on Public Accounts*, Industry Canada.

might be considered a small price to pay in exchange for being able to guarantee 100 per cent of the loan. More significant is the fact that, for a $200,000 capital acquisition loan, the 10 per cent down payment waiver that was in effect for SBLA loans would result in a $20,000 cash saving to the SME—no small amount for the average SME.

Thus, the SBLA program as it stood in 1993 was attractive to many cash-strapped SMEs. In fact, with so many benefits accruing on both sides of the lending equation, it is not surprising that both lenders and borrowers flocked to the program. During the next two years, the SBLA clearly more than achieved its objective of encouraging providers of financial services to increase the availability of financing for small business enterprises. In fact, "as more companies obtained more credit from more financial



Source: The Conference Board of Canada

institutions, lending under the SBLA program shot up from 2.5 billion in 1993–94 to 4.4 billion in 1994–95. In the process, "more than one-third of the total value of all loans made under the program in 37 years was extended under the SBLA program."[43]

Were all of these loans incremental? Probably not, since, as our example shows, there were significant financial incentives for both borrowers and lenders to cause them to direct as many loans as possible to the SBLA. The Haines and Riding findings in 1993

[43] *A presentation to the House of Commons Standing Committee on Public Accounts,* Industry Canada, February 1998, p. 10.

would support this; at that time, only 60 to 70 per cent of loans could be found to be incremental. This analysis suggests that the incrementality would have declined somewhat following the 1993 changes. The actual incrementality would be difficult to judge without an in-depth analysis of loan files from that period. However, based on our analysis of costs/benefits, as well as on the extent of the resulting lending spike, we speculate that the decline in incrementality was significant.

Were *any* of the loans incremental? Again, a proportion of the loans in 1993–94 were probably incremental, since some of the applicants would have been riskier SMEs normally prevented from obtaining financing without the SBLA. However, the existence and size of the lending spike and, more importantly, the behaviour of lenders following the announcement of the 1995 changes suggest that the 1993 changes did not in fact support the goal of helping provide *incremental* financing.

The Economics of SBLA Lending, Post-1995

The 1995 changes to the SBLA (see Exhibit 1) went a long way towards removing the significant SBLA lending incentives that were created by the 1993 changes. From a lender's perspective, the reduction of the guarantee from 90 to 85 per cent meant that each SBLA loan now retained substantially more risk than before. In addition, a yearly administrative fee of 1.25 per cent of the outstanding balance of each SBLA loan was implemented. Because of a corresponding rise in the interest rate cap to around prime plus 3, the cost of this administrative fee was effectively shifted to the SME borrower. However, the administrative burden associated with the SBLA loan was effectively increased, because in addition to reporting, there was an individual fee to be calculated and remitted for each SBLA and this without a corresponding increase in the margins available under SBLA lending (see Table 3).

Table 3 The Economics of the SBLA, Post 1995

Cost	Post 1995 SBLA	Non SBLA	Cost Difference
Prime	8%	8%	Same
Interest margin	1.75%	3%	1.25% higher
Institutional risk	Low (15%)	Full (100%)	Higher
Set-up fee (year 1)	2.0%	N/A	1.75% less
Yearly admin fee	1.25%	N/A	N/A
Total cost	13% (year 1)	11%	2% Higher
	11% (other years)	11%	same
			(unless renegotiated)
Desirability of financing	Above average	Average	
	Requires down payment	Requires down paym	
	Limited collateral	Requires collateral	
	Low risk	Relatively risky (lend	
	Additional administration		

The impact of this change on lenders' appetite for the SBLA was significant. This fact is supported by our numerical examples but also by the stakeholder opinion survey. One major bank mentioned the "extensive administrative components" of the SBLA, indicating they thought the new administrative burdens to be significant. Another cautioned Industry Canada not to "increase the complexity of lending under the program," again suggesting that the administrative burden associated with the SBLA is not insignificant.[44]

The 1995 amendments also imposed a significant burden on borrowers, and from their perspective, the cost of SBLA loans increased significantly as a result of the changes. Borrower costs on SBLA loans effectively went from prime plus 3.75 to prime plus 5 in the first year (in subsequent years, the cost would of course drop to prime plus 3). At the same time, the amount eligible for the guarantee dropped from 100 per cent of the loan to 90 per cent, necessitating a 10 per cent down payment for lending to take place. More

[44] See *Stakeholder Opinions, SBLA Policy Issues,* p. 2 & p. 3, respectively, section 4.

than anything else, the requirement for this cash down payment would place a significant hurdle in the way of any new lending. Finally, with prime having declined significantly by 1995, the fees associated with the SBLA became a more significant proportion of the total costs of obtaining an SBLA loan (see Chart 2).

For financial institutions, the impact of these changes would also have been significant. A non-SBLA loan at prime plus 3 would generate better returns to the institution but at the cost of an increase in risk. In effect, by not writing SBLA loans—unless absolutely necessary for the loan to be approved—the lending institutions would be better off from a return and administrative burden point of view (given an acceptable level of risk).

As a result, the number of SMEs benefiting from SBLA lending declined by half—probably in cases where non-SBLA alternatives were just not available.[45]

Our estimates of incrementality based on the cost/benefits of SBLA lending are consistent with the findings of several of Alan Riding's reports related to incrementality. In Haines and Riding (1994), SBLA loans were found to be incremental in 60 to 70 per cent of cases. In Riding 1996, the incremental portion of the SBLA loan had grown to 86 per cent. Both of these results would be entirely consistent with our cost/benefit analysis. In another Riding study, a higher percentage of SBLA borrowers were in fact found to be financing the fees associated with their SBLA loan through the loan itself. By 1996, a full 45 per cent of borrowers were paying the fees from borrowed funds.[46] This suggests that the new fees are in fact considered to be substantial by a subset of SBLA borrowers. If the fees are substantial, then they represent a significant incentive to avoid SBLA loans whenever possible.

Thus our analysis suggests that SMEs would prefer to avoid the costs and fees associated with the SBLA, where possible, by obtaining loans outside of the SBLA. *It follows, therefore, that those loans that remain with the SBLA do so because there is a real need for the SBLA guarantee and are therefore incremental.*

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[45] Industry Canada, *Small Business Loans Act: Annual Report on Operations for the 12-month period ended March 31, 1997*, Table 1.

Does this suggest that post-1995 SBLA loans are more incremental than pre-1995 SBLA loans? It is likely that as a result of the changes, only those SMEs that have no alternative but to obtain financing under the SBLA are doing so. This would be especially true when the prime is low (currently almost 5 per cent) and the fees associated with the SBLA comprise more than 30 per cent of the ultimate cost of financing during the first year. This tendency would also apply to financial institutions which, even though they rarely charge above prime plus 3, are now able to charge as much as 500 basis points on top of the prime rate before the borrower—on a cost basis—is indifferent as between SBLA and non-SBLA loans (in the first year). With this much margin at play, many lenders should be able to justify a significant amount of risk within their SME lending portfolio. Non-SBLA lending would also provide additional savings and benefits, including those related to the administrative burden of the SBLA loan and the added benefit of not having any limitations on collateral.

Thus, in the current environment, our calculations suggest that both borrowers and lenders will generally want to avoid the SBLA unless it is deemed necessary in order to be able to obtain financial support for their SME client. In the end, we conclude that when the SBLA provided a "free" guarantee (i.e., before the current fee structure), the argument could be made that it presented SMEs and financial institutions with a cost-effective opportunity to transfer risk to the government. The only "real" costs were registration and administration. As a result, SBLA lending had the potential of not being very incremental.

When the SBLA became self-supporting, fees were introduced that effectively changed the economics of offering an SBLA loan. Currently, both the provider and the borrowers are likely to want to avoid the SBLA unless the guarantee is really needed for the approval of the loan. When the risk of default is more than the institution is willing to bear, the additional costs and lower margins associated with SBLA loans become acceptable. In such cases, the borrower is also better off, because the alternative would be to be rejected for the loan. Thus, by sharing its risk with the government, the

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[46] Riding, *Impact of SBLA Lending: An Evaluation of the Economic Impact of the SBLA Program,* p. 15.

institution is able to effectively achieve the objectives of the SBLA and, in the process, achieve an incremental financing result.

The Risks Associated with SBLA Lending

This section reviews how the risks of SBLA lending have been affected by the changes made in 1995, as well as by economic cycles. The Riding study confirms that the bulk of the lending undertaken by the SBLA is relatively risky. The study identifies four types of incremental lending: lending to new firms (where the firm is established concurrent with the loan), lending to young firms (less than one year old), lending to established firms that are unable to access debt capital and lending to firms in distress. [47]

The type of incremental lending the SBLA seeks to support tends to be more risky than the types of loans financial institutions would want to make on their own. This was a basic conclusion of the introductory section of the Riding study and is completely consistent with what we would expect, given our analysis of cost/benefits of offering SBLA loans (post-1995). [48]

Clearly, all of the incremental lending documented by the Riding study is relatively risky, because:

1. Lending to a new firm (where the firm is established concurrent with the loan) presents a number of financial challenges to a lender. In this case, uncertainty about the business increases the risks associated with the loan. This uncertainty exists because the business has yet to establish itself, there is a lack of financial records, it is difficult to assess the ability of the new firm to actually survive and repay the loan, and there is uncertainty about management skills. In this case, the institution lends on the basis of the potential viability of the applicant's business plan or industry.
2. Lending to young firms (less than one year old) is also problematic. Young firms, which would include those mentioned under item 1 above, have a tendency to struggle during the first few years of operation. During this time, they are getting

[47] Ibid., p sum. 1.
[48] Ibid., pp. 2–3.

established within their markets, and they must compete head-on with more established players, establish trade and supplier financing channels, and otherwise create or capture market share from competitors. This is not always easy, and studies have shown that a large proportion of new business entrants cease to exist, either because their owners abandon the business (i.e., they return to other employment, they are bought out by competitors, or they simply cannot survive in their business environment).[49]

3. Lending to established firms that are unable to obtain debt capital also presents some unusual challenges. Their inability to obtain financing might be because of a lack of financial records or because in the past the business was largely financed by internal capital or by funds provided by relatives. In other situations, the firm may not have managed its cash flows effectively. Having become a "bad risk" in the financial marketplace, these borrowers are rejected by lenders. In either case, financial institutions become reluctant to lend on a term basis because of both the uncertainty resulting from past behaviour and the risk of non-payment.
4. Lending to firms in distress is particularly risky. In such cases, established firms may have reached a point where they must modernize, expand or fail. For example, a firm might need new machinery in order to survive in competition with a new market entrant. In such a case, the firm has been unable or unwilling to reinvest in the business in the past and, as a result, has not maintained its competitiveness. By the time the problem is recognized, the firm is likely to be in dire straits and in danger of failing altogether if it does not gain access to new capital. Such a firm will typically find itself in this situation as a result of either financial mismanagement or poor economic conditions. Its operating costs may be out of line with its competitors', and an expansion is the only way to bring in economies of scale. By financing capital acquisitions with short-term money in good times, many firms face a working capital squeeze during economic downturns. In short, there are many reasons why a firm in distress would want an SBLA loan. In such cases, the risk comes from the uncertainty of the ultimate success of the loan, since there are no guarantees that the modernization or refinancing of the assets will be sufficient to

[49] As mentioned before, Baldwin et al. (1997) found that over 63 per cent of firms that failed did so during the first five years of operations.

return the firm to health. There is also the risk that management will repeat past mistakes and run the company into the ground. However, the alternative is almost certain failure.

In each of these four examples, drawn from actual SBLA case files, the risk of the firm was identified as part of the loan approval process and deemed to be in excess of what the financial institution was willing to take. Yet, in each case, the viability of the business plan was such that the institution was willing to put part of its capital at risk on the understanding that the loan would lead to the business' success and eventual repayment of the loan. In some cases, the institutions may have wanted to establish a banking relationship with the SME or may have wished to limit the impact on the collateral of the firm to allow it to get other types of financing, such as working capital loans. These are all situations that lend themselves very well to loan guarantees and result in truly incremental SBLA lending.

Risks and the Economic Environment

The types of risks described above will often become significantly more problematic during economic downturns. At such times, the risk of the institution's current loan portfolio will be increased by virtue of general economic difficulties. The reaction of the lending institution will be to limit losses by restricting lending. In an economic downturn, the risk associated with each type of SME mentioned above will increase, making the SBLA that much more important in ensuring the continuing availability of financing for SMEs.

During economic downturns, the risks associated with non-SBLA loans will also increase. Financial institutions will therefore be more inclined to put loans through the SBLA guarantee program to share some of this additional risk with government. This suggests that the incrementality of the SBLA will tend to increase, all other things being equal, during recessions. At the same time, claims are likely to increase.

What would be the impact of abandoning the SBLA program? Doing so without replacing it with some other initiative targeted at the same SME niche would probably

mean that many SMEs would not receive financing. Thus, a significant number of SMEs (more than 30,000 or so SMEs received guaranteed loans last year) would not be able to grow and expand in the next year. If the analysis described above is correct, a substantial proportion of SMEs would be rejected for loans. Based on the analysis contained in the report that looked at the incrementality of the loans registered under the SBLA, we speculate that between 60 and 80 per cent of current SBLA lending patterns would cease altogether or at least be severely constrained. Furthermore, it is likely that this proportion would grow significantly during the next economic downturn. In some cases, impaired access to financing would result in the failure of these small businesses. Suffice it to say that the SBLA, in its current form, appears to be incremental in good economic times and would become even more so during recessions.

SBLA Delivery Issues

This section will examine how the SBLA is delivered in the context of industry developments such as electronic distribution, telephone banking, personal computer banking and consolidation. It will suggest emerging delivery mechanisms that might be effectively considered by the SBLA administration in modernizing and ensuring that the SBLA is delivered effectively in the future.

Consolidation in the financial services sector has occurred in the past and will continue to occur in the future. The Conference Board's yearly publication *The Canadian Financial Services Industry, The Year In Review* has examined this trend for many years, and for 1997 it reported that, while mergers and acquisitions remained at a high level, especially in the insurance and securities sectors, the number of M&As in the Canadian financial services sector had declined for the second year in a row.[50] In fact, preliminary data suggested that the overall number of mergers and acquisitions would continue its downward trend. This appears to contradict common wisdom, based on two large-profile merger transactions that were announced in 1997 and involve four of the major banks: Royal Bank/Bank of Montreal and CIBC/Toronto Dominion Bank. In fact, it is currently unclear whether these proposed mergers will be allowed to proceed.

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[50] See Table 2 in Roth and Williams, *The Canadian Financial Services Industry: The Year in Review, 1997 Edition*, p. 10.

The trend in mergers and acquisitions is not a local trend but a global one. In fact, cross-border mergers in the banking sector are more common than is generally known.[51] The recently announced merger of Swiss Bankcorp and UBS and the proposed takeover of Bruxelles Banque Lambert of Belgium by ING of the Netherlands highlight the accelerating pace of mergers in the banking sector. In the United States, the same process has been under way for some time, changing the face of the historically decentralized American banking system.

"Government can either be your champion or your roadblock."[52] In almost all countries, including the United States, the United Kingdom, Germany, France, the Netherlands, Belgium, and the European Union (EU) as an entity, there are no formal restrictions on acquiring major national banks. In fact, with the harmonization of its banking legislation, the EU makes it difficult for any member state to block a merger on the basis of keeping banks under national control. Canada and Australia, on the other hand, still maintain formal restrictions on ownership of major banks in addition to requirements that the federal government approve significant changes in bank ownership.

The conclusions of these various analyses suggest that Canada can delay or otherwise stand in the way of consolidation as it seeks to moderate the pace of change and protect Canadian depositors and investors. However, the pace of change internationally suggests that Canada will be unable to stand alone and will not be able to prevent large mergers indefinitely. We conclude that bank mergers will happen; it is not a question of if but when.

Do bank mergers affect delivery of the SBLA? Will consolidations reduce the number of outlets providing SBLA loans? The answers to these questions are not obvious unless one presupposes that SBLA loan delivery is dependent on the number of branches providing SBLA loans. The fact is that financial services are much more available now

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[51] Chris Roth, *Crossborder Mergers in the Banking Sector: Real and Perceived Barriers to Entry*, for Finance Canada (Ottawa: The Conference Board of Canada, March 1998).
[52] Roth and Williams, *The Canadian Financial Services Industry: The Year in Review, 1997 Edition*, p. 1.

than in the past. Data on the number of bank branches show a steady increase over the last five years, from 7,623 bank branches in 1992 to 8,390 in 1997.[53] While it is true that the impact of consolidation has been uneven in some areas and across regions, it is equally true that SBLA loans are provided not only by banks but also by credit unions, trust companies, and a limited number of finance and leasing companies. There are thus a number of outlets providing financing to small business and many providers and types of such financing. Consequently, there is uncertainty about the impact of financial sector consolidation on SBLA delivery, and it is not clear that any impending consolidations will in fact reduce the overall number of locations where SBLA loans can be obtained.

At the same time, developments in electronic banking and the related new technologies maintained their momentum in 1996–97, with the services becoming available on a national basis from a number of suppliers. This includes telephone banking services, PC banking, Internet banking, smart cards and debit cards, as well as financial services at more than 19,000 ABMs.

In fact, the financing world is changing, and delivery methods used for SMEs will change accordingly. Indeed, many owners of SMEs are rapidly getting used to electronic banking. They like the convenience of these new services and will soon demand that their financial institutions offer business services that are as convenient (read electronically distributed).

Consequently, the impact of consolidation on the availability of SBLA loans depends on both the number of outlets and the willingness of providers to offer SBLA loans. The impact of the consolidation of the financial services industry in recent years has been uncertain, and the recent experience reflects a greater number of smaller branches. More importantly, there has been a proliferation of electronic means of distribution, and these are now increasingly being made available to SMEs.[54]

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[53] Data obtained from the Canadian Bankers Association.
[54] Moser and Vanasse, *What's New in Debt Financing for Small and Medium-sized Enterprises?*

Should there be a decline in the number of physical outlets for SBLA loans, the SBLA administration could implement several measures to ensure that SBLA loans continue to be made available to SMEs:

- It could make the program more attractive (as was done in 1993). This would be a way to ensure that the remaining outlets deliver SBLA loans more often. As discussed earlier, such changes might also have implications on the risk and incrementality of the program.
- It could make the delivery of SBLA-supported lending simpler. For example, by allowing electronic filing of loan applications through the Internet (i.e., from an Industry Canada web site) and direct deposit or automatic withdrawal of the associated fees directly between the administration and providers, the administration could reduce the cost of administering the SBLA. This might encourage financial institutions, and more importantly those loan officers that currently perceive the SBLA process as too complex, to consider using it more often.
- It could facilitate the design and implementation of additional delivery mechanisms that provide SBLA loans. Already, several banks employ telephone and PC banking techniques to service an ever-growing number of clients. By aligning with these new delivery mechanisms, the SBLA administration would increase the frequency of use of the program.
- It could accept applications directly from SMEs. As a retailer of SBLA loans (in partnership with one or more financial institutions), the administration could try to disseminate information more effectively and accept applications directly from SMEs seeking SBLA loans. By acting as an agent, it might be able to promote the use of the SBLA without having to rely on the network of branches.
- It could expand the definition of SBLA eligible lenders. There are several new developments under way in the area of debt financing for small business.[55] There are now also several Internet banking providers, including Citizens Bank, mbanx, Wells Fargo and ING Direct, and these could be encouraged to offer SBLA loans. A way could be found to encourage other providers (such as leasing companies) to offer

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[55] Ibid., p. 15.

these new and growing sources of financing to SMEs that otherwise cannot access such modes of financing (e.g., start-ups or micro enterprises).[56]

Many of the above levers are entirely within the control of the SBLA administration. By modifying the delivery methods of the SBLA, the administration can directly affect the availability of such loans. In effect, the impact of consolidation can be offset through initiatives aimed at ease of use within the authorized SBLA delivery outlets. Additional providers should be encouraged; capital leasing companies, local co-operatives and Internet financial service providers (such as Wells Fargo) should all be able to offer SBLA-backed financing as part of their regular lending activities. In addition, the SBLA administration itself could accept applications for SBLA loans, working in co-operation with BDC, EDC, commercial banks or other financing providers to actually issue the loan. The ability of the SBLA administration to understand the emerging delivery mechanisms and to modify the SBLA requirements to fit into the new mechanisms will directly affect future success in a world of financial sector consolidation and rapid change. The beauty of the guarantee mechanism is that it need not adapt completely to the new delivery mechanisms, merely be flexible enough to be offered through these new and emerging mechanisms.

Conclusion

The Conference Board of Canada, as part of an ongoing review of the Small Business Loans Act, was asked to critically review both internal documents and external assessments of key aspects of the SBLA. Based on this review, it was to provide an assessment of the effectiveness of the Small Business Loans Act (SBLA) in light of financial sector developments.

The Conference Board assessment was as comprehensive as possible within the SBLA review timetable. In the process, the Conference Board was able to come up with a

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[56] See the report of the *Focus Group Session to Develop Industry-Supported Requirements and Modalities Related to the Provision of an SBLA-Type Guarantee for Capital Leasing (SBCL),* prepared for Industry Canada by The Conference Board of Canada, February 1998.

number of significant conclusions on the usefulness and effectiveness of the SBLA within the current Canadian context.

The review of the SBLA comes at an opportune time as developments on the regulatory and supervisory front await the outcome of the Task Force on the Future of the Canadian Financial Services Sector (scheduled to release its report and the supporting research work in late 1998). The Conference Board encourages the SBLA administration to consider how the eventual conclusions of the Task Force might be incorporated within the context of the SBLA review. The Task Force report is widely expected to shape developments within the financial services industry for years to come. An effective and vibrant SBLA, assuming it is allowed to continue on the basis of the review, will be likely to have to take into account such fundamental developments within the sector, as they affect financing for SMEs.

As it stands, the Government of Canada has supported the financing of Canadian small businesses by providing a loan guarantee through the SBLA since 1961. In the process, the SBLA has encouraged financial institutions to grant loans to SMEs aimed at improving the conditions of their businesses. The program has been successful, and the SBLA is now by far the broadest tool used by governments to support the financing of new, small and growing SMEs.

The SBLA has facilitated the financing of more than 500,000 SMEs since its inception. It has encouraged financial institutions to provide more than $20 billion in financing to SMEs. Since claims totalled only $669 million as at March 31, 1997, this means that more than $19 billion went towards improving the facilities and status of Canada’s SMEs. This is clearly a significant financial contribution to the success of Canadian SMEs.

Relative to the size of this contribution by the SBLA, claims on the guarantee have been minimal—less than $700 million since inception. This suggests that most of the 500,000 SMEs who received government assistance under the SBLA have been successful enough to repay their debts and prosper past the stages at which they needed assistance under the SBLA.

The analysis contained in the report suggests that the areas covered by the SBLA are much broader and substantially different than those covered by many of the new and emerging financing instruments. Indeed, the markets served by the SBLA (small, young firms) are not the primary targets of many of these new sources of financing. The SBLA continues to be useful, because it targets firms and industries that would not otherwise qualify for loans from their financial institutions.

The various analyses presented in the report support the notion that a substantial proportion of the loans covered by the SBLA are incremental and would not have been granted without the SBLA. This is because the vast majority of SBLA loans are granted to firms not traditionally well-served by the financial industry. Such firms, often because of age, industry or lack of a financial track record, end up obtaining only term financing because the risks associated with them are partly mitigated or otherwise guaranteed by the SBLA.

The fact that new sources of financing are also, in and of themselves, extremely helpful to small business, does not negate the usefulness of the SBLA. Indeed, as statistics suggest, there continue to be new SMEs, and many are just not able to qualify for traditional loans, even when a special initiative exists to assist them. Consequently, through the SBLA, the government is able to encourage financial institutions to provide the additional funding needed by such firms.

It is important to note that many indirect benefits also flow from the availability of SBLA loan guarantees to SMEs. The SBLA has enabled many SMEs to establish themselves with their financial institutions. SMEs that lack a financial track record, that are too small or too young, were in the past considered less able to gain the attention of their financial institutions. Furthermore, in the process of offering its guarantee, the SBLA also provides SMEs with an increased opportunity to obtain non-guaranteed funds, such as working capital loans, because collateral is freed up when a firm's business improvement loans are guaranteed under the SBLA. As a result, such firms continue to make up the bulk of the borrowers covered by the SBLA guarantee.

Therefore, the SBLA continues to be an important supporter of financing for SMEs and should be given due priority.

A number of financing gaps relative to SMEs have been documented, and the SBLA fills a number of them. However, it is not clear that a broad financing support tool such as the SBLA should be used to fill all gaps. For example, offering a guarantee under the SBLA for working capital loans would be difficult: working capital needs to be actively managed and the guarantee would encourage borrowers and lenders not to manage their working capital loans. Other gaps have been identified, such as knowledge-based businesses, Aboriginal lending, etc. Of the SME financing gaps that remain, most tend to be relatively focused, and many are beginning to be served through special initiatives of the financial services industry (including the relevant government agencies). It would be difficult to adapt such a broad tool as the SBLA to fill financing gaps that are targeted and specific. In fact, it is likely that such a change would increase duplication, particularly with ongoing efforts being made by financial institutions and government financing agencies in many of those areas.

Consolidation of the financial services sector has happened in the past and will continue in the future. This not a local trend but a global one, and although Canada can delay or stand in the way of this trend, it is not likely to be able to prevent large mergers indefinitely. The analysis suggests that despite conventional wisdom and continued uncertainty, such consolidations may not in fact reduce the absolute number of outlets providing SBLA loans in Canada, though the impact of such consolidation is likely to be variable in specific areas or in specific regions. At the same time, new, more convenient delivery mechanisms are being developed, largely on the personal banking side. It is likely that these will become increasingly available to small business clients in the near future.

While the impact of these delivery trends on the availability of SBLA loans is uncertain, it will clearly depend on both the number of outlets and the willingness of providers to offer SBLA loans. Since the willingness of providers to offer SBLA loans depends largely

on the cost/benefit of the loans relative to the risk being assumed, it is unclear that consolidation alone will reduce the availability and effectiveness of the SBLA.

In fact, several levers are within the control of the SBLA administration to help ensure that providers of financing are willing and able to offer SBLA loans to as many deserving SME clients as possible. In fact, by modifying the structure of the SBLA in 1995, the administration demonstrated it could directly affect the availability of SBLA loan guarantees for SMEs. Thus, the impact of consolidation within the financial sector could be offset by initiatives aimed at improving ease of use, modernizing delivery mechanisms or allowing additional providers of financing to offer SBLA loans.

As long as government policy continues to be supportive of financing initiatives for SMEs, particularly the very small and very young businesses, then the SBLA appears to be an effective tool of government policy. Both borrowers and lenders value the SBLA and this despite significant fees and a reportedly complex process of administration for lenders. In the end, the fate of the SBLA rests on its ability to adapt to the changing business environment, ensuring that it continues to meet a unique need for financing by SMEs.