EVALUATION OF THE CANADA SMALL BUSINESS FINANCING PROGRAM FINAL REPORT

Prepared for: Audit and Evaluation Branch, Industry Canada

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EXECUTIVE SUMMARY

This report presents the results of the 2004 evaluation of the Canada Small Business Financing (CSBF) program. This evaluation is an element of the comprehensive review of the program, the results of which will be completed by March 31, 2005, and tabled in Parliament.

The study was based on a results-based management and accountability framework for the program, which specifies the questions that are to be addressed in the evaluation study. The most important of these questions and the key study findings related to each question are presented below.

Program rationale. Is there a valid rationale for government involvement in facilitating access to asset-based debt financing for small and medium-sized enterprises (SMEs)?

Findings. There is an on-going need to facilitate access to asset-based debt financing for SMEs. SMEs have more difficulty obtaining financing than large firms, primarily because loans to SMEs are riskier. Because of this higher degree of risk, lenders limit the availability of financing for SMEs, so there is a need to fill this "financing gap". In addition:

- There are no viable alternatives to a federally managed program;
- The CSBF program is consistent with government-wide and Departmental priorities; and
- There is no significant degree of overlap and duplication between the CSBF program and other government loan support programs.

Incrementality. To what extent has the program facilitated the availability of financing to SMEs that would not have been available to these businesses in the absence of the program?

Findings. The loans made under the CSBF program have been highly incremental. In particular:

- 50 to 55% of these loans have been "fully financially incremental" – i.e., in the absence of the CSBF program, no loan at all would have been granted to the borrower.
- Approximately an additional 25% of CSBF loans have been "partially financially incremental" – i.e., in the absence of the CSBF program, the borrower would have been granted a smaller loan.

Cost recovery. To what extent are the claims and interest paid by the program counter-balanced by the fees paid by borrowers? In other words, to what extent is the program cost recoverable?

Findings. The CSBF program, as it is currently structured, is not cost recoverable in an accounting sense (i.e., in the sense that program revenues would be greater than or equal to program costs). In particular:

- The net cost to government (claims plus interest paid minus fee payments received) of loans made under the predecessor program between 1995 and 1999 is $275 million as at March 31, 2004.
- The net cost to government of CSBF loans that have been made over the period 1999/00 through 2003/04 are estimated to be approximately $330 million ($250 million on a net present value basis).

Employment impact. What has been the impact of the CSBF program on job creation?

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Findings. The most defensible available estimate of the direct employment impact of the CSBF program at participating firms is 2.7 jobs (on a full-time equivalent basis) of employment per loan. Note, however, that the issues of job displacement and indirect (supplier-related) and induced (re-spending-related) job creation have not been measured, so it is not possible to assess their impact on the net employment created.

Possible program improvements. Are there alternative ways of delivering the CSBF program that would increase the degree of cost recovery and/or incrementality?

Findings

- The program cannot be restructured in a way that would make it cost-recoverable if any sort of "reasonable" degree of loan incrementality is maintained that is consistent with the program's raison d'etre to facilitate high-risk loans to small and medium-sized enterprises.

- The challenge for Industry Canada is to structure the program in such a way that both the degree of loan incrementality and the degree of cost recovery are "acceptable" – i.e., finding the point at which the net costs of the program are justified by the benefits associated with the resulting degree of incrementality. While this study did not determine what that point is, there are some indications that the degree of cost recovery should be higher and the degree of incrementality should be lower than currently exists.

- There are ways of restructuring the program to increase the degree of cost recovery that would be acceptable to the stakeholder community (lenders and borrowers). These include some combination of the following:

  a) allowing financial institutions to charge higher interest rates (a portion of which could be returned to the government as a restructured administration fee);

  b) changing the government fee structure (e.g., eliminating the registration fee and increasing the administration fee); and

  c) reducing the percentage of loan losses covered by the government.

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LIST OF ACRONYMS

BDC – Business Development Bank of Canada

CFIB – Canadian Federation of Independent Business

CSBFA – *Canada Small Business Financing Act*

CSBF program – Canada Small Business Financing program

CSBFPD – Canada Small Business Financing Program Directorate (of Industry Canada)

FDI – Financing Data Initiative

FTE – Full-time equivalent (usually used in relation to jobs)

ILO – International Labour Organization

NGOs – Non-governmental organizations

OAG – Office of the Auditor General of Canada

SBPB – Small Business Policy Branch (of Industry Canada)

SBL program – Small Business Loans program

SMEs – Small and medium-sized enterprises

RMAF – Results-based management and accountability framework

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1.0 INTRODUCTION

This report presents the results of the 2004 evaluation of the Canada Small Business Financing (CSBF) Program. It is based on the results-based management and accountability framework (RMAF) approved for the program in 2002.[1] This evaluation is an element of the comprehensive review of the program, the results of which will be completed by March 31, 2005.

The objective of the evaluation is to

> *Provide accountability regarding the operation of the program, with a focus on the program's impact (the degree to which it produces its desired outcomes), as well as providing recommendations for its improvement where advisable.*[2]

The RMAF specifies the questions that are to be addressed in the evaluation study. As indicated by the above quote, the most important of these questions deal with the impact of the program, in particular:

- To what extent has the program facilitated the availability of financing to small and medium-sized businesses (SMEs) that would not have been available to these businesses in the absence of the program? This is called the "incrementality question".
- To what extent are the claims paid by the program counter-balanced by the fees received from lenders? In other words, to what extent is the program self-sustaining (revenue neutral)? This is called the "cost recovery question".
- What is the impact of the program on employment?

Other important evaluation questions deal with the extent to which there is still a valid rationale for this program and possible ways in which either the efficiency or the effectiveness of the program might be able to be increased.

This evaluation was overseen by a Steering Committee consisting of representatives of Industry Canada, Treasury Board Secretariat, Finance Canada, and several lender and borrower organizations. The members of the Steering Committee are listed in Appendix A.

The next two sections provide a brief overview of the activities carried out in this study and the CSBF program. Following that, we present the findings regarding each of the evaluation questions.

[1] Details regarding the RMAF can be found at http://www.strategis.ic.gc.ca/sbresearch/csbfa.

[2] *Terms of Reference for the Canada Small Business Financing Program RMAF-Based Final Evaluation Report*, Industry Canada, 2003.

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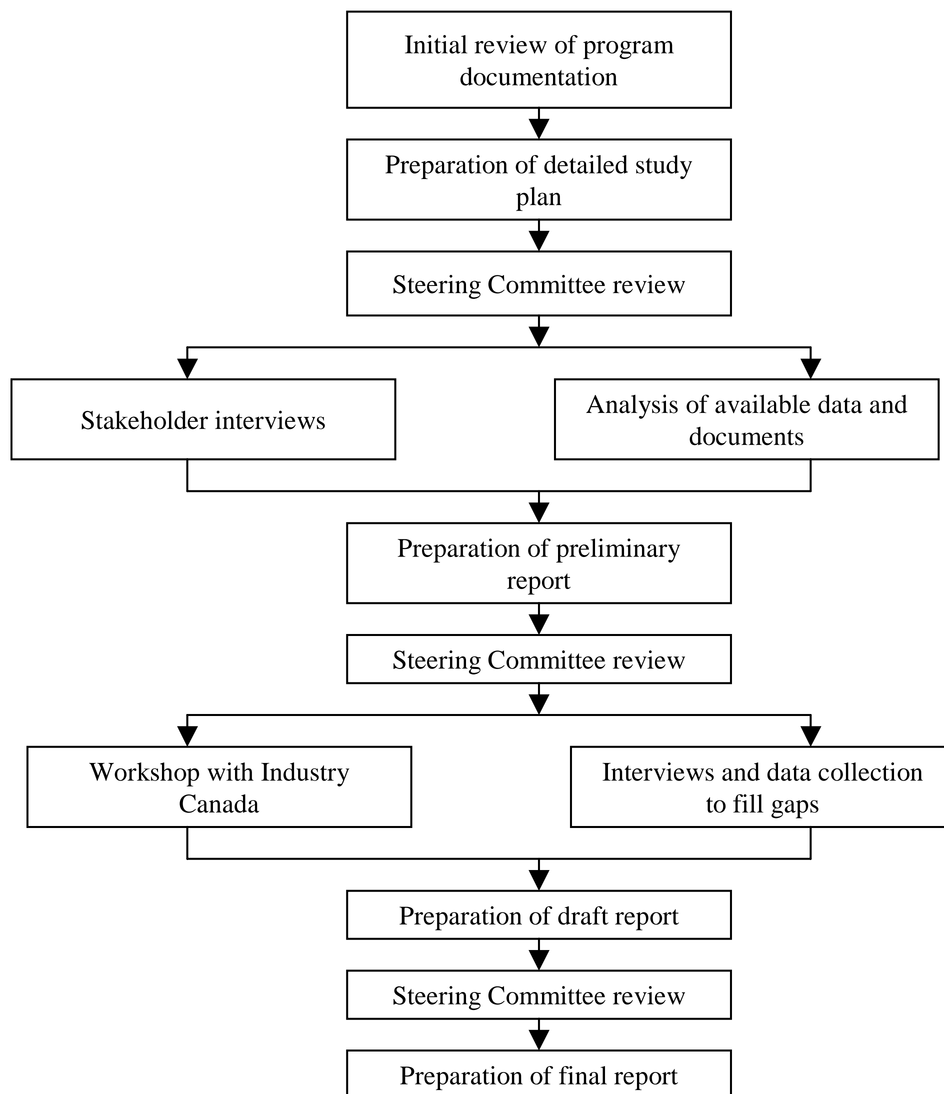
2.0 STUDY ACTIVITIES AND METHODOLOGY

The work plan for the CSBF evaluation study is illustrated in Figure 1 below. Following the Figure, we describe those activities that are not self-explanatory.

Figure 1—Work Plan for the CSBF Evaluation



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2.1 Stakeholder interviews

The data collection for this study involved interviews regarding several of the evaluation questions with senior representatives of stakeholder organizations – borrowers, lenders, and government stakeholders. A total of 24 stakeholder organizations were identified in consultation with Industry Canada as organizations representing important participants in the program who would be expected to be knowledgeable regarding these questions. We were successful in interviewing 19 of these organizations. The breakdown of the interview sample and responses by type of organizations follows:

	Lending Organizations	Borrower Organizations	Government Stakeholders
Completed	11	3	5
Unable to reach or unwilling to participate	2	3	0
Totals	13	6	5

A list of the organizations that were interviewed is contained in Appendix B.

The interview guides were designed to address questions regarding:

- the niche of the CSBF program;
- the feasibility and desirability of alternative loan guarantee schemes that do not rely on the government;
- the impact of the program on sustainable development and the environment;
- possible modifications to the program that would increase its coverage, and
- possible measures to increase cost recovery.

The bulk of the questions dealt with this latter category (cost recovery measures) and were designed to obtain opinions regarding the acceptability and desirability of various possible measures, as well as the potential impacts of these measures on borrower uptake and use of the program, the administrative burden associated with the program, and the risk profile and incrementality of CSBF loans. The interview guides are contained in Appendix B.

2.2 Analysis of available data and documents

Much of this project involved the review, analysis, and integration of information contained in other studies and data collection activities carried out recently by Industry Canada or by researchers contracted by Industry Canada. The most heavily used of these studies and data collection activities are described below.

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SBLA and CSBFA Claims and Costs Experience, Equinox Management Consultants Ltd., March 2003. This study compares the operation of the program during two time periods – April, 1995, through March, 1999 (the SBL program) and April, 1999, through March, 2002 (the CSBF program). It was based on the analysis of information from the registration and loans databases on all loans during these periods. It deals with:

- the profiles of businesses that have been borrowers under the program during these two periods, and
- patterns of defaults and costs associated with claims on loans advanced during these two periods.

Impact of SBLA Lending: An Evaluation of the Economic Impacts of the SBLA Program, Equinox Management Consultants Ltd., January, 1997. This study was based on an analysis of loan registration data for periods 11 and 12 (1990 through mid-1996) and telephone interviews of a random sample of 682 borrowers during this period. It deals with

- the incrementality of SBLA loans granted during this period (and other characteristics of the loans), and
- the new employment that is attributable to this incremental lending.

Incrementality of CSBF Program Lending, Volume 1: Insights from SME FDI Data, Equinox Management Consultants Ltd., December, 2003. This study was based on SME FDI data on loans made during the year 2000. It involved two steps:

- Use of the FDI data to derive a model based on applications to commercial lenders for (non-CSBF) term loans. Logistic regression analysis was used to identify patterns in the values of explanatory variables between two groups: applications that were turned down and those that were not turned down.
- Application of this model to the population of CSBF loans to estimate the percentage of loans that would have been turned down in the absence of the CSBF program.

Incrementality of CSBF Program Lending, Volume 2: Findings from Aligned Interviews, Equinox Management Consultants Ltd., February, 2004. This study involved interviews of 38 firms that received CSBF loans between September 1 and December 8, 2003, and 36 of the corresponding account managers for these loans. Both the lenders and the borrowers provided opinions regarding the incrementality of the loans.

Incrementality of CSBF Program Lending, Volume 3: Findings from Survey Data, Equinox Management Consultants Ltd., March, 2004. This study involved telephone interviews of 816 firms that received CSBF loans over the period 2000 through 2003. These borrowers were asked a series of questions regarding various types of loan incrementality, as well as questions regarding the role of the loan and its direct employment impact.

CSBFA Cost Recovery, Industry Canada (SBLA), October, 2003. In this study CSBFPD, with the assistance of Equinox, developed models to forecast both expenses (claims plus interest paid by the government) and revenues (registration fees plus administration fees) for loans made over the five-year period 1999-00 through 2003-04 (the period of operation of the CSBF program). The Canada Small

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Business Financing Program Directorate (CSBFPD) has continued to work since that time on projecting program revenues and expenses based on different scenarios which involve possible modifications to the program parameters (e.g., changes to the fees charged, changes to the loss-sharing ratio).

Satisfaction and Awareness Among Canada Small Business Financing Partners, 2004, Circum Network Inc., May, 2004. This study involved a survey of lenders regarding their satisfaction with various aspects of the CSBF program and their awareness of program tools and guidelines. There were two components of the survey:

- Interviews of 39 “strategic partners” (individuals who have a global perspective regarding the relationship between Industry Canada and the financial institutions, such as senior financial institution managers).
- Interviews of 1,494 “operational partners” (individuals who are concerned with the day-to-day machinery of the program). The operational partners sample contained two sub-samples: commercial loan managers in financial institutions and “users” of the CSBF program (defined to be people who have made a claim or registered a loan since April, 1999).

2002 On-Site Examination: Report on Findings, Industry Canada (CSBFPD), August, 2003. This project involved the on-site examination of documentation related to a sample of CSBF loans issued by 12 lending organizations (the six major chartered banks plus six other lenders) during the period April 1, 1999, through March 31, 2002. The objective of the project was to determine the degree of compliance with the mandated due diligence procedures and other requirements of the regulations.

Report on Small Business Loans Administration Discussions with Financial Institutions, Heron and Company, June, 2004. This document summarizes the results of discussions held by CSBFPD with representatives of 10 financial institutions (the eight chartered banks, Credit Union Central of Canada, and Fédération des caisses) during April and May, 2004. These discussions dealt with administrative requirements of the program, profitability of program loans to lenders, and general trends in lending practices.

Other studies and data collection activities that were important sources of information for the evaluation included:

- *Small and Medium-Sized Enterprise Financing in Canada,* Industry Canada, 2002.
- *Credit Guarantee Schemes for Small Business: Theory and Practice,* Anke Green, September, 2002.
- *Guaranteeing Loans for Small and Medium-Sized Enterprises,* European Mutual Guarantee Association, undated [but recent].
- *Canada Small Business Financing Act Awareness Study,* COMPAS Inc., April, 2001.
- *Canada Small Business Financing Act Loans Decline Study,* COMPAS Inc., January, 2002.
- *Canada Small Business Financing Act Employment Impact Study, COMPAS* Inc., March, 2002.
- *2002 Report of the Auditor General of Canada – 2002 Status Report, Chapter 5,* Office of the Auditor General of Canada, 2002.
- *An Evaluation of the Small Firms Loan Guarantee Scheme,* KPMG Management Consulting (UK), March, 1999.

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2.3 Preliminary Report

This report summarized our preliminary findings regarding each of the evaluation questions and described any additional data collection and analyses relevant to each question that were planned. This report was reviewed in a meeting with the Steering Committee on June 22, 2004.

2.4 Workshop with Industry Canada

The purpose of this workshop, which was held on July 5, 2004, was to obtain information and opinions regarding the following three categories of topics from Industry Canada officials who are knowledgeable about the CSBF program:

- The desirability and feasibility of various options for program changes that might increase the degree of cost recovery. The discussion focused on the "most popular" options that emerged from the stakeholder consultations we conducted (see above).
- The desirability and feasibility of measures that might be considered to increase the degree of loan incrementality.
- The desirability and feasibility of various measures that might increase the efficiency of the delivery of the program. The discussion focused on the "most popular" measures that came to light during the lender discussions conducted by CSBFPD (see above).

2.5 Interviews and Data Collection to Fill Gaps

This activity heading is a "catch-all" for a number of activities that were carried out in order to fill the remaining information gaps prior to the preparation of the draft report. These included:

- Preparation of a discussion paper dealing with the incrementality of CSBF program lending. Incrementality is the most complex and potentially confusing topic that is addressed in the evaluation, and we felt it was important to summarize our interpretation of the information contained in the various reports dealing with incrementality prior to preparing the full draft report.
- Collection of data from CSBFPD related to program administration (e.g., data on claims rejections and adjustments).
- Interviews with Industry Canada officials to address specific topics on which additional information was required – the cost recovery analyses currently underway, the extent of overlap and complementarity between the CSBF program and the programs of the Business Development Bank of Canada, and various program delivery issues.

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3.0 PROGRAM DESCRIPTION

3.1 Description

The Canada Small Business Financing program facilitates loans to small and medium-sized business through a loan loss-sharing partnership with private sector lenders in which the federal government has agreed to cover a portion of loan losses. The overall purpose of the program is to

Improve access to financing for the establishment, expansion, modernization, and improvement of small businesses in Canada.[3]

The program has two specific objectives:

Incrementality. *The program seeks to facilitate financing that would otherwise not have been available to SMEs, or available only under less attractive conditions (e.g., higher interest rate).*

Cost recovery. *It is intended that the program's revenues (from the fees that are charged over the term of loans) offset the cost of claims and interest payments the government makes on loans that default*[4].

It should be noted that these objectives are at odds with one another. If the program were designed in such a way that it achieved its cost-recovery objective, that would mean that the total cost of claims would be covered in one way or another by the borrowers and the lenders. However, any set of loans whose costs were covered by the private sector would, at least in theory, be granted by the private sector on its own, without the need for government intervention[5] – i.e., there would be no loan incrementality.

Accordingly, it is recognized by Industry Canada that these goals will never both be achieved simultaneously and that, as a result, a balance must be struck between these goals. As incrementality increases, this generally means that the degree of risk associated with the CSBF loan portfolio increases; so the potential for default increases, and the degree of cost recovery decreases. The challenge, therefore, is to achieve an "acceptable" level of incrementality while, at the same time, maintaining an "acceptable" level of cost recovery.

Loans under the program are available for the purposes of financing equipment, real property, and leasehold improvements. Farming, not-for-profit, and charitable institutions are not eligible for CSBF loans. Industry Canada administers the CSBF program through a network of private sector lenders. An important feature of the program is that Industry Canada plays no role in assessing individual loan

[3] In addition to its loan component, the program also has a small capital leasing component, the Capital Leasing Pilot Project. The capital leasing component is not addressed in this evaluation.

[4] Cost recovery does not include the costs of administering the program, which are relatively minor and are absorbed by Industry Canada.

[5] This could only happen if the interest and fees charged on this set of loans were at least as great as the cost of claims. This means that the issuing of these loans would comprise a profitable business (or at least not an un-profitable business), so theoretically the private sector would be likely to undertake this business on its own.

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applications. The lenders are responsible for all credit decisions, making the loans, and registering them with Industry Canada. Lenders are also responsible for registering security for the loan and, when necessary, realizing on the security. The government pays up to 85% of lenders' losses on defaulted loans registered under the program.

The main parameters that define the structure of the program are listed in the following table.

Parameter	Description
Eligible businesses	For-profit enterprises (excluding agricultural businesses) with annual gross revenues of $5 million or less.
Loss-sharing ratio	85% government, 15% lender
Cap on claims	The government's liability to an individual lender is to pay eligible claims on defaulted loans in its account up to a maximum of the aggregate of: ▪ 90% of the first $250,000 of loans registered by the lender ▪ 50% of the next $250,000 ▪ 10% of all loans in excess of $500,000.
Eligible purposes	To finance the purchase of equipment, real property, and leasehold improvements, and the improvement of real property and equipment.
Maximum loan amount	$250,000
Financing rate	The most that can be financed is 90% of the eligible assets.
Payment terms	Maximum of 10 years
Registration fee	2% of the loan amount, paid up front (although this may be financed as part of the loan)
Administration fee (annual)	1.25% of the outstanding loan amount (paid quarterly)
Maximum rate of interest	For a floating rate loan, the maximum rate is prime plus 3% (which includes the 1.25% administration fee); for a fixed rate loan, the maximum rate is the residential mortgage rate plus 3% (which includes the 1.25% administration fee).

3.2 Program History[6]

The Small Business Loans program was launched in 1961. From that time until 1993 the program remained relatively stable and also relatively modest[7]. Only companies with under $250,000 in sales were eligible at the beginning of the program; this increased slowly over the years to $2 million in 1985. The maximum loan size started at $25,000, reached $100,000 in 1980, and remained at that level until 1993.

[6] This section is summarized from *Meeting the Changing Needs*, Industry Canada, 1998, pages 8 – 10.

[7] There were only a little over 10,000 loans registered in 1992, with aggregate value of approximately $400 million.

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A number of changes were made to the program in 1993 in order to extend its coverage. This was in response to economic difficulties and uncertainty being experienced in Canada at that time and a commitment by the government that it would help small businesses lead the way to recovery[8].

Several of these changes resulted in increased risk to the government and the likelihood of a larger gap between fees paid to the government (the registration fee only at that time) and the cost of claims paid by the government. These changes included:

- expansion of program eligibility to encompass firms doing up to $5 million of business per year;
- government coverage of 90% of the cost of claims (up from 85%);
- increase to 100% from 80%-90% of the cost of assets that could be financed, and
- increase in the maximum loan size to $250,000 (up from $100,000).

Not surprisingly, the number of loans skyrocketed, as did the number of loan defaults and claims a few years later.

In 1995 the most significant of these changes were reversed – in particular, the government's guarantee was decreased to 85%, and maximum financing levels returned to 90% of asset value. In addition, the government introduced a cost recovery mandate and began to move toward an increased degree of cost recovery by introducing the annual administration fee of 1.25%. Some additional changes were made in 1999, largely as a result of the comprehensive review of the program undertaken in 1998-99. These were intended to increase the accountability of lenders and strengthen the program's ability to move toward cost recovery. The program was renamed the Canada Small Business Financing program at that time.

[8] *Financing Growth: for 37 Years with the Small Business Loans Act,* Industry Canada1998, page 22.

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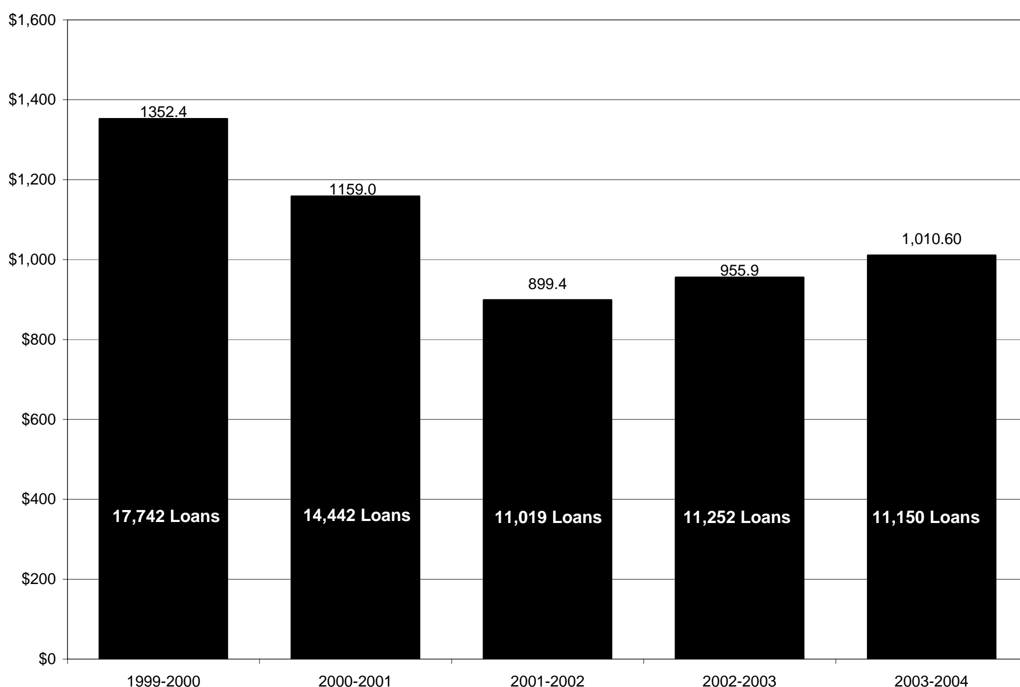
3.3 Program Uptake

Figure 2 below shows the number and value of CSBF loans over the first five years of the CSBF program.

Figure 2—Number and Value of CSBF Loans, 1999-2004 (in millions)



The industry sectors that were the heaviest users of the program during this period are shown below:[9]

Industry sector	Number of loans (% of total)	Value of loans (% of total)
Food and beverage services	16	21
Retail trade	15	15
Transportation and warehousing	12	10
Manufacturing	9	10

9 *Canada Small Business Financing Act Annual Report: 2002-2003*, Appendix A, Table IV, Industry Canada, 2003.

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During the most recent of these years the breakdown of loan uses was:

- Equipment purchases – 55%.
- Real property purchases and renovations – 22%.
- Leasehold improvements – 21%.
- Other (software acquisition, registration fees) – 2%.

Franchise businesses accounted for 12% by number and 17% by value of loans made. Firms with revenues over $100,000 accounted for 85% by number and 87% by value of loans made.

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4.0 FINDINGS REGARDING EVALUATION QUESTIONS

4.1 Question 1: Is there an on-going need to facilitate access to asset-based debt financing for SMEs?

Findings

1. There is considerable evidence that SMEs have more difficulty obtaining financing than large firms. This is primarily because loans to SMEs are riskier. Lenders respond to this higher degree of risk in a variety of ways that have the effect of limiting the availability of financing for SMEs.

2. The Industry Canada rationale for the CSBF program is based on the need to fill this "financing gap" that is not being filled by private sector institutions. The program is intended to reduce lenders' potential risks through the sharing of loan losses, thereby stimulating lending to this client base and addressing the unmet demand.

Discussion

Our approach to this question was based on the review and analysis of the literature regarding the need for governments to facilitate SME loan access.

Summary of the literature review

There is considerable evidence that SMEs have more difficulty obtaining loans than large firms. There are two main categories of reasons for this discussed in the literature:

1. Reasons related to the fact that loans to SMEs (particularly start-ups and young firms) are riskier than loans to large firms.

2. Reasons related to firm size – e.g., the higher relative costs to lenders of preparing and assessing SME loans.[10]

Most of the evidence points to the higher degree of risk – or higher perceived degree of risk – as the main factor which affects lender decisions to limit the availability of financing to SMEs. Lenders do this in a variety of ways, ranging from setting unattractive or sometimes impossible loan conditions (e.g., high interest rates or high collateral requirements) to outright rejection of loan applications.

Highlights of individual reports

The relevant findings from the individual reports that were reviewed were summarized below. The table provides an overview of what information is contained in which reports.

[10] This partly relates to the fact that loans to SMEs tend to be smaller, so the amount of administrative effort per dollar of loan tends to be higher; but there are other factors as well, such as the fact that SMEs, on average, do not provide as clear and comprehensive information as part of their loan application.

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Information regarding the existence of the "SME financing gap"	Discussion of reasons for the "SME financing gap"	Other information
Industry Canada 2002	Industry Canada 2002	Equinox 2002 (government programs in other countries)
KPMG (UK) 1999	KPMG (UK) 1999	
Green 2002	Green 2002	
Compas 2001	Norton 1998	
CFIB 2001 and 2003	ARA 1005	
	BDC 2001	
	Equinox 1997	
	European Mutual Guarantee Association undated (recent)	
	Compas 2002	

Small and Medium-Sized Enterprise Financing in Canada, Industry Canada, 2002
This report was prepared as part of the SME Financing Data Initiative. Most of the data are from the Statistics Canada Survey on Financing of Small and Medium-Sized Enterprises, 2000. There are no comparisons with non-SMEs. Note also that the survey data do not include firms that believed they would not qualify for a loan and, therefore, did not apply—e.g., "discouraged borrowers". If these firms has been included and if they had, in fact, applied for loans, then presumably the approval rates discussed below would be lower.

The useful findings in relation to this evaluation question are:

- In 2000, 23% of SMEs made a request for debt financing, and 82% were approved. (It is noted that a 1998 study by the CBA found these percentages to be 38% and 93% respectively.) Note that some of the approved loans would have been made under the CSBF program, and since CSBF loans represent, in effect, an informal turndown the data on approvals is higher than it would be in the absence of the CSBF program.
- Firms with more employees had higher approval rates, as illustrated by the following:

	No employees (owner-operated)	1 to 4 employees	5 to 19 employees	20 to 99 employees	100 to 499 employees
Approval rate	82%	79%	85%	87%	94%

- SMEs cited five main reasons given by the debt financing supplier for rejection:
  - They had insufficient revenue or sales (23%).
  - They had a poor credit history (13%).
  - They could not produce sufficient collateral or security (11%).

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- Their business had insufficient cash flow (10%).
- Their business was too young (8%).

Note that all these reasons imply a high degree of risk of the loan and/or a low degree of likely viability of the business.[11]

The financing challenges faced by SME start-ups are particularly acute. Subsequent work by Industry Canada[12] contains the following findings:

- Loan application rejection rates for start-ups are greater than 40%. The degree of risk associated with start-ups is simply too high for most financial institutions.
- Only 29% of start-up SMEs are financed through commercial loans or lines of credit from financial institutions, compared with 49% of established SMEs.
- Start-ups rely much more than established SMEs on informal sources of external financing and tend to rely more on the personal credit and savings of the business owners.

An Evaluation of the Small Firms Loan Guarantee Scheme, KPMG Management Consulting (UK), March, 1999

This study provides considerable data, from their own surveys and interviews and also from other studies, which indicate that there is a higher rate of loan refusal for SMEs than large firms. It indicates that the lack of collateral and the lack of a track record are major constraints. The study also notes that there are a significant number of “discouraged borrowers” among small firms (i.e., firms that do not apply for financing).

An important feature of this study is that it contains a comprehensive review of the literature dealing with financial market imperfections – both the theoretical and the empirical literature. The focus of this review is on “credit rationing”, the situation in which two borrowers with equal probability of repayment have an unequal probability of obtaining credit. The study attempts to show that credit rationing exists[13], and a great deal of effort is spent on this; but, in the end, the analysis is not conclusive.[14]

[11] Note that, even though much of the literature states that lenders are excessive in their demands for collateral for SME loans – or at least that SMEs believe they are excessive – the data presented here indicate that lack of collateral only negatively affects 2% of SME loan applications (11% of the 18% that were rejected).

[12] Industry Canada Analysis, unpublished document, 2004.

[13] This is particularly important in this case because the existence of credit rationing was put forward by the UK government at the time as the rationale justifying their Loan Guarantee Scheme.

[14] At the end of a long and complex discussion with many indicators in each direction and no convincing conclusion the authors simply assert that credit rationing exists.

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Credit Guarantee Schemes for Small Business: Theory and Practice, Anke Green, September, 2002
This study summarizes the literature on the access of SMEs to finance. The data indicate that the share of SME investment financed through commercial banks is significantly less than for large companies.[15]

The study outlines the author's perceptions regarding the main reasons banks are reluctant to extend credit to SMEs:

- High administrative costs of small-scale lending.
- Asymmetric information (i.e., borrowers have more information than lenders [regarding the viability of their projects and their ability and willingness to repay], so it is difficult for lenders to distinguish between good and bad loans, and, accordingly, they impose high collateral requirements).
- High risk perception.
- Lack of collateral of borrowers.

The study discusses whether these four reasons constitute market imperfections (which would justify government intervention) and concludes that this is the case for asymmetric information but not the others.

The study notes that the main motivation for government intervention is often political: "In light of growing unemployment numbers, governments have come to realize that the development of the SME sector does not only sustain employment but can also lead to considerable net employment creation. Governments worldwide…have turned to small firms…"

SBLA and CSBFA Claims and Cost Experience, Equinox Management Consultants Ltd., March, 2003
This study notes that loan guarantee or loan-loss sharing programs are currently implemented in more than 170 countries, usually with the stated goal of facilitating the formation and growth of SMEs by easing access to debt capital. These countries include all our major trading partners (the US, the UK, France, Germany, Japan). This is, in our opinion, an indirect indicator of the need for the program – i.e., the fact that so many other countries have similar programs indicates that SME financing gaps are perceived to exist on a widespread basis and that it is considered the business of government to assist in addressing these gaps.

The Current Market for Small Business Financing, Roy B. Norton, April, 1998
This report contains an extensive discussion of the financing gaps faced by SMEs. It is concluded that smaller businesses face enduring gaps in the financing market. Some of the reasons are systemic (i.e., related to the relatively small sums they seek and low level of return for lenders). Smaller businesses suffer greater loan losses and are more vulnerable to bankruptcy – both partially a function of their relative inexperience – and, unsurprisingly, they face heavier demands for collateral. The panoply of recent credit innovations have only minimally facilitated their access to term capital.

[15] For example, in the US SMEs make up half the economy in terms of sales, private sector output, and employment, but receive only 6% of total business finance.

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Study of the Rationale for the Yukon Business Development Fund, The ARA Consulting Group Inc., April, 1995
Even though this is an older study, it is useful since it focused on the issue of the rationale for government small business financing programs. The Yukon BDF program was a program that provided government loans and loan guarantees to small businesses. The study included a review of all non-federal programs (at that time) in Canadian jurisdictions that are similar to the Yukon – the Atlantic provinces, the northern regions of the remaining six provinces, and the Northwest Territories – plus the state of Alaska, a total of 17 programs[16].

The review found that there were two main rationales put forward for these programs:

- Regional bank practices—Even when the projected viability of SMEs in the region and the degree of risk associated with small business financing are in line with what is normally required by financial institutions, it is difficult for these businesses to obtain financing because of the practices of financial institutions related to the particular region.[17]
- Economic development—Programs based on this rationale are intended to assist businesses which do not meet the normal criteria of financial institutions related to the viability of the business, or the degree of risk associated with the financing, or both. These programs are intended to bring about the establishment and operation of businesses which would not be financed under normal lending criteria in order to develop the economy of the region and create additional employment.

The economic development rationale was the main rationale for most of the programs reviewed (12 of the 17 programs), and it was an equal "co-rationale" to the regional bank practices rationale for an additional four programs. The regional bank practices rationale was a strong secondary rationale for many of the programs.[18]

Supporting Small Business Innovation, Business Development Bank of Canada, 2001
This report states that there are major gaps in SME financing. It hypothesizes the following reasons for this:

- Risk [unwillingness of conventional lenders to provide riskier loans even at higher interest rates].
- Size [higher relative costs of preparing and assessing SME loans].
- Flexibility [lack of lender flexibility in tailoring repayment terms and conditions].
- Knowledge [reluctance to provide loans to knowledge-based companies because of the lack of tangible assets to secure loans].

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[16] Including at least one program in each of these jurisdictions, except for northern British Columbia.

[17] For example, financial institutions in the region are more conservative than financial institutions in other regions toward providing SME financing; there is limited availability of financial institutions in the region; financial institutions don't like providing financing in the region (e.g., because of the difficulty of servicing loans); managers of financial institutions in the region have lower loan approval limits than they do in other regions, etc.

[18] This study also concluded that the regional bank practices rationale is not valid in the Yukon.

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No empirical data are provided.

Impact of SBLA Lending: An Evaluation of the Economic Impacts of the SBLA Program, Equinox Management Consultants Ltd., January, 1997
This report discuss the academic thinking regarding the conditions under which government intervention of this type is justified and concludes that there are two such conditions which frequently apply to Canadian SMEs:

a) Lenders place "undue" emphasis on the role of collateral in making their lending decisions; and/or

b) The high fixed cost of due diligence (relative to loan size) makes it uneconomical for lenders to extend small loans.

Equinox states that these conditions justify government support for financing on the basis of the size of the borrowing business, not on the basis of the degree of risk – i.e., government loan guarantees should be intended to assist small firms to raise capital, but such loans should not be riskier.

However, there are no data provided to indicate that either

- condition (a) occurs more than it "should" (i.e., more than is required to reduce the degree of risk to an acceptable level), or

- condition (b) significantly limits the availability of small loans.

Guaranteeing Loans for Small and Medium-Sized Enterprises, European Mutual Guarantee Association, undated [but recent]
This report states that "SMEs experience difficulties in amassing the necessary capital for their creation and/or their development." It puts forward three categories of factors that are hypothesized as impeding access to financial support by SMEs:

- SME structural factors – higher risk related to single-person or small operations, less equity capitalization, less collateral, etc.

- Factors related to external venture capital sources – various reasons associated with challenges in raising equity investment.

- Factors relating to external sources of loan capital – banks more comfortable with large-scale borrowers, difficulty of analyzing business plans and forecasts for new firms, high relative admin costs, etc.

There are no empirical data.

Canada Small Business Financing Act Awareness Study, Compas Inc., April, 2001
This study included a random sample of SMEs and obtained results similar to the SME FDI study (the first study discussed above) regarding approval rates:

- 79% of companies that applied for a loan were successful in obtaining it for the amount requested.
- 8% obtained a loan, but for a lesser amount.

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- 15% were turned down for a loan. (Presumably the numbers do not add to 100% because of rounding.)

Note that approximately three-quarters of the successful applicants said that their loan was not covered by a federal government loan guarantee.

Surveys Carried Out by the Canadian Federation of Independent Business

- A survey of CFIB members carried out in March, 2001, titled *Banking on Entrepreneurship,* found that one in five SMEs was unable to obtain the necessary level of financing (particularly younger and smaller businesses) and that, of the "under-funded group", 31% are young, high performers (i.e., with revenue growth over 20% for three years).
- A survey carried out in October, 2003, titled *Banking on Competition*, found that, compared to previous years, fewer SMEs were applying for financing but that loan applications were being rejected at a significantly higher rate. In particular, the overall loan rejection rate for the period 2000 to 2003 was 16%, up from 10.5% for the 1997 to 2000 period. Young businesses (in business for less than 10 years) and small businesses were found to be more likely to have their loan application turned down.

Canada Small Business Financing Act Loans Decline Study, Compas Inc., January, 2002
This study was based on 18 interviews with representatives of Canada's main lending institutions. The finding most relevant to this evaluation question was: "[When] asked to identify the main strengths or positive features of CSBF loans, participants pointed most often to their belief that they meet a need by providing financial assistance to businesses that might not or would not qualify for any other type of loan". In elaborating on this response, the interviewees most commonly commented on the higher degree of risk associated with CSBF loans, e.g.: "such [CSBFA-assisted] businesses tend to come primarily from the service sector, which tends to have a high failure rate."

Note that the role of the CSBF program in guaranteeing loans with a higher degree of risk was also emphasized in the recent lender consultations conducted by CSBFPD.[19]

[19] *Report on Small Business Loans Administration Discussions with Financial Institutions,* Heron and Company, June, 2004, page 7.

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4.2 Questions 3A – 3C: What is the appropriateness and need for federal government involvement in delivering the CSBF program?[20]

4.2.1 Question 3A: Are there viable alternatives to a federally managed program (i.e., alternative loan loss sharing programs for SMEs)?

Note: We have interpreted this question as dealing with different types of programs that would not rely on the delivery of the program by the federal government – not alternative systems that would mirror the current program but without the federal government involved in the program delivery. It is our opinion that those kinds of alternatives are impractical.

In those kinds of alternatives the federal government would still be responsible for guaranteeing the loans, but the administration of the program would be devolved to private sector lenders, the provinces, or the Business Development Bank of Canada (BDC).

Devolving the administration to the private sector is not a sensible alternative for several reasons:

1. The administration of the program requires very few resources (29 FTEs in 03/04 and a budget of $2.7 million), so contracting out the administration does not have the potential for significant cost savings.
2. Some of the major policy decisions made by Industry Canada may be politically sensitive.
3. There is a great deal of federal money at stake.

[20] Note that in the RMAF, between question 1 and questions 3A-3C, there are two questions dealing with the extent to which the CSBF program is serving the target market: (2A) To what extent is the CSBF program appropriately addressing the SME target market? and (2B) To what extent is the CSBF program appropriately designed to serve the target market? Because of timing considerations, the analyses of these questions will be carried out by SBPB after this report has been completed.

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Furthermore, our stakeholder interviews indicated that private sector lenders have no interest in delivering this program. In addition, the history of the attempt to devolve the delivery of the Canada Student Loans Program to private sector lenders illustrates that this alternative may not be feasible.[21]

Reasons (1) to (3) also apply to the notion of devolving the delivery of the program to either the provinces or the BDC. Devolution to the provinces would have the additional disadvantage of being unable to ensure uniform program delivery across the country. Devolution to the BDC would have the additional disadvantage that lending organizations would most likely be uncomfortable with the BDC having information on their loan portfolios, since the BDC also has a commercial mandate.

Findings

1. One conceptually viable alternative to a federally managed program would be a system of mutual guarantee associations. However, the main rationale for these associations (which is to address the problem of asymmetric information) is not particularly applicable to Canada. Moreover, reliance on these kinds of associations would reduce the ability of the federal government to use this program as an instrument of economic development.

2. Another conceptually viable alternative would be a loan loss reserve fund program, in which the federal government contributed to the fund but otherwise was not directly involved in the program delivery. This type of program could have some relatively minor advantages to the CSBF program (mainly administrative simplicity), but it would reduce the degree of control of the government in the claims process, which may not be acceptable.

3. In summary, there are no attractive alternatives to a federally managed program along the lines of the CSBF Program.

Discussion

Our approach to this question was based on the stakeholder interviews conducted by BearingPoint and the review and analysis of existing documents.

[21] From 1964 to 1995 the banks were in change of administering these loans, but the government assumed responsibility for loans that fell into significant arrears. This was fine with the banks but not with the government. The structure was changed in 1995 because the government wanted the banks to take on more of the risk and be more involved in the collection of debt and the burden of default. From 1995 to 2000 the banks were paid a 5% risk premium, and they were allowed to pass on a limited portion of their poorest performing loans to the government. That was not an acceptable situation to the banks (their view was that they were incurring a loss), and they lobbied to have the government take over the program, which has been the situation since 2000.

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Summary of interviews and literature review

In the stakeholder interviews lending organizations were asked two questions relevant to question 3A:

- "Is there any way the CSBF program could be delivered totally by Canadian private sector lending institutions (including no government involvement in either program administration or in guaranteeing loans)?" Not one respondent could imagine the program being delivered by Canadian private sector lending institutions. There would simply not be enough incentives for them to operate such a program, and hence there is no interest.
- "Are you aware of other credit guarantee systems which do not rely on the public sector that would be viable alternatives to the CSBF program?" No respondents were aware of any comparable systems that do not rely on the public sector. Several interviewees did mention that there are some product offerings based on personal collateral that are competing, to some extent, with a portion of the CSBF program. These include lines of credit attached to personal collateral and credit cards. Traditionally, clients were attracted to the CSBF program because of the lack of a requirement for personal collateral, but because of the recent offerings of banks to easily secure lines of credit on the surplus value of homes at interest rates as low as prime, many of these clients have shifted to collateral-based credit.

One potentially viable alternative to a federally managed program identified in the literature was mutual guarantee associations (private societies formed by potential borrowers, possibly together with other partners). The main rationale for these associations in the countries in which they exist appears to be to provide better information to lenders regarding potential loans by virtue of local knowledge and entrepreneur representation. To the best of our knowledge, lack of information for evaluating loan applications is not a significant problem in Canada. In addition, there is no indication in the literature that mutual guarantee associations support riskier loans than would be supported by lending institutions on their own if they had access to complete information regarding the loan. Thus, these associations would not fully address the financing gap addressed by the CSBF program

Another potentially viable alternative would be a loan investment fund program[22]. In this type of program the government enters into agreements with lending institutions in which the institutions set up specific loan funds (usually targeted toward specific purposes or borrowers, but that need not be the case). The purpose of the loan funds is to provide incremental (i.e., high risk) loans to SMEs, and there are program guidelines to ensure a high degree of incrementality. The government contributes funds to a loan loss reserve fund – generally an agreed-on percentage of the total loan fund. The lending institution is then allowed to charge a certain percentage of the losses from the loans in the fund to the reserve fund.[23]

An apparent advantage of these types of programs is a lower degree of government involvement in the claims process (and consequent administrative cost savings). The lenders are simply allowed to charge a percentage of their loan losses to the reserve fund with no (or few) questions asked. On the other hand, because of this "blank cheque" feature of the claims process, these programs are generally characterized by a higher degree of government involvement in the loan decision process, so, on balance, there may be

[22] Also called "loan loss reserve fund programs".

[23] In the loan investment fund of Western Economic Diversification, this percentage is 80%.

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no significant administrative cost savings in this structure. The lack of government involvement in the claims process may actually be a disadvantage of this type of program. For a program with as large a loan portfolio as the CSBF program (about $1 billion per year) and consequent large loan losses, taxpayers may want certain controls on claims payments (e.g., assurance that guidelines were followed, assurance that loans were used for the intended purposes).[24]

Highlights of individual reports

Documents prepared by the International Labour Organization – e.g., *Working Paper on Guarantee Funds and NGOs,* ILO, 1997
These documents reflect a perception that public guarantee funds are hampered by bureaucratic management and guidelines based on political considerations (e.g., targeting or portfolio restrictions based on political priorities). In addition, the alternative schemes that are discussed, such as guarantee mechanisms run by NGOs or self-help organizations, are mainly oriented toward third world countries.

Credit Guarantee Schemes for Small Business, Anke Green, September, 2002
In this report the author identifies five types of loan guarantee schemes, two of which are only applicable to third world countries[25] and three of which are theoretically relevant to Canada:

1. Publicly-operated national schemes.
2. Corporate associations—based on a guarantee fund provided by government but managed by participating banks (or possibly others, such as chambers of commerce).
3. Mutual guarantee associations—private societies formed by potential borrowers.

Scheme (2) in the Canadian context would essentially involve contracting out the administration of the CSBF, which, as noted above, is not a sensible alternative.

Mutual guarantee associations are discussed at some length and are the preferred scheme of the author, mainly because they are perceived to be better equipped to deal with the problem of "asymmetric information" (i.e., borrowers have more information than lenders regarding the viability of their projects and their ability and willingness to repay, so lenders have difficulty distinguishing between good and bad loans [and borrower organizations are better able to do this]). However, the author does not present a convincing case that asymmetric information is a major problem, especially in developed economies with sophisticated methods for evaluating loan applications. In addition, like the ILO documents discussed above, the author has a negative predisposition toward government involvement in guarantee schemes. In our opinion this is not an objective report.

[24] A (relatively minor) advantage of loan investment fund programs is greater certainty and clarity regarding the cost of the program to the government—it is exactly equal to the government's contribution to the reserve fund.

[25] These are (a) schemes due to bilateral or multi-lateral cooperation and (b) schemes operated by NGOs.

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Guaranteeing Loans for Small and Medium-Sized Enterprises, European Mutual Guarantee Association, undated [but recent]
The bulk of this document deals with comparisons among 26 of the 30 member organizations of the Association. In spite of the fact that there are 30 members, a review of the organization profiles indicates that many of these are not really mutual guarantee associations in the sense described above. In fact, many of them are not very different from public guarantee schemes. Others are associations or extensions of banks, and some are primarily active in other areas. What is common among the organizations is "the presence of entrepreneur representatives on the commitment committees, bringing to them a different vision from that of the bankers".

Those that appear to be true mutual guarantee associations and are functioning in developed economies are listed below. Note that the average percentage of the loan guarantee provided by the 26 organizations included in this study is about 70%.

Organization	Description	Composition of the capital	% of guarantees that are for long-term loans	Maximum % of the loan that is guaranteed
Burgschaftsbanken - Germany	A network of 24 guarantee banks, owned by financial institutions and SME organizations.	60% from SME organizations; 40% from banks	99%	80%
SOCAMA - France	A system of 42 mutual co-operative societies, whose members are entrepreneurs who have to buy shares. Craftsman-oriented and connected with the Banques Populaires network.	100% from members (entrepreneurs)	90%	Generally 80% but can be up to 100%
The Italian Confidi Networks	A network of 600 organizations, most of them guarantee co-operatives. Active in scrutinizing loan applications based on their local knowledge.	90-100% from members (entrepreneurs), depending on the organization	30-60%, depending on the organization	50%
Kredi Garanti Fonu - Turkey	A guarantee society owned equally by six organizations (including the Confederation of Traders and Craftsmen, Union of Chambers of Commerce and Industry, and the Turkish Popular Bank). Works closely with the SME public bank and three other banks.	66% SME organizations (e.g., Chambers of Commerce), 17% banks, 17% government	20% (80% of guarantees are short-term)	80%

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4.2.2 Question 3B: To what extent is the CSBF program consistent with government-wide and Departmental priorities?

Findings

1. The CSBF program is consistent with the long-standing government-wide emphasis on fostering and stimulating economic development.
2. The program directly supports three of Industry Canada's priorities – productivity growth, employment growth, and income growth.

Discussion

Our approach to this question was based on the review and analysis of existing documents, supplemented by interviews with Industry Canada officials to validate the findings.

Many government-wide policy documents emphasize the role of the federal government in fostering and stimulating economic development, and it is clear that this has always been a high government priority. The CSBF program is certainly consistent with this priority.

A review of the Throne Speeches since 1997 indicates that, increasingly, the focus of the federal government has been on stimulating economic development through supporting innovation. This is even true of references to government support for small business:

> *Our small, innovative firms face two key obstacles – access to adequate early-stage financing and…The Government will help to overcome these obstacles – building, for example on the venture financing capabilities of the Business Development Bank.*[26]

The CSBF supports loans to innovative firms, and in this way it is consistent with this emphasis on innovation.[27]

Industry Canada's mission includes "fostering a growing Canadian economy". One of the five strategic objectives of the Department is Investment,[28] and one of the Department's planned strategic actions is effecting increased investment by SMEs.

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[26] Speech from the Throne, February 2, 2004.

[27] Although there is no specific emphasis within the CSBF on support for innovation.

[28] Specifically, "improving Canada's position as a preferred location for investment".

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The Department's priorities are discussed in the document *Making a Difference.*[29] This document notes that Industry Canada's policies, programs, and services help grow a dynamic and innovative economy that, among other things:

- provides more and better-paying jobs for Canadians, and
- support stronger business growth through continued improvements in productivity and innovation performance.

The CSBF program obviously supports these thrusts.

The four priorities of the Department[30] are:

1. productivity growth (through the development and application of more efficient ways of producing goods and services)
2. employment growth
3. income growth (which, for the most part, follows from the first two priorities, combined with other influencing factors such as an efficient tax regime), and
4. sustainable development.

Through providing incremental loans to SMEs, the CSBFA directly supports the first three of these priorities:

- Productivity—CSBF loans support modernization and other productivity-enhancing investments.
- Employment—CSBF loans lead to increases in employment at the borrowing firms, as well as employment generated through supplier-related spending and the re-spending of profits and incomes.
- Income—increased income is generated as a result of increased employment and increased profits resulting from CSBF loans.

The sustainable development priority is not particularly applicable to this program.

4.2.3 Question 3C: To what extent is there overlap and duplication between the CSBF program and other government loan programs?

Note: What this question means is: To what extent could the financing needs of SMEs that are being met by the CSBF program be met equally well by some other government program?

[29] *Making a Difference: Contributing to the Quality of Life of Canadians*, Industry Canada, October, 2003.

[30] *Ibid.,* Industry Canada

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Findings

The only other nationwide government program that provides financing assistance to SMEs, other than those targeted to specific groups or specific sectors, is the term loan program of the Business Development Bank of Canada (BDC). That program does overlap, to some extent, with the CSBF program; but there are also a number of differences between the two programs, so there is not a large degree of overlap.

Discussion

Our approach to this question was based on the BearingPoint stakeholder interviews and the review of documentation describing other programs.

In the stakeholder interviews, interviewees were asked: “To what extent does the CSBF program overlap with the loan programs of the Business Development Bank of Canada and of the regional agencies?” Respondents did not perceive a significant degree of overlap with regional programs precisely because of their regional nature – i.e., the CSBF program has nationwide applicability, while regional programs are, by definition, only applicable to specific regions.

Regarding the programs of the BDC, all respondents felt that the BDC programs and the CSBF program are too dissimilar in scope and application to have a significant degree of overlap. Most felt that the BDC has positioned itself recently more as a venture capitalist type of small business investment program. Some specifically mentioned that the BDC used to be known as the lender of last resort for restaurants and leasehold improvement loans, but with their retraction from this type of activity, this title has now been conferred upon the CSBF program.

In our review of documentation regarding other programs, we determined that the only other nationwide government program that provides financing assistance to SMEs, other than those targeted to specific groups (e.g., Aboriginal or young entrepreneurs) or specific sectors (e.g., agriculture) is the term loan program of the Business Development Bank of Canada. BDC provides term loans for:

- Business start-ups (loans up to $100K).
- Working capital.
- Expansion projects.
- Plant overhauls.
- Purchases of existing businesses.
- Purchases of land, buildings, or equipment.
- Purchases of other fixed assets.

The BDC targets SMEs, and loans are offered at both fixed and floating rates for up to 20 years. BDC loans are intended to be complementary to those offered by private sector lenders by virtue of being higher risk.

With regard to overlap with the CSBF program, there are a number of differences between the two programs:

- The BDC provides loans for working capital, while CSBF loans cannot be used for working capital. (Loans for working capital made up approximately 35% of the BDC loans to SMEs in 2002-03).

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- While the CSBF program facilitates conventional loans, the BDC term loan program emphasizes "flexible solutions", such as bridge financing to cover planning costs, the possibility of deferred principal payments, progressive or seasonal repayment options tailored to the business' cash flow, long-term financing, and a choice of floating or fixed interest rates.
- The BDC has less formal emphasis on incrementality (it is intended to be a "complementary lender"), and although it offers high-risk loans, it prices the loan in accordance with the risk, with no fixed ceiling on interest rates.
- The sector coverage of BDC loans is quite different. For example, 33% of BDC loans in 2003-04 (and 38% of loan values) went to firms in the manufacturing sector, compared with only about 10% of CSBF loans.
- The losses on BDC loans are in the neighbourhood of 7%[31], while CSBF loan losses (claims paid as a percentage of loans granted) are in the neighbourhood of 10%[32]. One possible interpretation of this is that, in general, BDC loans are less risky than CSBF loan. This same point was made in a 1998 study[33], which concluded that there is little overlap between the BDC programs and the SBL program (and, therefore, presumably, the CSBF program also).

The following table briefly summarizes the characteristics of the main regional government programs that provide financing assistance to SMEs.[34]

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31 *Business Development Bank of Canada 2003 Annual Report*, page 12.

32 Based on recent forecasting work carried out by CSBFPD.

33 *The Current Market for Small Business Financing*, Roy B. Norton, 1998.

34 There are several other provincial programs that provide financial assistance to SMEs, but these are not at all comparable to the CSBF program: (a) the Manitoba Business Start Program provides loan guarantees of up to $10K to new businesses; (b) the Saskatchewan Small Business Loans Association Program provides loans of up to $10K to SMEs; (c) the Newfoundland Small Business Seed Capital Equity Program provides grants of up to $50K on a matching basis to new or expanding SMEs; (d) the New Brunswick Entrepreneur program provides loan guarantees of up to $10K to individuals who are unemployed to assist them in starting a business.

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Program	Description
Community Futures Program	There are 268 Community Futures Development Corporations[35] operating in rural areas across Canada. CFDCs can lend a maximum of $125K to new or existing businesses to assist entrepreneurs who may have trouble accessing capital from traditional lenders.
Investissement Québec	Investissement Québec offers SMEs support in their development by guaranteeing the financing of their projects in collaboration with financial institutions through the SMB Financial program. However, SMB Financial is intended for a certain range of clientele. In particular: businesses that carry out projects centered on exporting and innovation (R&D, design, marketing) and in particular sectors (manufacturing, information technologies, tourism [specific activities], recycling, research laboratories, environmental restoration, centralized call services, and the new economy).
Atlantic Canada Opportunities Agency	ACOA provides loans (called “repayable contributions”) to SMEs through its Business Development Program. In general, this program only provides 50% financing.
Western Economic Diversification Canada	The Loan Investment Fund Program of WED provides repayable contributions to lending organizations to assist them in establishing and maintaining loan loss reserves for high risk SME loans.
Alberta Financial Services Corporation	Provides term loans to small businesses “when conventional financing is not available”.
Nova Scotia Small Business Financing/Loan Guarantee Program	Provides loans to SMEs up to a maximum of $150K and loan guarantees up to 75% of $150K.
New Brunswick Financial Assistance to Industry Program	Provides loan guarantees to businesses in certain sectors.

4.3 Question 4: To what extent have the loans made under the program been incremental?

Findings

1. 50 to 55% of the loans that have been made under the CSBF program have been “fully financially incremental” – i.e., in the absence of the CSBF program, no loan at all would have been granted to the borrower.

2. Approximately an additional 25% of CSBF loans have been “partially financially incremental” – i.e., in the absence of the CSBF program, the borrower would have been granted a smaller loan.

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[35] Called Business Development Corporations in some of the Atlantic provinces and Sociétés d’aide au développement des collectivités in Québec.

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3. Of the CSBF loans that were neither fully nor partially financially incremental (i.e., the borrower would have received the full amount of the loan in the absence of the CSBF program), over two-thirds exhibited "loan quality incrementality" – i.e., the loan was more advantageous to the borrower than the loan they would have obtained in the absence of the program (e.g., provided on a more timely basis, lower interest rate, less collateral required, etc.).

Discussion

Our approach to the analysis of this question was based on the review and analysis of existing studies, primarily the four studies carried out by Equinox Management Consultants described in section 2.2.[36] The latter three of these studies (i.e., December, 2003, February, 2004, and March, 2004) were based on a Conference Board review of methodologies for carrying out incrementality studies.[37]

Definitions

We say that a CSBF loan demonstrates *full financial incrementality* if no loan at all would have been granted to the borrower if the CSBF program had not existed. In most cases this means that the CSBF program was necessary in order for the loan to be approved – i.e., the borrower firm would not have qualified for a loan in the absence of the program.[38]

We say that a CSBF loan demonstrates *partial financial incrementality* if a smaller loan would have been granted to the borrower if the CSBF program had not existed. In most cases this means that the CSBF program was necessary in order for the borrower to qualify for the full loan but that, without the program, the borrower would have qualified for a smaller loan.[39]

We say that a CSBF loan demonstrates *loan quality incrementality* if the loan is more advantageous to the borrower – in ways unrelated to the amount of the loan – than the loan the borrower would have had if the CSBF program had not existed. Situations which reflect loan quality incrementality include the following:

[36] (1) *Impact of SBLA Lending: An Evaluation of the Economic Impacts of the SBLA Program* (2) *Incrementality of CSBF Program Lending, Volume I: Insights from SME FDI Data* (3) *Incrementality of CSBF Program Lending, Volume 2: Findings from Aligned Interviews* (4) *Incrementality of CSBF Program Lending, Volume 3: Findings from Survey Data,* Equinox Management Consultants Ltd., January, 1997, December, 2003, February, 2004, and March, 2004.

[37] *Methodological Review: Review of Loan Incrementality Studies for the Canada Small Business Financing Act,* Conference Board of Canada, 2003.

[38] The reason this interpretation is not precisely correct is that there could be situations in which, in the absence of the CSBF program, the borrower would have qualified for a smaller loan or a less attractive loan (e.g., higher interest rate) and the borrower would have turned down this loan – so, in the absence of the CSBF program, no loan at all would have existed.

[39] The difference between this and the formal definition is reflected by those situations in which, in the absence of the CSBF, the borrower would have qualified for a smaller loan but, for whatever reason, no loan at all would have been granted.

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- The CSBF loan was provided on more favourable terms than the loan the borrower would have had in the absence of the CSBF program (fees were lower; interest rate was lower; term to maturity was longer; less collateral was required, etc.).
- The CSBF loan was provided on a more timely basis than the loan the borrower would have had in the absence of the CSBF program.
- The CSBF loan was part of a broader financing package than would have been provided to the borrower in the absence of the CSBF program.[40]

Note that loan quality incrementality can only occur in cases in which the degree of financial incrementality is either none or partial – a loan which is fully financially incremental cannot be a case of loan quality incrementality. This is because the definition of loan quality incrementality involves comparing the characteristics of the CSBF loan with the characteristics of the loan the borrower would have had if the CSBF program had not existed, the "alternative loan". This comparison doesn't make sense if there is no alternative loan. For example, if a CSBF loan is fully financially incremental, one couldn't say that the borrower received a better interest rate on that loan than on the loan they would have received in the absence of the CSBF program, since they wouldn't have received any loan at all in the absence of the CSBF program.[41]

Results

The findings from these studies regarding **full financial incrementality** are summarized in the following table.

Source of incrementality estimate	Estimate of full financial incrementality (%)	Comments
1. Equinox 1997	54	This study dealt with the SBL program (loans granted from 1990 through mid-1996). The total universe of loan recipients was sub-divided into three categories: new firms, young firms (established less than one year at the time of the loan), and established firms. All loans to new firms and 80% of loans to young firms were assumed to be fully financially incremental. 25% of loans to established firms were assumed to be fully financially incremental based on telephone interviews of these firms.

[40] The Equinox studies also discuss a fourth situation – the CSBF program was instrumental in facilitating or initiating the working relationship between the borrower and the lending institution. This could well be an incremental impact of the program, but it should not be included under loan quality incrementality, since it is not related to characteristics of the loan. We assume that the inclusion of these situations as part of loan quality incrementality in the Equinox studies has not significantly affected the findings regarding loan quality incrementality.

[41] However, one can imagine survey respondents saying something like: "I wouldn't have qualified for a loan without the CSBF guarantee, and the guarantee also helped me get a lower interest rate" without realizing that this statement doesn't make sense.

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Source of incrementality estimate	Estimate of full financial incrementality (%)	Comments
2. Equinox Vol 1	75 = full plus partial financial incrementality	This estimate is based on applying the derived regression model to predict the % of CSBF loans that would have been turned down in the absence of the CSBF program. It therefore includes both full and partial financial incrementality.[42] The 95% confidence interval for this estimate is $\pm$ 9%.
3. Equinox Vol. 2 – lenders' estimates	74	This is considerably higher than the borrowers' estimates (see next row of table). One possible explanation for the discrepancy is that lenders would want to be seen as having given a lot of fully incremental CSBF loans, since they know this is what Industry Canada is looking for. 15% of the lenders estimated that the CSBF loan was partially incremental.
4. Equinox Vol. 2 – borrowers' estimates	39	42% of the borrowers estimated that their CSBF loan was partially financially incremental, so there is a high degree of overall agreement with the lenders regarding some form of financial incrementality, either partial or full – lenders say 89% (74% + 15%); borrowers say 81% (39% + 42%). It is not unreasonable to assume (and this is consistent with the lenders' opinions) that some of the borrowers were optimistic – i.e., they thought they would have gotten at least a small loan in the absence of the CSBF, when, in fact, they would have gotten no loan at all.
5. Equinox Vol. 3	50	Equinox feels this may be low since it is based on borrowers' opinions, which Vol. 2 indicates may under-estimate full incrementality (because lenders provided a higher estimate – see rows 3 and 4 of table). The 95% confidence interval for this survey finding is +/- 3%.

Based on the above, it is reasonable to conclude that full financial incrementality of CSBF loans is 50-55%. This is consistent with estimates (1), (2), and (5), and the average of the lenders' and borrowers' estimates in Equinox Vol. 2 (i.e., the average of estimates (3) and (4), which is 56.5%).

[42] All loans that would have been turned down are classified as (financially) incremental, both those cases in which no loan at all would have been granted (full financial incrementality) and those cases in which a smaller loan would have been granted (partial financial incrementality).

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The findings from these studies regarding **partial financial incrementality** are summarized in the following table.

Source of incrementality estimate	Estimate of partial financial incrementality (%)
1. Equinox 1997	Not estimated
2. Equinox Vol. 1	75 = full plus partial (so if 50% is full, 25% would be partial)
3. Equinox Vol. 2 – lenders' estimates	15
4. Equinox Vol. 2 – borrowers' estimates	42
5. Equinox Vol. 3	27

Based on these results and the analysis of full incrementality discussed above, it is reasonable to conclude that partial financial incrementality applies to approximately an additional 25% of CSBF loans. This is consistent with estimates (2) and (5) and the average of estimates (3) and (4).

Two of the referenced studies also discuss the notion of **loan quality incrementality.**

Equinox Vol. 2 reports that 58% of the CSBF borrowers interviewed said they experienced some form of loan quality incrementality (better terms, etc.). However, this appears to include respondents who said they experienced full financial incrementality, so it is probably not meaningful.

Similarly, Equinox Vol. 3 reports that 62% of the CSBF borrowers interviewed said they experienced some form of loan quality incrementality, but again this appears to apply to the whole population of respondents (including full financial incrementality respondents), so it is probably not meaningful. However, some findings can be inferred from Table 9 of Equinox Vol. 3. That table reports:

a) 49.6% of loans had full incrementality.

b) 26.9% of loans had partial incrementality.

c) 6.4% of loans had no incrementality (i.e., neither full financial nor partial financial incrementality nor loan quality incremenetality).

It follows from (a) and (b) that 23.5% (= 100 – 49.6 – 26.9) of loans had no financial incrementality. The loans that had no incrementality of any kind, i.e., 6.4% of all loans, must be a subset of this, and the complement – i.e., 17.1% of all loans (= 23.5 – 6.4) – must be the set of loans that had no financial incrementality but loan quality incrementality.

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4.4 Question 5: To what extent is the CSBF program cost-recoverable?

Findings

1. The CSBF program, as it is currently structured, is not cost recoverable.
2. Certain types of loans are significantly riskier than other loans – specifically, loans to the Accommodation, Food & Beverage sector, large loans (over $100,000), loans to new firms, and possibly loans for leasehold improvements[43].
3. The CSBF program loan portfolio is riskier than the 1995-99 SBL program portfolio.
4. The net cost to government (claims plus interest paid minus fee payments received) of SBL loans made between 1995 and 1999 is $275 million as at March 31, 2004 (on a non-discounted basis).
5. The forecasted net cost over a 10-year period CSBF loans made during the 1999/00 – 2003/04 period is approximately $330M (on a non-discounted basis, or $250M on a net present value[44] basis, using a discount rate of 5%).

Discussion

Our approach to this question was based on the review and analysis of two studies described in section 2.0 – the 2003 Equinox report[45] and the summary of recent forecasting work carried out by the CSBFPD with the assistance of Equinox.[46]

<u>Background</u>

As discussed in section 3.0, a number of changes were made to the program in 1993 in order to extend its coverage. Several of these changes resulted in dramatically increased loan take-up and loan defaults and claims. In 1995 the most significant of these changes were reversed, and the annual administration fee of 1.25% was introduced in order to steer the program toward cost recovery.

The 1997 OAG report estimated a net loss of $210M for loans made between 1993 and 1995, and in 1998 some additional program changes intended to increase cost recovery were made, such as the requirement for lenders to exercise due diligence and measures to reduce the amount of loan interest paid on claims. The 2002 OAG report estimated a net loss in excess of $200M for loans made between 1995 and 1999.

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[43] The higher risk associated with leasehold improvement loans has been demonstrated based on data from the SBLA period; it has not yet been demonstrated for the CSBFA period.

[44] The calculation of the net present value of a series of dollar values in future years involves discounting the dollars in each future year to the present year based on the opportunity cost of capital. One can think of this as using an interest rate to determine how much money would be required today to equate to a dollar, say six years in the future – and note that, because of the interest, the amount required today would be less than one dollar

[45] *SBLA and CSBFA Claims and Cost Experience*, Equinox Management Consultants Ltd., March, 2003.

[46] *CSBFA Cost Recovery,* Industry Canada (SBLA), October, 2003.

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Before proceeding to the analysis of the two studies, we note that, based on the findings from section 4.3 (Incrementality), one would predict a large gap between expenditures and revenues for the CSBF program. That is because this program has a high degree of financial incrementality. This means that there must be a large gap between claims and fee revenues related to these loans, because if this gap were not large – i.e., if the program during this period were close to being cost-recoverable – the private sector would be granting many of these loans on its own[47], which means that the degree of incrementality would be low.

Analysis of the 2003 Equinox report

This study compares the operation of the program during two time periods – Apr/95 through March/99 (SBLA) and Apr/99 through March/02 (CSBFA). It is based on the analysis of information from the registration and loans database (on all loans during these periods).

One set of useful findings from this study is from the analysis of claim losses. Key findings related to the risk profile of SBL/CSBF loans include:

- The sectors with the highest losses are Accommodation, Food & Beverage and Information and Cultural Industries. (Real Estate, Rental & Leasing also had high losses, but this sector is a minor user of the program; Wholesale Trade had high losses under the SBLA but not the CSBFA.).
- The highest losses are for loans used primarily for leasehold improvements.
- Loans in excess of $100,000 have higher claim frequencies and losses.
- New firms show much higher losses.
- Loans to franchises have higher losses.
- Firms with a high number of employees tend to have lower losses.

Equinox also carried out a logistic regression analysis of these data to identify attributes correlated with high/low loan losses. The findings were consistent with the above, i.e., the regression analysis indicates that:

- Loan losses are higher for
  - firms in high risk sectors (see above[48]);
  - new firms, and
  - borrowers who used the funds to finance leasehold improvements.

[47] This is because the issuing of these loans would comprise a profitable business (or at least not an unprofitable business), so theoretically the private sector would be likely to undertake this business on its own.

[48] Actually, more sectors than these two were included in their high risk category, but these were the main two.

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- Loan losses are lower for
  - sole proprietorships, and
  - firms with higher numbers of employees.

The SBLA 95-99 and CSBFA 99-02 portfolios were then compared. This comparison indicated "an overall increase in the proportion of borrowers with relatively high risk records in the CSBFA and a decrease in the proportion of borrowers with lower-risk profiles". This is illustrated in the following table.

Factor	SBLA Portfolio	CSBFA Portfolio
New firms	39% of loans	50% of loans
Leasehold improvements	10% of loans	14% of loans
High risk sector	14% of loans	22% of loans
Large loans (>$100K)	22%	28%

The study also compared the early claims experience under the SBLA with the early claims experience under the CSBFA, where "early claims experience" is defined as the claims from loans during a given two-year period received by the end of the third year.[49] Equinox concludes that the early claims experience under the CSBFA is comparable to the early claims experience under two separate two-year SBLA periods, as shown in the following table.

Two-year period	% of loans on which there were early claims	Value of early claims as a % of loan values
1995-97 (SBLA)	4.07%	2.55%
1997-99 (SBLA)	3.49%	2.30%
1999-01 (CSBFA)	3.56%	2.57%

It should be noted, however, that, based on historical experience, early claims represent fewer than a third of the likely claims for loans made during a given two-year period – i.e., for a given two-year period, more than two-thirds of the claims are going to be received after the end of the third year. Early claims experience is, therefore, only a partial indicator of the total claims related to a given set of loans.

The final analysis in this report relevant to this evaluation question dealt with the level of cost recovery for loans made during the SBLA period studied (95-96 through 98-99). The analysis compares the present value of fee incomes to date with the present value of claims paid to date for loans made during this four-year period. The conclusions are:

- The present value of the net cost of these loans to date is estimated at $117M - $152M (12% and 8% discount rate respectively). On an undiscounted basis, therefore, the net cost of these loans would be in excess of $200 million, which confirms, in approximate terms, the 2002 OAG estimate.

[49] For example, for loans made between April 1, 1995, and March 31, 1997, the early claims would the all claims received by March 31, 1998.

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- Looking at the claims experience for loans made in each of these four fiscal years, the net cost is lower for the most recent years, so the study concludes that "the program has been operating progressively closer to cost recovery over time". However, the validity of this conclusion is questionable, since loans made in the more recent years only have a few years of claims experience – e.g., for loans made in 1998-99 there are only four years of claims experience up to March, 2002; and, based on historical experience, only about 60% of the claims related to these loans would have been made by that time. It may not be valid to compare the amount of these claims to claims related to loans made during earlier periods, which have a longer claims history.

October/03 Industry Canada Cost-Recovery Forecasting

In this study CSBFPD, with the assistance of Equinox, developed models to forecast both expenses (claims plus interest) and revenues (registration fees plus admin fees) for loans made over the five-year period 1999-00 through 2003-04 (the CSBFA period). The results are shown below.

Cohort	Claims ($M) (claims as a % of total loans made)	Net cost ($M) (claims plus interest minus fee revenues) (Net cost as a % of total loan values)	NPV of net cost @ 5% ($M) (NPV as a % of total loan values)
1999-00	135 (10%)	60 (4.4%)	44 (3.3%)
2000-01	130 (11%)	64 (5.5%)	47 (4.0%)
2001-02	115 (13%)	64 (7.1%)	48 (5.4%)
2002-03	126 (13%)	73 (7.7%)	56 (5.8%)
2003-04	125 (13%)	72 (7.6%)	55 (5.8%)
Total	630 (12%)	333 (6.3%)	250 (4.7%)

Thus, the net cost to government of CSBF loans that have been made during this period is forecasted at approximately $330 million, or $250M on a net present value basis, using a discount rate of 5%.

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This study estimates the total annual loss on loans granted during this period as follows.

Forecasted Annual Net Program Costs/(Revenues) Related to Loans Granted From 1999-00 through 2003-04											
	1999-00	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**	**2006-07**	**2007-08**	**2008-09**	**2009-10**[50]
Claims and interest paid ($M)	1	15	43	69	94	111	108	82	53	30	14
Revenues received from fees ($M)	32	44	45	48	50	28	19	13	8	5	3
Total loss on loans granted from 1999-00 through 2003-04 ($M)	(31)	(29)	(2)	21	44	83	89	69	45	25	11

We emphasize that this table does not show the total annual net program costs/(revenues) over the period 1999-00 through 2009-10. It only shows the annual net program costs/(revenues) over this period that are due to loans granted from 1999-00 through 2003-04. If one were showing the total annual net program costs/(revenues) over the period 1999-00 through 2009-10, this table would have to be amended to include all revenues and claims associated with loans made under the SBL program prior to April 1, 1999, and with loans made under the CSBF program after March 31, 2004.

Industry Canada is currently working on refining the cost recovery forecasting models to take into consideration the additional data now available for 2002-04. However, any future program changes made to bring the program closer to cost recovery will not affect the forecast losses.

4.5 Questions Regarding Lender Awareness and Satisfaction

4.5.1 Question 6: Has the CSBF program strengthened the partnership with lenders

Findings

1. Financial institutions have a positive view of Industry Canada, but there is a perception that Industry Canada needs to improve its communications with them.
2. There is an adequate level of satisfaction on the part of lenders with the quality of service delivery by Industry Canada (overall level of satisfaction = 75 out of 100).

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[50] Claims during 2010-11 through 2012-13 are forecasted at $10.0M. Revenue during this period is forecasted at $2.7M.

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Discussion

In the Lenders Survey[51] the strategic partners were asked specifically about the partnership with Industry Canada. It should be kept in mind that these questions were open-ended (i.e., the interviews with strategic partners yielded qualitative data only), and there were a limited number of responses.

Many interviewees had little contact with Industry Canada over the years, and some had no contact at all. The people who responded perceive Industry Canada (CSBFPD) as having been open, transparent, responsive, and balanced. The group with the most positive relationships is the claims officers, who have had many contacts with the personnel at Industry Canada.

There was a general perception among senior managers and financial institutions' coordinators that there is room for improvement in establishing and maintaining partnerships with lenders. Note, however, that Industry Canada has very little interactions with this group and that claims officers were generally satisfied with Industry Canada's efforts in this area.

There were suggestions that a partnership agreement between the financial institutions and Industry Canada be established. The financial institutions expect Industry Canada to work with them in reducing the level of administrative burden, and they also expect on-going dialogue and open exchanges regarding how to improve the product.[52]

Questions regarding lender satisfaction were addressed to the operational partners surveyed. Their average overall rating of satisfaction with the service provided was 75 (0=very dissatisfied; 25=dissatisfied; 50=neutral; 75=satisfied; 100=very satisfied). They were also asked to rate their level of satisfaction with 12 specific aspects of service delivery. The average satisfaction ratings for those aspects that reflect the quality of the service provided by Industry Canada staff were as follows:

- Speed of service by Industry Canada's Small Business Loans Administration: 73
- Courtesy of Industry Canada's Small Business Loans Administration: 73
- Competence of Industry Canada's Small Business Loans Administration: 72
- Fairness of Industry Canada's Small Business Loans Administration decisions: 71
- Ease of doing business with Industry Canada's Small Business Loans Administration: 70
- Accessibility of the staff by telephone, e-mail, or fax: 69.

More than two-thirds of operational partners (69%) did not identify any priority for improvement in CSBF service delivery.

[51] *Satisfaction and Awareness Among Canada Small Business Financing Partners, 2004,* Circum Network Inc., May, 2004.

[52] Note that this survey was carried out prior to the recent Industry Canada consultations with lenders.

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The CSBFPD discussions dealt with opportunities for improvement in the program regulations and administration and did not specifically address the partnership with lenders. The discussion report did note that financial institutions feel that Industry Canada (CSBFPD) needs to improve communications with them.[53] This echoes the opinions expressed by the strategic partners in the Lenders Survey.

4.5.2 Question 7: To what extent are lenders aware of the CSBF program?

Findings

1. Almost all commercial loan managers know about the CSBF program.
2. Lenders have a very good knowledge of the main program guidelines and parameters.

Discussion

In the Lenders Survey, 85% of commercial loan managers had heard of the CSBF program, and an additional 10% had heard of the program under one of its previous names.

This survey also found that lenders have very good knowledge of the main program guidelines and parameters, such as what assets are eligible for financing, the maximum loan size, the due diligence requirements for issuing loans, and other details related to loan issuance. This is discussed further in section 4.7.

These findings are consistent with the findings from previous studies.

4.6 Questions Regarding Borrower Awareness

4.6.1 Question 8A: What is the level of awareness of the CSBF program among SMEs?

Findings

The CSBF program is not well known within the general SME community:

- Only about 40% of SME managers are aware that there is a federal government program that guarantees loans to SMEs.
- Only 10% of these managers can recall the name of the program.

[53] *Report on Small Business Loans Administration Discussions with Financial Institutions*, Heron and Company, June, 2004, page 16.

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These percentages are higher for firms that have received recent CSBF loans – 80% and 40% respectively.

Note that these findings may be out of date. Partly as a result of the survey discussed below, Industry Canada developed an information campaign to increase the level of awareness of the CSBF program among SMEs (and also among financial institutions).

Discussion

Our approach to this question was based mainly on the review of existing documents, supplemented by interviews with Industry Canada (CSBFPD).

The main document that contains information relevant to these questions is the CSBFA Awareness Study[54]. That study involved two surveys of SMEs:

- Survey of the general business population – a random sample of 300 SMEs supplemented by 94 firms in the "early start-up" and "survival" stages of development, for a total sample of 394 businesses.
- Survey of CSBF clients – a random sample of 202 businesses that had obtained a CSBF loan within the past year.

The findings discussed below are from this study unless otherwise noted.

In the survey of the general business population:

- 41% of the business managers said they were aware of a federal government program that guarantees the loans of SMEs.
- Half the business managers surveyed said they had heard of the CSBF/SBL program. However, note that this includes respondents who said they had heard of the program on an aided basis (i.e., given the name of the program and asked if they had heard of it), as well as those who could identify the program on an unaided basis. The majority of this awareness of the program name was on an aided basis (only 10% were able to do this on an unaided basis).

Two-thirds of those who were aware of the existence of a federal government loan guarantee program for SMEs were unable to recall any program by name. However, when those business managers who said their firm obtained a loan covered by a federal program were asked if they remembered the name of the program, 85% were able to do this.

In the survey of CSBF clients:

- 81% of the business managers said they were aware of a federal government program that guarantees loans of SMEs (a surprisingly low percentage, since all of these businesses had made use of the CSBF program within the past year).

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[54] *Canada Small Business Financing Act Awareness Study,* COMPAS Inc., April, 2001.

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- Just over two-thirds of client businesses (68%) said they had heard of the CSBF/SBL program. As above, this includes everyone who could recall the program on either an aided basis or unaided basis. As in the survey of the general business population, the aided awareness was higher than the unaided awareness, but, in this case, not much higher. (Unaided awareness was 40%.)

The report *Lending a Hand* [55] summarizes the results of interviews of a [non-random] sample of 24 firms that received CSBF loans. Only two of the representatives interviewed said they had heard of the CSBF loans before speaking to a banker or other financial expert, again indicating a low level of awareness of the program among the general SME population.

4.6.2 Question 8B: To what extent are borrowers aware of the role of the CSBF program in guaranteeing loans?

Findings

The data regarding the knowledge of borrowers of the role of the CSBF program in guaranteeing loans are somewhat ambiguous, but they indicate that at least three-quarters of the recipients of CSBF loans are aware of the role of the program.

Discussion

In the survey of CSBF clients in the Awareness Study, managers of firms that obtained a loan were asked whether the loan was covered by a loan-guarantee program offered by the federal government. Despite the fact that all of these businesses received loans under the CSBF program, one-quarter said they thought their loan was not covered by a federal program (a bizarre result, which could be due to some sampling anomaly – e.g., it might have been the case that some of these survey respondents were not the people in the company who would be expected to be up-to-date regarding the company's financing arrangements).[56]

On the other hand, in the study *Lending a Hand*, 23 of the 24 firms interviewed were aware of the nature of their loan, and usually of the role of the government as well.

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

[56] COMPAS' interpretation of this finding is that financial institutions may not be consistently identifying the CSBF program to businesses that make use of it.

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4.7 Questions Regarding Lenders' Knowledge and Practices

4.7.1 Question 9: Are the guidelines, Act, and regulations understood by lenders?

Findings

1. Lenders have very good knowledge of the things they need to know in order to be able to issue CSBF loans. Approximately 90% of them understand:

   - what assets are eligible for financing;
   - the maximum loan size, and
   - the due diligence requirements for issuing loans.

   Three-quarters of them also have good knowledge of the "nitty-gritty details" related to loan issuance – eligible charges, cost and proof of payment, appraisal, repayment term, interest rate, security, guarantees and suretyships, etc.

2. Lenders are less knowledgeable regarding information that is not important to their day-to-day operations and which there is no need for them to remember. For example, only about half of them know how much of a loan loss is covered by the government, and fewer than a third of them know the maximum time to register a loan or submit a claim.

Discussion

Our approach to this question was based on the review and analysis of existing studies, supplemented by the analysis of claims data. We begin by summarizing the results from three studies.

The Lender Survey[57]

As discussed in section 2.0, this survey involved interviews with 1,494 "operational partners", and the sample of operational partners contained a sub-sample called "users" (people who had either registered a loan or made a claim after April 1/99). The findings presented below refer specifically to the sub-sample of users.

The users were asked 11 questions to assess their knowledge of the program parameters. First, they were asked to state whether or not the CSBF guidelines allow the financing of various different types of assets. 89% or more of the respondents gave the correct answer to six out of seven of these questions (only 83% gave the correct answer to the question regarding the financing of inventory, which is not eligible).

The maximum loan amount of $250K was correctly stated by 89% of respondents. On the other hand, only 52% correctly identified 85% as the maximum percentage of losses the government will reimburse the lender.

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[57] *Satisfaction and Awareness Among Canada Small Business Financing Partners, 2004*, Circum Network Inc., May, 2004.

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The pieces of information least known to respondents were the time period available to register a loan with Industry Canada (29% had correct knowledge) and the time period to submit a claim to Industry Canada (6% had correct knowledge). At first glance, this is surprising, since these people had all been involved in either registering a loan or submitting a claim or both. However, it could be the case that many of these operational personnel simply perform these tasks expeditiously and don't worry much about what the maximum allowable time is – this seems plausible, at least, for the questions regarding loan registrations. As might be expected, people who handle both registrations and claims fared better on these questions than people specialized in either one or the other.

Overall, program users were able to provide 8.2 correct answers out of 11. Representatives from caisses populaires provided, on average, 1 more correct answer than representatives of banks (9 versus 8).

The On-Site Examination[58]

This project included the review of a randomly selected set of 143 loans made by 12 lenders between April 1, 1999, and March 31, 2002. It dealt with the extent to which the lenders had followed the requirements of the CSBFA. It is, therefore, somewhat reflective of the degree of understanding of the Act and regulations among the lenders, but we emphasize that this is an indirect indicator only. Lack of understanding is certainly not the only reason certain regulations may not have been followed. On the other hand, a high degree of compliance definitely indicates a high degree of understanding.

The findings regarding the extent to which the lenders had followed the required due diligence procedures, which are reported under evaluation question 10, were positive – 94% of the lenders complied with the requirements.

This project also investigated other compliance requirements regarding: eligible charges, cost and proof of payment of the purchase or improvement, appraisal, repayment term, interest rate, security, guarantees and suretyships, and default and claims procedures. 73% of the 143 loans examined complied with all or these requirements.

The remaining 38 loans (27%) did not fully comply with one or more of the requirements:

- In 18 cases the loan amount exceeded 90% of the cost of the assets financed.
- In 5 cases appropriate appraisals were not obtained as required.
- In 3 cases there were problems with the timing of the first principal payment.
- In 3 cases the interest rate charged to the borrower was in excess of the maximum rate authorized.
- In 10 cases ineligible charges (e.g., application fees, late payment fees) were collected from borrowers.
- In 6 cases there were problems with the security taken.
- In 2 cases personal guarantees were taken for amounts exceeding the maximum percentage authorized.

This project also included the review of the loan documentation. It was found that 106 of the 143 loans examined (74%) were supported by accurate and complete documentation.

[58] *2002 On-Site Examination: Report on Findings*, CSBFA, August, 2003

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Overall, this project revealed that 98 of the 143 loans (69%) fully complied with all aspects of the three categories of requirements examined (due diligence, other compliance requirements, and documentation).

Loans Decline Study[59]

This project involved a set of 18 in-depth telephone interviews with representatives of financial institutions. Interviewees included both senior executives and day-to-day CSBFA contacts. This research was qualitative in nature.

As noted under evaluation question 10, this project revealed some confusion over what constitutes due diligence in regard to applications for CSBF loans. There was also some confusion regarding what qualifies for a CSBF loan as opposed to an SBL loan – i.e., what the differences are between the two programs.

Claims Data

Data on the number of claims rejected are an (admittedly imperfect) indicator of the level of lender understanding, since one possible reason for a high level of rejects would be a low level of understanding.[60] The key information is:

- CSBF program claim rejections since the beginning of the program have been 4.5% of the number of claims submitted. This seems to us to be a relatively low level of rejection, given the complexity of the regulations.
- This is half the rate of claim rejection that has been experienced under the SBL program. While this could indicate a higher level of lender understanding, the most likely reason for this is that the CSBFA added a non-compliance provision to allow for adjusting rather than outright rejecting a claim. This did not exist with the SBLA (pre-1999).

4.7.2 Question 10: Has the CSBF program had an impact on participating lenders' loan practices?

Note: While this question as stated deals with loan practices generally, two loan practices are of particular interest:

- due diligence practices, and
- claim submission practices.[61]

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[59] *Canada Small Business Financing Act Loans Decline Study*, COMPAS Inc., January, 2002.

[60] The level of rejects is also affected by other factors, such as changes in regulations.

[61] *Progress Report on Implementing the Evaluation Framework for the Canada Small Business Financing Program*, Industry Canada (Small Business Policy Branch), August, 2003, page 17.

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Findings

The data regarding these loan practices indicate that:

- Due diligence procedures are being followed and have probably improved as a result of the CSBFA.
- Lenders have been submitting claims sooner following default as a result of the new CSBFA regulations.

Also, as a result of faster claims submissions combined with the non-payment of interest by the government during year three following default, interest payments by the government have declined.

Discussion

Due diligence practices

Section 8 of the CSBF program regulations states that lenders must apply the same procedures as those they would apply in respect of a conventional loan in the same amount, including, before making the loan:

a) obtaining credit references or conducting a credit check on the borrower, and

b) completing an assessment of the repayment ability of the borrower, taking into account all other financial obligations of the borrower.

In the *On-Site Examination*[62], documentation related to the due diligence procedures of 12 lenders was reviewed. CSBFPD concluded that "[These] lenders applied the same procedures as those applied to a conventional loan."

In addition, CSBFPD reviewed a randomly selected set of 143 loans made by the 12 lenders between April 1, 1999 and March 31, 2002. It was found that 135 of the 143 loans (94%) complied with the requirements of the regulations. With respect to the eight loans that did not comply, there was no record of obtaining credit references or conducting a credit check on the borrower before making the loan.

The only other information related to due diligence practices is from the *Loans Decline Study*[63] and the *Lender Survey*.[64] The *Loans Decline Study* involved interviews with representatives of 11 of the 12 lending institutions that are the top users of CSBFA-registered loans. That report notes that: "A few participants expressed confusion over what constituted due diligence in regard to applications for a CSBFA loan…"

62 *2002 On-Site Examination: Report on Findings*, SBLA, August, 2003.

63 *Canada Small Business Financing Act Loans Decline Study*, COMPAS Inc., January, 2002.

64 *Satisfaction and Awareness Among Canada Small Business Financing Partners, 2004*, Circum Network Inc., May, 2004.

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The *Lender Survey* involved interviews with 40 "strategic partners" (qualitative data) and 1,494 "operational partners" (quantitative data). The data regarding due diligence procedures were:

- In general, the current requirements are not perceived to be a problem. Due diligence requirements received one of the highest satisfaction ratings from operational partners.
- However, it was suggested by the strategic partners that consideration be given to reducing the due diligence requirements on smaller loans.

Note: There is no information regarding pre-CSBFA due diligence practices of financial institutions, since the due diligence requirements (and the on-site audit capacity) were only introduced under the CSBFA. So even the *On-Site Examination* data does not necessarily reflect impacts of the CSBFA – i.e., even though due diligence was discovered to be high during the CSBFA period, it might have already been high prior to the CSBFA. Note, however, that in the 1997 audit of the program by the OAG, the OAG said that Industry Canada needed tighter controls to ensure that lenders exercised due diligence in granting loans. This was because they had some concerns that due diligence was not always being exercised. In their 2002 report the OAG states: "In 1997 we examined files of financial institutions on loans made under the Small Business Loans Act, and we observed that they did not always contain evidence that the Program rules had been followed."

In the recent CSBFPD discussions with lenders, financial institutions did not report any concerns regarding due diligence requirements.[65]

Claim submission practices

In the 1997 Office of the Auditor General audit, the OAG expressed concern about the amount of interest that was being paid by the government on defaulted loans. The situation prior to the CSBFA was that:

- A lender had up to three years to claim its losses on a defaulted loan;
- The claim included the eligible proportion of the unpaid principal as well as all the interest the lender would have received for the first year and one-half the interest the lender would have received for the second and third years.[66]

The OAG recommended that the Department implement measures to reduce the amount of interest it was paying on claims.

[65] *Report on Small Business Loans Administration Discussions With Financial Institutions,* Heron and Company, June, 2004, page 9.

[66] The 2002 OAG report implies that, prior to the CSBFA, the government paid all the interest for all three years, but this is incorrect.

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The CSBFA and associated regulations introduced two changes:

a) Lenders were allowed to submit an interim claim before having collected a personal guarantee, but after having collected on all other security on the assets financed.[67]

b) The period for which the government will pay interest to the lender was shortened. While lenders still have three years after a default to submit their claims, the Department no longer pays interest to the lender for the third year. As before, it pays the full rate of interest for the first year (i.e., at the interest rate at which the loan was issued) and half that rate for the second year

These measures, together, were expected to speed up claims submissions and reduce the amount of interest paid.

The 2002 OAG audit report contains the following information:

- In 2001-02, interim claims represented 23% of settled claims.
- The OAG estimated that in 2001-02 measure (b) resulted in a reduction of $800K in interest paid.[68]

The *Claims and Cost Experience Study*[69], which was based on analyzing the SBLA/CSBFA databases (the loan registration and claims databases), undertook two analyses to estimate the impacts of changes (a) and (b):

- The time between default and claims submission.
- The amount of interest per dollar of claim paid.

It was found that lenders were submitting claims sooner following default with the new interim claims procedure and that interest payments have declined. The detailed data are shown below:

[67] The interim claim payment can be for up to 85% of the loss minus 85% of the value of any guarantees or personal liability of the borrower associated with the loans.

[68] Although note that, if the OAG did not correctly understand the situation prior to the CSBFA (see footnote 66), this may be an over-estimate.

[69] *SBLA and CSBFA Claims and Costs Experience*, Equinox Management Consulting Ltd., March, 2003.

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Fiscal year in which loans were disbursed	Average time (years) elapsed between default date and date claim received	Total interest paid as a percent of total claims (excluding interest)
SBLA period		
95-96	1.34	30.0%
96-97	1.28	16.5%
97-98	1.22	17.1%
98-99	1.03	16.0%
CSBFA period		
99-00	0.82	13.6%
00-01	0.60	11.3%

Note that both indicators were decreasing prior to the introduction of the CSBFA, but the rate of decrease accelerated after the CSBFA was introduced. In particular, the average time from default to claim submission decreased from about 1.2 years during the post-1996 SBLA period to about 0.7 years during the early CSBFA period.

Other impacts on loan practices

The 1997 and 2004 Incrementality Studies[70], based on surveys of borrowers, discuss "loan quality incrementality", and several features of loan quality incrementality reflect impacts of the SBLA/CSBFA on loan practices:

a) Providing for a loan on more favourable terms (fees were lower; interest rate was lower; term to maturity was longer; or less collateral was required).
b) Providing for credit on a more timely basis.
c) Providing for a broader financing package than would otherwise have been available.

The 1997 study only reports on (b): "Approximately five percent of respondents reported that the SBLA provided their firm with access to financing in a more timely manner than would otherwise have been available".[71]

Unfortunately, the 2004 study does not report on any of these separately. They are reported on in aggregate together with "facilitating or initiating the working relationship between the borrower and the lender". This impact (i.e., facilitating or initiating…) together with (a) through (c) are defined to collectively comprise "loan quality incrementality", and the study reports that, over the four years (2000 through 2003) loan quality incrementality was, on average, 61.5% -- i.e., 61.5% of the borrowers experienced either a better working relationship with the lender or one or more of (a) through (c). Note,

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[70] *Impact of SBLA Lending: an Evaluation of the Economic Impacts of the SBLA Program*, Equinox Management Consultants Ltd., January, 1997 and *Incrementality of CSBF Program Lending, Volume 3: Findings from Survey Data*, Equinox Management Consultants Ltd., March, 2004.

[71] 1997 study, page 28.

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however, that this estimate is probably high, since items (a) through (c) do not make sense for loans that are fully financially incremental, and 50% of loans are in this category.[72]

4.8 Question 11: What has been the impact of the CSBF program on job creation? Job displacement? Job improvement? Job maintenance?

Findings

The most defensible available estimate of the direct employment impact of the CSBF program at participating firms is 2.7 jobs (on a full-time equivalent basis) per loan. ("Impact" includes both new jobs created and jobs maintained that otherwise would have been lost.)

Note, however, that the issues of job displacement and indirect (supplier-related) and induced (re-spending-related) job creation have not been measured, so it is not possible to assess their impact on net employment creation.

Industry Canada (SBPB) is currently carrying out a study with Statistics Canada that should provide additional valuable information regarding the economic impacts of the CSBF program. However, that study will not address displacement impacts or indirect and induced employment impacts.

Discussion

Approach

Our approach to this question was based on the review of existing studies, especially *Impact of SBLA Lending: An Evaluation of the Economic Impacts of the SBLA Program*, Equinox Management Consulting Ltd., January, 1997 (referred to as "Equinox 1997" below) and *Incrementality of CSBF Program Lending, Volume 3: Findings from Survey Data*, Equinox Management Consultants Limited, March, 2004 (referred to as "Equinox 2004" below). These studies are described in section 2.0 of this report.

The following studies were used in a more limited way:

- *Canada Small Business Financing Act Employment Impact Study*, COMPAS Inc., March, 2002 (referred to as "COMPAS 2002" below). This study was based on a mail survey of borrowers who received CSBF loans during the period January-July, 2000. It followed a literature review of best practices in job studies commissioned by Industry Canada.[73]
- *Canada Small Business Financing Act Annual Reports*.
- *Lending a Hand: The Role of the Canada Business Financing Act in Fostering Entrepreneurial Success*, Nicole Baer Communications, December, 2001. This study contains case study write-ups of employment impacts.

[72] This appears to have been recognized by Equinox for items (a) and (b) – see page 16 of their report.

[73] *A Literature Review of Best Practices of Job Studies,* Heidrick et al, 2001.

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Methodological Issues

The measurement of the employment impacts of government programs is very difficult, and there are a number of common methodological issues which tend to affect employment impact studies. These are described below in the context of the CSBF program.

1. The study is based solely on opinions of borrowers with no confirmatory evidence. There are potential response biases associated with relying on borrower opinions (e.g., overstatement of employment impacts). The most obvious potential bias is that firms that did not survive up to the time of data collection (and, therefore, had negligible employment impact) are not included in the data.

2. The study is based on attempting to estimate direct employment impacts only – i.e., changes in employment at the firms that received CSBF loans. There is no attempt to estimate indirect (supplier-related) employment impacts or induced (respending-related) employment impacts. For example, the study does not recognize that a loan leading to an efficiency improvement which allowed the firm to reduce its employment would generally result in an overall positive employment impact within Canada as a whole (because of increased spending on supplies and/or increased respending of profits).

3. The study is based on a before-after comparison (i.e., employment after the loan compared with employment before the loan) rather than a with-without comparison (i.e., employment after the loan compared with what employment would have been during this period in the absence of the loan).

   Example 1: In Equinox 2004 respondents were asked the following series of questions:

   - Did the CSBF loan allow your firm to expand? If respondents answered "no", they were directed to skip the employment impact questions. If they answered "yes", they were then asked

   - Did this allow your firm to increase employment? If yes, by how many employees?

   A firm that did not expand following the CSBF loan would answer "no" to the first question, and the study would record 0 direct employment impact. However, if, in the absence of the CSBF loan, the firm would have had to lay-off one employee, the actual direct employment impact is +1.

   Example 2: Looking at the same two questions, if, following the CSBF loan, a firm expanded and added 3 employees, the firm's answer to the first question would be "yes", and their answer to the second question would be "3". The study would record a direct employment of +3. If, however, in the absence of the CSBF loan, the firm would have expanded by 1 employee, the actual direct employment impact is +2.

4. The study is based on estimating the number of "jobs", but the term "job" is not defined. Sometimes studies distinguish between "full-time job" and "part-time job", but there is rarely a definition of what a "part-time job" is.

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5. The study does not adjust for the fact that some of the jobs recorded are related to CSBF loans that are not incremental (or are only partially incremental). For example, if a CSBF loan had no financial incrementality (i.e., the borrower would have obtained the full loan in the absence of the CSBF) and if, following the loan, the firm expanded by 3 employees, the direct employment impact of the program is 0, not +3.
6. The study does not account for job displacement. For example, opening up new restaurant A may create employment at A but may draw customers away from restaurant B, thereby reducing employment at B. Displacement can be significant in loan guarantee programs.[74]

Review of study findings

Equinox 1997

This study is affected by issues 1-4 and 6 listed above and partly by issue 5. The main results are:

- Anticipated additional hires, calculated from loan registration data, were 2.3 employees per loan; actual additional hires, calculated from telephone interviews, were 3.9 employees per loan. These data are not adjusted for loan incrementality.
- Taking into account loan incrementality, Equinox estimates that there were 2.5 additional hires per loan during this period – a total of 350,000 additional hires over the 140,000 loans during this period. Note, however, that some of these employees were part-time, and it is not possible to convert these data to full-time equivalent jobs.
- Equinox also reports additional profits of around $30-42K per loan – which would contribute to additional employment (outside of the firm).

Compas 2002

This study is affected by all six issues listed above, although there is some recognition given to issues 2, 3, and 4. Specifically:

- Regarding issue 2, there is an attempt to estimate indirect (supplier-related) employment impacts, but no useful data were obtained, since very few of the responding firms thought these effects occurred.
- Regarding issue 3, this is partially addressed in that the study separately discusses jobs "created" and jobs "maintained".
- Regarding issue 4, this is partially addressed in that the study separately discusses "full-time" and "part-time" jobs.

The most significant issue is #5 (no adjustment for incrementality).

[74] For example, the 1999 evaluation of the UK's Small Firms Loan Guarantee Scheme included a rigorous analysis of displacement effects. That study concluded that the estimate of 2.4 jobs created per firm based on borrower opinions had to be adjusted downward to 0.3-0.6 jobs per firm after accounting for displacement.

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Equinox 2004

This study is affected by issues 1-4 and 6, although there is some recognition given to issues 3 and 4. Specifically:

- Regarding issue 3, the study took into account the fact that some loans may have enabled efficiency improvements that, in turn, led to lay-offs. However, these are treated as losses in employment. (As discussed above, they do represent losses in direct employment, but probably not losses in overall Canadian employment.)

- Regarding issue 4, the distinction between full-time and part-time jobs is recognized. It is assumed that 1 full-time job = 2 part-time jobs, which may seem like a rough approximation but is at least an attempt to convert the employment impact estimates to a common basis (full-time equivalent jobs).

Issues 3 and 4 probably do not have a major effect on the overall estimates, and this study adjusts the employment impact estimates for loan incrementality, so we conclude that this study provides the most methodologically sound estimates of the direct employment impact of the CSBF at participating firms.

The key finding from this study is that the CSBF has resulted in employment impacts of 2.15 – 3.22 jobs per loan (assuming 1 full-time job = 2 part-time jobs). The low estimate is based on including only the employment impacts attributable to loans that are fully financially incremental. The high estimate is based on also including the employment impacts attributable to loans that are partially financially incremental. These latter employment impacts should not all be included, of course (since some of this employment would have occurred as a result of the smaller loans the firms would have obtained in the absence of the CSBF), so the most reasonable point estimate of direct employment impact would be the mid-point of 2.7 jobs (on a full-time equivalent basis) per loan.

CSBFA Annual Reports

Each annual report provides the data on the number of jobs borrowers with loans registered during that year estimate will be created by their CSBF loan. This information is provided by borrowers on their loan registration forms. The most recent data are:

- 2000-01 Annual Report – 3.3 jobs/loan
- 2001-02 Annual Report – 3.0 jobs/loan
- 2002-03 Annual Report – 2.8 jobs/loan.

The 2001-02 Annual Report discusses some of the difficulties associated with relying solely on these estimates (no consideration of indirect and induced employment, no consideration of displacement, etc.) and suggests that, if one were to take all these factors into consideration, an estimate of 2.0 jobs/loan would be conservative.

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Lending a Hand

This study contains case study write-ups of employment impacts that provide good illustrations of the kinds of employment impacts this kind of loan guarantee program can have. Three such illustrations are provided below.

(abc Country Restaurant Nanaimo, B C, (Dwayne Carter Enterprises Ltd.)

Dwayne Carter (a former supervisor at McDonalds) and his wife Danya decided that they wanted to purchase their own franchise. They chose abc Country Restaurant because it was affordable and they enjoyed the food as well as the friendly and casual atmosphere. In 2000 they had $250,000 of their own equity and applied to the Canada Small Business Financing program for an additional $224,000. The loan went towards leasehold improvements. The couple now employs 40 staff, 25 of whom are full-time. At the time of the interview they were planning on opening a second restaurant.

Allgard Security Services, Trail, BC, (596130 B.C.Ltd.)

William Richard Lee (a retired RCMP officer) had been working for Allgard Security Services for 11 years when the owner of the company decided to retire. In 1999 Mr. Lee bought the company and used a $38,285 CSBF loan to purchase new computers and to upgrade the central alarm monitoring station in Trail. This enabled them to, “handle jobs that once we could never have even dreamed of doing”. In his two years of ownership he managed to double the number of workers (mostly part-time and contract) from 30 to 60.

Reena Campbell Promotional Marketing Ltd., Regina, SK

Reena Campbell chanced into her fist promotions job through a temporary placement from a Canada Employment office. She went on to establish her own promotions company in 1992. She has received two loans from the CSBFA program the first was for $92,300, enabling her to purchase a larger facility. The expansion allowed her to hire two additional full-time staff. The second CSBF loan was for $30,000. She used it to purchase an embroidery machine. This purchase allowed her to further expanded her employee base with the hiring 3 new part-time machine operators. Since then, Ms. Campbell has gone on to open a second office in Calgary and now employs a total of 15 people. Ms. Campbell is actively involved in giving new immigrants to Canada a chance to secure their first job. She does this in cooperation with Regina’s Open Door society.

4.9 Question 12: What has been the impact of the program on sustainable development and on the environment?

Findings

1. It is unlikely that the program has had much of an impact in this area in either direction (i.e., either positive or negative).
2. There is limited potential for the program to make a major contribution in this area because of the market served by the program and the hands-off policy of Industry Canada with regard to their relations with lenders.

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Discussion

The 1997 Industry Canada Sustainable Development Strategy includes a planned activity to: "Assist SMEs to use eco-efficient practices, tools, and technologies, and promote the adoption of environmental standards". The 2000 Strategy goes further: "Promote increased uptake of sustainable development management practices such as eco-efficiency, environmental management systems, and environmental performance agreements" and, in particular, "support the adoption of environmental stewardship approaches and tools for small business".

The Consultation Document for the Department's 2003-06 Sustainable Development Strategy states that the Department plans to promote "increased uptake of sustainable development management practices, such as eco-efficiency, environmental management systems, and environmental performance agreements" and says that the Department will "support the adoption of environmental stewardship approaches and tools for small business". It also states that the Department will seek to "increase the quantity and quality of 'corporate social responsibility reporting' by industry".

The question is: To what extent has Industry Canada in its administration of the CSBF program required or encouraged lenders to consider the sustainable development/environmental impacts of proposed projects? For example, in theory lenders could be required or encouraged to consider the following when reviewing loan applications:

- Reducing material requirements for goods and services;
- Reducing the energy intensity of goods and services;
- Reducing toxic dispersion;
- Enhancing material recyclability;
- Maximizing sustainable use of resources;
- Extending product durability, and
- Increasing the service intensity of goods and services.

The answer is that Industry Canada has taken a hands-off position in this area. SBPB and CSBFPD have not actively participated in the development of the Department's Sustainable Development Strategies, and the CSBFPD does not issue any requirements or guidelines to lenders regarding sustainable development or environmental protection.[75] This is consistent with the Department's hands-off policy generally toward lenders.

[75] Note, however, that the program regulations state that the cost of decontamination can be treated as an eligible component of the cost of purchasing real property.

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On might then ask: To what extent do the lenders, on their own, have policies and procedures that encourage sustainable development and environmental protection? In BearingPoint's interviews with lenders we posed the following question:

> *Are you aware of any policies or procedures your organization uses that are intended to promote sustainable development practices on the part of borrowers – for example, policies or procedures related to the following:*

- *the use of eco-efficient practices by borrowers….*
- *the use of environmental management systems or environmental performance agreements by borrowers*
- *reporting by borrowers on the sustainable development implications of their operations?*

All the institutions reported that they did not have any specific policies regarding sustainable development with respect to their loans to small business. However, many outlined informal mechanisms to identify and cull projects that had potentially negative impacts on the environment. Some interviewees stated that they do have policies along these lines with respect to large corporate loans.

A 1999 study commissioned jointly by Environment Canada and Industry Canada investigated the potential of the SBL program to promote the greater adoption of energy efficiency measures. It analyzed potential changes to the program parameters that might lead to greater impacts in this area. It concluded that there is limited potential for the program to do this: "…with the exception of the 'SBLA to provide working capital option' [i.e., changing the program parameters to allow loans for working capital] the options with the best potential energy efficiency impact are primarily existing private and public sector initiatives complementary to the SBLA". The main reason there is not much potential for impact is the small size of the target market for the SBLA (relative to the set of large energy users, including the residential sector): "…the eligibility criteria and cost of participation limit the size of the possible target market".

In summary, there are very limited data regarding the program's impact in this area. It is possible that it has had an impact, but, if so, it is impossible to tell in which direction (positive or negative) or the size of the impact. Whatever the impact, it is very likely that it has been small. The study noted above indicates that large positive impacts (at least with regard to energy efficiency) are unlikely, and the nature of the sectors that are primarily supported by the CSBF program indicate that large negative impacts are also unlikely. As noted in section 3.3, half the loans go to businesses in the food and beverage, other services, and retail trade sectors – none of which are big polluters – and only about 20% of the loans go to the transportation and manufacturing sectors. In addition, informal mechanisms used by lenders in assessing loan applications probably mitigate against large negative impacts.

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4.10 Question 13: Are there alternative ways of delivering the CSBF program that would increase the degree of cost recovery and/or incrementality?

Findings

1. The program cannot be restructured in a way that would make it cost-recoverable if any sort of "reasonable" degree of incrementality is maintained that is consistent with the program's raison d'etre to fill a gap in the availability of financing to SMEs.

2. The challenge for Industry Canada is to structure the program in such a way that both the degree of loan incrementality and the degree of cost recovery are "acceptable" – i.e., finding the point at which the net costs of the program are justified by the benefits associated with the resulting degree of incrementality. While this study did not determine what that point is, there are some indications that the degree of cost recovery should be higher and the degree of incrementality should be lower than currently exists.

3. There are ways of doing this that would be acceptable to the stakeholder community. The most attractive restructuring package would involve some combination of letting the financial institutions set [higher] interest rates on CSBF loans, eliminating the registration fee and increasing the administration fee, and reducing the percentage of loan losses covered by the government.

Discussion

We first discuss incrementality and then cost recovery. Before beginning, we note that this question as worded above is a bit misleading. It allows for the possibility that there might be ways to increase the degree of cost recovery and, at the same time, increase the degree of incrementality, which is not possible. If the program were to be restructured in a way that would cause cost recovery to go up, then incrementality would go down; and vice versa.

The question of what the appropriate degrees of incrementality and cost recovery should be is a policy question that is beyond the scope of this study. It is our impression that there is a widely held view within Industry Canada that the current degree of cost recovery is too low (and, therefore, also that the current degree of incrementality is too high).

Incrementality

As discussed in section 4.3, the degree of incrementality of CSBF loans is, in our opinion, quite respectable – over 50% of the loans are fully financially incremental, and an additional 25% are partially financially incremental. This high degree of incrementality occurs "automatically" as a result of the program parameters, i.e.,

- CSBF loans are generally more expensive for borrowers than conventional loans, so most borrowers would not obtain a CSBF loan if they could obtain a conventional loan.

- CSBF loans are generally less profitable to lenders than conventional loans, so most lenders would not issue a CSBF loan if issuing a conventional loan would be acceptable to their organization.

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Nevertheless, the degree of incrementality could presumably be increased further by such measures as:

a) publicizing the importance of incrementality to the lenders; or

b) requiring lenders to certify that each CSBF loan is incremental.

The consensus of the workshop with SBPB and CSBFPD was that a higher degree of incrementality is not desirable. Higher incrementality implies more risk, which in turn implies less cost recovery. There are also some practical issues with measures such as (b) – it would increase the administrative burden on the lenders, which program staff would like to decrease, and if it were required by regulation, compliance with this measure would have to be audited.

Cost recovery

We first summarize the results of our interviews with stakeholders. These results primarily reflect the opinions of lenders. Only a few borrower organizations were able to be interviewed; those instances in which their opinions differed dramatically from the lenders are noted.

There was a general overall recognition among lending institutions that there has been a shift over the past few years toward higher risk clients under this program. Many of the former lower risk clients, who used to prefer the program because they did not have to put up any collateral (as with other small business loan products offered) have shifted away from the program because of the low interest rate environment. Many clients have found themselves in a situation where their personal assets (such as their homes) have appreciated, and the banks have offered them as little as prime to borrow against that increased value in their equity. Many have also shifted to credit cards, which, although the interest rates can be higher than CSBF rates, are offered with very little paperwork required, either on the part of the bank or the borrowers.

On the subject of potential cost recovery options, all those interviewed agreed that something has to be done to reduce the increasing costs of the program, both for their sakes as well as the taxpayers'. They perceive that more CSBF loans are defaulting than previously and that they are doing so earlier in the loan cycle. They also believe that a shift in the distribution of the risk is required, but it is imperative that it not be transferred only onto the banks and that borrowers must assume a larger portion of the risk. (The [few] borrower organizations did not disagree with this.) There was also a negative reaction to the possibility of creating any new administrative burden or adding, in any way, to the cost of administering the program, both to them and to the government.

A number of potential cost recovery options were presented to the lenders for discussion purposes. Although there was no unanimous choice regarding the most desirable option, generally the preferred options (not in any particular order) were:

a) Increasing the registration and/or the administration fees that are charged in connection with CSBF loans – e.g., increasing each of these from the current rates by somewhere between 0.5% and several percentage points.

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b) Increasing these fees for loans that are riskier, for example:

- loans to high-risk sectors (e.g., accommodation, food, and beverage)
- loans for leasehold improvements
- loans to franchises
- large loans (loans greater than $100,000)
- loans to new firms.

c) Letting the lending institutions risk-adjust the fees. This could be structured as follows: There would be no fixed administration fee, and the cap on interest rates would be adjusted or eliminated. The government would be given a cut of the total interest rate charged. For example, the government might be allocated 50% of the increment in the interest rate above the prime rate (e.g., if the interest rate charged were prime plus 3%, the government would get 50% of 3%, or 1.5%).

d) Requiring applicants to finance a higher percentage of the loan, say 15% rather than the current 10%.

With regard to (a), most lender organizations did not think that raising government fees would have a measurable impact on the use of the program or the risk profile of their portfolios. Most agreed, however, that some borrowers would decide to opt out or go with a conventional loan, such as those borrowers who like the CSBF program only because it doesn't require them to put up any personal collateral.

Regarding (b), many lender organizations mentioned that, if fees were to be risk-adjusted, then the high-risk categories should include new start-ups and restaurants. A few mentioned that franchises be categorized further and that successful brand-name international franchises be differentiated from regional ones or those recently established. This option was the major area of disagreement between the [few] borrower organizations and the lenders. Borrower organizations were against any sort of increases in fees to a particular sector (i.e., those sectors that are considered more risky). They argued that it is impossible to determine which sectors are most risky and that loans and risk level should be determined on an individual basis. (They were also against any sort of lending caps by sector or differing loss-sharing ratios by sector – as were the lenders [see below].)

Option (c) was by far the most positively received option among the lender organizations. However, a few lenders did note that this option could lead to potentially negative political and public relations problems. Their concern was that, although there are attempts to create standard rate sheets, most agents still operate based on their personal experience, which could result in the application of significant differences in fees and rates across branches and institutions for essentially the same types of loans. They also warned that, under this type of solution, there could be potential for abuse by some institutions who might shift some of their riskier conventional loans onto the program.

With regard to (d), lenders were almost unanimous in arguing that requiring borrowers to put in a larger share of the project financing themselves would be a positive measure in reducing the level of loan defaults, both by increasing the motivation of the borrower to find solutions in the face of adversity and by increasing the level of liquidity available, which is an important success factor for small business projects. There were, however, a couple of respondents who were against making applicants finance a higher percentage of the loans, stating that this would be a barrier for some CSBF customers and that it could increase the up-front costs to the borrowers.

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In addition to options (a) – (d), there was also some support among lenders for reducing the loss-sharing ratio – for example, the loan losses covered by the government could be reduced from 85% to 80% or 75%. Although many initially had a negative reaction to this option, most realized upon reflection that this might not have a significant impact on them. It was the opinion of a few who offered more reflection on this issue that most lenders understand that some increased risk will probably have to be taken on by them, and they would prefer this option as the lesser of evils.

There was unanimity among lending organizations regarding what they found to be the least acceptable options. They were:

- Risk adjusting the payouts – i.e., have a different loss-sharing ratio for loans in certain specified high-risk categories.
- Program-wide or lender specific caps on the number or amount of loans in certain specified high-risk categories.
- Decreasing the government liability ceiling.

The latter was, by far, the least favoured of the options discussed and the only one that met with true disdain. They considered this option as being an “unfair” transfer of the risk onto the lenders. The other two options were seen as adding administrative burden, and the first option was also seen as an attempt to transfer more risk onto the lenders (or to force the lenders to severely limit the number and value of loans offered in the high-risk categories).

In the workshop with CSBFPD/SBPB, the point was repeatedly made that the challenge is for the program to find the right balance between limiting risk and too much risk – i.e., between cost recovery and incrementality. Specific comments with regard to options (a) – (d) follow:

a) In addition to raising the fees, changing the fee structure could be considered, including changing the balance between the administration and the registration fee. If Industry Canada were to just increase the fees, the result would simply be less demand and a higher risk portfolio. It was noted that borrowers are more sensitive to the registration fee than the admin fee. One option would be to reduce or eliminate the registration fee and increase the admin fee. If the registration fee were eliminated, this would reduce the administrative burden for lenders, and also give them more opportunity to charge their own fees (if that were allowed). This would give lenders the same incentives to issue CSBF loans as they have for their other products. It was also noted that changing the fee structure in this way (i.e., eliminating the registration fee) could make CSBF loans more attractive and, in particular, increase the attractiveness of these loans to lower risk borrowers, which would, in turn, contribute to increased cost recovery.

b) This was seen to be undesirable, since it would bring bureaucrats more into the process of making lending decisions, because they would be required to “pick the losers”. It would increase the administrative burden for CSBFPD. It was also noted that high risk sectors change over time, so, if this were done correctly, there would be the need for continuous study and constant updating of the system.

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c) This was seen to be a real possibility and a desirable option, since it is consistent with the general principle that the sectors that benefit from the program (the high risk borrowers) should pay for it. The potential problem mentioned by some lenders (possible inconsistencies in interest rates charged) was not seen as a problem for Industry Canada. A number of different "mechanical" variations were discussed – e.g., keeping an interest rate cap, but setting it very high; eliminating the interest rate cap altogether; fixing the admin fee but leaving interest rates up to the lenders, etc. This option was seen as having the advantage of letting the people who are best qualified to assess risk make the decisions regarding what should be charged for loans at various levels of risk.

d) It was noted that currently there are not many loans financed at more than 80% of the total project costs, so if the maximum financing allowed were shifted from 90% to 80%, this change would be more cosmetic than real (but this still might be a good thing). A larger shift might have too much of an impact on working capital, and, therefore, especially on start-ups. One possibility mentioned was to eliminate this requirement altogether and let the banks decide how much of the project costs should be financed, but, at the same time, possibly make some personal security mandatory.

With regard to the possibility of reducing the loss-sharing ratio, it was noted that this might not have a large increase on cost recovery because of the government's liability cap – i.e., assuming the cap were not changed, a reduction in the loss-sharing ratio might just delay the time until lenders reach their cap.[76] The observation was also made that this would punish the banks that have the less risky portfolios (and, therefore, are slow to reach their cap) – but it was also stated that perhaps this would be acceptable, since those banks are not doing what the program is supposed to do (i.e., support incremental loans). It was noted that this measure could be combined with other measures that would make the program more profitable for lenders, thereby making the measure more acceptable to lenders. The consensus of the group was that, if this option were adopted, the loss sharing ratio could not go any lower than 75-25, or the message would be that the program does not support loans with any significant degree of risk.

Our conclusions, based on the stakeholder interviews, the Industry Canada workshop, and all the other information discussed in this report, are as follows. First, it is clear that the program is not cost-recoverable if any sort of "reasonable" degree of loan incrementality is going to be maintained that is consistent with the underlying rationale for the program (see section 4.1). Secondly, the preponderance of opinion expressed in these data sources is that the current balance between cost recovery and incrementality is inappropriate (i.e., too little cost recovery and too much incrementality) and that a greater share of the costs of the program needs to be shifted to the borrowers, particularly the high-risk borrowers, who are the main beneficiaries of the program.

[76] Note that this is not necessarily the case, since most lenders will never hit their cap,

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Based on the data presented above, a sensible set of adjustments to the program parameters, in our opinion, would be as follows:

- The maximum interest rate limit should be removed, so that it is possible to charge higher interest rates for higher risk loans. The identification of which loans are higher risk should be the responsibility of the financial institutions, not the government. In particular, the financial institutions should be allowed to set the interest rates on CSBF loans.
- The registration fee should be eliminated, and the administration fee should be increased (but probably structured as a percentage of the interest rate). This would provide some "space" for financial institutions to charge their normal loan set-up fees, and that should be allowed.
- More security should be required for CSBF loans. For example, the 25% maximum personal guarantee could be made mandatory, and tangible assets other than the assets being financed could be required as part of the security package.
- The percentage of the project assets that are eligible for financing should be reduced, possibly to 80%.
- In return for being able to charge higher interest rates and charge loan set-up fees (and possibly also in return for less detailed regulations – see section 4.11), the financial institutions should be required to cover a higher percentage of loan losses. In particular, the loss-sharing ratio should be adjusted downward, probably to 75-25. Along with this, consideration should be given to reducing the government's liability cap by about the same amount (i.e., by about 10%), so that the reduction in the loss-sharing ratio represents – at least potentially – a real cost to the financial institutions.

4.11 Question 14: Are the human, system, and financial resources used to deliver the CSBF program being used efficiently to achieve its objectives?

Findings

1. The program is being delivered efficiently by Industry Canada. There are no obvious improvements that could be made that would significantly increase the efficiency of the Department's administration of the program.
2. The lenders feel that CSBF loans are burdensome and consume too much time and that there are improvements that can be made to the regulations and/or the delivery process that would increase the efficiency of their operations in administering these loans. Their suggested improvements do not involve major changes in the program structure, and the consideration of these improvements by CSBFPD (which is currently underway) is part of normal program operations.

Discussion

While Question 13 deals with possible program modifications to increase program effectiveness (i.e., the degree of cost recovery and/or incrementality), this question deals with possible modifications that might increase the efficiency of the delivery process. If, in looking at the program delivery process, one focuses just on Industry Canada's role in the delivery process, then there isn't much to say about this question, other than to note that the program is delivered efficiently. The CSBFPD staff consists of only about 30

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people, 12 of whom are engaged in processing claims, which does not seem excessive. Furthermore, claims processing times for the CSBF program are 30-35 days, which seems reasonable. The 1997 OAG report on the program identified very few issues related to the program delivery process that needed to be addressed, and the 2002 OAG Status Report noted that those issues that were noted had been satisfactorily dealt with.

It is useful, therefore, to take a broader perspective and also consider the role of the lending institutions in delivering the CSBF program. If this is done, then there is a bit more that can be said. The recent discussions with lending institutions conducted by CSBFPD concluded that, from the perspective of the lenders, there are definitely opportunities for improvements in the delivery process. The lenders currently feel that CSBF loans are burdensome and consume too much time, and they are of the opinion that the CSBF program is not a good fit with their highly automated organizations, which are focused on handling large volumes of conventional products.

The main measures suggested by the financial institutions and the thoughts regarding these expressed at the Industry Canada workshop are summarized below.

a) Suggestion: Simplify the loan application and registration process. The financial institutions are particularly interested in the availability of “smart” forms on-line to allow them to efficiently complete the application and registration process electronically.

   Workshop thoughts: These forms are currently available on the program web site, but they cannot be filled out electronically. CSBFPD is currently developing on-line “smart” forms (which will be able to be filled in electronically; however, the filing process will remain paper-based, given certain constraints regarding electronic signatures and the electronic transfer of funds.) In the meantime, some work was done this summer to improve the current web site.

b) Suggestion: Reduce/simplify the regulatory requirements for proof of payment documentation. This is a major irritant in cases in which standard lender practices are not consistent with CSBF requirements – e.g., loans for leasehold improvements. The main specific suggestions are: (i) Accept an undertaking from the financial institution that loan proceeds were spent for the intended purpose; (ii) Require proof of payment documentation only for certain loan sizes or only for a certain percentage of the loan value.

   Workshop thoughts: Industry Canada is currently considering options for relaxing the proof of payment requirements for leasehold improvement expenditures and small purchases. One possibility would be to simply require an undertaking from the lender. Another possibility would be to just require proof of payment documentation for claim amounts.

c) Suggestion: Reduce or eliminate the requirement for appraisals. Financial institutions believe that accurate independent appraisals are impossible or impractical in certain situations. The main specific suggestions are: (i) Require appraisals for non-arms length transactions but not for on-going concerns; (ii) Allow financial institutions more flexibility in deciding whether and how to obtain appraisals.

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Workshop thoughts: It would probably not be possible to eliminate the requirement for appraisals for on-going concerns, because these are required in order to obtain a "true" market value for the business, which, in turn, is necessary if the business is used to secure the CSBF loan. CSBFPD is considering amending the regulations to allow for exemptions to the requirement for appraisals in certain situations (e.g., in remote areas or in cases in which unique expertise is required to carry out the appraisal).

d) Suggestion: Simplify or eliminate the loan balance and administration fee reports.

Workshop thoughts: The loan balance report is required by CSBFPD for estimating the administration fees owed and for estimating the government's contingent liabilities. Regarding the administration fee report, currently lenders with 50 or more loans must submit an external auditor's report certifying that the amount remitted is correct in accordance with the requirements of the CSBFA. An on-site compliance review is planned in order to measure any existing problems with the process.

e) Suggestion: Deregulate items relating to conversion and pre-payment penalties and items relating to substitution and release of security provisions.

Workshop thoughts: These are currently under consideration by CSBFPD.

f) Suggestion: Shorten/streamline the claims process.

Workshop thoughts: This is currently not a problem (see above). Lenders who are concerned about the claims process are often confused between claims under the SBL program (which are still occurring) and claims under the CSBF program. The former are more complex and time-consuming.

g) Suggestion: Provide more and better information. The main specific suggestions are: (i) publish regular bulletins describing current rulings; (ii) enter into partner agreements for turn-around time on inquiries; (iii) maintain a current list of frequently asked questions on-line; (iv) create an interactive link on the CSBF web site for inquiries; (v) institute a telephone hotline.

Workshop thoughts: CSBFPD is currently working on a number of improvements in this area including the publication of information bulletins, improvements to the web site, updating the frequently asked questions and maintaining these on-line, additional reports that will be provided to the lending institutions, and various ways of improving access for inquiries.

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5.0 RECOMMENDATIONS

Recommendation 1: Industry Canada should carry out an analysis of the employment displacement impacts of CSBF loans and, if possible, also the indirect (supplier-related) and induced (re-spending related) employment impacts.

Discussion: See section 4.8. The lack of an analysis of displacement impacts is the major gap in the current analysis of employment impacts. Some work on indirect and induced impacts is also desirable (although this is less urgent), because the positive employment impacts of loans used to support efficiency improvements at the borrower firms (which may actually lead to employment reductions at those firms) are missed with the methodologies currently being used.

Recommendation 2: Industry Canada should carry out a study of the economic benefits (i.e., net income benefits) of the CSBF program for the Canadian economy as a whole.

Discussion: See section 4.4. Current projections show that, in the absence of significant changes to the program parameters, the program is not close to being cost recoverable in a strict accounting sense. A study of the net income benefits of this program for the Canadian economy as a whole, based on formal benefit-cost methodologies, could show that the program is justified in terms of its economic benefits.[77]

Recommendation 3: Industry Canada should give explicit recognition to the fact that cost recovery and incrementality are inversely related, and decisions should be made regarding:

- the level of [full financial] incrementality that would be acceptable to the government, and
- the associated level of cost recovery that would be acceptable to the government.

Discussion: See sections 4.3 and 4.4. Work is underway to estimate the impacts of a range of possible changes to the program parameters on the degree of cost recovery. However, any increase in the degree of cost recovery will be accompanied by a decrease in the level of incrementality; and, therefore, it needs to be decided how low the current level of full financial incrementality (50-55%) should be allowed to fall. The work currently being carried out by the Department should be expanded to include an analysis of the approximate impact of each cost recovery option on the level of incrementality. We realize that, because of the complexity of the situation, this will be difficult, and the estimates of impacts may need to be judgemental, but they are necessary for a thorough understanding of the acceptability of potential program changes.

[77] The current economic impacts study being carried out by Statistics Canada is expected to provide information on revenue growth, survivorship, profitability, corporate income taxes, and GST paid by assisted firms, so it will go part way toward addressing this recommendation. That study is also addressing employment growth, so it may also partially address recommendation 1.

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Recommendation 4: In order to increase the degree of cost recovery of the program, Industry Canada should seriously study and discuss with its stakeholders a restructuring of the program that would involve some combination of the following:

- removing the cap on interest rates on CSBF loans;
- eliminating the registration fee and increasing the administration fee (probably structured as a percentage of higher interest charges); and
- reducing the percentage of loan losses covered by the government.

Discussion: See section 4.10. This is, in our opinion, the most sensible set of options based on our stakeholder interviews, the Industry Canada workshop, and all the other information presented in this report.

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Appendix A

Steering Committee Members

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Appendix A Steering Committee Members

Committee Members

Keith Parsonage (Chair)
Information and Communications Technologies Branch
Spectrum, Information Technologies and Telecommunications
Industry Canada

Jean Clark
Small Business Policy Branch
Industry Canada

Kim Cronkwright
Centre of Excellence for Evaluation
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André Piché
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Agriculture and Agri-Food Canada

Marion Wrobel
Canadian Bankers Association

Secretariat

Rob Conn
Audit and Evaluation Branch
Industry Canada

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Appendix B

Stakeholder Interviews

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Appendix B Stakeholder Interviews

List of organizations interviewed

Banks and other lenders (10)
Royal Bank of Canada
TD Canada Trust
Fédération des caisses populaires Desjardin du Quebec
Banque Laurentienne du Canada
HSBC Bank of Canada
Credit Union Central of Alberta
Capital City Savings Credit Union
Bank of Montreal
Bank of Nova Scotia
Canadian Imperial Bank of Commerce

Industry Associations (4)
Canadian Bankers Association
Canadian Restaurant and Food Services Association
Canadian Federation of Independent Business
Canadian Franchise Association

Government stakeholders (4)
Canada Business Service Centres
Western Economic Diversification
Federal Economic Development Initiative for Northern Ontario
Atlantic Canada Opportunities Agency

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Interview Guide For Lending Organizations

Questions regarding program design and delivery

(1.) To what extent does the CSBF program overlap with the loan programs of the Business Development Bank of Canada and of the regional agencies?

(a) Areas of overlap –

(b) Main differences between the two programs –

(2.) Is there any way the CSBF program could be delivered totally by Canadian private sector lending institutions – i.e., the federal government would not be involved either in program administration or in guaranteeing loans? If so, please describe how such a system would work and its advantages and disadvantages relative to the current arrangement.

(3.) Are you aware of other credit guarantee systems which do not rely on the public sector that would be viable alternatives to the CSBF program? If so, please describe how these systems work and their advantages and disadvantages relative to the CSBF program.

(4.) Are you aware of any policies or procedures your organization uses that are intended to promote sustainable development practices on the part of borrowers – for example, policies or procedures related to the following:

- the use of eco-efficient practices by borrowers (reduced material requirements, reduced energy intensity, reduced toxic dispersion, increased material recyclability, increased product durability, etc.)
- the use of environmental management systems or environmental performance agreements by borrowers
- reporting by borrowers on the sustainable development implications of their operations?

If so, are you aware of any follow-up processes to measure the impact of such policies?

(5.) What are your views regarding the desirability and potential impacts of the following possible program modifications that would alter the coverage of the program:

(a) Increasing or decreasing the $5 million annual sales ceiling for business eligibility?

(b) Changing the asset classes of eligible expenditures (currently limited to purchase and improvement of premises and equipment, purchase of land, and leasehold improvements)? Note that, in this study, we have already determined that it would not be feasible to extend the CSBF to include guarantees for working capital loans.

Increasing or decreasing the maximum loan size (currently $250,000)?

(6.) What impacts has the CSBF program had – if any – on the loan practices of participating lenders?

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Questions regarding cost recovery

As you probably know, the CSBF program is intended to be cost recoverable—i.e., the funds the government receives for registration and administration fees are supposed to equal the funds the government pays out for loan defaults. Current estimates indicate that the program is falling short of this cost recovery goal. Therefore, in the coming months Industry Canada will be exploring possible measures for potentially increasing cost recovery with the program's stakeholders.

We emphasize that these measures are being put forward for discussion purposes only. Neither Industry Canada nor BearingPoint are proposing that the following measures will be on the "short list" of options that will be recommended—this is just the wide range of options that one would typically consider in a study of this nature.

(7.) One possible measure to increase the degree of cost recovery would be to increase the registration and/or the administration fees that are charged in connection with CSBF loans—e.g., increasing each of these from the current rates (2% and 1.25% respectively) by somewhere between 0.5% and several percentage points. How do you think this would affect (and explain why):

(a) the number and value of CSBF loans?

(b) the risk profile of CSBF loans?

(c) the extent to which CSBF borrowers would be comprised of businesses that could not obtain equivalent financing through other means (i.e., the percentage of borrowers that would fall into this category)?

(d) the relationships between lenders and their customers?

(8.) A related possibility would be to increase these fees for loans that are riskier, for example:

- loans to high-risk sectors (e.g., accommodation, food, and beverage)
- loans for leasehold improvements
- loans to franchises
- larger loans (e.g., loans greater than $100,000)
- loans to new firms.

How do you think this would affect (and explain why for each):

(a) use of the CSBF program—i.e., by how much would the uptake in these high-risk categories be reduced?

(b) the risk profile of CSBF loans?

(c) the administrative burden?

(d) the relationships between lenders and their customers?

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(9.) A similar measure would be to let the lending institutions risk-adjust the fees. This could be structured as follows: There would be no fixed administration fee; the cap on interest rates would be adjusted; and the government would be given a cut of the total interest rate charged. For example, the government might be allocated 50% of the increment in the interest rate above the prime rate (e.g., if the interest rate charged = prime + 3%, the government would get 50% of 3% or 1.5%).

In this scheme both the lending institution and the government could be compensated for issuing higher-risk loans (as in the example). Would your organization find this measure acceptable? Do you see any difficulties with implementing this measure (e.g., administrative burden)? How would it affect:

(a) the use/uptake of the CSBF program?

(b) the risk profile of the portfolio?

(c) the administrative burden?

(10.) An alternative risk adjustment measure would be to risk-adjust the payouts – i.e., have a different loss-sharing ratio for loans in certain specified high-risk categories. If the government guarantee were reduced to, say, 75% for loans in these categories, what effect would this have on:

- the number and value of loans your organization would make in these categories?
- administrative burden?

Explain why for each response.

(11.) Another possibility related to differing loan risks would be to have program-wide or lender-specific caps on the number or amount of loans in certain specified high-risk categories. For example, one possible cap would be that leasehold improvement loans could not comprise more than 15% of the portfolio of loans. This could be done on either a program-wide basis (i.e., no more than 15% of the total CSBF portfolio) or a lender-specific basis (i.e., no more than 15% of the CSBF portfolio of each lender). Leaving aside the question of how this measure would be implemented, would your organization find either of these (i.e., program-wide or lender-specific) measures acceptable?

(12.) A totally different measure to increase cost recovery would be to decrease the government's liability ceiling. For example, in each five-year period the government currently pays claims totalling 90% of the first $250,000 of loans in a lender's account, 50% of the next $250,000, and 10% of all remaining loans. This is called the 90-50-10 rule. This could be changed to something like 90% of the first $150,000, 50% of the next $150,000, 12% of the next $200,000, and 8% of all remaining loans (i.e., 90-50-12-8). What effect would this have on the number and value of CSBF loans your organization issues? Explain why?

(13.) The government could also reduce the guarantee rate (i.e., the loss sharing ratio). For example, the government currently covers 85% of loan losses; this could be reduced to 80% or 75%. Would either of these have any effect on the procedures used by your organization in assessing loan applications and issuing loans? What effect would this have on the number and value of CSBF loans your organization issues? Explain why?

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(14.) A similar measure to reduce the government's exposure would be to require applicants to finance a higher percentage of the loan, say 15% rather than the current 10%. How do you think this would affect:

(a) the number and value of CSBF loans?

(b) the risk profile of CSBF loans?

(c) the extent to which CSBF borrowers would be comprised of businesses that could not obtain equivalent financing through other means (i.e., the percentage of borrowers that would fall into this category)?

(15.) Finally, we would like to ask about the possibility of reducing the maximum loan size, from $250,000 to, say, $200,000 or $150,000. Would your organization find this acceptable? What effect do you think this would have on the number and value of CSBF loans?

(16.) Overall, of all the potential measures described above, which one(s) does your organization believe is most feasible? Which one – or which combination of measures – would be preferable?

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Interview Guide For Borrower And Government Organizations

Questions regarding program design and delivery

(1.) To what extent does the CSBF program overlap with the loan programs of the Business Development Bank of Canada?

(a) Areas of overlap –

(b) Main differences between the two programs –

(2.) What are your views regarding the desirability and potential impacts of the following possible program modifications that would alter the coverage of the program:

(a) Increasing or decreasing the $5 million annual sales ceiling for business eligibility?

(b) Changing the asset classes of eligible expenditures (currently limited to purchase and improvement of premises and equipment, purchase of land, and leasehold improvements)? Note that, in this study, we have already determined that it would not be feasible to extend the CSBF to include guarantees for working capital loans.

(c) Increasing or decreasing the maximum loan size (currently $250,000)?

Questions regarding cost recovery

As you probably know, the CSBF program is intended to be cost recoverable—i.e., the funds the government receives for registration and administration fees are supposed to equal the funds the government pays out for loan defaults. Current estimates indicate that the program is falling short of this cost recovery goal. Therefore, in the coming months Industry Canada will be exploring possible measures for potentially increasing cost recovery with the program's stakeholders.

We emphasize that these measures are being put forward <u>for discussion purposes only</u>. Neither Industry Canada nor BearingPoint are proposing that the following measures will be on the "short list" of options that will be recommended—this is just the wide range of options that one would typically consider in a study of this nature.

(3.) One possible measure to increase the degree of cost recovery would be to increase the registration and/or the administration fees that are charged in connection with CSBF loans—e.g., increasing each of these from the current rates (2% and 1.25% respectively) by somewhere between 0.5% and several percentage points. How do you think this would affect (and explain why):

(a) the demand for CSBF loans?

(b) the risk profile of CSBF loans?

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(c) the extent to which CSBF borrowers would be comprised of businesses that could not obtain equivalent financing through other means (i.e., the percentage of borrowers that would fall into this category)?

(d) administrative burden?

(e) the relationships between lenders and their customers?

(4.) A related possibility would be to increase these fees for loans that are riskier, for example:

- loans to high-risk sectors (e.g., accommodation, food, and beverage)
- loans for leasehold improvements
- loans to franchises
- larger loans (e.g., loans greater than $100,000)
- loans to new firms.

How do you think this would affect (and explain why for each):

(a) use of the CSBF program—i.e., by how much would the demand in these high-risk categories be reduced?

(b) the risk profile of CSBF loans?

(c) the administrative burden?

(d) the relationships between lenders and their customers?

(5.) Another possibility related to differing loan risks would be to have program-wide or lender-specific caps on the number or amount of loans in certain specified high-risk categories. For example, one possible cap would be that leasehold improvement loans could not comprise more than 15% of the portfolio of loans. This could be done on either a program-wide basis (i.e., no more than 15% of the total CSBF portfolio) or a lender-specific basis (i.e., no more than 15% of the CSBF portfolio of each lender). Leaving aside the question of how this measure would be implemented, would your organization find either of these (i.e., program-wide or lender-specific) measures acceptable?

(6.) A similar measure to reduce the government's exposure would be to require applicants to finance a higher percentage of the loan, say 15% rather than the current 10%. How do you think this would affect:

(a) the demand for CSBF loans?

(b) the risk profile of CSBF loans?

(c) the extent to which CSBF borrowers would be comprised of businesses that could not obtain equivalent financing through other means (i.e., the percentage of borrowers that would fall into this category)?

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(7.) Finally, we would like to ask about the possibility of reducing the maximum loan size, from $250,000 to, say, $200,000 or $150,000. Would your organization find this acceptable? What effect do you think this would have on the demand for CSBF loans?

(8.) Overall, of all the potential measures described above, which one(s) does your organization believe is most feasible? Which one – or which combination of measures – would be preferable?

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