ANNEX
to Comprehensive Review Report to Parliament for the

Canada Small Business Financing Program Comprehensive Review Studies

Summary

February 2005

Prepared for Industry Canada
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Introduction

The Canada Small Business Financing Act (CSBFA) came into force in 1999, when it replaced the Small Business Loans Act (SBLA) as the primary federal public sector mechanism for facilitating small business access to debt financing.

The CSBFA, which exists to "increase the availability of financing for the establishment, expansion, modernization, and improvement of small businesses," has two main objectives: It is intended to provide financing to small businesses that are not eligible for conventional loans, and it is intended to recover its own costs.

The CSBF Program is mandated by Parliament to be reviewed every five years. The fourteen studies summarized in this annex have been completed as part of that ongoing review. Their purpose is to determine whether and how the program is fulfilling its *raison d'être* and its objectives.

The studies have been divided into three groups, as follows:

Overview and CSBFA Costs: These studies describe the program's overall effectiveness and discuss its claims and costs.

CSBFA Benefits to SMEs: These studies examine the benefits – most particularly in terms of incrementality and jobs – to SMEs and therefore to the Canadian economy.

Lender Perspectives of the CSBFA: These studies look at how the program is perceived by the financial institutions that deliver it.

The studies, listed in the table of contents, have been summarized in the following pages. Their most salient points are then synthesized on page 27. Copies of the studies, in their original language, are available from Industry Canada.

I

Evaluation of the Canada Small Business Financing Program, Final Report

BearingPoint

December 2004

The 2004 evaluation of the CSBF Program was based on a results-based management and accountability framework that specifies questions to be addressed with regard to program rationale, incrementality, cost recovery, employment impact, and program efficiency and effectiveness.

The study found the following:

Program Rationale

- There is an ongoing need for facilitated access to asset-based debt financing for SMEs.
- There is no viable alternative to a program like the CSBF Program, nor is there overlap between the CSBF Program and other government support programs.
- The CSBF Program is consistent with government-wide and departmental priorities.

Incrementality

- The loans made under the CSBF Program are highly incremental.
- Fifty to 55 percent of the loans have been fully incremental; an additional 25 percent have been partially incremental.

Cost Recovery

- The CSBF Program is not close to being cost recoverable in an accounting sense, which would require that program revenues be greater than, or equal to, program costs.
- The net cost to government of SBL loans made between 1995 and 1999 is \$275 million to date. The net cost to government of CSBF loans between 1999-2000 and 2003-2004 will be about \$250 million on a net present value basis.

Employment Impact

- There has been an average of 2.7 full-time equivalent jobs created per loan.

Possible Program Improvements

- It is not possible to make the program cost-recoverable if it is to be consistent with its objective of incrementality: providing loans to firms that would otherwise be unable to obtain them.
- The challenge, therefore, is to find the “acceptable” balance between cost recovery and incrementality. The study did not determine what that balance should be, but did indicate that it might lie closer to cost recovery than was then forecast.
- This might be achieved through some combination of:
  - Allowing financial institutions to charge higher fees;
  - Increasing program registration and administration fees; and,
  - Reducing the percentage of loan losses covered by the government.

SBLA and CSBFA Claims and Costs Experience

Allan Riding
Equinox Management Consultants Ltd.

March 2003

Equinox Management Consultants was asked to compare SBLA and CSBFA patterns of borrowing, defaults, and claims costs. SBLA borrowing during the period of April 1, 1995 through March 31, 1999 was contrasted with CSBFA borrowing from April 1, 1999 through March 31, 2002.

They determined that four sectors – accommodation, food, and beverage; retail trade; other services; and transportation and warehousing – account for more than 60 percent of borrowing for both the SBL and CSBF Programs. Lending has increased under the CSBF Program for three sectors: accommodation, food, and beverage; retail trade; and manufacturing. It has decreased for three sectors: other services; transportation and warehousing; and agriculture support activities, forestry, fishing, and hunting.

Banks continue to be the programs' primary lenders. Under the CSBF Program, the banks appeared to be making fewer, but larger, loans.

CSBF loans are trending towards financing leasehold improvements and away from financing the acquisition of equipment.

Most borrowers, for both programs, are limited companies, and their share of the borrowing continues to grow. However, a higher share of CSBFA borrowing went to new firms than was the case with the SBLA: the introduction of the CSBFA saw a sharp, sustained increase in lending to goods producers, to new firms, and to finance the purchases of the assets of going concerns. The average term of loans increased under the CSBFA to 67 months from an average of 64 months under the SBLA.

The accommodation, food, and beverage sector accounted for a disproportionate share of losses under both programs. During the SBLA period studied, this sector accounted for 18.6 percent of loans and almost 30 percent of claims. Similarly, under the CSBFA, it comprised 22.7 percent of the loans, and accounted for 31.8 percent of claims.

Claims were highest for loans used primarily for leasehold improvements; loans in excess of $100,000; new firms; limited companies; restaurant franchises; firms with low coverage ratios; and, firms from which lenders required guarantees.

Under the SBLA, lenders cited poor management skills on the part of business owners as the main reason for default. Under the CSBFA, lenders tended to believe that owners' unrealistic plans and expectations were primarily responsible for default.

Lenders make claims more quickly under the CSBFA. The average time from default to claim submission was 1.2 years during the SBLA period under study. That average time decreased to between 0.6 and 0.8 years under the CSBFA.

Forecasting Expenses Related to SBLA and CSBFA Lending

Dr. Allan Riding
Dr. Georges Haines, Jr.
Equinox Management Consulting Ltd.

July 2003

Various models were developed to forecast accurately the costs of making loans under the SBL and CSBF Programs. The models aimed to forecast the value of non-rejected claims received in any given month. All displayed good accuracy and were free of measurable bias. It is important to note, however, that forecasting models rely on existing data, which means that forecasting always lags actual results. (As the volume of lending decreases, so too will relative claims—and the number of CSBF loans made were continuing to decrease.)

Three periods, all with different loan parameters, were studied:

- the SBLA between April 1, 1990 and March 31, 1995 (during which program changes introduced in 1993 led to substantially higher numbers of loans, and therefore claims);
- the SBLA between April 1, 1995, and March 31, 1999; and,
- the CSBFA between April 1, 1999 and March 31, 2002 (which led to a decrease in loans, and therefore claims).

Short-term forecasting

1) The exponential smoothing model predicted claims of $167.3 million per year for the fiscal year ending March 31, 2003, which was a forecasting error of 13.4 percent. It predicts claims of $167.3 million per year until 2004-2005, an estimate that is likely to be high because it is more accurate in the very short term and because it can’t take into account that fewer loans were made and therefore relatively fewer claims are likely.

2) The AR1 econometric model predicted claims of $162 million for the fiscal year ending March 31, 2003, a forecasting error of 9.8 percent. It predicted claims of $128 million for fiscal 2003-2004; and $122.5 million for fiscal 2004-2005.

3) The ARIMA model predicted claims of $149.8 million for the fiscal year ending March 31, 2003, a forecasting error of only 1.6 percent. For the 2003-2004 fiscal year, the ARIMA model predicted claims of $154.7 million; and for the 2004-2005 fiscal year, it predicted claims of $157.5 million.

Longer-term forecasting

In addition to the above, the econometric model was used to estimate claims in the long term. Assuming that loan parameters remain unchanged, the model estimated that the value of claims will increase from approximately $124 million in fiscal 2003-2004 to approximately $160 million during 2007-2009.

Forecasting Expenses Related to SBLA and CSBFA Debt Financing Loans

Dr. Allan Riding

January 2005

Given that forecasting models rely on existing data, which means that forecasting always lags actual results and will change over time, Allan Riding updated expense forecasts and models for Industry Canada, using loan data through the end of the 2004 fiscal year.

Three periods, all with different loan parameters, were studied:

- the SBLA between April 1, 1990 and March 31, 1995;
- the SBLA between April 1, 1995, and March 31, 1999; and,
- the CSBFA between April 1, 1999 and March 31, 2004.

Three forecasting models were used. Two of these, the exponential smoothing model and the ARIMA, or Box-Jenkins model, use historical patterns to predict future claim values. The third, econometric modeling, also uses salient economic indicators such as interest rates or the unemployment rate to predict both future economic scenarios and future claim values.

All three models estimated claims of $85 to $90 million per year for the 2004-2005 and 2005-2006 fiscal years. These figures, more accurate than the earlier study due to their using more recent data, are considerably lower than earlier predictions.

The longer-term forecast was for $85 to $90 million per year through 2012, assuming that the current volume of lending continues. This forecast is also significantly lower than earlier long-term predictions.

II

Methodological Review of Loan Incrementality Studies

The Conference Board of Canada

May 2003

The Conference Board was asked to review best practices in methodologies for measuring loan incrementality and to recommend a methodological approach for future Industry Canada studies. Its report concluded that the methodologies used by Allan Riding in 1994 and 1996 were state-of-the-art and appropriate for use in further incrementality studies.

Given that incrementality is difficult to study (as one is always examining the counterfactual), the report recommended that:

- Incrementality be carefully defined;
- Multiple approaches be used simultaneously to understand incrementality, including surveys, data comparisons, and interview comparisons;
- Small Business Loan Administration and Canada Small Business Financing Program Directorate data – including the databases of the SBLA, the CSBFA, and lenders – be carefully analysed;
- Primary data be generated and collected through interviews with program and Industry Canada staff and managers; SMEs and borrowers; and selected lenders;
- Financing of CSBF firms be analysed relative to the general SME population; and,
- A review of certain loan applicants be conducted *at the time of application*. This would provide a new source of primary data and would mean that one was not trying to do interviews after the fact, which is always a problem with periodic surveys.

CSBFA Incrementality Studies

Equinox Management Consultants Inc.

December 2003, February 2004, and March 2004

Incrementality is one of the two objectives of the CSBF Program. Incrementality can be defined in different ways. Equinox Management Consultants refined their definitions as a result of the three-part study they conducted for Industry Canada.

Financial incrementality refers to loans that would not have been granted in the absence of the CSBF Program. It has two sub-categories:

- *Full financial incrementality* refers to loans that would not have been granted *at all* in the absence of the program.
- *Partial financial incrementality* refers to cases where borrowers would have qualified for smaller loans in the absence of the CSBFA.

Loan quality incrementality, meanwhile, refers to the qualities that make a loan more advantageous to the borrower than they would have been without the program. These include the terms (lower fees; lower interest rates; less collateral), the timeliness of the loan provision, the facilitation of the working relationship between borrower and lender, and the breadth of the financing package.

Incrementality, in any form, is notoriously difficult to measure accurately, because one is by necessity investigating the counterfactual (what would have happened, but did not). It is for this reason that Equinox used three separate approaches to study incrementality in CSBF loans:

- They did statistical analysis of data collected from the 2000 and 2001 baseline surveys of the SME Financing Data Initiative (FDI);
- They analysed the qualitative and quantitative data from a series of "aligned" interviews: interviews with both CSBF borrowers *and* their respective loan managers; and,
- They performed a large-scale survey of 816 CSBF borrowers.

They found that almost 50 percent of CSBF loans (49.6 percent) were made under conditions of full financial incrementality.

Partial financial incrementality was identified in 26.9 percent of CSBF loans, and the incidence of loan quality incrementality was 61.5 percent.

All three stages of the study concurred: incrementality was present in roughly 75 percent of the CSBF loans examined.

Borrowers interviewed were more likely than their lenders to believe that they would have qualified for loans in the absence of the CSBFA.

The studies also found that:

- Both forms of financial incrementality were highest for start-ups and smaller firms.
- Full financial incrementality was more likely for younger firms.
- Many – 45.3 percent of survey respondents – firms reported that the CSBFA freed funds for working capital.
- 54.5 percent of survey participants said the CSBF loan had helped them start up; 34.7 percent said it helped them operate more efficiently; 29.8 percent said that it helped them expand; 24.0 percent said it helped them operate more efficiently *and* expand; and 23.3 percent said they did not think their firms would be operating without the benefit of the CSBF loan.

A Literature Review on Best Practices of Job Studies

Ted Heidrick, John W. Kramers, and Rosa Spadavecchia

March 2001

This study reviewed the best practices – in Canada, Western Europe, and the United States – for evaluating government programs' impacts on job creation.

It recommended that the best approach for Industry Canada to use to evaluate the CSBFA's impact on job creation was a combination of selected case studies and user surveys.

Cost benefit analysis methodology indicates that the largest percentage of benefits tends to come from a small percentage of successful companies. Therefore, selected case studies were recommended as a way of understanding the costs and benefits associated with job creation, as well as displacement and job maintenance within industries, regions, and firm sizes. It was further recommended that firms in the case studies be examined from the beginning of their relationship with the small business loans program through the time of study, so as to give the most complete view possible of benefits created, costs incurred, and the overall net creation of jobs attributable to the program's financial assistance.

User surveys were recommended as a way of extrapolating information gained to the program as a whole. The study recommended the use of telephone surveys of a sample representative across industry, firm size, and region.

Finally, the study suggested that information on actual jobs created (as opposed to expected jobs created, which was the current information collected) be gathered and organized into a longitudinal data base. This data base would be used to facilitate future employment impact studies.

Canada Small Business Financing Act Employment Impact Study

COMPAS Inc.

March 2002

Compas was commissioned by Industry Canada to identify employment impacts among CSBF borrower firms who obtained loans between January 1 and June 30, 2000. Both direct and indirect employment were examined, as well as jobs maintained, and the difference between full- and part-time positions.

A total of 3,200 surveys were sent out in February, 2002, of which 603 self-administered questionnaires were returned by mail or fax, a response rate of 21 percent.

On average, companies estimated that 4.24 new jobs – including full-time, part-time, seasonal and permanent positions – were created. Once the companies with invalid responses are eliminated, that number drops to 3.57 new jobs.

Almost 40 percent created 1-3 jobs; 15 percent created no jobs; and 17 percent created 6 or more jobs.

On average, 57 percent of the new jobs created were full-time, and 43 percent were part-time.

An average of 3.76 percent of jobs of all kinds were maintained as a result of CSBF loans. Once companies with invalid responses were eliminated, this figure decreases to an average of 2.49.

Over 30 percent of firms maintained 1-3 jobs, and 12 percent maintained 6 or more jobs as a direct result of the loan.

Survey participants were generally unaware of indirect employment benefits to their suppliers or clients.

Compas's model also indicated that, statistically speaking, the loans were significant in new job creation as well as job maintenance.

Interestingly, the older the firm and the older the firm's owner, the fewer new jobs tended to be created with CSBF loans. This having been said, the older the owner, the more likely were the created jobs to be maintained.

The amount of the loan proved to be the largest single factor in job creation: the larger the loan, the more jobs created. The gross revenue of the firm was also significant: more jobs were created by firms with higher gross revenue.

Longitudinal Economic Impact Study of the Canada Small Business Financing Program

Statistics Canada

December 2004

Statistics Canada did a longitudinal economic impact study of CSBF clients who borrowed under the program between April 1999 and March 2000. They were compared with similar firms that were not CSBF clients.

Statscan's statistical analysis showed the following:

- Across industries, business size, and regions, CSBF borrowers showed more employment growth than non-CSBF borrowers.

- CSBF borrowers with fewer than five employees were significantly more likely to survive than non-borrower SMEs of the same size.

- CSBF borrowers increased their sales significantly more than non-borrower firms: by 13 percent over two years; by 20 percent over three years; and by 43 percent over four years. Across industry, region, and size, CSBF borrowers increased sales more than non-borrowers.

- CSBF borrowers increased their net GST remittances by 28.4 percent between 1999 and 2002, significantly more than non-borrowers, whose net GST remittances for the same period increased by only 6.4 percent.

- CSBF borrowers increased their operating profits more than non-borrowers, but not their return on assets.

- CSBF borrowers did not, however, demonstrate more improved operating efficiencies (at least as measured by sales-to-assets ratios or by sales-to-employees ratios) than non-CSBF borrower firms.

Lending a Hand:
The role of the CSBFA in fostering entrepreneurial success

Nicole Baer Communications

December 2001

Nicole Baer interviewed the proprietors of 22 small businesses to gather anecdotal evidence of how they had benefited directly from CSBF loans. Many firm owners said that loans had made the difference between being able to run their business and not, and many were convinced that they would not have been able to obtain financing absent the CSBF Program.

Firms were chosen from across the country and across a wide range of sectors.

The following are typical stories:

- William Richard Lee is a retired RCMP officer who used the loan to buy new computers and software for his Trail, BC security firm, Allgard Security Services.
- Immigrants Erwin and Theresia Beck, whose small bakery had been operating for 17 years in Pembroke, ON, used the loan to finance a major renovation and expansion. They more than doubled their anticipated gain in sales as a result.
- Sven Tergesen, a former drag racer, financed the expansion of his high-performance auto parts shop into a five-bay, full-service repair shop in Winnipeg, resulting in a significant growth in revenues.
- Edward C. Turnbull used his loan to buy a new, seaworthy ocean-going boat with which to fish crab, allowing him to stay in his Labrador village.
- Marla Yanofsky and Vikki Stark, both therapists, opened the Montreal Family Centre with their loan. The centre counsels divorcing couples on how to help their children manage the transition.
- True North Safaris Ltd. has offered professionally guided adventures across the barren lands of central Northwest Territories since 1983. Gary Jaeb and his family used a CSBFA loan to ensure boats, motors, and other crucial equipment are always in perfect running order.

III

Small Business Loans Administration Discussions with Financial Institutions

Heron & Company

June 2004

The Small Business Loans Administration[1] met with representatives from 10 financial institutions, including all large banks, to discuss the CSBFA's relevance and the extent to which its goals are being met, and to determine whether any changes to the program are necessary.

The strong message from all financial institution representatives is that there is a place for the CSBF Program, but, in their present form, CSBF loans are burdensome and unprofitable. The program is not currently a good fit with organizations that are highly automated and focused on handling high volumes of conventional products.

There were three specific and recurring complaints:

- CSBF Program loans are too time-consuming;
- They are unprofitable; and,
- The government guarantee is undermined by fear of claims rejection.

Financial institutions' recommendations include:

- *Reducing the regulatory burden* by allowing financial institutions to use their normal loan administration procedures – including security documentation and default recovery – to eliminate duplicate sets of procedures;
- *Improving compensation to financial institutions* by allowing them to charge the same fees for CSBF loans as for conventional loans and removing the interest rate cap, so that CSBF loans become a competitive product. In this way, the interest rate would reflect the credit risk involved;
- *Automating the loan forms* by enabling them to be completed electronically, as is done with conventional loans. Among other things, financial institutions believe this will reduce errors;
- *Improving claims administration* by adopting a more flexible, less adversarial approach. Quality assurance procedures would ensure uniform service. In the event of good faith administrative lapses on the

[1] Currently called the Canada Small Business Financing Program Directorate.

part of FIs, there should be room for claims adjustments instead of outright rejections.

- *Improve SBL Administration communications* by establishing protocols for responding to inquiries; publishing and updating a file of decisions and claim rulings for financial institutions' use; and providing ongoing information on program trends and statistics.

Financial institution participants all expressed a desire to work with the SBL Administration to find ways to better balance their interests with those of the government and of small business clients, and to continue to offer CSBF loans.

Lender Awareness and Satisfaction Survey

Circum Network Inc.

June 2004

Circum Network completed two sets of telephone surveys in early 2004 to determine levels among financial institutions of awareness of the CSBF Program and satisfaction with CSBF loans.

Open-ended interviews were conducted with 39 of the program's "strategic partners": senior managers, financial institution coordinators, claims officers, and registration officers of banks, caisses populaires, and credit unions. Interviews were completed between January 26 and February 25, 2004.

A further set of 15-minute telephone interviews were conducted with 1,494 "operational partners": commercial loan managers and people who had either registered a loan or made a claim against the program after April 1999. These interviews were done between February 10 and March 19, 2004, and represented a response rate of 37 percent.

Strategic partners attributed the ongoing decline in the use of CSBF loans to the availability of the less costly and less risky financing alternatives that have been developed in recent years by financial institutions. They cited a heavy administrative burden, lack of program flexibility, and the high risk of claim rejection as disincentives to use the program.

On the operational side, 85 percent of commercial loan managers had heard of the CSBF Program. An additional eight percent had heard of the SBLA, and two percent knew of the BIL. Six percent had heard of none of the programs. Among program users, knowledge of the CSBF Program was high: on average, they were able to answer correctly 8.2 out of 11 questions on program details.

Sixty-six percent of commercial loan managers surveyed had registered a CSBF loan since April 1999; 49 percent had done so since April 2002. Half of those who had not used the program said it was because they had had no suitable clients; smaller numbers indicated the existence of corporate policies not to use the program due to its administrative burden.

Eighty-eight percent of the program's users indicated some level of satisfaction with service delivery, and 87 percent were satisfied with its parameters. That said, the study found a low level of "high satisfaction", and greater satisfaction with the "simple, solid overall service relationship", rather than with a "finely tuned loan support product".

Comment: What do you think of the following suggestion by the Directorate?

we find that the summary could be more balanced and note some of the positive results of the survey such as:

o When asked questions about the CSBFP, program users were able to provide 8.2 correct answers out of 11 questions asked i.e. high level of understanding.

o 87% of clients indicated some dose of satisfaction with program parameters

o 88% expressed some level of satisfaction with service delivery

o Among the top nine most effective levers of satisfaction were: the ease of doing business with Industry Canada's CSBFP Directorate; the competence of the Directorate and its fairness; and the clarity of information on the program and its operations.

Operational partners were more satisfied with service delivery than program parameters; strategic partners were least satisfied with the program's processing time and the fairness of Industry Canada decisions.

Participants recommended simplifying forms, required documentation, and claims payments.

Canada Small Business Financing Act Awareness Study

COMPAS Inc.

April 2001

Compas Inc. conducted a survey of two groups to gauge awareness of the CSBFA among small and medium-enterprise owners, as well as their experience of obtaining financing. Telephone interviews were done in March 2001 – two years after the introduction of the new program with the new name – with the business managers of 394 firms in the general business population, and 202 firms that had obtained CSBF loans (CSBF clients) within the previous 12 months.

The survey found relatively low levels of knowledge, and a great deal of confusion, among both groups about all aspects of the CSBFA.

Among the 202 CSBF clients:

- Only 68 percent were aware of the existence of the CSBF or the SBL Program, although they could not all name it, even though they had all received loans from the program within the previous 12 months.
- Only 40 percent could name either the CSBFA or the SBLA without prompting: 39 percent knew about the SBLA; only 1 percent could identify the CSBFA by name.
- Fully half of those aware of the CSBF/SBL Program said they knew nothing at all about it.
- Over 71 percent of CSBF clients were unaware that their loan was part of a federal loan support program.

Not surprisingly, awareness was yet lower among the general business population:

- 41 percent were aware of the existence of a federal government program; 10 percent could name either the SBLA or the CSBFA. Only .6 percent could identify the CSBFA by name.

Client firms tended to use caisses populaires far more than the general business population, which may indicate that the caisses are more active in identifying the program to their clients than other financial institutions.

Knowledge of the old program name – SBLA – was much higher than the new one. COMPAS speculated that this is in part because the older name more clearly represents the content of the program than the new name, and is easier to retain. It might also be because financial institutions were continuing to identify the program by the old name, rather than the new.

Finally, many businesses that are turned down for loans appear not to be informed about the CSBF Program by financial institutions.

COMPAS also ascertained that:

- most respondents identified financial institutions as their preferred source of information about financing options; and,
- most respondents preferred receiving hard copy, rather than electronic, information about financing options.

Canada Small Business Financing Act Loans Decline Study

COMPAS Inc.

January 2002

There was a decline in the use of CSBF loans in the late 1990s and into the new millennium. COMPAS was commissioned to do a qualitative research study with lenders to understand why this had occurred. Eighteen in-depth telephone interviews were conducted between November and December 2001 with both the main CSBF contact person at the financial institution and a senior executive with direct responsibility for small business loans.

All respondents claimed to be at least “moderately familiar” with the CSBFA; over half said they were “very familiar”. Almost all respondents were aware that there had been a decline in CSBFA use during the previous five years, and over half described that decline as “large”.

They cited two main reasons for the decline:

- the heavy administrative burden associated with the loans; and,
- the increasing tendency on the part of the federal government to reject claims.

Respondents also noted lenders’ inability to charge fees, the availability of cheaper sources of funding for borrowers, and the amount of profit or incentive for lenders as explanatory factors.

All participants expressed a belief that CSBF loans are useful and important because there will always be borrowers who would not otherwise qualify for loans. Nonetheless, they tended to be critical of the program: Just over half believe that it is a valuable but cumbersome tool because of its administrative and documentary requirements. Others were critical of what they perceive to be ambiguity regarding due diligence, lack of profit for lenders, costs to borrowers, the government’s tendency to reject claims, the lack of a guarantee on claims, and the lack of assistance from government.

Most participants said their conventional loans to SMEs over the time period in question had, in fact, increased.

Respondents also noted that an increased use of credit cards over the five years in question might also help to explain the decline in the use of CSBF loans.

CSBFA On-Site Examination: Report on Findings

Program Integrity and Revenues
Small Business Loans Administration

August 2003

The Auditor General of Canada recommended, in a 1997 report, that Industry Canada ensure that lenders exercise due care in making loans. In consequence, section 15 of the CSBFA provides for the examination of lenders' documentation to verify that the CSBFA and the *Canada Small Business Financing Regulations* (CSBFR) are being complied with.

Industry Canada's first on-site examinations of lenders' documents were conducted between January 13 and March 17, 2003. Its general objectives were to ensure that lenders understand the requirements and implications of section 15 of the CSBFA, and to acquire their full cooperation in this exercise. Industry Canada wanted, as well, to ascertain compliance with respect to due diligence, and the accuracy and completeness of supporting documentation for loans.

Twelve lenders were selected for the exercise, a random sample of two credit unions, two caisses populaires, two medium-size lenders, and all six major chartered banks. The banks were responsible for 69 percent of loans made during the period under examination.

Twelve loans for each lender were then randomly selected for examination, all made and registered between April 1, 1999 and March 31, 2002.

The examinations found that:

- 94 percent of the loans were in compliance with all due diligence requirements. In the case of 6 percent, there was no record of obtaining credit references or conducting credit checks on the borrower before the loan was made;
- 73 percent of the loans were compliant with all other aspects of the CSBFA and CSBFR, i.e., with regard to 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.
- 74 percent of the loans were supported by complete and accurate documentation. The remaining loans were missing documentation such as credit references, invoices, proof of payment, or appraisals;
- In total, 69 percent, or 98 of the 143 loans examined, were fully compliant with all aspects of the requirements.

Industry Canada was confident that the exercise raised awareness and understanding of the need for compliance, and that it did secure the cooperation of all lenders concerned during the exercise.

IV

Synthesis of Study Findings

The studies concluded overwhelmingly that there is an ongoing role for government-facilitated access to debt financing for small and medium-sized enterprises. There is no existing alternative to a program like the CSBFA, nor is there overlap between the CSBF Program and other government loan programs.

CSBF loans are highly incremental – which means that the majority (roughly 75 percent) of small businesses that receive them would either have been unable to get financing *at all* in the absence of a program like the CSBF Program, or would only have had access to reduced levels of financing or less favourable terms.

Studies also found that an average of 2.7 full-time equivalent jobs are created per loan granted, or 3.57 full-time, part-time, seasonal and permanent positions. Across industries, business size, and regions, CSBF borrower firms showed more employment growth and increased their sales significantly more than comparable non-borrower firms. Their operating profits also increased more than comparable non-borrower firms. In addition, CSBF borrower firms with fewer than five employers were significantly more likely to survive than non-borrower firms.

The CSBF Program is not, and cannot be, cost recoverable in its present form, or if it is to retain its incrementality for borrowers. The challenge is to find the balance between cost recovery and a desired level of incrementality: it is, therefore, possible to move toward less incrementality and more cost recovery by changing program parameters such as fee structures.

With its present parameters in place, claims are predicted of $85 - $90 million for the fiscal years 2004-2005 and 2005-2006. Assuming that present levels of lending continue to hold, claims are predicted of $85 - $90 million through 2012.

CSBF Program lending has been declining over the past five years. Interviews with lenders indicate that, while 85 percent of commercial loan managers are familiar with the program, and 66 percent had registered at least one CSBF loan since April 1999, there are also high levels of dissatisfaction with the program's administrative burden. The strong message from financial institutions is that in their present form, CSBF loans are burdensome and unprofitable. They are time-consuming to prepare and the government guarantee is undermined by fear of claims rejection.

Financial institutions would like to be able to use their normal loan administration procedures, which would reduce the regulatory burden. They would like to be able to charge the same fees for CSBF loans as they do for conventional loans, and they would like to see the interest rate cap removed, so that CSBF loans become a competitive product. Finally, they would like to see protocols established for claims administration and communications so that the process is more flexible and less adversarial.