

Canada Small Business Financing Act

Developing the Pilot Projects

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Overview

The purpose of this paper is to provide members of the House of Commons Standing Committee on Industry with an update on Industry Canada's work in designing pilot projects under the *Canada Small Business Financing Act* (CSBFA). This paper is a companion to "The *Canada Small Business Financing Act*: Assessing New Opportunities" (Industry Canada, 1999), which provides summaries of most of the research and consultations undertaken as part of the process of developing the possible pilot project designs.

The preliminary nature of the designs outlined in this paper reflects the fact that Industry Canada currently is in the middle of the policy development process. No final recommendations have been made, and options are still being explored with a number of interested stakeholders.

Recently, concern has been expressed about the administration of loans under the program. In designing the pilot projects, Industry Canada has been very conscious of the need to ensure an appropriate level of due diligence in extending and administering financing contracts. While we realize that some lessors and lenders may be less interested in these projects if the administrative burden is too great, the preliminary design of the pilot projects as laid out in Section 4 below will be no less stringent than the core program.

The paper is divided into four sections. Section 1 provides a design summary that includes every major program parameter and how Industry Canada proposes to adapt it within the pilot project design. Section 2 outlines the purpose and key objectives of the pilot projects. Section 3 outlines the next steps to be taken. Section 4 provides preliminary details of the program designs. These are subject to adjustment as the department hears more from stakeholders. Therefore, the reader should not mistake these proposals for recommendations. Rather they are issues for further discussion, which will inform the options eventually given to the Minister of Industry.

The CSBFA was enacted by Parliament in December 1998. It facilitates access to financing for small businesses by making provision for the federal government to share the risk of losses with financial service providers who make loans to eligible borrowers. Eligible borrowers include for-profit firms operating in Canada and having less than \$5 million in annual revenues, but exclude agricultural enterprises, charities and religious organizations. Under this Act and its predecessor, the *Small Business Loans Act* (SBLA), the government has facilitated access to about \$14 billion in lending through about 200 000 loans during the past six years. As such, it is the federal government's single most

important program to assist small businesses. It is delivered by a network of 1 500 private sector lenders through some 13 000 points of service. The Act also provides for the creation of pilot projects for lending to the voluntary sector and for capital leasing. The purpose of the pilot projects is to identify and test the viability and utility of the program in these areas currently excluded from the CSBFA. In undertaking the pilot projects, the federal government seeks to meet the same incrementality and cost recovery objectives as in the core program.

Over the past year, Industry Canada, as the department responsible for administering the Act, has undertaken extensive research to determine the feasibility, needs and design challenges of these pilot projects. This research has examined the scope and financial structure of the voluntary sector and has probed its financing needs. It has also examined the structure of the leasing industry, the gaps in serving financing needs in the small and medium-sized business community, securitization and other technical issues essential to the implementation of a pilot project for capital leasing.

VOLUNTARY SECTOR PILOT PROJECT

The federal government in 1997 committed to review all programs directed toward small businesses to determine their applicability to the voluntary sector. One result of this review is the current voluntary sector pilot project under the CSBFA. The real test of applicability will be the degree to which a pilot project can provide incremental access to financing for key parts of the voluntary sector.

Research conducted by Industry Canada into how the estimated 175 000 charitable and non-profit organizations in Canada that make up the voluntary sector fund themselves reveals that most traditional charities prefer not to take on debt, but find it cheaper and more effective to undertake fund raising. This sector differs from others in that it is not driven by a profit motive. Therefore, acquisition of capital equipment does not necessarily result in additional revenues, as it does for most small businesses. Adding debt does not necessarily make sense to many of these organizations, except in special circumstances. Consultations show that some members of the non-profit sector could benefit from a pilot project based on the current CSBFA program.

Three main issues emerged from the research and consultations.

First, voluntary organizations appear to be more interested in access to sources of working capital than to the asset-based debt financing offered by the CSBFA. The position of the government and the House of Commons Standing Committee on Industry is outlined

in “Taking Care of Small Business” (Report of the Standing Committee on Industry, October, 1994, p. 27), which is that the CSBFA/SBLA is not well suited to providing support for working capital loans. Consistent with this position, Industry Canada is not proposing to extend the pilot project to working capital for the voluntary sector. This will ensure equity of treatment between this sector and the small business community.

Second, some people in the voluntary sector appear to believe that personal guarantees are an absolute requirement for security in lending under the program. However, this is not the case. Financial service providers now can seek several kinds of security for a loan, aside from the asset being financed. Personal guarantees are among these options, but may be substituted for other types of security, such as a corporate guarantee.

Finally, an issue for many is the overall cost of borrowing under the program. The CSBFA provides access to debt, but, given the maximum interest rate of prime plus 3 percent and program fees, these loans can be more expensive for the borrower than non-CSBFA-guaranteed lending. If the proposed pilot project is to meet its cost recovery objective, it is difficult to see how the cost of borrowing can be reduced.

Research and consultations within this sector have found no compelling reason to change the current program in extending it to the voluntary sector. The proposed pilot project design will be very similar to the existing program.

In the proposal, registered charities and incorporated non-profit organizations with annual revenues of less than \$5 million will be eligible for up to \$250 000 in asset-based financing. While the pilot project will be open to all types of charities, Industry Canada expects that non-profit organizations such as industry associations, unions, agricultural societies, non-profit co-operatives and community economic development organizations will be the most frequent users. It is proposed that political parties be specifically excluded. A contingent liability ceiling of \$88 million over five years should be sufficient to accommodate about \$500 million of lending over the five-year period of the pilot project. In the absence of specific information on the pattern of lending to the voluntary sector, these forecasts are based upon the assumption that lending to the voluntary sector will exhibit the same behavioural patterns as small businesses using the core program. If this assumption proves to be incorrect, the pilot project will have to be adjusted accordingly.

CAPITAL LEASING PILOT PROJECT

The capital leasing industry argues that the existence of a loan guarantee program such as the CSBFA creates an undue distortion in the market in favour of loans, even when leases

make more economic sense to the small business in question. This view is shared by the House of Commons Standing Committee on Industry in its report "Taking Care of Small Business"(October 1994).

Capital leases in all likelihood transfer ownership at the end of the lease to the lessee. Such leases are characterized by very fast decision making and fixed interest rates. However, firms with less than two years of experience and those seeking leases of less than \$100 000 are often rejected out-of-hand.

Capital leases are provided by over 550 firms that range in size from multinational firms to small, local equipment dealers and every size in between. About 60 percent of these firms' clients are small and medium-sized enterprises (SMEs). Nearly 450 of the leasing companies themselves are SMEs, and the majority of them have been in business for more than 20 years. About 90 percent of all capital leases are issued by 10 percent of leasing companies. Leases typically have six-year terms with fixed interest rates for that term, which range from the Government of Canada long bond rate plus 6 percent and higher.

The key issues in the design of the capital leasing pilot project relate to the technical adjustments needed because of the differences between a lease and a loan. For example, with a loan, a loss occurs when payments stop. The government repays the principal claimed after security has been realized. However, leases have fixed payment terms and take little security beyond the leased item. Our challenge is to define the outstanding balance on leases in order to determine an amount which would qualify as eligible losses. These definitions seem simple at first glance, but have become very difficult technical issues.

The early design of this pilot project features eligibility criteria for lessees, as in the CSBFA today. The criteria for eligibility of lessors is proposed to be similar to that of the existing program. However, for the pilot project, Industry Canada is considering establishing a cap of 150 lessors, to minimize risk and administrative costs. In addition, the design of the pilot project entails a loss sharing ratio (or guarantee rate) of 80 percent for the government and the remaining 20 percent for the lessor, combined with an existing 2 percent registration fee, a 1.25 percent annual administration fee and an interest rate of Government of Canada bonds (for the appropriate term) plus 8 percent including the 1.25 percent annual administration fee. The program will likely make it possible for eligible lessors to securitize their CSBFA-registered leases. The total of all leases and loans made under the program to a single business and its related entities will not exceed \$250 000. The

contingent liability ceiling for this pilot project will be about \$314 million, permitting about \$2.5 billion of leasing over the five-year life of the pilot project.

NEXT STEPS

The present paper provides an outline of the current state of development of the pilot projects. Industry Canada expects to consult with key stakeholders including financial service providers, small business groups and voluntary sector groups over the summer. Their input, together with that received from the House of Commons Standing Committee on Industry, will be taken into consideration in developing the pilot project regulations. Once all this information is available, the Minister of Industry, the Minister of Finance and Treasury Board Ministers will be asked to approve the pilot project designs. Once the designs are approved, the department hopes to move forward with approval of the regulations. This step will involve pre-publication of the regulations in the fall and further consultations, together with their tabling with parliamentary committees pursuant to s. 14(3) of the CSBFA. The department hopes to have final regulations in place by the end of December. This will allow 90 days in which financial services providers can conduct required training and marketing to implement these projects by April 1, 2001. This is an ambitious schedule, which provides sufficient but not ample time to complete this work. If consultations reveal unexpected obstacles to implementation, it may not be possible to meet this deadline.

While the pilot projects are in a very preliminary stage and are subject to change during the next round of consultations, the views of the House of Commons Standing Committee on Industry with regard to the approach being taken with the voluntary sector and the capital leasing industry will be most useful. The department will be asking all stakeholders and the House of Commons Standing Committee on Industry the following fundamental question. In view of our objective in designing pilot projects to determine whether they should ultimately be incorporated in the core program, and in view of the risks and costs associated with launching any new program, will these pilot projects adequately test this objective while meeting identified needs and cost recovery?

Section 1. Design Summary

This section provides a preliminary summary of this work to date and options for pilot project design. The chart below is an overview of proposed elements in the designs for voluntary sector and capital leasing pilot projects under the CSBFA and with a side-by-side comparison with the parameters of the core program. These elements may be adjusted following the consultations.

A more detailed explanation of the proposed design features for these pilot projects is contained in Section 4 of this document.

Program parameters	Current CSBFA	Voluntary sector pilot project	Capital leasing pilot project
Designation of lender	<ul style="list-style-type: none"> • Canadian Payments Association members • designated by Minister (as described in policy) 	Existing lenders under the CSBFA	Proposed designation criteria: <ul style="list-style-type: none"> • Canadian Payments Association members • lessors approved by a Canadian rating agency for a securitization program • designated by Minister (as per a Lessor Designation Policy)
Due diligence and care	Expectations of lenders are to: <ul style="list-style-type: none"> • obtain satisfactory credit references • assess customer's ability to repay • apply similar procedures to those applied to non-CSBFA loans 	Same as CSBFA	Same as CSBFA, plus the expectation to apply similar payment terms to those normally applied by the industry for each class of equipment
Eligibility criteria	Customer operating: <ul style="list-style-type: none"> • for-profit enterprises • in Canada • with less than \$5 million in annual gross revenues 	<ul style="list-style-type: none"> • Registered charities and incorporated non-profits as defined by CCRA operating in Canada with less than \$5 million in annual gross revenues • Political parties are excluded 	Same as core CSBFA (voluntary sector not to be included)
Purpose of loans	<ul style="list-style-type: none"> • Real property • Leasehold improvement • Equipment 	Same as CSBFA	New equipment only

Developing the Pilot Projects

Program parameters	Current CSBFA	Voluntary sector pilot project	Capital leasing pilot project
Maximum amount	Maximum of \$250 000 (including all SBLA, CSBFA and CSBFA pilot project financing)	Same as CSBFA	Same as CSBFA
Program fees	<ul style="list-style-type: none"> • 2% registration fee • 1-1/4% annual fee 	Same as CSBFA	Same as CSBFA
Payment terms	Maximum 10 years	Same as CSBFA	Same as CSBFA
Maximum interest rate	Prime plus 3%	Same as CSBFA	Prime plus 8%
Financing rate	Maximum of 90% of eligible cost of financed assets	Same as CSBFA	100% of eligible cost of financed assets
Loss sharing ratio	<ul style="list-style-type: none"> • 85% government • 15% lender 	Same as CSBFA	<ul style="list-style-type: none"> • 80% government (or lower) • 20% lender (or higher)
Cap on claims	<ul style="list-style-type: none"> • 90% of first \$250 000 • 50% of next \$250 000 • 10% of excess of \$500 000 	<ul style="list-style-type: none"> • 90% of first \$50 000 • 50% of next \$50 000 • 10% of excess of \$100 000 	<ul style="list-style-type: none"> • 90% of first \$50 000 • 50% of next \$50 000 • 10% of excess of \$100 000
Security	Security ranking requirements	Same as CSBFA	Same as CSBFA, plus registration of lease contract under PPSA* (or equivalent Act in Quebec)
Personal guarantee	Maximum 25% of value of CSBFA loan	Same as CSBFA, with emphasis on flexibility to substitute personal with corporate guarantees	Same as CSBFA
Corporate guarantee	Unlimited	Same as CSBFA	Same as CSBFA
Five-year contingent liability ceiling	\$1.5 billion, permitting up to \$10 billion in lending	\$88 million, permitting up to \$500 million in lending	\$314 million, permitting up to \$2.5 billion in leasing

* PPSA = *Personal Property Security Act*.

Section 2. Pilot Projects' Purpose and Key Objectives

The pilot projects for the voluntary sector and for capital leasing are being proposed to test the extension of the CSBFA guarantee to these new markets. The goal is to determine whether either or both would be viable as a permanent addition to the core CSBFA program. There may, of course, be fine-tuning of the provisions as required during the pilot project phase.

The viability of the pilot projects will be measured primarily against their success in satisfying two core objectives set out for the CSBFA:

- any overall increased access to asset-based debt financing (loans or leases) will be incremental, according to an agreed-to definition of incrementality
- the pilot projects will be independently cost-recoverable, separate from the core program, where user fees cover projected costs.

With implementation of the pilot projects, the reach of the CSBFA will be expanded. More delivery agents will be attracted through the existing capital leasing infrastructure, accessibility to financing for members of the voluntary sector will be increased, and SMEs will have an additional financing option.

The draft pilot project designs are based on the best research, industry statistics, stakeholder consultations and other evidence available to Industry Canada. Our goal is to test the validity of our consultations and research by implementing pilot projects that most accurately reflect the needs of the voluntary sector and capital leasing industry. For example, the capital leasing industry reports a gap in leasing to firms under two years old looking for leases of less than \$100 000. Industry Canada hopes to determine whether this finding actually represents a significant gap in the leasing industry and whether the CSBFA is an effective tool for responding to it. As for the voluntary sector, while anecdotal evidence signals that a financing gap exists, research and consultations have been unable to specifically identify it (clearly there is a funding gap for the voluntary sector, but that is beyond the scope of this loan guarantee program). Take-up of the pilot project by the voluntary sector and data gathered on voluntary sector borrowers will allow the government to better understand the sector's needs. In doing so, a permanent extension of the CSBFA to the voluntary sector can be designed.

The next step in designing the pilot projects is determining whether the preliminary parameters chosen will produce the intended results. A challenge in proposing preliminary designs for these pilot projects is that there are no known best practices to follow, domestic or international. The most accurate information on how an aggregate of borrowers behave under a CSBFA-type loan guarantee program is data gathered on the SBLA and CSBFA. Assumptions related to the parameters for the pilot projects have been made based on this knowledge. These assumptions will have to be tested against the actual results of the pilot projects, and changes may have to be made.

Pilot Project Success Factors – Clients

In addition to the core objectives outlined above, a number of other success measures related to the pilot projects' design will determine the effectiveness of the pilot projects:

- transparency in communications regarding the purpose and ultimate goals of the pilot projects; more specifically, awareness that these pilot projects are not a subsidy but are government-facilitated tools for use by small businesses and members of the voluntary sector in accessing financing
- widespread take-up by pilot project deliverers (banks, caisses populaires, credit unions, leasing companies) who regard the pilot projects as a useful tool for their clients and who actively involve themselves in making the guarantee available to customers able to benefit from it
- growing awareness among SMEs of the opportunity to use the program for leases, not just loans, and to benefit from the guarantee under the pilot project if it best suits the needs of their businesses
- growing awareness among voluntary sector organizations (defined as registered charities and incorporated not-for-profits) of the pilot project and the opportunity to determine whether a guarantee on asset-based debt financing could meet their financing needs and would fit within the mandate of their organization.

Pilot Project Success Factors – Program Implementation

From a technical perspective relating to effective pilot project delivery, success will be based on the following objectives:

- simple delivery mechanisms: pilot project take-up will be evaluated to determine if deliverers have found the designs difficult to understand, communicate to their clients, or adhere to in terms of regulatory compliance, data collection and reporting

- ease of use by SMEs and members of the voluntary sector: the pilot projects are unlikely to be used if the steps to access them are too complicated or if potential users cannot see how they might be useful to their business or organization
- ability to produce the desired effect: parameters may be adjusted to meet the specific needs of the leasing industry or the voluntary sector and to ensure they do not cause impediments to pilot project delivery or take-up
- ability to track whether evidence collected on the pilot projects provides an adequate basis for determining whether there is a need to adjust or fine-tune any of the initial assumptions regarding behaviour.

Pilot Project Evaluation Framework

To evaluate these success factors during and after the life span of the pilot project, an evaluation framework will be developed prior to the launch. The goal of this framework is to determine, in advance, what data need to be collected to properly evaluate the pilot projects in order to assess the extent to which the pilot projects are managed efficiently and are achieving their objectives — with an emphasis on the objectives of cost recovery and the ability to meet a need for our target clientele. This information will also be used to decide whether the pilot projects should be permanently amalgamated with the core program.

Defining Pilot Project Incrementality

Like the core CSBFA program, incrementality for both pilot projects will be defined as providing access to financing that, without the CSBFA guarantee, would not have been made at all, or would have been made under less favourable terms. For the voluntary sector in particular, the pilot projects are aimed at facilitating or initiating working relationships between borrowers and lending institutions.

As capital leasing will share the same market of borrowers as the core program, incrementality will also encompass the extent to which the pilot project provides a viable alternative to loans under the core CSBFA program. In providing the leasing alternative, the pilot project will allow CSBFA clients to access leases when, in the absence of a pilot project, a lease would provide more favourable financing terms but a CSBFA loan would be the only financing option.

Incrementality, pricing and cost recovery are closely tied. Fees will be a key element of the pilot projects, as with the core program, to ensure cost recovery. As the fees raise the

overall cost of the financing, small businesses or voluntary sector organizations that qualify for traditional financing should not use the program, ensuring that lending is extended to firms that actually need the CSBFA guarantee.

Defining Pilot Project Cost Recovery

Cost recovery for the pilot projects, as under the core program, will be achieved when fee revenue meets the costs of honouring the guarantees on the financings (loans or leases) undertaken during the five years of the pilot projects, but expressed over the total life of the financings.

In designing the pilot projects, Industry Canada is attempting to balance parameters that control the risk, and therefore the cost, with appropriate eligibility criteria. A pilot project without fees would improve take-up but would not be cost-recovered. A pilot project incorporating a lower guarantee rate would have a better chance of meeting the cost recovery objective, but may discourage participation by smaller financial service providers.

Industry Canada has conducted research on the core program, the leasing industry and the voluntary sector. It has explored how changes to project parameters may affect borrower and lender behaviour. The department is attempting to find a balance for each of the pilot projects. Performance measures are being developed to track the pilot projects. If initial forecasts are shown to be incorrect or if either of the pilot projects moves significantly away from the cost recovery objective, changes to parameters or eligibility criteria will be recommended.

The overall lending risks to the voluntary sector and therefore for this pilot project are not well known. Little information exists to understand how the sector uses debt financing and voluntary organizations' success in repaying debt. If successful, the pilot project will provide insight into voluntary sector organizations' use of financing and will help measure the risks associated with lending to them in comparison with small businesses.

The preliminary estimate of activity under this pilot project is \$500 million, or an average of \$100 million a year. Using CSBFA methods and the characteristics of this sector, this volume of lending would produce a contingent liability to the government of \$88 million (17.7% of overall lending). It should be stressed, however, that this contingent liability figure does not include a provision for the fees that are expected to be collected. The program is designed to be cost-recovered over the life of the loans guaranteed.

For the capital leasing pilot project, the identified gap in the leasing market for SMEs is similar to that for lending (small businesses younger than two years old and seeking

financing of less than \$100 000). Therefore, this pilot project would be targeted at the same group of eligible small businesses. However, while the deliverers of the capital leasing pilot project may include existing CSBFA lenders, many will come from the leasing industry itself, which is largely unregulated and is composed of a few very large and many small leasing companies. Therefore, to control the risks and costs involved, the department is proposing a new definition of lessor, which is based on the current structure of the CSBFA definition of lender.

A few changes to other parameters are also being proposed. One purpose is to take into account the critical differences between a capital lease and a loan and between a leasing company and most CSBFA lenders. Differences include, among others, the absence of (or minimal) up-front payment requirement, due diligence practices in the leasing industry relative to lending industry standards, and higher interest rates usually charged on a lease relative to a comparable loan. As a result, Industry Canada is proposing to increase the financing rate from 90 percent to 100 percent and to balance this additional risk with a reduction in the loss sharing ratio (or guarantee rate) from 85 percent to 80 percent (or lower), applicable to new equipment capital leases only. Other parameters, such as the fee level and the maximum lease amount would remain unchanged.

The preliminary estimate of activity under this pilot project is \$2.5 billion, or an average of \$500 million a year. Using CSBFA methods and the characteristics of this sector, this volume of lending would produce a contingent liability to the government of \$314 million (12.6% of overall lending). Again, it should be stressed that this contingent liability figure does not include a provision for the fees that are expected to be collected. The program is designed to be cost-recovered over the life of the loans guaranteed.

Section 3. Next Steps

The launch of the CSBFA pilot projects is targeted for April 1, 2001. To meet this target date, the proposed approach is to bring forth both pilot projects simultaneously through the following steps:

- two formal, separate rounds of consultations for both pilot projects:
 - a first round on the proposed pilot project designs
 - a second round on pilot projects draft regulations
- regulations drafting (summer 2000)
- pilot project evaluation framework drafting (fall 2000)
- regulations approval process (late fall 2000)
- implementation and marketing phase (winter 2001).

Following discussions with the House of Commons Standing Committee on Industry on the proposed approach for the development and implementation of the pilot projects, the next step will be to begin consultations on the detailed pilot projects design.

The first round of consultations is planned for late June 2000. As part of this, both pilot project design proposals will be presented to a broad spectrum of stakeholders including:

- for the voluntary sector pilot project, financial institutions, representatives of the voluntary sector, industry associations and government departments
- for the capital leasing pilot project, financial institutions, leasing companies, representatives of the small business community and industry associations.

The goal for this first round of consultations will be to get stakeholders' views on the proposed parameters for the pilot projects. Parallel to the first round of consultations, regulations drafting will begin in June 2000 and will continue through the summer.

Once the draft regulations are completed, a second round of consultations with the stakeholders will be held to obtain feedback on the pilot projects draft regulations. The focus of this round will be to ensure that the specifics of the regulations accurately reflect the policy direction determined from previous consultations and to ensure that the technical issues relating to the administration of the program (e.g. the individual relationships that exist between both the lenders and the lessors with the government) are appropriately addressed. Once the consultation results are incorporated into the draft regulations, the necessary Ministerial and Cabinet approvals will be sought. Then, the regulatory approval process, including pre-publication in the *Canada Gazette Part I* will take place, likely

starting mid-September and continuing through the fall of 2000. As required under the Act, the regulations will be tabled with the appropriate parliamentary committees.

Another key step, to be undertaken in parallel with the consultations and the regulatory development process, will be the drafting of the pilot projects evaluation framework. The structure will be based on the current structure of the CSBFA program evaluation framework and will have the objective of measuring the performance and success of the pilot projects, as defined earlier. The development of the evaluation framework is expected to begin in July and continue through the summer of 2000.

Finally, the pilot projects will be implemented, with a launch target of April 2001. The implementation efforts will be key to the success of the pilot projects, as they will increase awareness and provide information to potential users of the pilot projects. The awareness program will include marketing initiatives targeted at voluntary sector organizations and small businesses. Training efforts will include development of a guide for lenders and lessors to ensure ease of delivery and use of the pilot projects.

Section 4. Pilot Projects Design

This section outlines proposed regulations for the two pilot projects. The first subsection contains the general interpretations and definitions related to the pilot projects. The second and third subsections describe the designs of the voluntary sector pilot project and the capital leasing pilot project, respectively.

For each parameter, a box describing “issues considered” provides, where possible, the rationale and arguments for and against the proposal. Included are elements such as previous research and consultations results; stakeholders’ views or suggestions; potential impacts on take-up, incrementality or cost recovery; additional research results expected; and outstanding issues to be addressed.

The proposed pilot projects’ design parameters are at an early stage with respect to negotiations with key stakeholders.

INTERPRETATIONS

“*Act*” means the *Canada Small Business Financing Act. (Loi)*

Voluntary Sector Pilot Project

“*borrower*” includes:

- (a) an organization registered under the Canada Customs and Revenue Agency as a “charity”; or
- (b) a federally or provincially incorporated non-profit club, society, or association that is organized and operated solely for:
 - social welfare
 - civic improvement
 - pleasure or recreation
 - any other purpose except profit.

It does not include:

- (a) Her Majesty or an agent of Her Majesty in right of Canada or a province, a municipality or a municipal or other public body that performs a function of government; or

(b) any organization owned by or registered as a political party. (*emprunteur*)

Issues considered:

- ▶ This definition has been chosen to ensure that a majority of the voluntary sector's 175 000 organizations have reasonable access to the program, and that the non-profit or charitable status of the organization can be confirmed, within reason, by their interaction with Revenue Canada.

“*conventional loan*” means a loan that is not subject to the Act. (*prêt ordinaire*)

“*equipment*” means equipment that is used or is about to be used in the course of carrying out the mandate of the borrower. It includes computer software and any ship, boat or other vessel that is used or is about to be used in navigation and water supply systems. It does not include stock-in-trade or inventory of the organization except stock-in-trade or inventory that is leased by the borrower to the borrower's customers. (*matériel*)

“*health care industry*” means an organization classified under the heading Major Group 86 — Health and Social Service Industries, of the Standard Industrial Classification, 1980 published by Statistics Canada. (*industrie des soins médicaux*)

“*hospitality industry*” means an organization classified under the headings Major Group 91 — Accommodation Service Industries, and Major Group 92 — Food and Beverage Service Industries, of the Standard Industrial Classification, 1980 published by Statistics Canada. (*industrie hôtelière*)

“*improvement*” includes construction, renovation and modernization and, with respect to equipment, installation. (*amélioration*)

“*lender*” means an organization as defined under section 2 of the Act. (*prêteur*)

“*loan term*” means the period set out in a loan agreement for repayment of the total amount of the loan. (*durée du prêt*)

“*mini-storage industry*” means an organization classified under the heading 479 — Other Storage and Warehousing Industries, of the Standard Industrial Classification, 1980 published by Statistics Canada. (*industrie du mini-entrepôt*)

“**responsible officer of the lender**” means:

- (a) the manager or assistant manager of the lender or a branch of the lender;
- (b) the credit committee of the lender or a branch of the lender; or
- (c) any person duly authorized by the lender to approve the granting of loans.
(*responsable du prêteur*)

Capital Leasing Pilot Project

“**capital lease**” means a lease that meets one or more of the following conditions:

- (a) there is a reasonable assurance that the lessee will obtain ownership of the leased property by the end of the lease term;
- (b) the term of the lease is greater than 75 percent of the useful life of the leased equipment;
- (c) the present value of the contractual payments is 90 percent or more of the cost of the equipment at the start of the lease. (*contrat de location-acquisition*)

“**equipment**” means new equipment that is used or is about to be used in the course of carrying on a small business. It includes computer hardware, tractor trailers, office and professional equipment, manufacturing equipment, printing equipment, construction equipment, material handling equipment and vehicles. It does not include software and personal cars, except where it is part of the equipment and where its value does not exceed 10 percent of the overall value of the lease. (*matériel*)

“**going concern**” same definition as in the CSBF Regulations. (*entreprise en exploitation*)

“**health care industry**” same definition as in the CSBF Regulations. (*industrie des soins médicaux*)

“**hospitality industry**” same definition as in the CSBF Regulations. (*industrie hôtelier*)

“**lease**” means a capital lease that meets the conditions set out in section X (to be determined later) of the Regulations, and is made to a lessee that meets the criteria set out in section Y (to be determined later). (*contrat de location*)

“**lease term**” means the period set out in a lease agreement for payment of the total amount of the lease. (*durée du contrat de location*)

“*lessee*” means a person who carries on or is about to carry on a small business to whom a capital lease has been made under the Act. It does not include Her Majesty or an agent of Her Majesty in right of Canada or a province, a municipality or a municipal or other public body that performs a function of government. (*locataire*)

“*lessor*” means:

- (a) a member of the Canadian Payments Association;
- (b) a leasing company approved for a securitization program by a Canadian rating agency;
- (c) a Special Purpose Entity, created by a chartered bank, as legal owner of the lease contract/equipment;
- (d) any organization designated by the Minister as a lessor for the purpose of the CSBFA capital leasing pilot regulations. (*propriétaire*)

Issues considered:

- ▶ To be designated by the Minister, the organization must have a letter of credit from a third party (e.g. a bank or a private credit agency) and an outside auditor’s certificate stating that the lessor has at least five years of experience in commercial leasing and is financially sound.

“*other categories of lease*” means a lease that is not subject to the Act. (*contrat de location ordinaire*)

“*related lessee/borrower*” means (see section 3 of the CSBF Regulations):

- (a) a person who controls or is controlled by the lessee/borrower;
- (b) a corporation that is controlled by the same person who controls the lessee/borrower;
- (c) a person who operates or intends to operate, in partnership with the lessee/borrower, the small business in respect of which the lease/loan was made;
or
- (d) a person who operates or intends to operate a small business, not in partnership with the borrower/lessee, but who has agreed with the lessee/borrower to share management services, administrative services or facilities or overhead expenses

for the operation of that small business with those for the operation of the small business in respect of which the lease/loan is made.

“**responsible officer of the lessor**” means:

- (a) the manager or assistant manager of the lessor;
- (b) the credit committee of the lessor; or
- (c) any person duly authorized by the lessor to approve the granting of leases.
(*responsable du locateur*)

“**securitization**” means the transfer of financial assets from their owner (a Seller) to a Special Purpose Entity (SPE), which in turn, funds the acquisition by issuing publicly traded securities (Notes) to various parties (Investors). (*titrisation*)

“**small business**” means a business carried on or about to be carried on in Canada for gain or profit with an estimated gross annual revenue:

- (a) not exceeding \$5 million or any prescribed lesser amount for the fiscal year of the business during which a lease is approved by a lessor in respect of the business; or
- (b) in the case of a business about to be carried on, not expected at the time a lease is approved by a lessor in respect of the business to exceed \$5 million or any prescribed lesser amount for its first fiscal year that is of not less than 52 weeks duration.

It does not include the business of farming or a business having as its principal object the furtherance of a charitable or religious purpose. (*petite entreprise*)

Issues considered:

- ▶ In implementing the pilot, the following definitions have been borrowed from other legislation:
 - “**asset**” includes tangible and intangible property of any value. (*actifs*)
(*Investment Canada Act*)
 - “**note**” means a promissory note. (*billet*) (*Bills of Exchange Act*)

- “**security interest**” means an interest in or charge on property of a corporation to secure payment of a debt or performance of any other obligation of the corporation. (*sûreté*) (*Canadian Business Corporations Act*)
- ▶ Other definitions are proposed for greater clarity:
 - “**back-up servicer**” means a corporation identified as capable of servicing a securitization portfolio should an existing servicer fail to perform its duties. A back-up servicer is identified in securitization legal agreements. (*second prestataire de service*)
 - “**credit enhancer**” means the entity that provides credit enhancement or protection to a securitization transaction. Credit enhancers include banks and insurance companies, among others. (*agent ou agence de majoration de crédit*)
 - “**investor**” means parties, both institutions and individuals, who purchase publicly traded commercial paper or medium-term notes issued by the Special Purpose Entity. (*investisseur*)
 - “**seller**” means a leasing company that sells a pool of assets, which it owns, to a third party. (*vendeur*)
 - “**servicer**” means a designated corporation, normally the seller of the securitized assets, which maintains ongoing contact with customers on a frequent basis. A servicer maintains the account records, performs credit and collection activities and remits collections to the Special Purpose Entity (SPE) in conformity with the securitization legal agreements. (*prestataire de service*)
 - “**special purpose entity**” means a bankruptcy remote (from the seller/lessor) charitable trust that is structured to hold assets on behalf of the investors. (*entité à désignation spécifique*)

VOLUNTARY SECTOR PILOT PROJECT DESIGN

Loan Amount (*Act — Section 4(3)*)

Instructions:

- Same as the CSBFA.
- The Act sets the maximum lending per borrower at \$250 000 for all loans and all related borrowers.

Issues considered:

- ▶ 1999 consultations provided mixed views on the sector's financing needs and the ideal maximum loan amount, including substantial support for the \$250 000 maximum. As there was no clear indication that this program feature should change, it is proposed that it be kept consistent with the existing program.

Financing Rate (*Regulations — Section 5*)

Instructions:

- Same as the CSBF Regulations.
- A loan may not be made in an amount exceeding 90 percent of the cost of purchasing or improving the assets.

Issues considered:

- ▶ Consideration was given to reducing the financing rate from 90 percent of the asset price, as in the current program, to a lower rate (e.g. 75 percent) to mitigate risk in the event that other parameters are adjusted to better meet the voluntary sector's circumstances (i.e. the possible removal of personal guarantees).

Loan Registration (*Regulations — Sections 2, 3*)

Instructions:

- Same as the CSBF Regulations, with minor wording adjustments.

Fees (*Regulations — Sections 4, 7, 8, 9, 10/Act — Sections 10, 11, 12*)

Instructions:

- Same as the CSBFA and Regulations.
- The registration fee in respect of a loan is 2 percent of the amount of the loan.
- The annual administration fee for a loan for a year is the amount calculated at the annual rate of 1.25 percent applied to the end-of-month balances of the loan during the year.

Issues considered:

- ▶ Some voluntary sector organizations consulted in 1999 expressed concern over the accessibility of financing through a CSBFA pilot project if payment of fees is required. To a greater extent than for small businesses, the cost of financing is an issue for this sector.
- ▶ Maintaining the existing CSBFA fee structure is being proposed primarily for three reasons:
 - without program fees, the core objective of pilot project cost recovery is unattainable
 - the government will need to absorb additional administrative burden if a pilot project's fee structure differs from the core program or other pilot projects, or is eliminated
 - small business stakeholders will be concerned that such an advantage for non-profits and charities in competition with them is unfair.

Loan Classes and Conditions (*Regulations — Sections 5, 6/Act — Section 4(1)*)

Instructions:

- Same as the CSBFA and Regulations, with minor wording adjustments.
- In general, a CSBFA loan must fall within one of the following prescribed classes:
 - (a) loans to finance the purchase or improvement of real property or immovables;
 - (b) loans to finance the purchase of leasehold improvements;
 - (c) loans to finance the purchase or improvement of equipment; or
 - (d) loans to finance the payment by the borrower of program registration fees.

Issues considered:

- ▶ 1999 research and consultations indicate that asset-based debt financing will be of limited use to voluntary sector organizations, but that operational or working capital financing will increase the utility of the program.

- ▶ 1998 consultations on the extension of the *Small Business Loans Act* (SBLA) to include working capital indicate that both small business stakeholders and program lenders would be against it. Key arguments include:
 - the program already provides indirect relief for working capital shortfalls
 - without significant adjustment to existing program parameters, working capital will have a negative impact on cost recovery
 - higher program costs resulting from working capital may have a negative spill-over effect on accessibility to traditional loans.

Designation of Lenders (*Regulations — Section 7/Act — Section 2*)

Instructions:

- Same as the CSBFA and Regulations.
- The Regulations provide the Minister with authority to designate organizations as lenders.
- The term “lender” is defined in the Act.

Due Diligence Requirements (*Regulations — Section 8*)

Instructions:

- Same as the CSBF Regulations.
- In making and administering a loan, the lender must apply the same procedures as those that would be applied 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.

Appraisal (*Regulations — Section 9*)

Instructions:

- Same as the CSBF Regulations.
- In general, an appraisal must be provided, at any time within 180 days before the loan is approved, of the value of the assets if a borrower uses, or intends to use, all or part of a loan to purchase:

- (a) assets from a person who is not at arm's length from the borrower;
- (b) all or substantially all of the assets of a going concern; or
- (c) assets from the lender or its representative that, at the time of purchase, are being or had been used to secure a conventional loan of the lender.

Repayment Terms (*Regulations — Section 10*)

Instructions:

- Same as the CSBF Regulations.
- In general, loans repayment terms must provide that:
 - (a) the loan is payable by instalments;
 - (b) at least one principal instalment is payable annually; and
 - (c) the first principal instalment is payable no later than one year after the day on which the loan is made.

Revision of Payment Terms (*Regulations — Section 11*)

Instructions:

- Same as the CSBF Regulations.
- In general, the lender and borrower may, at any time, agree to revise the repayment terms of a loan.

Interest Rate (*Regulations — Section 12*)

Instructions:

- Same as the CSBF Regulations.
- The maximum annual rate of interest payable in respect of a loan as set out in the document referred to in subsection 10(1), on the day on which the loan is made or, if the document must be registered, on the day on which it is signed, must not exceed:
 - (a) in the case of a floating rate loan, the aggregate of 3 percent and the prime lending rate that is in effect at that lender on each day of the loan term, beginning on the day on which the loan is made; or
 - (b) in the case of a fixed rate loan, the aggregate of 3 percent and
 - (i) the residential mortgage rate in effect at that lender for the loan term, or

- (ii) in the case of a loan term of more than five years where there is no residential mortgage rate for that loan term, the five-year residential mortgage rate.

Issues considered:

- ▶ As with program fees, some voluntary sector organizations consulted in 1999 expressed concern over the cost of financing through the existing program. The idea of lowering the interest rate ceiling from the existing program's prime plus 3 percent was discussed in consultation.
- ▶ Maintaining the existing CSBFA interest rate cap is being proposed primarily for three reasons:
 - if lowered, the core objective of pilot cost recovery will be far more difficult to achieve
 - the additional administrative compliance for lenders would be greater if a pilot project's maximum interest rate differs from that of the core program or other pilot projects, creating an opportunity for errors which would cause their claims to be rejected and, as a result, affecting lender willingness to participate in the pilot project.
 - small business stakeholders will be concerned that such an advantage for non-profits and charities in competition with small businesses is unfair.

Additional Amount Payable by Borrowers (*Regulations — Section 13/Act — Section 10*)

Instructions:

- Same as the CSBFA and Regulations.
- In general, a lender may require the borrower to pay to the lender, in addition to the program's registration fee:
 - (a) any charge that would be charged by the lender for taking security in respect of a conventional loan of the same amount; and
 - (b) any premium under a life or disability insurance policy that provides that a benefit is or may become payable to the lender, if the lender pays the premium under the loan agreement.

Security (*Regulations — Sections 14, 15, 16, 17, 18*)

Instructions:

- Same as the CSBF Regulations.
- The existing Regulations outline the terms for: lenders taking primary security in borrowers' assets; the substitution of assets used as the object of security; the release of primary security; additional security; and the release and substitution of additional security.

Issues considered:

- ▶ While the voluntary sector has expressed some concern over many organizations' ability to provide collateral security, a prohibition on the provision of security for loans will expose the pilot project to too much risk, and would make it unlikely that it would meet its cost recovery.

Guarantees and Suretyships (*Regulations — Sections 19, 20, 21, 22*)

Instructions:

- Same as the CSBF Regulations.
- The existing Regulations outline the terms for: personal guarantees and suretyships (set at a maximum of 25 percent of the original amount of the loan); corporate guarantees and suretyships; release of guarantors and sureties; and substitution of guarantors and sureties.

Issues considered:

- ▶ Eliminating current personal guarantees provisions would likely result in opposition or criticisms from small businesses and lenders.
- ▶ Eliminating this parameter would also impose a restriction on organizations able to extend personal guarantees, if the extension of one results in more favourable financing terms for a CSBFA-guaranteed loan.
- ▶ While we do not propose to change this provision, the taking of security is subject to the discretion of lenders who have the option of taking other forms of guarantee or security if a personal guarantee is unavailable.
- ▶ The voluntary sector has made it clear that personal guarantees are a significant barrier to accessing financing. Leaving open the opportunity for lenders to require a personal guarantee against CSBFA loans may leave an insurmountable barrier in place for voluntary sector borrowers. As this is one of the few CSBFA features seen by the voluntary sector as a significant barrier to access, the sector may view leaving personal guarantees in a pilot project as a lack of willingness of the government's part to be sensitive to their particular concerns.

Non-compliance (*Regulations — Sections 23, 24, 25, 26, 27, 28/Act — Sections 15, 16*)

Instructions:

- Same as the CSBFA and Regulations.
- Notwithstanding that a lender has been non-compliant with Regulations related to fee payment, some loan class provisions, or guarantees and suretyships, the Minister must pay a lender's losses if:
 - (a) the non-compliance is inadvertent; and
 - (b) the annual administration fee is paid within 90 days after the day on which notice of the non-compliance is received at the head office of the lender.

Transfer of Loans between Lenders (*Regulations — Sections 29, 30*)

Instructions:

- Same as the CSBF Regulations.
- Sets conditions that must be met if a lender assigns a loan to another lender at the request of the borrower.

Amalgamation of Lenders (*Regulations — Section 31*)

Instructions:

- Same as the CSBF Regulations.

Discontinuance of Lending Business (*Regulations — Section 32*)

Instructions:

- Same as the CSBF Regulations.

Transfer of Loans between Lenders (*Regulations — Section 33*)

Instructions:

- Same as the CSBF Regulations, with minor wording adjustments.

Reporting Requirements (*Regulations — Sections 34, 35*)

Instructions:

- Same as the CSBF Regulations.

Default (*Regulations — Section 36*)

Instructions:

- Same as the CSBF Regulations.

Procedures in Default (*Regulations — Section 37*)

Instructions:

- Same as the CSBF Regulations, with adjustments of wording.

Loss (*Regulations — Section 38*)

Instructions:

- Same as the CSBF Regulations.

Claims for Loss Procedures (*Regulations — Section 38/Act — Section 8*)

Instructions:

- Same as the CSBFA and Regulations.

Loan Loss Sharing Ratio (*Nothing in Regulations/Act — Section 8*)

Instructions:

- Same as the CSBFA.

Cap on Claims (*Act — Section 6*)

Instructions:

- Same as the CSBFA.
- The 90/50/10 rule sets a limit on the government's exposure on the portfolio of loans of an individual lender over a five-year lending period, while ensuring that low-volume lenders can use the program. As lenders make loans during a lending period, their individual claims account accumulates as follows:
 - (a) 90 percent of the first \$50 000 in lending;
 - (b) 50 percent of the second \$50 000 in lending; and
 - (c) 10 percent of the excess of \$100,000.

Issues considered:

- ▶ Consideration was given to maintaining the CSBFA's \$250 000 thresholds; however, with no change to the thresholds, claims as a percentage of overall lending would be higher than under the existing program, making cost recovery a less attainable objective.
- ▶ The preliminary estimate of activity under this pilot is \$500 million, or an average of \$100 million a year. Using CSBFA methods and the characteristics of this sector, this volume of lending would produce a contingent liability to the government of \$88 million. It should be stressed, however, that this contingent liability figure does not include a provision for the fees that are expected to be collected. The program is designed to be cost-recovered over the life of the loans guaranteed.

Interim Claims (*Regulations — Section 39/Nothing in the Act*)

Instructions:

- Same as the CSBF Regulations.

Subrogation (*Regulations — Section 40*)

Instructions:

- Same as the CSBF Regulations

Coming into Force (*Regulations — Section 41*)

Instructions:

- These Regulations come into force on April 1, 2001.

Ceiling for the Five Years of the Pilot

Instructions:

- The lending ceiling for the pilot project will be set at \$500 million.

	Voluntary Sector				
	Year 1	Year 2	Year 3	Year 4	Year 5
Rate of take-up	40%	80%	80%	100%	100%
Average loan size under the CSBFA	\$77 000				
Estimated sector borrowing	unavailable				
Total eligible organizations	150 000 (est.)				
CSBFA as % of overall small business lending	18%				
Total estimated five-year lending volume	\$500 million				
Estimated five-year lending volume per year	Year 1	Year 2	Year 3	Year 4	Year 5
	\$50 M	\$100 M	\$100 M	\$125 M	\$125 M

CAPITAL LEASING PILOT PROJECT DESIGN

Lease Registration (*Regulations — Sections 2, 3/Nothing in the Act*)

Instructions:

- Same procedures as the CSBF Regulations, with some adjustments of wording:
 - (a) the lease must be registered within three months;
 - (b) the registration period may be extended for three months in the case of inadvertent non-compliance;
 - (c) the lease registration form must be signed by the lessee and lessor and must contain the same information as a loan registration form;
 - (d) the definition of related borrower/lessee and provisions must also be included.

Issues considered:

- ▶ Current procedures are supported by the Canadian Finance and Leasing Association (CFLA) and by the Conference Board Report on Focus Group, 1998. The industry indicated some concerns regarding administrative burden with respect to registration and reporting, and suggested electronic registration to reduce administrative burden and costs. However, electronic registration is not currently available under the core program but will be analysed in the future. At the moment, electronic forms are available, but hard copy must be submitted with the registration fees at the time of registration. A recent draft report from the Conference Board on the profile of the leasing industry suggests that registration and reporting requirements for high-volume lessors may need to be different from those for low-volume lessors to ensure maximum participation from all leasing companies.

Fees (*Regulations — Sections 5, 6, 7, 8, 9, 10/Act — Sections 10, 11, 12*)

Instructions:

- Same as the CSBFA and Regulations, with some adjustments of wording:
 - (a) registration fee is 2 percent of the amount of the lease payable upon registration;
 - (b) annual administration fee for a lease for a year is the amount calculated at the annual rate of 1.25 percent applied to; and
 - (c) annual administration fee is payable quarterly within two months after the end of each quarter of the year.

Issues considered:

- ▶ The current fee level is supported by the CFLA and by previous and recent studies from Kalymon, Allan Riding, Conference Board and PricewaterhouseCoopers (see Annex).
- ▶ A draft research report by PricewaterhouseCoopers suggests that the 2 percent registration fee should be paid up-front by the lessee and that the 1.25 percent annual administration fee should be included in the calculation of the interest rate charged on the lease.

Lease Conditions (*Act — Sections 4(1) and 4(2)*)

Instructions:

- Same conditions as in the Act, with some adjustments of wording. The following conditions must be satisfied in respect of a lease, in addition to any further conditions that may be prescribed (see section 4). A lessee is eligible for a lease on application to a lessor if, at the time of the lease is made:
 - (a) the lessee meets the prescribed eligibility criteria; and
 - (b) the outstanding lease/loan amount in relation to the lessee/borrower does not exceed \$250 000.

Lease Amount (*Act — Section 4(3)*)

Instructions:

- The outstanding amount of the lease being made to the lessee, including the 2 percent government fee, may not exceed \$250 000 under the CSBFA capital leasing pilot project.
- The outstanding balance of principal owed by the lessee on CSBFA leases and/or loans obtained under the SBLA/CSBFA programs, including the up-front 2 percent government fee, may not exceed \$250 000. The outstanding lease amount referred to is the aggregate of the amount.

Issues considered:

- ▶ The proposal is supported by the CFLA, Kalymon, Allan Riding and Conference Board studies (see Annex).
- ▶ The rationale for keeping the maximum lease amount to \$250 000 and to impose a maximum total CSBFA leases and loans amount to \$250 000 is as follows:
 - It will address the identified gap, which is for leases under \$100 000.
 - Based on research findings, the average lease amount is similar to the average amount observed in CSBFA loans, which is \$70 000 (Allan Riding, see Annex).
 - It will not exclude any specific type of small business or type of equipment (e.g. tractor trailers).
 - It will provide small and medium-sized enterprises (SMEs) with a better choice of financing instruments (i.e. ability to lease and to lend or to lease more than one piece of equipment) without being exposed to a higher total liability.
 - It will likely exclude a very small proportion of SMEs, as only 3.5 percent of CSBFA loans in 1999 were of \$250 000, and 15 percent of CSBFA loans were in the range of \$125 000–\$250 000.
- ▶ A final report from PricewaterhouseCoopers on the Profile of Accounting and Pricing Practices in the Leasing Industry will propose a definition and calculation of the lease amount (principal owing).

Purpose of Leases (*Regulations — Sections 5, 6/Nothing in the Act*)

Instructions:

- A lease must be used to acquire use of new equipment necessary for the operation of the lessee's small business.
- A lease may be used to finance the payment by the lessee of registration fees payable in respect of the lease.
- A lease may not be made for any classes of used equipment, premises lease or land lease.

Issues considered:

- ▶ The proposal to restrict the pilot project to new equipment is supported by the CFLA.
- ▶ A draft report from the Conference Board on the profile of the leasing industry suggests that new equipment leases represent, on average, 77 percent of capital leases. It also indicates that most leasing companies interviewed provide both used and new equipment capital leases. The rationale for the proposal to restricting the program to new equipment is that it will ensure a better value of the equipment and therefore will reduce the potential loss ratio.

Classes of Equipment Leases (*Regulations — Section 1/Nothing in the Act*)

Instructions:

- The equipment leased must fall within one of the following prescribed classes of equipment:
 - (a) computer hardware (restricting software to 10 percent of value of lease)
 - (b) tractor trailers
 - (c) office and professional equipment
 - (d) manufacturing
 - (e) construction equipment
 - (f) material handling equipment
 - (g) printing equipment
 - (h) vehicles (restrictions for personal cars).

Financing Rate (*Regulations — Section 5(5)/Nothing in the Act*)

Instructions:

- A lease may not be made and registered in an amount exceeding 100 percent of the cost of the equipment. Certain costs may not be included in the cost of the lease.

Issues considered:

- ▶ The proposal for 100 percent financing rate is supported by the CFLA.
- ▶ The rationale for increasing the financing rate to 100 percent is as follows:
 - This is current practice in the industry, as no up-front payment is usually required.
 - There would be better incentive for take-up from the lessees (a 90 percent financing rate would probably result in very low take-up, as they would prefer taking a loan or would not be able to provide the 10 percent).
 - The need to require the 10 percent from the lessee is less appropriate, given that the ownership of the equipment stays with the lessor and given that increasing the responsibility of the lessor may be more efficient to ensure better leasing decision.
 - Allan Riding’s study on the sensitivity of altering the guarantee rate for the CSBFA and like programs (see Annex) suggests that cost recovery would be maximized if the guarantee rate were to be reduced to 80 percent (instead of 85 percent). It would place more onus upon the lender to be prudent in approving loans, and would eliminate some riskier lending. The financing rate could also be increased. This would have a more direct impact on borrowers and would push some of them toward alternate means of financing.
- ▶ The final report from PricewaterhouseCoopers will provide information on the calculation of the lease amount and on what costs should be included in the 100 percent.

Designation of Lessors (*Regulations — Section 7/Act — Section 2*)

Instructions:

- The Minister is authorized to designate organizations as lessors.

Issues considered:

- ▶ See the proposed definition of “lessor” in the interpretation section.
- ▶ It is proposed to include securitization in the capital leasing pilot project, subject to the satisfactory resolution of technical and legal issues.
- ▶ Legal advisors will provide Industry Canada with advice on how to include or assign SPE so that the pilot project allows for securitization arrangements by the lessors.

Due Diligence Requirements (*Regulations — Section 8/Nothing in the Act*)

Instructions:

- Same as the CSBF Regulations:
 - (a) obtain satisfactory credit references;
 - (b) assess customer's ability to repay; and
 - (c) apply similar procedures to those applied to non-CSBF leases.
- There is in addition an expectation for the lessor to apply similar payment terms to those normally applied by the industry for each class of equipment.

Issues considered:

- ▶ No consultation has yet been done on this issue.
- ▶ Draft research findings from the Conference Board indicate that leasing companies are applying a certain level of due diligence, similar to that of the lending institutions, as close to 25 percent of lease applications are denied.
- ▶ A draft report from PricewaterhouseCoopers suggests that due diligence practices of the leasing industry are of a much lower standard than those used by the lending industry.
- ▶ The rationale for the proposed due diligence requirements is as follows:
 - It is not the government's role to regulate the due diligence practices of the industry (the government does not do it for the core program).
 - It will ensure a certain due diligence standard in exchange for the government guarantee.
 - It will permit keeping unchanged the payment terms of a maximum of 10 years and will likely deal with all classes of equipment.
 - It will deal with potential difficulties for the lessors to class equipment in a specific category to determine the payment terms.
 - It will not require any changes in the Regulations if the industry practices were to change. It is also proposed to include current CSBFA audit provisions in the pilot project. This will require leasing companies to provide the project administrators with their due diligence practices (as was previously done with the lenders).

Audit provisions (*Nothing in Regulations/Act — Section 15*)

Instructions:

- Same as the CSBF Regulations.

Appraisal (*Regulations — Section 9/Nothing in the Act*)

Instructions:

- Same as the CSBF Regulations, with adjustments of wording.

Issues considered:

- ▶ This is to determine the residual value of the equipment in the case of a claim for loss procedure. The greater of the residual value and the sale price will be used for calculating the loss.

Payment Terms (*Regulations — Section 10/Nothing in the Act*)

Instructions:

- Same as the CSBF Regulations; that is, a maximum of 10 years.
- Details of how the terms are calculated are to be determined.

Issues considered:

- ▶ The proposal is supported by the CFLA (which also supports the idea of adjusting the term according to the class of equipment) and previous studies.
- ▶ Research findings suggest that the average lease term observed is similar to that observed under the core program (five to six years). Aon Structured Finance Services (see Annex) also indicates that the average maximum leasing terms observed in securitization programs is between 60 and 72 months.
- ▶ See due diligence requirements, whereby Industry Canada would expect the lessor to apply similar terms used by the industry for each class of equipment. It is not the government's role to regulate the due diligence practices of the industry (the government does not do it for the core program).

Revision of Payment Terms (*Regulations — Section 11/Nothing in the Act*)

Instructions:

- Same as the CSBF Regulations; that is, the lessor and the lessee may, at any time, agree to revise the payment terms of a lease, as long as it does not exceed the maximum of 10 years.

Interest Rate (*Regulations — Section 12/Act — Section 10*)

Instructions:

- The maximum annual rate of interest payable in respect of a lease, on the day on which the lease is made, must not exceed the aggregate of 8 percent and the yield on Government of Canada Bonds on the day on which the lease is made.

Issues considered:

- ▶ The industry and most research findings indicate that the prime rate plus 3 percent will not be appropriate, given the cost of funding in the leasing industry. All suggest using between 6 and 7 percent above the Government of Canada long bond rate to which the 1.25% annual administration fee would be added (This would result in an interest rate of 7.25 to 8.25 percent added to the Government of Canada long bond rate).
- ▶ Key elements to take into account are the incrementality and access to financing for SMEs and the probability of take-up from lessors, which may be very small if the interest rate is too low.
- ▶ Of concern is whether an elevated interest rate will result in abuses from leasing companies or will impact on current lenders' decisions regarding loans.

Additional Amount Payable by Lessees (*Regulations — Section 13/Act — Section 10*)

Instructions:

- Section 13 of the CSBF Regulations must be adjusted for leases.

Issues considered:

- ▶ Not yet discussed with the industry.
- ▶ The final report from PricewaterhouseCoopers will provide information on charges that are usually included in a lease.

Security (*Regulations — Sections 14, 15, 16, 17, 18/Nothing in the Act*)

Instructions:

- Make registration security in the asset a requirement, but make other security requirements including guarantees optional.

Issues considered:

- ▶ The current provision is supported by the CFLA, which also suggests that the lessors should register lease contracts as security under the federal *Personal Property Security Act* (or Sections 1842 to 1850 of the Quebec Civil Code).
- ▶ A study by PricewaterhouseCoopers indicates that the industry does not generally take security, as the equipment is usually the only collateral.

Guarantees (Regulations — Sections 19, 20, 21, 22/Nothing in the Act)

Instructions:

- Same as the CSBF Regulations.

Issues considered:

- ▶ The current CSBFA provisions are supported by the CFLA and all previous studies.
- ▶ Eliminating current personal guarantees provisions will likely result in higher claims and opposition from small businesses and lenders.

Non-compliance (Regulations — Sections 23, 24, 25, 26, 27, 28/Act — Sections 15, 16)

Instructions:

- Same as the CSBF Regulations.

Amalgamation of Lessors (Regulations — Section 31/Nothing in the Act)

Instructions:

- Same as the CSBF Regulations, with some adjustments of wording.

Discontinuance of Leasing Business (Regulations — Section 32/Nothing in the Act)

Instructions:

- Same as the CSBF Regulations.

Transfer of Leases between Lessors (Regulations — Section 29/Nothing in the Act)

Instructions:

- Same as the CSBF Regulations, with some adjustments of wording.

Transfer of Leases between Lessees (*Regulations — Section 33/Nothing in the Act*)

Instructions:

- Same as the CSBF Regulations, with some adjustments of wording.

Reporting Requirements (*Regulations — Sections 34, 35/Nothing in the Act*)

Instructions:

- Same as the CSBF Regulations.

Issues considered:

- ▶ The industry has raised some concerns regarding the administrative burden and costs involved with the reporting requirement. It suggests electronic reporting.
- ▶ However, electronic reporting is not available under the current program. This possibility will be analysed in the future.

Default (*Regulations — Section 36/Nothing in the Act*)

Instructions:

- Same as the CSBF Regulations, with adjustments of wording.
- Only financial defaults will be considered. The events of financial default are to be defined in the lease.

Issues considered:

- ▶ A study by PricewaterhouseCoopers indicates that only financial default should be in defining default for the pilot project. Financial default is defined as occurring when a payment is 24 hours late.
- ▶ This definition of default is similar to that of default for a loan.

Procedures upon Default (*Regulations — Section 37/Nothing in the Act*)

Instructions:

- Same as the CSBF Regulations, with adjustments of wording.

Issues considered:

- ▶ The current procedures are supported by the CFLA.
- ▶ A study by PricewaterhouseCoopers indicates that even if the lessors act only on the defaulted lease after 90 days from the date the payment is due, lessors usually go through the same procedures to recoup as lenders (e.g. call after 30 days, negotiations after 60 days and legal action after 90 days).

Loss (*Regulations — Section 38/Nothing in the Act*)

Instructions:

- The amount of loss is calculated from the sum of net present value of future payments minus the highest value of: the residual value of the equipment or the price obtained from the sale of the equipment.
- The residual value is calculated at the lessors' cost of borrowing money and is indicated in the lease agreement.

Issues considered:

- ▶ The government's loss sharing payments would be net of any management fees , insurance premiums or other fees, but would include interest.

Claims for Loss Procedures (*Regulations — Section 38/Act — Section 8*)

Instructions:

- Same as the CSBF Regulations.

Issues considered:

- ▶ The CFLA has indicated that the same procedures should apply.

Lease Loss Sharing Ratio (*Nothing in Regulations/Act — Section 8*)

Instructions:

- 80 (or lower)/20 (or higher).

Issues considered:

- ▶ No consultation yet with the industry on this issue.
- ▶ Allan Riding's study on the sensitivity of altering the guarantee rate for the CSBFA and like programs (see Annex) suggests that cost recovery would be maximized if the guarantee rate were to be reduced to 80 percent (instead of 85 percent). It would place more onus upon the lender to be prudent in approving loans, and would eliminate some riskier lending. The financing rate could also be increased, which would have a more direct impact on borrowers and push some of them toward alternate means of financing. A draft report by PricewaterhouseCoopers suggests a 50 percent guarantee rate, given the light due diligence practices done by leasing companies.
- ▶ This is being proposed because research findings indicate that the estimated loss ratio for leases is likely to be lower than that for loans.
- ▶ Industry Canada is proposing to maintain current due diligence requirements and audit provisions.

Cap on Claims (*Nothing in the Regulations/Act — Section 6*)

Instructions:

- Same as the CSBFA:
 - (a) 90 percent of the first \$50 000;
 - (b) 50 percent of the next \$50 000; and
 - (c) 10 percent of the excess of \$100 000.

Issues considered:

- ▶ Not yet discussed with the industry.
- ▶ Previous research shows that the leasing industry is highly concentrated and that default and loss ratios are similar to that of the lending industry.
- ▶ The draft report from the Conference Board indicates that the spread of lessors in the industry is similar to that of the lending institutions.

- ▶ The preliminary estimate of activity under this pilot project is \$2.5 billion, or an average of \$500 million a year. Using CSBFA methods and the characteristics of this sector, this volume of lending would produce a contingent liability to the government of \$314 million. It should be stressed, however, that this contingent liability figure does not include a provision for the fees that are expected to be collected. The program is designed to be cost-recovered over the life of the loans guaranteed.

Interim Claims (*Regulations — Section 39/Nothing in the Act*)

Instructions:

- Same as the CSBF Regulations.

Ceiling for the Five Years of the Pilot Project (*Nothing in Regulations/Act — Sections 6, 13(2)*)

Instructions:

- Estimated at \$2.5 billion for the five years of the pilot project.

Issues considered:

- ▶ Our estimate of the leasing ceiling is based on:
 - assumptions that 60 percent of the industry customers are SMEs, that 50 percent of all industry leases are capital leases and that 75 percent of capital leases are new equipment leases (based on the CFLA and Conference Board draft report)
 - estimated annual volume of capital leases (new equipment) by SMEs
 - assumptions that CSBFA leases will represent 18 percent of total SME leases (as do the core program)
 - estimated annual take-up for the five years (15%/40%/75%/100%/100%).
- ▶ Factors affecting take-up include the knowledge gap related to new delivery channels (leasing companies), strong interest from leasing industry to participate, and the level of awareness of SMEs.
- ▶ Based on previous studies, the average principal amount being lease financed is similar to the average CSBFA loans size of \$70 000.
- ▶ A Conference Board study suggests that new lease contracts related to SMEs in 1994 were in the range of \$3–\$5 billion (which is similar to the \$4 billion estimated from the CFLA).

Assumptions and Estimates CSBFA leases to Small Business					
Average lease size	similar to the CSBFA with \$70 000 (less than \$100 000)				
Total eligible SMEs	same as in the core program				
New leases (equipment)	\$13.4 billion in 1998				
New capital leases to SMEs	\$4 billion ($\$13.4 \text{ billion} \times 60\% = \$8 \text{ billion} \times 50\% = \4 billion)				
CSBFA as % of overall borrowing	using 18%. as with the core program				
Estimated annual volume of CSBFA leases	\$0.72 billion/year ($\$4 \text{ billion} \times 18\%$)				
	Year 1	Year 2	Year 3	Year 4	Year 5
Estimated take-up per year	15%	40%	75%	100%	100%
Estimated \$ per year	\$108 M	\$288 M	\$540 M	\$720 M	\$720
Estimated leasing ceiling for the five years of the pilot project	\$2.5 billion				

Subrogation

Instructions:

- Same as the CSBF Regulations, with adjustments of wording.

Coming into Force

Instructions:

- April 1, 2001.

Annex. Consultations and Research Results: Summary

VOLUNTARY SECTOR PILOT PROJECT

Financing Needs of the Voluntary Sector

Niagara Enterprise Agency, 1999

Industry Canada asked the Niagara Enterprise Agency (NEA) to prepare a statistical overview of the voluntary sector and to assess the financing needs of its subgroups, particularly their potential use of a CSBFA-type loan program.

The NEA defined the sector as including all organizations “which are legally prohibited from distributing profits or financial surpluses to those who own or control” them. The study presented the following financial profile of the sector:

- The voluntary sector’s annual revenues are almost \$75 billion, an amount comparable with the GDP of Alberta.
- This is a growth sector. There are about 78 000 registered charities in Canada, roughly 20 000 more than during the 1980s.
- The debt-to-asset ratio varies considerably within voluntary sector organization subgroups. Charitable organizations’ debt-to-asset ratio is relatively low at \$0.30:\$1.00. Other non-profit groups have a significantly higher ratio of \$0.69:\$1.00. (This is roughly equivalent to the median debt ratio of retail-based SMEs, which stands at \$0.73:\$1.00.)

The NEA was sceptical about the extent of the need for asset-based debt financing among voluntary sector organizations. It concluded that, in general, most charities — hospitals and teaching institutions, places of worship, foundations and others — and non-profit organizations require operational rather than asset-based funding. Where voluntary sector organizations do require asset-based financing, the NEA asserted, their needs probably exceed the CSBFA loan limit, and they have other, adequate sources of funding.

Calgary Focus Groups

Canada West Foundation, 1999

In November 1999, the Canada West Foundation organized two focus groups for Industry Canada to gauge voluntary sector groups' reaction to and need for asset-based debt financing under the umbrella of the CSBFA.

The general consensus of participants was that a loan program was a potentially valuable tool for voluntary sector organizations. Voluntary groups do interact with financial institutions, and some use such financial services as mortgages and lines of credit.

There was, however, some concern raised, as many voluntary sector organizations are not accustomed to dealing with debt financing.

Voluntary Sector Round Table Report

Judith Szabo Broadcast Consultants, 1999

In November and December 1999, Industry Canada conducted consultations with 79 voluntary sector organizations in six Canadian cities. The resulting report emphasized the strong and consistent messages delivered about the extension of the CSBFA to the voluntary sector.

Participants welcomed the government's initiative as an attempt to address the financing concerns of the voluntary sector. However, a significant number maintained that the CSBFA cannot be delivered in its current form to the voluntary sector, for the following reasons:

- Most respondents felt that the voluntary sector has a greater need for working capital and funding for marketing than it has for asset-based financing.
- Many respondents appeared to be unfamiliar with financial concepts and indicated that "economic illiteracy" would make voluntary sector organizations nervous about engaging in debt financing.
- At present, the operating rules of many voluntary sector organizations are not designed to manage debt repayment.
- As currently structured, the program would benefit only large voluntary sector organizations, which already face no difficulty in obtaining asset-based funding. Small voluntary sector organizations with under \$5 million in revenues would not qualify for loan approval because of inadequate or uncertain financial security.

- Most respondents expressed ethical and moral concerns about fund raising to repay CSBFA-type debts.
- Personal guarantees would not be acceptable to voluntary sector organization board members.
- Program fees were felt to be prohibitively high.
- Participants were adamant that, while a CSBFA-type tool could be a useful alternative source of funding, the government should not replace grant funding with loans nor attempt to force voluntary sector organizations to behave more like small businesses.
- Concern was expressed that the program's existing definition of revenue might force some voluntary sector organizations to become profit-making enterprises in order to qualify for a loan, putting them in conflict with Revenue Canada Regulations.

CAPITAL LEASING PILOT PROJECT

Preliminary Study on the Implications of an Extension of the Small Business Loans Act to Capital Leasing

Kalymon Consulting, 1995

This study was prepared by Basil Kalymon of Kalymon Consulting Ltd. and was submitted to Industry Canada in October 1995. Its purpose was to assess available data and to conduct interviews with members of the Canadian Finance and Leasing Association (CFLA) in order to determine the viability of extending the *Small Business Loans Act* to the capital leasing market.

The study's key conclusions are that, since SMEs rely heavily on leasing to finance business improvements, and since the purpose of the SBLA is to increase SME access to financing, the extension of the SBLA to capital leasing is consistent with its purpose and could be done fairly simply. Kalymon also concludes that capital lease contracts do not in principle entail a higher risk exposure than loan agreements.

Kalymon recommends extending the SBLA to capital leasing. He also recommends further study to determine precisely how revisions, including a fee structure to allow for full cost recovery in this portion of the program, should be made.

Operational Issues Related to the Provision of a Small Business Loan Act-Type Guarantee for Leasing

Conference Board of Canada, 1996

Further to Kalymon's work, Michael Andrews and Mahmood Iqbal of the Conference Board of Canada prepared a study for Industry Canada in December 1996. Its purpose was to identify the issues involved in extending the SBLA to leasing. Seventeen executives from large, established leasing firms were interviewed for the study.

The study suggests that the operational issues involved in extending the SBLA to capital leasing are more straightforward than those involved in operating leasing, but that both forms could be incorporated into an expanded SBLA.

Among other key issues noted are the following:

- Industry executives are concerned about the costs of establishing registration and reporting requirements, given the expected volume of leasing.
- Leases are commonly transferred from one company to another. Further, lessors frequently fund their portfolios through asset-backed securities. The compatibility of government guarantees with these practices would have to be examined.

Extension of the SBLA to Capital Leases: Analysis of Lessee Attributes and Defaults
Allan Riding, Equinox Management Consultants, 1996

The Equinox study examines which firms use capital leases and what kind of default rates those leases tend to generate. It finds that most of the firms leasing equipment such as computers, office/professional/printing equipment, vehicles and tractor trailers are small firms with revenues under \$5 million, and that the capital invested in these leases is typically under \$250 000.

The types of equipment most frequently leased are the following:

- office and professional equipment (photocopiers, fax machines, office furniture, etc.)
- tractor trailers
- computers and computer-related equipment.

Lease financing amounts are generally found to be consistent with the terms of the SBLA, as are average terms to maturity of the leases. On the other hand, the average lease yield is 5.6 points above prime, considerably higher than the rates banks charge SME clients for loans.

The default rates for contracts vary from 1.09 percent for tractor trailers to 2.72 percent for computer equipment. Loss rates for leases are found to be lower — from 0.07 percent for tractor trailers to 0.96 percent for computers.

The study also finds that, even though default rates are low, defaults involving computers and tractor trailers tend to occur early in the contracts.

Report on the Focus Group Session to Develop Industry-supported Requirements and Modalities Related to the Provision of an SBLA-Type Guarantee for Capital Leasing
Conference Board of Canada, 1998

In this study, presented to Industry Canada in March 1998, the Conference Board prepared and reports on a focus group session designed to achieve consensus on elements of an extension of the SBLA to capital leasing. The focus group found support for such a program, which the report provisionally calls the Small Business Capital Leasing Program (SBCL).

The following key suggestions emerged from the focus group:

- To be eligible for the program, lessors would have to meet financing criteria and have a three-year track record in the business. Industry Canada would have the power to approve lessors on the basis of these criteria.
- An electronic-based registration, payment and balance tracking schedule would allow for the speed and low cost required to meet government reporting requirements economically.
- The maximum guarantee amount for all CSBFA loans and SBCL leases with an eligible SME would remain at \$250 000, including the 2 percent registration fee. Repayment should begin within 12 months, but flexible and irregular payment patterns should be allowed.
- Market rates rather than a fixed rate ceiling should be applicable to guaranteed capital leases. A maximum lease financing rate formula was suggested, based on a fixed spread over an equivalent-term Government of Canada bond rate, which would have to exceed the 3 percent currently used by the CSBFA
- Research suggests that lease loss rates are somewhat lower than conventional loan loss rates.

Capital Leasing Pilot Project: Impact of Securitization on the Canada Small Business Financing Act

Aon Structured Finance Services, April 2000

The purpose of the research conducted by Aon Structured Finance Services (ASF) is to provide a better understanding of the securitization practices in the Canadian leasing industry. The report provides information on the Canadian securitization market and discusses its use by the leasing industry. In particular, the report addresses the following issues: definition of securitization; benefits and drawbacks of securitization; its historical growth in Canada and the United States; securitization structures used in the leasing industry; accounting and legal issues; and a profile of a typical user of securitization.

In addition, ASF reviews the current CSBFA and provides its views on the potential impact of securitization on current CSBFA legislation, including the effect on its definition of lender (or lessor in the case of the capital leasing pilot project). Finally, ASF also makes recommendations on how the current CSBFA program might be adjusted to account for the use of securitization as a financing tool.

Definition of securitization: Method of financing that transfers financial assets from their owner (a Seller), or a lessor (Lessor) in the case of a leasing transaction, to a Special Purpose Entity (SPE) that, in turn, funds the acquisition by issuing publicly rated securities (Notes) to various parties (Investors).

Benefits and drawbacks of securitization: Benefits are that securitization provides the lessor with an alternate source of funding; it offers leverage as it allows a lessor to release equity for other purposes; it involves lower costs than direct borrowing; and it is a transparent process to the customers. The drawbacks are that it must involve an asset class that is acceptable to rating agencies. It is also intrusive to the lessor, is expensive to establish, and requires ongoing reporting.

History and growth of securitization: According to the Dominion Bond Rating Service January 2000 reports, the asset-backed securities market rose from \$10 billion at the end of 1995 to \$66 billion at the end of 1999. This rapid growth is expected to continue over the near term, as Canadian investors are feeling increasingly comfortable with this market. The United States is the leader in all areas of securitization and is continuously developing new asset classes for securitization. The use of securitization in the U.S. rose from less than US\$50 billion in 1985 to US\$850 billion in 1999.

Profile of a typical leasing company users of securitization: Lessors must qualify through a stringent due diligence process by key parties to the securitization transaction (e.g. investment bankers, rating agencies and any providers of third-party credit enhancement). This means they are usually bigger leasing companies, as securitized pool

must be at least \$25 million, with high-quality assets and a good track record (historical financial information for the previous five to seven years is reviewed). Newer leasing companies with limited financial history or companies with inadequate information systems often find that they cannot satisfy the rating agency's criteria and accordingly will not be in a position to use securitization.

Risks for the government are relatively low, given that lessors who qualify for securitization are bigger, are sound financially and are experienced in commercial leasing. Therefore, the use of securitization does not involve riskier lessors or riskier types of equipment, as the proportion of riskier equipment such as computer or used equipment is restricted in securitized pools.

Profile of Accounting and Pricing Practices in the Leasing Industry (Draft)

PricewaterhouseCoopers, 2000

The purpose of this draft report is to provide an understanding and analysis of current leasing industry standards with respect to accounting and pricing practices and to make recommendations for the capital leasing pilot project. The overall objectives of this study are to define default, loss and the optimal maximum interest rate that could be used under the capital leasing pilot project.

Preliminary research findings include:

Practical concept of default is well defined the industry. While organizations may differ in the elapsed time required to define a default (from 24 hours to 30 days), each of the organizations interviewed indicated that after non-payment for 90 days, they actively begin to try and recoup their loss.

The theoretical concept of loss is consistently defined in the industry as the net present value of the remaining payments, less the resale value of the equipment.

The optimal maximum interest rate is a complicated subject. None of the lessors has just one interest rate, or even a straightforward calculation algorithm for calculating the interest rate. In all cases, various factors, including the term, administrative costs and creditworthiness of the client, jointly determine a premium in excess of the 10-year long bond rate. The maximum premium, which is charged to the high-risk SMEs (the target group for this project), appears to be approximately 10 percent.

The leasing business model is very different from the loan business model. Because the leases are typically smaller and higher risk, and because the ability of the lessor to reclaim

the asset lowers the potential loss value, lessors typically minimize administrative costs by conducting less due diligence and charging a higher interest rate to cover losses.

The final report is expected by June 2000.

Profile of the Leasing Sector and Potential Criteria for a Definition of Lessor under the CSBFA Capital Leasing Pilot Project (Draft)

Conference Board of Canada, 2000

The purpose of this research from the Conference Board of Canada is to provide an overview of the leasing industry as a whole using available data from Statistics Canada and Dunn and Bradstreet, supplemented by 20 interviews of small leasing companies that are not members of the Canadian Finance and Leasing Association (CFLA). As a result of this review, the Conference Board is able to profile both the CFLA membership and the industry as a whole in terms of the leasing market, the profile of employment, the age of lessors, the income statements and balance sheets. It also provides an overview of the lease size and length of leases, the due diligence procedures used by leasing companies, the interest rates normally charged and the type of equipment usually leased.

Preliminary findings include:

The market for lease contracts: The value of lease receivables held by Canadian financial institutions totalled almost \$15 billion in 1998, an increase of more than 50 percent since 1994. The largest share of the business lease market in 1998 was held by specialized finance companies (74.5 percent), followed by domestic chartered banks (18.6 percent).

SME leasing market: Financing provided to SMEs in the form of lease contracts are estimated at \$7.2 billion in 1998. The largest share of the SME lease market in Canada in 1998 is attributed to specialized finance companies, with 84.8 percent of total lease contracts outstanding with SMEs. Domestic banks account for 12.2 percent.

Overview of the CFLA membership and the industry as a whole: The CFLA membership is significantly different from the industry as a whole. The CFLA has 175 members including most of the larger lessors (but not all CFLA members write leases). Indications are that there are many more companies who are not members of the CFLA and who are not included in this figure, particularly among the small and medium-sized lessors. This is confirmed by the industry statistics, which suggest that there are more than 568 leasing companies in Canada.

Which leasing market?: The largest sectors in the leasing industry are the equipment leasing (manufacturing and construction) and vehicle (automotive and truck) leasing. All equipment leasing companies report leasing both new and used equipment. The average was 77 percent for new and 23 percent used equipment.

Profile of employment: Most leasing companies have fewer than 25 employees and almost all firms report fewer than 200 employees. The industry is very fragmented, with many small firms. This suggests that a different approach may be required to address the needs of such small lessors relative to the much larger sophisticated lessors.

Age profile of lessors: The industry is primarily made up of firms that have been in business for a long time. As many as 300 lessors report being in business for more than 20 years, and 95 percent of the industry report being in business more than five years. This suggests that almost all leasing firms will meet the eligibility criteria for the leasing pilot project if it is similar to that for the CSBFA.

Profile of incomes: The industry is very much dominated by a large number of very small firms. However, the leasing industry appears to be a classic case where the top 10 percent of leasing firms write 90 percent of the sales. According to Statistics Canada data, the average leasing firm has about \$21 million in sales. Firms with less than \$10 million in assets (most of the industry) average just under \$2 million in annual operating revenues.

Profile of balance sheets: Small firms are funded differently and on a much longer term basis than large firms. Funding comes primarily from borrowings.

Lease size and length of lease: The average lease size for leasing companies that offer a wide array of products is in the range of \$10 000–\$25 000 and the average length of lease is three to four years throughout the industry. However, there is considerable variability depending on the type of lease being offered. The average large lease varies between \$100 000 and \$250 000 and is more often associated with specialized construction or manufacturing equipment. Small leases are usually for office and small business type products.

Due diligence procedures: The leasing companies interviewed confirm that they use normal industry credit check procedures and leasing criteria before they write leases. This includes credit checks, an assessment of the viability of the lessee, and its track record. The majority of leasing companies report that they deny leases to approximately 25 percent of applicants.

Interest rates charged: In the case of equipment leasing, interest rates are generally between 10 and 21 percent. A number of variables come into play to determine the interest

rate (e.g. size and length of the lease, new customer, type of equipment). The risk tends to be greater when leasing to new small businesses, and the higher rates help to offset the losses.

The final report is expected by June 2000.